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DEPOSIT INSURANCE REFORM

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

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DEPOSIT INSURANCE REFORM

WEDNESDAY, MAY 16, 2001

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 9:36 a.m., in room 2129, Rayburn House Office Building, Hon. Spencer Bachus, [chairman of the subcommittee] presiding.

Present: Chairman Bachus; Representatives Weldon, Roukema, Baker, F. Lucas of Oklahoma, Kelly, Gillmor, Manzullo, Toomey, Cantor, Grucci, Hart, Ferguson, Tiberi, Waters, C. Maloney of New York, Watt, Ackerman, Bentsen, Sherman, Meeks, Moore, Hooley, Carson, Hinojosa, Lucas of Kentucky, Shows, and LaFalce.

Chairman BACHUS. The hearing will come to order. The subcommittee meets today for the first of a planned series of hearings on the subject of reforming our country's deposit insurance system. And I want to stress that this is the first of what will be more hearings on the subject. The focus of today's hearing will be on a report prepared by the FDIC entitled "Keeping the Promise: Recommendations for Deposit Insurance Reform."

As we commence this hearing, the Vice President is speaking before the Republican Conference, so on the Majority side, our attendance may be down some. I understand that the Democrats are also in a caucus. But our primary focus at today's hearings will be listening to our witness, and I don't anticipate a lot of questions, although the Members are free to ask as many as they want to. I don't say that in a limiting way.

Federal deposit insurance, established during the Great Depression to restore confidence in the Nation's troubled banking system, is that rare product of the legislative sausage-making factory that has actually worked pretty well as it was intended to. It has enhanced economic stability, largely eliminated the prospect of panic-driven runs on banking institutions, and succeeded in minimizing the risk to taxpayers from bank failures. Yet even the most effective Government programs require periodic review and updating to ensure that they continue to serve the purposes for which they were originally created.

Our objective this morning is to begin what I hope will be a constructive dialogue about the future of the deposit insurance system. I can think of no better starting point for that discussion than the report filed by the FDIC last month.

We are pleased to have FDIC Chairman Donna Tanoue with us this morning to present the Agency's findings and recommendations, and I will say that your report and recommendations basically focus on every aspect of the reforms that people have proposed.

The subcommittee's consideration of deposit insurance reform comes at a time when the system itself is as healthy as it has been in more than 20 years. Thanks largely to sizable contributions by the banking and thrift industries in the 1990's, the Bank Insurance Fund and the Savings Association Insurance Fund are both fully capitalized, with combined balances exceeding $41 billion.

The strong condition of the deposit insurance funds might cause some to conclude that the status quo should simply be maintained, or argue for a more proactive approach. As the FDIC has correctly pointed out, the current system leaves open the possibility of sizable 23-basis-point premium assessment on institutions if and when the designated reserve ratio falls below 1.25 percent.

While there is significant debate within the industry about the factors that might cause a penetration of this 1.25 hard target, there is no doubt that a 23-basis-point assessment, which has been aptly compared to falling off a cliff, would have serious consequences both for banks' profitability and for their ability to fund economic growth in the communities they serve.

If such were to occur in a period of economic weakness, it would even be worse. The FDIC's request for more flexibility in setting the reserve ratio, therefore, warrants the subcommittee's careful consideration.

Perhaps no deposit insurance issue has been more hotly debated than the question of whether to increase coverage levels above the current $100,000 per account limit. While several influential policymakers have been openly skeptical of the need for such an increase, many of us on this subcommittee have heard from community bankers in our district who strongly believe that a substantial coverage increase is critical to their ability to attract core deposits and remain competitive in their local markets. In my view, devising solutions to the funding challenges faced by community banks should be this subcommittee's highest priority. It is my hope that the subcommittee will be reviewing various reform proposals with that in mind.

In this regard I am particularly interested in hearing from our witnesses on the issue of higher coverage levels for municipal deposits, which have historically been a vital source of funding for community banks, but have become increasingly expensive to attract and maintain.

I notice the FDIC's recommendations for coverage limits is simply to go up on all deposits—at least that is my understanding from reading your proposal—and index them for inflation as opposed to singling out retirement accounts, pension accounts or municipal accounts.

In closing, I want to commend Chairman Oxley for his leadership in placing the issue of deposit insurance reform on the subcommittee's agenda. I look forward to working with him and other Members of the subcommittee to develop legislation that ensures the

continued strength and vitality of a system that has served us well for over 70 years.

I now recognize the Ranking Minority Member Ms. Waters for her opening statement.

[The prepared statement of Hon. Spencer Bachus can be found on page 42 in the appendix.]

Ms. WATERS. I thank you very much, Chairman Bachus. I would like to be somewhat brief in my opening remarks to allow time to hear from the witnesses.

First of all, I really do want to thank you for calling this hearing, and I look forward to working with you on Federal deposit insurance reform. I want to commend Chairman Tanoue for her work on this issue. She has worked very hard to produce a comprehensive analysis of the strengths and weaknesses of the deposit insurance system, and I think she and her staff have given their time and attention to this issue than anyone since Congressman Henry Steagall, who was the original architect of the system in 1932. It was his infamous partnership with Senator Carter Glass that produced the system we know today, as well as other aspects of banking law that we won't necessarily be talking about today.

In any case, deposit insurance has served America well for over 65 years. It has maintained public confidence in our banking system throughout times of prosperity and times that weren't so good. It is important that we examine these issues closely in order to maintain and strengthen today's system for tomorrow's consumers.

I look forward to hearing the testimony of the witnesses so that we can ensure that we have a deposit insurance system that will serve us well throughout the new millennium.

I thank you very much, Mr. Chairman, and I yield back the balance of my time.

Chairman BACHUS. Thank you.

Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman. I want to compliment you for bringing this subject to the subcommittee's attention and conducting this hearing this morning. My concerns go to the basic fairness of the current system, and I have read with considerable interest past studies of how the current system has been constructed and the consequences of it.

For example, there are a significant number of new institutions de novo who have enjoyed full and complete insurance coverage without contributing a penny toward the cost of that premium expense, while at the same time there are those institutions which have been operational for many years, operating at relatively low risk levels, that endured the difficult years of the S&L bailout and repayment of obligations not of their own making.

And in looking at the statutorily created risk categories, the difference between the profile of the most risky institution and the least risky institution, there is no differential in premium paid because they pay nothing. There seems to be little incentive in the current regime to operate prudently, safely and conservatively.

My view is that there should be some modest increase in the amount of coverage provided today, given inflationary factors, but we should be very careful as we move forward in increasing exposure for the taxpayer.

However, as to whether someone deposits their funds at a small institution or one of the largest, there should be no disparity in the coverage given to the depositor, so that there should be a uniform system from the depositor's side.

However, I would like to know the view of the FDIC with regard to one particular recommendation. I believe the agency has evaluated in past years with regard to coinsurance. And perhaps in looking at the market where you have 10 percent of the institutions that represent potentially 90 percent of the exposure to the fund, perhaps a different premium structure than we currently view today with regard to coinsurance, where the larger institutions perhaps would contribute significantly more in premium to those that represent no risk to the fund ultimately.

My basic question, then, Ms. Tanoue, is can you comment on the possibility and usefulness of risk sharing, either through reinsurance or other means, in determining an adequate price for deposit insurance; and second, if such arrangement could, in fact, be useful to limit the Government's exposure in a potential institution's failure?

Chairman BACHUS. I am sorry. We are still in opening statements, Mr. Baker.

Mr. BAKER. I am sorry. Rhetorically. Thank you, Mr. Chairman.

Chairman BACHUS. Mr. LaFalce.

Mr. LAFALCE. Thank you very much, Mr. Chairman.

Today, the American deposit insurance system appears sound, with surpluses in both the BIF and the SAIF above the statutory minimum reserves. However, the current system contains features, many enacted during the banking and thrift crises of a decade ago, which do not represent optimal public policy. Therefore, it is very appropriate for you to have this hearing and for Congress to examine the structure of this system to ensure that it provides the protection of depositors and taxpayers that it should.

The FDIC recently issued a comprehensive report on the deposit insurance system. In examining the need for reform, Congress should thoroughly review all of the issues identified in the FDIC report and other relevant analyses of the current system.

In my view, a priority should be the merger of the BIF and the SAIF. This would clearly benefit the deposit insurance system by creating a single more diversified fund that is less vulnerable to a regional economic problem.

In addition, a merger of the funds would more accurately reflect the reality of today's financial services industry, in which over 40 percent of the SAIF deposits are held by commercial banks and FDIC-regulated State savings banks. But I am increasingly of the opinion that the ultimate stability of any combined fund would be dependent on the adoption of a more effective risk-based premium system.

Part of the unfortunate fallout of the banking and thrift crises is the current FDIC recapitalization provision that requires the FDIC to impose a 23-basis-points assessment if one of the FDIC funds falls below the required reserve ratio and the funds cannot be recapitalized in a year. Such a mandatory assessment could come precisely at the wrong time during an economic downturn.

Chairman Greenspan recently expressed concern about precisely this aspect of the current system, and the FDIC has put forward meaningful recommendations to deal with this problem. The change in this approach should be a part of any deposit insurance reform legislation.

Another priority should be a reexamination of the current risk-based system in which over 92 percent of all banks and thrifts have paid no deposit insurance premium since 1996. This zero premium creates a poor set of incentives for risk-taking that would not exist if pricing were more accurately tied to risk.

Additionally, the zero premium situation permits institutions with dramatic deposit growth to significantly increase the amount of funds protected by the deposit insurance system without compensating the FDIC.

Many in the industry are understandably concerned that the current pricing system allows institutions with large growth in deposits to spread the cost of the increased exposure to the other members of the system. And this, too, is clearly another issue that deserves attention in our discussion.

Now, some banks, especially community banks, and a number of Members of Congress have called for an examination of the level of deposit insurance coverage. I am not yet convinced of the wisdom of this, and the burden of proving either the necessity or desirability of such an increase rests, it seems to me, on the advocates of an increase. However, this is clearly a very important issue for the banking industry, particularly those community banks that rely more on core deposits for funding. Then it is also an important issue for many consumers who wish to ensure their savings are secure.

This subcommittee in Congress should give due consideration to their concerns, but we must also give great consideration to the views of those such as Chairman Greenspan, former Secretary of the Treasury Summers, and so forth, who believe that an increase in the level of coverage will increase the moral hazard within our deposit insurance system. There may be a way to increase the coverage, but also at the same time better assessing both risk and the premiums necessary for that risk. I look forward to a thoughtful exploration of this issue.

Any debate on comprehensive deposit reform must also inevitably include a discussion of the proper level of reserves of the FDIC. In determining the proper level for the FDIC's reserves and insurance premiums, policymakers must strike an appropriate accommodation between many objectives, and at least two: first and most importantly, ensuring that the FDIC is able to meet its obligation to depositors, while protecting taxpayers, and that might well include paying for the costs and examinations and supervision by regulators other than the FDIC; and second, minimizing transfers of capital from the thrift and banking industries where that capital can be used to fund business loans, mortgage and other consumer credit needs. The current approach that is a hard 1.25 ratio may not best achieve an appropriate balance.

And I look forward to hearing the testimony of the FDIC Chairman and other witnesses. I thank the Chair very much.

Chairman BACHUS. Thank you.

Are there any Members on the Majority side that wish to be recognized? Not so.

Ms. Carson.

Ms. CARSON. Thank you very much, Mr. Chairman, for convening this hearing. I look forward to the panelist testimonies. I thank them for their presence. I am especially pleased to see here again my good friend Mr. David Bochnowski from the State of Indiana, who will be testifying on the second panel. He brings to this hearing a wealth of experience, a lifetime of public service dedicated to the people of Indiana and the United States, and I certainly thank him for attending today.

Mr. Chairman, Members of the subcommittee, since the 1930's, the full faith and credit of the United States has stood behind $3 trillion of insured deposits at banks and savings associations. Although Congress has only modified the system twice, once in 1989 and again in 1991, in response to financial crisis, there has been a renewed effort to reform the current system.

In August of last year, FDIC Chairman Donna Tanoue—I hope I didn't mispronounce your name—released an 84-page overview of options on deposit insurance reform position paper, which was opened to public comment until the beginning of this year. The FDIC in the paper described in detail several possible approaches to reform the deposit insurance system without advocating any of them, except to recommend the merger of the Bank Insurance Fund, BIF, and the Savings Association Insurance Fund, SAIF.

Today, we are faced with a very different report. One which takes a strong stance on four key areas of reform, including the need to merge the BIF and the SAIF, the need to reform how deposit insurance is priced to reflect risk, the need to adjust insurance premiums, and the need to keep insurance coverage in line with inflation. However, while there is general agreement between FDIC, the banking industry and Congress on some of these issues, there are still areas that we need to address with specific care.

Unlike the previous reforms of deposit insurance in 1989 and 1991, economic crisis is not acting as a catalyst. To an onlooker, concern over deposit insurance may seem to come at an unlikely time, at least as far as the U.S. banking industry is concerned. Banks are performing well, along with the U.S. economy, despite the slight slowdown, downturn, recently, and the industry has been stable in recent years. However, interstate banking restrictions have been lifted, and the barriers between commercial and investment banking are starting to fall.

U.S. Banks are consolidating in record numbers, and the size and complexity of our largest banks are growing. While this consolidation and growth may not in itself be bad, one thing is clear. The loss of just one of these too-big-to-fail banks could pose an even greater systemic risk than before. Yet too much depositor protection could result in such banks taking too much risk.

Having said this, we are faced with a unique opportunity, because we are not forced to reform deposit insurance because of an economic crisis. We have an opportunity to reform deposit insurance to avert future economic crisis. I stress again we must do it with care and develop a consensus within the banking industry on the right way to approach this issue.

There is general agreement that the BIF and the SAIF funds should be merged, and as my colleague Mr. LaFalce pointed out when he introduced his legislation to do this, the merger of the BIF and SAIF would clearly benefit the deposit insurance system by creating a single more diversified fund that is less vulnerable to regional problems.

However, there has been a great deal of discussion within the banking industry as well as here in Congress over some of the other issues presented in the FDIC report. For example, if insurance coverage is to be kept in line with inflation, what is the appropriate year for beginning this inflation adjustment? The FDIC has pointed out that if the base year were 1980, when the limit increased from $40,000 to $100,000, the insurance level would be approximately $200,000 today to account for inflation. If 1974 was chosen as the base year, when the limit was increased from $20,000 to $40,000, the new limit would be approximately $135,000.

Both Senator Phil Gramm and Mr. Greenspan initially expressed opposition at setting the level at $200,000, and there were also many bankers who were very concerned about the loss of the current buffer above the 1.25 reserve ratio and a potential for premium increases that would accompany a doubling of the insurance limit. There were also bankers who expressed concern about the political price that would have to be paid if such an increase were to be enacted.

We must also consider the problems associated with effectively pricing deposit insurance to reflect risk. We must establish which financial institutions currently pay FDIC insurance premiums and which ones do not. Are the distinctions reasonable, or should they be changed? How can we as policymakers toughen risk-based premium pricing but still ensure that it is fair? It is my understanding that many banking industry trade—officials—and there is one more point that I want to make, and that is for community bankers who believe insurance reform will help them compete with larger banks and want to FDIC to increase the coverage to $200,000.

I am sorry, Mr. Chairman, that I extended my time, but I appreciate the opportunity to make a few points. Thank you.

Chairman BACHUS. Are there any other Members that wish to be recognized?

All right. At this time we will introduce our first panel, which is made up of one panelist, the Honorable Donna Tanoue, Chairwoman of the Federal Deposit Insurance Corporation, whose report, as she says, has raised some yellow flags, and we look forward to hearing from you, Ms. Tanoue. And as I have told you privately, if you want to take longer than 5 minutes, that would be fine.

STATEMENT OF HON. DONNA TANOUE, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. TANOUE. Thank you. Mr. Chairman, and Members of the subcommittee, on behalf of my colleagues at the FDIC, I want to extend our sincere appreciation for the subcommittee's recognition of the importance of Federal deposit insurance reform and for your holding hearings today.

Chairman BACHUS. Chairwoman, if you would move the mike a little closer.

Ms. TANOUE. OK.

In addition, we appreciate the efforts of several Members of the Congress who have introduced or cosponsored legislative initiatives addressing deposit insurance issues. We believe strongly that these efforts will stimulate and further advance the debate.

Deposit insurance plays a vital role in promoting financial stability. As a recent survey by the Gallup organization showed, the security that Federal deposit insurance provides is a very important and continuing consideration when Americans weigh where to place their money.

This morning I would like to talk about why reforming our deposit insurance system is important, why reform should be addressed now, what our recommendations are, and why reform of deposit insurance should be comprehensive.

Why is reform important? As good as it is, our current system has certain flaws, some of which undercut the very purpose for which deposit insurance was created. Under our current system, 92 percent of the insured institutions pay no premium for coverage. Because deposit insurance has been free for most of these institutions, our current system distorts incentives. The results? More than 900 institutions, or about 1 out of every 10 institutions in our country, have never paid premiums. Major investment firms have begun sweeping large dollar volumes of brokerage accounts into deposit accounts in their FDIC-insured subsidiaries.

In addition, underpriced deposit insurance also may promote moral hazard, the incentive for insured institutions to engage in riskier behavior than they might otherwise in the absence of deposit insurance.

Our current system could also have a harmful economic side effect, a procyclical bias, that is, a tendency to make an economic downturn longer and deeper than it might otherwise be. How is that? During a severe downturn, the current statutory framework would require that the FDIC charge banks high premiums, thus limiting the availability of credit to communities when they need it most, and thus impeding economic recovery.

If we don't reform our system, it is likely to take a toll on the safety and soundness of the banking industry and on the economy, because a premium increase would hit when banks are less healthy and losses might be depleting the insurance funds.

Why do we advocate deposit insurance reform now? Despite some recent trends that are of some concern, both the economy and the banking industry remain strong. We need to address the flaws in our deposit insurance system now, without the pressures and distractions that a downturn would bring or the urgent demands for action that might arise during a crisis.

We at the FDIC have five recommendations. Recommendation number one: the FDIC should be permitted to charge all institutions premiums on the basis of risk. Insurers generally price their product to reflect the risk of loss. Today, because more than 92 percent of our insured institutions are in the FDIC's best risk category and paying no deposit insurance assessment, our premium system is ineffective in capturing and curbing risk.

Recommendation number two: change the law to eliminate sharp premium swings. If the fund falls below a target level, the law should allow premiums to increase gradually. Charging premiums more evenly over time, allowing the fund to absorb some losses temporarily, and increasing premiums more gradually than is required at present would soften the blow of an economic downturn.

Recommendation number three: give the FDIC the authority to rebate portions of deposit insurance premiums based on past contributions to the fund when the fund is above a specified target level. Tying rebates to the current assessment base would increase moral hazard. Fairness dictates that rebates should be based on past contributions to the fund. Allowing the FDIC to pay rebates would create a self-correcting mechanism to control the growth of the fund. The higher the fund gets, the larger the rebate. Thus, should the fund continue to grow, rebates eventually might exceed assessment income and provide a break on the growth of the insurance fund.

Recommendation number four: merge the Bank Insurance Fund and the Savings Association Insurance Fund. As I am sure many of you are aware, the FDIC has made this recommendation for a number of years, in large part because the resulting fund would be stronger and more diversified.

Recommendation number five: index deposit insurance coverage for inflation so that depositors do not see the real value of their coverage erode over time. While Congress should decide on the initial coverage level, indexing would provide a systematic method of maintaining the real value of deposit insurance coverage.

In closing, I would like to emphasize that it is important for these recommendations to be implemented and to be considered and implemented as a package. Picking and choosing among the parts of our proposal could weaken the deposit insurance system, magnify economic instability and distort economic incentives. In particular I can't emphasize enough that the ability to price for risk is essential to an effective deposit insurance system and must be included in any reform package.

Thank you, and I am happy to address any questions or comments that you might have.

[The prepared statement of Hon. Donna Tanoue can be found on page 49 in the appendix.]

Chairman BACHUS. Chairman Tanoue, I will lead off the questioning, and I think we are all concerned about a possible erosion of the ratio below $1.25. And you have pointed out several factors where that may happen. One, you have talked about the addition of new deposits. Sort of looking at the figures—at least up until 6 months ago, the infusion of new deposits hasn't brought down that ratio that much as it seems to be—is it about $1.35?

Ms. TANOUE. Yes.

Chairman BACHUS. Go ahead.

Ms. TANOUE. That is true. Some recent examples of rapid and dramatic growth, though, have made people more appreciative and more sensitive to how the factor of growth in deposits can affect the reserve ratio level. What we have tried to emphasize at the FDIC, however, is that it could be a potential combination of factors, perhaps a slowing of the economy, unanticipated or expensive bank

failures and perhaps continued deposit growth. It is not inconceivable that those factors could combine to reduce the current cushion and perhaps to reduce the reserve ratio over time and, therefore, to cause the FDIC to charge very steep premiums.

Chairman BACHUS. Have you noticed, we have had some periods of stock market volatility in the past year. We have had large shifts of deposits from some of the full-service financial institutions into insured deposits. Has there been any evidence that that has caused—has the ratio at times dropped three or four basis points, or has it pretty much been steady at a $1.35 ratio?

Ms. TANOUE. Some of the recent infusion of deposits into the system has caused a reduction in terms of several basis points, but I would like to emphasize that the issue of rapid growth is on the minds of many. The FDIC has made several recommendations to address this issue of rapid growth. And we would do so first by recommending that all insured institutions pay premiums based on risk, including those that are growing rapidly. If that growth—and I would underscore "if"—if that growth presents additional risk exposure to the fund, then we would recommend that premiums reflect that additional exposure.

In concert with the recommendation to charge all institutions based on risk, we are recommending that rebates be paid if the fund meets the target level that is established or deemed essential by the FDIC and that those rebates take into consideration past contributions to the fund. We would recommend that such rebates not be made based on the current assessment base, because we think that would create some perverse incentives. In other words, you might have a situation—if you use the current assessment base for your rebate methodology—you might have a situation where you are encouraging growth and actually rewarding institutions that are growing rapidly, but may not have made past contributions to the fund.

Chairman BACHUS. You have mentioned that if the ratio fell below $1.25 or 1.25 percent, that it could trigger—well, it would, if it was not recapitalized within a year—a 23-basis point premium, and you further said that that could trigger a $65 billion loss of ability to loan money. Would you give me some basis for the $65 billion figure?

Ms. TANOUE. Yes. The current statutory framework envisions a situation if the fund falls below the 1.25 designated reserve ratio, and the fund isn't recapitalized within a year, the FDIC would be required to charge premiums as steep as 23 basis points. We are recommending, again, that institutions be charged premiums based on risk, but I would like to emphasize that we are not trying to increase the assessment burden. We are trying to allocate the existing assessment burden more evenly over time. So we would avoid that kind of premium volatility.

We believe that if institutions could pay small, steady premiums over time, they would be able to manage their operational expenses better and, again, avoid a situation where during tougher economic times, they might be called upon to pay such steep premiums, thereby taking monies out of the economy and taking monies away really at a time when communities would really need money for credit extension most.

Chairman BACHUS. I guess my question was the $65—you mentioned there might be a $65 billion reduction in lending.

Ms. TANOUE. Yes.

Chairman BACHUS. And was that based on the cost of the premiums?

Ms. TANOUE. That is based, yes, potentially on the steep increase in premiums during a downturn.

Chairman BACHUS. My time has expired, but I would also be interested in whether you have any evidence—and I want to ask this as a question—any evidence that fast growth in and of itself increases risk, whether you have focused on that, or whether charging premiums to fast-growing institutions is more a question of fairness as opposed to risk?

Ms. TANOUE. I would say that fast growth in and of itself is not risky, per se. At the FDIC we would look at fast growth in combination with other factors, capital, assets, management, the quality of an asset portfolio.

Chairman BACHUS. Thank you.

Ms. Waters.

Ms. WATERS. Mr. Chairman, we all must be concerned about whether or not we are going to take resources away from consumers, that whether or not the recommendations that you are making would place consumers who would need loans, need to have access to the resources of the banks, in jeopardy here, and I guess, you know, what I would like you to respond to that a little bit more, and I would also like to understand a little bit better your discussion about how you determine risk. You make the case that the risk now is determined for the short term rather than the long term, and you believe that it should be looked at over a longer period of time. I would like you to explain that a little bit better, and I would also kind to like the ask the question that if under the present system we have a surplus, we have excess to the point of rebate, then what is so terribly wrong with it?

Ms. TANOUE. Well, perhaps I could take that last issue first. In terms of the size of the fund, an appropriate level of the fund, the FDIC would conduct an analysis based on expected loss presented by the institutions that are insured by the fund, but there is always a tradeoff between the size of the fund, ensuring that the fund is sufficient and adequate to protect taxpayers, and also ensuring that the fund doesn't grow so large that funds over and above, say, the level that is deemed necessary by the FDIC might not be otherwise returned to institutions to be put back into the communities for community lending.

In terms of assessing risk, that is our job basically, and we have put forward in the recommendations an example of how we might assess the risk exposure of institutions, particularly the small institutions. And we consider a number of factors, including supervisory ratings based on examinations as well as a number of different types of financial ratios.

Going back to the earlier point that you made, one of the central features of our recommendation is to avoid the potential premium volatility that exists potentially under the current statutory framework. We want to, again, allocate the assessment burden of our institutions more evenly over time and to avoid a situation where we

might be calling upon them to pay premiums again as high as 23 basis points at a time when the economy might be suffering a sharp downturn.

We believe that if you moderate the premiums more slowly and steadily over time, you would avoid that type of sharp premium increase at the roughest part of the economic cycle, and we would avoid a situation where we are exacerbating the economic downturn by extracting large sums of money from insured institutions at a time when communities might need that money for lending purposes and also to help an economic recovery.

Mr. WELDON. [Presiding.] The gentlelady yields back her time.

The hearing will stand in recess for a vote on the floor of the House and reconvene in about 10 minutes.

[Recess.]

Chairman BACHUS. The hearing will come back to order.

Mr. Gillmor, you are recognized for questions.

Mr. GILLMOR. Thank you very much, Mr. Chairman and Madam Chairwoman. I would like to just ask you to comment on the question of municipal deposits. Concerns that I hear expressed on a number of occasions in my district are from local communities who would like to put public funds into their local financial institutions, but because some of these institutions are relatively small and also because of the FDIC coverage limit, they have to put the money in some other institution outside the community. This is detrimental because it takes money out of the community, which could be utilized there. I am—along with some other Members—considering legislation that would extend the level of insurance for municipal deposits in local banks. I would just like what ever comments you would want to make on that subject.

Ms. TANOUE. Thank you. We have taken a look at the issue of raising coverage for municipal deposits. Raising the coverage level for this category of deposits could potentially provide banks with greater latitude to invest in other assets. Higher coverage level also might help such institutions be more competitive for public deposits. But the collateralization requirements that are placed by different States also place limits on the ability of riskier institutions to attract public moneys, while a higher deposit insurance coverage level might not. And I would also point out that giving higher coverage or full coverage for municipal deposits might also relieve some of the State treasurers or community treasurers from having to vigorously monitor local institutions or financial institutions, and that might result in a loss of some level of depositor discipline. But having said that, I will say that there are obviously potential benefits as well as consequences of favoring these types of deposits with higher coverage levels and the full potential benefits and consequences are not yet certain. It is our view that this issue should be looked at further, analyzed further and discussed with the parties that have a stake in the system.

Mr. GILLMOR. If I might attempt to characterize your response, I guess I would say if this is accurate, it is cautiously favorable, but we still want to look at it; is that pretty close to on the mark?

Ms. TANOUE. I would say cautious.

Mr. GILLMOR. But also favorable, we hope.

Ms. TANOUE. I guess what I would also point out is that there are obviously other calls for higher coverage levels that might favor other classes of depositors, and these will all present issues for Congress to consider. Some people are asking for higher coverage for certain types of retirement accounts, and we could anticipate that the calls for higher coverage for different categories might expand. Those might include deposits by charities or savings for college You would have to take a hard look from a public policy standpoint at the potential benefits and consequences.

Mr. GILLMOR. Well, I think my time is about to expire, but I might say, I think you can find a lot of worthy types of deposits, but the one thing that distinguishes this category of deposits from others is that it is local money raised in that community, which may not be the case with other deposits, and the failure to provide that protection is taking money out of those communities, which means small businesses aren't getting loans, which means that some home mortgages aren't being made. So I think there is a little bit of a distinguishing character to these types of deposits, but I appreciate your comments.

Chairman BACHUS. Would the gentleman yield?

Mr. GILLMOR. Yeah, I yield.

Chairman BACHUS. I would also say, Chairman, you talked about moral hazard, or that this may encourage some lack of supervision, but I would focus on the fact these are community banks, and these would be the cities in which they do business, and I would think those cities would probably be more aware of those banks and the soundness in that there would probably be a local board of directors, and they would probably be well qualified to make judgments on the soundness of the bank, you know.

Ms. TANOUE. Again, we would want to look hard and we probably want to do more analysis on any potential significant increase in deposit coverage for any new category of expanded deposit insurance coverage.

Chairman BACHUS. I am not sure these cities now are depositing their moneys with different banks, so I think they would simply be transferring a lot of that money into banks, into the city, would try to invest it or deposit it in their own city or in their own county to ensure that it was loaned within their own communities. But we may further explore this with you with some.

Ms. TANOUE. We would be happy to discuss it further.

Mr. Chairman, if I could, you had asked me a question earlier about the $65 billion potential contraction in lending, and I was wondering if I might call up one of my staff members to explain how we calculated that.

Chairman BACHUS. Certainly.

Ms. TANOUE. And to explain it more directly, if I could ask Fred Carns who is with our Division of Insurance.

Chairman BACHUS. If you could just identify yourself for the record. I know the Chairman just did that.

Mr. CARNS. I am Fred Carns, Associate Director of the Division of Insurance with the FDIC. Just in simple terms, the $65 billion, a 23 basis-point assessment with today's total deposits of about $4 trillion would result in about $9 billion in assessments from that 23 basis point rate, and then with the industry's average capital

ratio in the neighborhood of 14 percent, that translates into lending of about 7 times that amount, or somewhere in the neighborhood of $65 billion.

Chairman BACHUS. Thank you.

Ms. TANOUE. Thank you, Mr. Chairman.

Chairman BACHUS. Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman. And I thank the Chairwoman for being here today. Right at the outset of your prepared comments, you expressed appreciation to the efforts of Members of Congress who have introduced or cosponsored legislative initiatives addressing deposit insurance and applauded those efforts which stimulate and further advance the debate. I happen to be one of those people as cosponsor of H.R. 557, which acknowledges that there is an excess in the deposit insurance fund and advocates first the application of that excess to FICO assessments, and then subsequently to rebates after the FICO bonds have been paid off. I notice that you have, I guess, pretty much for the first time, acknowledged the possibility that there might be value to some rebates, and I won't ask you to comment particularly on our bill. I want to go through and compare how your recommendations match up with the bill, but I am delighted to see that you have acknowledged that rebating some of these excess insurance deposits might help us get more money into the lending process, and I take it that is what this last set of comments was about in response to the Chairman's questions.

Let me ask a question about, just for my own edification, the banks that are currently exempt from paying insurance, paying into the insurance fund, I take it that that was, that is based on some analysis of that those banks don't substantially contribute to risk. How does that correspond with the movement toward a risk-based analysis to get to assessing the premium?

Ms. TANOUE. Well, essentially, in 1996, when the Congress passed the legislation recapitalizing the SAIF and the BIF, the Congress chose to limit the FDIC's discretion to differentiate among its institutions and to charge premiums to those institutions that are basically rated one or two. So under the current law, the FDIC can only charge premiums to institutions that are rated 3, 4 or 5.

Mr. WATT. Isn't that, in and of itself, a somewhat of a risk-based system that Congress has put in place? Isn't that a determination that banks that are rated 1 and 2, much, much less likely to contribute to a draw on the insurance fund?

Ms. TANOUE. Congress did envision a risk-based premium system, and as I testified earlier, our system is painfully and obviously deficient. In terms of the 1- or 2-rated institutions that fall within the best category for insurance purposes, I would want to emphasize that you can't assume that a 1- or 2-rated institution does not present risk to the fund.

Mr. WATT. How do they get to be 1 or 2, then, if they are presenting risk?

Ms. TANOUE. Well, I would mention that our studies show that in looking back over historical periods, 2 years prior to failure, almost 47 percent of the institutions that failed during the crisis period had ratings of 1 or 2, and if you look 3 years prior to the fail-

ure, over 60 percent of the banks are rated 1 or 2. We have further studies that also show that the 5-year failure rate for CAMELS 2-rated institutions since 1984 was more than 2½ times the failure rate for 1-rated institutions.

So again, I think there is a great deal of information that shows that institutions, even if they are rated 1 or 2, do present risk. And our point is that currently, our system doesn't distinguish among those institutions. Again, more than 92 percent of the industry, thousands and thousands and thousands of institutions, do not pay premiums even though there are large and discernible and identifiable differences in terms of risk exposure among those institutions. And so essentially you have those institutions that are less risky subsidizing those that are riskier.

Mr. WATT. I than think my time is expired although the clock seems to move faster. Maybe if I just talk slower.

Chairman BACHUS. We have actually two clocks.

Mr. WATT. I yield.

Chairman BACHUS. Thank you, Mr. Watt.

Mr. Weldon.

Mr. WELDON. Thank you, Mr. Chairman. Madam Chairwoman, on the issue of rebates, you have testified that they should be based on past contributions to the fund and not on current premium assessments. What is your recommendation to us as to how those rebates should be calculated? For example, what I am talking about, the banks that helped recapitalize the BIF and the SAIF, should they be entitled to a greater refund if there is going to be a rebate than, say, those who did not contribute to that recapitalization?

Ms. TANOUE. There are a number of ways that the FDIC could develop rebate methodology, but again, one of our most important recommendations is that rebates be based on past contributions to the fund, and that would mean essentially that those institutions that helped to build the fund over time would see rebates earlier and in larger amounts.

Mr. WELDON. What about those institutions that have contributed nothing to the fund?

Ms. TANOUE. Those institutions would, assuming the risk-based premium system is put into effect and all institutions are charged premiums, those institutions, once they started putting money into the system, would eventually over time earn the right to attain rebates.

Mr. WELDON. Some people would advocate retiring FICO bonds early as opposed to issuing rebates. Can you comment on that?

Ms. TANOUE. Yes, our recommendations basically would recommend rebates once target levels of a fund are met, but we would leave it to the institutions themselves to decide how to use those moneys once they are rebated. Now I know that there is the bill that Congressman Lucas mentioned, H.R. 557, that would use funds above a certain level to pay for the FICO obligation. I would emphasize that that bill would not base rebates on past contributions. Old members of the fund would benefit from reduced FICO payments, even those that had never paid a penny in terms of insurance assessments.

Mr. WELDON. You talked about indexing insurance coverage, and I think you also mentioned increasing the limit. Should we do both, increase the limit and index? Which do you think is more important: indexing it or increasing the limit if we are going to increase the limit on FDIC, the size of FDIC insurance?

Ms. TANOUE. Our recommendation really goes only to recommending indexation of the current coverage level. We believe that Federal deposit insurance is a valuable program and confers a valuable benefit. And like other important Federal import programs like Social Security and Medicare, those benefits are indexed to inflation, and so Federal deposit insurance coverage should be as well. As to increasing coverage levels, that is a public policy decision that we would leave to Congress. We would point out, however, that you can index based on different points, from 1974, 1980, or you could start from today and those would result in very different coverage levels over time. I would also want to emphasize that in looking at any potential increase in coverage, we would strongly recommend that one part of any package of recommendations must be the putting into place of an effective risk-based premium system which would lend itself to mitigating any concern about increased moral hazard as a result of increasing coverage levels.

Mr. WELDON. And finally, can you comment for me on the too-big-to-fail doctrine? Do you think this permits certain large institutions to take on too much risk?

Ms. TANOUE. We have not addressed the too-big-to-fail issue, or the issue of systemic risk directly in our recommendations. There has been some concern that there is implicitly greater coverage for those institutions that are very large in size, and we would not recommend at this time charging premiums that would take such a factor into consideration.

Mr. WELDON. Thank you very much. Mr. Chairman, I believe my time has expired.

Chairman BACHUS. Ms. Hooley.

Ms. HOOLEY. Thank you, Mr. Chairman.

Madam Chairwoman, some people and some regulators have testified that the current zero premium creates improper incentive s for bankers to take risk. Do you agree with this, and can you explain why?

Ms. TANOUE. I do think that when you have a zero-based deposit insurance premium, that that can sometimes create the wrong incentives or create no incentives. We believe that it might increase the tendency of some institutions to take more risk, to engage in riskier activities than they might otherwise, if there was a risk-based premium system in place, a truly effective system in place.

Ms. HOOLEY. Is that problem more acute when the economy is in a downturn, or does that, do you think that has an impact at all?

Ms. TANOUE. I think it is an issue regardless of the economic circumstances.

Ms. HOOLEY. So you think that banks will take more risk, and it doesn't really matter whether the economy is in a downturn. Is that what I heard you say?

Ms. TANOUE. Well, if the institutions are not paying anything in premiums, that would probably exacerbate the impact on the economy.

Ms. HOOLEY. OK. Do you think it will have a negative impact on the economy?

Ms. TANOUE. It could potentially have a negative impact, yes.

Ms. HOOLEY. OK. Thank you. I yield back the rest of my time.

Chairman BACHUS. Thank you. Mr. Toomey. Ms. Hart.

Ms. HART. I have no questions.

Chairman BACHUS. Mr. Grucci, do you have questions?

Mr. GRUCCI. No, sir.

Chairman BACHUS. Mrs. Roukema.

Mrs. ROUKEMA. All right. I will take the opportunity, and I do apologize for not being here for your full testimony. There were unavoidable conflicts so you may have already addressed this, and I must say that I am not fully apprised of the totality of Chairman Greenspan's statement, recent statement, and it was reported in the paper the other day. I believe he recommended a regulatory policy that would quote: "flatten out or even reverse the cyclicality of the current system."

Did you address that question, or what is your reaction to Chairman Greenspan's statement, and what is the implications of it? I am not quite sure I understand it in its totality, and when Chairman Greenspan speaks, many of us listen. Could you assess that for us or give us an initial reaction?

Ms. TANOUE. I think our recommendations are very consistent with what Chairman Greenspan was talking about there. One of the key features that we focus on in our recommendation is the potential procyclical bias that our system has and that we would charge institutions potentially very steep premiums during a severe economic downturn, and our recommendations really go to avoiding that circumstance, avoiding charging institutions the highest premiums at a time when they are least able to pay, and we tried to allocate the assessment burden more evenly over time and to avoid such a procyclical bias in our system.

Mrs. ROUKEMA. So you feel that that is consistent with Chairman Greenspan's perspective and will resolve the problem and make it sound and secure?

Ms. TANOUE. Well, we think that the recommendations that we have put forward would go a long way to strengthening the system.

Mrs. ROUKEMA. All right, thank you. I will, of course, review your testimony. If there are further questions, I will submit them to you in writing, because this is certainly something that I believe strongly in, and I certainly am for merging the funds and want to work to make them secure for the future.

Ms. TANOUE. Thank you.

Mrs. ROUKEMA. Thank you.

Chairman BACHUS. Mr. Bentsen, I want to apologize to you, I was down the list and I overlooked you earlier.

Mr. BENTSEN. No apology necessary, Mr. Chairman. I was trying to remember everything I read about your invigorating testimony that I looked at.

Madam Chairwoman, a couple of questions. It would look like what your study is—what the FDIC is proposing is to move to a

more of a subjective-based premium, risk based premium, and a subjective reserve ratio, and as I read through your testimony, in looking at the example that you go through in the back, is it the idea would be, if I understand correctly, is to reinstate a premium on all insured deposits, and then adjust that premium based upon some risk analysis that the FDIC comes up with. And then on top of that, assuming that the total DRR is between, say, 115 and 135, then lay back a rebate of 30 percent to insured depository institutions based upon first, or maybe only their history and paying premiums, those that have paid, who have paid the most premiums would be first in line for rebates.

Is that generally a correct analysis? And is this just a model that you all are proposing, or one idea of how you would establish the structure, or is this the basic concept?

Ms. TANOUE. We have put forth the basic concepts, and then we have put forth some numerical examples to illustrate how those concepts might work, but obviously these are designed to engender further discussion and further narrow the debate. One thing that caught my attention was when you mentioned subjective premium system and a subjective reserve ratio. We would be asking that the FDIC be given discretion to establish an appropriate range or target, appropriate level.

Mr. BENTSEN. And that is fine. I will swap adjectives with you. "Discretionary" is probably a better adjective. I understand as opposed to a statutory DRR, but is the idea—I think your concept is interesting and I am sure some of the subsequent panelists will tell us what might be wrong with it, but it seems to me your idea sort of mirrors what our colleague from New Jersey just talked about with what the Chairman of the Federal Reserve had said, which is to establish sort of a current flow of funds so you don't have either a procyclical or countercyclical effect, if all of a sudden the economy turns downward and the fund starts to get hit, that you have to jack premiums up so high that you have a countercyclical effect coming out of the fund with everything else going on in the economy.

And this way, given the FDIC, a substantial amount of discretion I would add would allow you basically to go back and say within this range of 115 to 135, everybody pays a premium to start, but then, based upon your payment history, not your payment history, but how long you have been paying premiums, and what I don't know is based upon, well, I guess your initial premium would be set.

Ms. TANOUE. Based on certain risk exposure, yes.

Mr. BENTSEN. But the rebate, I am curious why the rebate would only be set on how long you had been paying premiums. I understand that, but why you also wouldn't look at some risk bases as well unless you think you have already accounted for that?

Ms. TANOUE. There is a potential to incorporate risk-based factors into the rebate methodology as well. So, for example, whether a rebate should be given to an institution that is actually paying premiums, because it is in serious financial trouble that would be a factor that would have to be looked at as we further look at how to develop the rebate methodology.

Mr. BENTSEN. It seems to me, and you sort of acknowledge this—I know my time is up. If I can just finish this point. You seem to acknowledge the historical aspect will go away as new funds are melded in and everybody will sort of equal out for the most part. So it would seem to me that you would want to have some risk basis associated with the rebate function so thank you. Thank you, Mr. Chairman.

Mr. BAKER. [Presiding.] Thank you, Mr. Bentsen. Obviously Mr. Bachus stepped out for a moment, and fortunately I am next in line so I will recognize myself.

You may recall this question from earlier comments. I have grave concerns about the basic equity of the current assessment requirements. The compression of the rating from the best to the least under the current regime seems not to reward conservative management, and in fact, there is no penalty of significance for being a bad operator in the current assessment of premium, much less the new entries into the market who paid nothing for 100 percent coverage plus the sweep account issue that you have talked about.

So in looking at the reconstruction of the insurance pool, I strongly recommend and support whatever the agency recommends in the way of appropriately assigning risk to the responsible parties, and then join those who suggest that some premium be assessed to everybody continually. I know that this is, to some extent, modestly controversial, but it is apparent that should we have significant downturn in our economic condition and a very small number of the very large institutions run into trouble, that we could rapidly dissipate the reserves that we have built up.

However, my specific question is, and I have to read this to make sure I get it constructed properly, can you comment on the possibilities and usefulness of risk sharing, either through reinsurance or other means in determining an adequate price for deposit insurance; and second, if such arrangement could, in fact, be used to limit the Government's exposure in a potential institution's failure.

And my point here is that we have talked internally in the office in looking at this issue, and reports generated by the FDIC of maintaining for the individual depositor, uniformity in the level of coverage, so when you walk in the bank, you don't know how the premium is paid or anything else. You just know that no matter where you are, you get the same coverage. But for those larger institutions which represent the bulk of the risk to the fund, coinsurance, some differing manner of assessment that brings about more market discipline in understanding the risk, those institutions really pose to the fund, and I don't know if you want to answer that today or get back to me at a later time.

Ms. TANOUE. Well, let me just say that the FDIC shares your interest in exploring the potential for reinsurance and we think that reinsurance does have the potential to offer us additional information about how we might be pricing risk in terms of the institutions of various classes of institutions.

You may be aware that the FDIC, several months ago, contracted with a company for this very purpose, and essentially they have developed a prospectus, and we will be going to the market to ascertain what interest there might be in the private sector in this issue

with the FDIC, and we would be happy to keep you apprised of the developments.

Mr. BAKER. Thank you very much. I appreciate that.

Mr. Moore.

Mr. MOORE. I have no questions, Mr. Chairman.

Mr. BAKER. Mr. Hinojosa.

Mr. HINOJOSA. Thank you, Mr. Chairman. Thank you for coming to speak to our subcommittee. I was looking at your conclusions and you talk about the economy being strong and that there is a window of opportunity to make improvements to the deposit insurance system. I am pleased that you are proactive instead of reactive, and I want to address the part where you talk about, you say in particular, the ability to price for risk is essential to an effective deposit insurance system. I have concerns that I want to express to you, and that is that as you make the risk calculations for each of the banks and knowing that even if they have a rating of 1 and 2, that some of them could go under, I would like to see what your response is.

What assurances can you give me that any policy decisions that are being made to change and improve the system will not hurt the smaller community banks, many of which I have in a congressional district like mine?

Ms. TANOUE. Well, let me just say as the primary supervisor for State chartered non-member institutions, we always have taken into consideration how proposals might affect institutions, and particularly community institutions, and let me also say that in developing any kind of methodology to assess premiums based on risk, it would be envisioned that the FDIC would have to go out for notice and comment through a public rulemaking.

So in other words, the methodology that we might come up with would have to be put out for the public to comment on before any kind of rulemaking could occur.

Mr. HINOJOSA. And how long would you have as a period to get input?

Ms. TANOUE. Usually the rulemaking process allows for certain substantial periods of time to allow interested parties to comment fully.

Mr. HINOJOSA. Give me an idea, would it be 90 days? 6 months?

Ms. TANOUE. Excuse me just one moment. I was just checking as to whether the Administrative Procedures Act had some minimum timeframe and sometimes, apparently, it is usually about 90 days, but an agency can always provide for more time for public comment.

Mr. HINOJOSA. Very well. Mr. Chairman, I have no other questions.

Ms. TANOUE. If I could just add one other thing. During this whole process that we have been looking at the deposit insurance issues, I would emphasize that the FDIC has worked very hard to provide for extensive outreach opportunities with the industry, and we have worked very closely and extensively with all the banking trade organizations and made a significant effort to be aware of their concerns throughout the process, and we would continue to do so.

Chairman BACHUS. [Presiding.] Chairman, has any consideration been given to granting banks the power to, or the ability to purchase on an optional basis, additional insurance for municipal deposits?

Ms. TANOUE. Yes. That subject was raised earlier and we have taken a look at that. We believe that conferring additional coverage for any category of deposits, including municipal deposits, does warrant further analysis and study and discussion with the parties.

Chairman BACHUS. If we were able to calculate, if we had some preset level and a definition and it was limited to local deposits or to, in State deposits and the premium was calculated and would fully cover the additional risk to the insurance fund, would that address most of your concerns or your concern?

Ms. TANOUE. You know, I am not sure at this point if higher coverage was to be provided for municipal deposit, what the potential impact or effect would be in terms of additional risk to the fund. But again, we are happy to look at that issue further and then get back to you.

Chairman BACHUS. When you look at it, could you also maybe look at the collateral requirements.

Ms. TANOUE. Well, the collateral requirements vary from State to State, but we can take that into consideration as well.

Chairman BACHUS. All right. Thank you.

Mrs. Maloney.

Mrs. MALONEY. First of all, I would like to thank Donna Tanoue for your service and leadership at the FDIC, and I wish you the best in all your future endeavors, and I certainly thank Chairman Bachus for holding this important hearing on modernizing the deposit insurance system.

For over 65 years, our deposit insurance system has effectively maintained public confidence in the banking system during periods when financial institutions have been profitable and when they have suffered failures. As we consider modernizing the system, maintaining public confidence in our financial institution and guarding their safety and soundness must be our driving focus. We are fortunate to be considering this topic at a time when banks are highly profitable and well capitalized.

At the same time, uncertainty about the future of the economy is a warning that the good times will not last forever. While the insurance funds are still comfortably above their mandated reserve ratios, the uncertainty about equity market has driven a substantial amount of funds into the banking system, increasing the deposit base. The possibility that this trend continues makes the need to merge the insurance funds even more timely.

I really want to compliment you on a very thoughtful proposal for the future of the insurance system, and I agree with the FDIC's position that a modern insurance system should include a general principle of risk-based pricing. But I would like to know, since today, we have 92 percent of our institutions do not pay for deposit insurance, yet many of these institutions have made substantial contributions in the past to the funds.

Individually, many are highly rated for safety and soundness and are well capitalized. How do you balance the fact that risk-based

pricing may be the future but that many institutions have a history of contributing to and stabilizing the financing of the funds?

Ms. TANOUE. Again, I would emphasize that if you have a system as we do now where 92 percent of the institutions are assigned to the same risk category, you don't truly have a risk-based pricing system, and there are large and identifiable differences in terms of risk exposure among these institutions that are presently classified in the best category.

Our recommendations include a recommendation to charge premiums for all institutions, but also coupled with that, we are recommending that when the fund meets certain targets or ranges that are established by the FDIC from time to time, that consideration be given to giving rebates back to the insured institutions to prevent the fund from growing overly large, and to make sure that funds are going back into the communities as appropriate.

Mrs. MALONEY. So I know that you have suggested rebates, but would institutions, but would institutions that have contributed to the funds be subject to charges under this system?

Ms. TANOUE. Yes. We would recommend that all institutions again be charged based on risk, but in terms of the recommendation for rebates, the rebates would be based taking into consideration not the current assessment base, but past contributions. So it would be a very important consideration.

Mrs. MALONEY. So you will take in consideration the past?

Ms. TANOUE. Yes.

Mrs. MALONEY. Thank you very much, and again, congratulations on your service to the country and we appreciate the proposal that you have put forward today.

Ms. TANOUE. Thank you.

Chairman BACHUS. This concludes——

Mr. WATT. Mr. Chairman, could I, before you excuse the witness, make a brief comment?

Chairman BACHUS. Mr. Watt.

Mr. WATT. I just wanted to thank her for flattering me by confusing me with Mr. Lucas.

Ms. TANOUE. Excuse me, that is right. Because you mentioned the bill. I apologize.

Mr. WATT. I would suggest to you that you might want to drop Mr. Lucas and apologize to him.

Chairman BACHUS. One has a southern accent and the other has a Midwestern accent. The subcommittee does want to wish you well in your further endeavors and thank you for your service to the country and to the banking system.

Ms. TANOUE. Thank you very much. I appreciate the opportunity to testify today. Thank you.

Chairman BACHUS. This concludes our first panel and we will ask the second panel of witnesses, all of whom are veterans testifying before this subcommittee, to take their seats.

The subcommittee would like to welcome the second panel. All of you gentlemen testified before us in March on business checking. We welcome you back. To my left is Mr. James Smith, chairman and chief executive officer of Union State Bank and Trust of Clinton, Missouri, also president-elect of the American Bankers Association, who will be testifying on behalf of the ABA; Mr. David

Bochnowski, Chairman and Chief Executive Officer, Peoples Bank, Munster Indiana, we welcome you back. You are testifying as Chairman of America's Community Bankers; Mr. Robert Gulledge, President and Chief Executive Officer, Citizens Bank of Robertsdale, Alabama, Chairman of the Independent Community Bankers of America. Bob, welcome back to Washington.

At this time, Mr. Smith, we will start with you, not because you are an ex-New York Yankee.

STATEMENT OF JAMES E. SMITH, CHAIRMAN AND CEO, CITIZENS UNION STATE BANK AND TRUST, CLINTON, MO; PRESIDENT-ELECT OF THE AMERICAN BANKERS ASSOCIATION

Mr. SMITH. I want to thank you, Mr. Chairman, for holding this hearing. Assuring that the FDIC remains strong is of the utmost importance to the banking industry. Over the past decade, the industry has gone to great lengths to ensure that the insurance funds are strong. In fact, with $41 billion in financial resources, the FDIC is extraordinarily healthy. The outlook is also excellent. There have been few failures and the interest income on BIF and SAIF easily exceeds the FDIC's cost of operation. Thus now is a good time to consider how we might improve an already strong and effective system.

I would like to commend the FDIC under the leadership of Chairman Tanoue for developing an approach to the key issues. While we do not agree with every detail in the FDIC report and are particularly concerned about the possibility of increasing premiums, that provides a reasonable basis for congressional discussion.

An industry consensus is key to any bill being enacted. As you will see today, while some differences remain the positions of the ABA, America's Community Bankers and the Independent Community Bankers of America are very similar. Our three associations have agreed to discuss the issues together and work with this subcommittee to develop legislation that would have broad support.

I would add that while there is willingness to work with Congress, we do have concerns that such legislation could increase banks' costs or become a vehicle for extraneous amendments. If that were to be the case, support among banks would quickly dissipate. In my testimony today, I would like to make several key points. First, today's system is strong and effective, but some improvements could be made. The current system of deposit insurance has the confidence of depositors and banks. Its financial strength is buttressed by strong laws and regulations, including prompt corrective action and enhanced enforcement powers, just to name a few. Even more important is that the banking industry has an unfailing obligation to meet the financial needs of the insurance fund. Simply put, the system we have today is strong, well-capitalized and poised to handle any challenges that we may encounter.

Second, a comprehensive approach is required as improvements are considered. Because deposit insurance issues are interwoven, any changes must consider the overall system. A piecemeal approach would only leave some important reforms undone, but worse, could lead to unintended problems. Since last year, support for our comprehensive approach has clearly grown. We are pleased

that the FDIC's proposal is comprehensive and acknowledges the important interactions between issues. A comprehensive reform system should include, among other things, a mutual ownership approach for determining rebates. Permanent indexing of the insurance limit, consideration of an increase in the $100,000 level, but one that does not result in significant cost that would outweigh the value of the increase. A higher level of coverage for IRAs and Keoghs, some method to address the issue of fast-growing institutions and a cap on the fund and expanded rebate authority.

On this last point, I would like to thank Mr. Lucas and Mr. Watt for introducing their bill that caps the fund and issues rebates to pay the FICO premium.

My third point is that changes should be adopted only if they do not create material additional costs to the industry. The current system is strong, and we see no reason why changes should be made that impose significant new costs or additional burdens on the industry. For instance, the example used by the FDIC in its report would result in unacceptable premium increases for many banks. We see no justification for such increases when the insurance funds are above the required reserve ratio.

Mr. Chairman, we are prepared to work with you and the Members of this subcommittee to pass a reform package that would enhance the safety and soundness of the deposit insurance system. Thank you.

[The prepared statement of James E. Smith can be found on page 53 in the appendix.]

Chairman BACHUS. Thank you.

Mr. Bochnowski

STATEMENT OF DAVID BOCHNOWSKI, CHAIRMAN AND CEO, PEOPLES BANK, MUNSTER IN; CHAIRMAN, AMERICA'S COMMUNITY BANKERS

Mr. BOCHNOWSKI. Thank you, Mr. Chairman. It is a pleasure to be here representing America's Community Bankers and to speak to you on deposit insurance reform. Our complete recommendations, which we provided to the FDIC last December, are included in "Deposit Insurance Reform for a New Century, a Comprehensive Response to the FDIC Reform Options," which has been made available to this subcommittee.

[The information can be found on page 101 in the appendix.]

Bankers do have varying views on deposit insurance reform, but let me assure you in this subcommittee that we are engaged in an open and constructive dialogue. The staffs of our respective associations have met to begin a more detailed discussion of our respective policy positions. The entire industry has every incentive to cooperate, because the safety and soundness of the deposit insurance system is important to our customers and the Nation's economic health.

Under Chairman Tanoue's leadership, the FDIC took advantage of the health of our banking system and the banking climate to review deposit insurance issues. ACB commends Chairman Tanoue for taking this important initiative.

The most urgent deposit insurance issue we face today stems not from any weakness in the system, but ironically, from its strength.

A few companies are taking advantage of that situation by shifting tens of billions of dollars from outside the banking system into insured accounts at banks they control. The problem is not that the FDIC is holding fewer dollars, BIF and SAIF balances are stable, but that those dollars are being asked to cover a rapidly rising amount of deposits in a few institutions.

The situation could get worse. Under current law, if a fund falls below 1.25 percent, the designated reserve requirement, and the FDIC does not expect it to return to that level within a year, all insured institutions would have to pay a 23-basis-points premium. For a community bank with $100 million in deposits, that equals $230,000.

ACB believes that Congress should act quickly on legislation to help ensure the continued strength of the FDIC and prevent unnecessary diversion of billions of dollars away from communities that could go into home lending, consumer lending and small business lending.

A bill is before you today that would do just that. Representatives Bob Ney and Stephanie Tubbs Jones have introduced the Deposit Insurance Stabilization Act, H.R. 1293. It has three key features. First, it would permit the FDIC to impose a fee on fast-growing institutions for their excessive deposited growth. Second, it would merge the BIF and SAIF insurance funds, creating a more stable, actuarially stronger insurance deposit fund. And third, it would allow for the flexible recapitalization of the deposit insurance fund.

Acting on this bill now would not preclude action on broader deposit insurance reform. In fact, H.R. 1293 is an excellent place to begin.

We are pleased that many of the FDIC's recommendations are consistent with our own for comprehensive reform, but they differ in one key respect. We agree on merging the Bank Insurance Fund in the Savings Association Insurance Fund, giving the FDIC flexibility to gradually recapitalize the fund in the event of a shortfall and establishing rebates based on past contributions, as well as indexing coverage levels.

However, unlike the FDIC, ACB does not believe that the highest-rated institutions should be required to pay premiums when there are ample reserves in the fund. Rather, as provided in the Ney-Tubbs Jones bill, ACB recommends that the FDIC have the authority to assess a special premium on excessive growth by existing institutions, such as Merrill Lynch, if necessary to preserve adequate reserves.

ACB also recommends indexing the coverage levels to help maintain the role of deposit insurance in the Nation's financial system.

Congress should use as a base the last time it adjusted coverage primarily for inflation, which was done in 1974. Under that system, which was at $40,000 then, adjusted for inflation, the coverage limit would be approximately $135,000 today.

To recognize the increasingly important role that individual retirement accounts play in the economy and in our pension system, ACB recommends that Congress substantially increase the separate deposit insurance coverage for IRA, 401(k) and similar retirement accounts. ACB also recommends that Congress set a ceiling

on the composite insurance fund designated reserve ratio, giving the FDIC the ability to adjust that ceiling, using well-defined standards after following full notice and comment procedures.

ACB appreciates the opportunity to present our views on these important issues. The deposit insurance system is strong today, but could be made even stronger. We hope that Congress will use the work the FDIC and the industry have done to craft legislation that will make the improvements necessary to ensure the continued stability of this key part of our Nation's economy.

Thank you for this opportunity. I look forward to answering your questions.

[The prepared statement of David Bochnowski can be found on page 73 in the appendix.]

Chairman BACHUS. Mr. Gulledge.

STATEMENT OF ROBERT I. GULLEDGE, PRESIDENT AND CEO, CITIZENS BANK, ROBERTSDALE, AL; CHAIRMAN, INDEPENDENT COMMUNITY BANKERS OF AMERICA

Mr. GULLEDGE. Good morning, Chairman Bachus, Ranking Member Waters and Members of the subcommittee. My name is Bob Gulledge, and I am a community banker from Robertsdale, Alabama. I also serve as Chairman of the Independent Community Bankers of America, on whose behalf I appear before you today.

Chairman Bachus, I commend you and Chairman Oxley for moving this important issue forward. It has been 10 years since the Congress last took a systematic look at the deposit insurance program. Now is the time, during a non-crisis atmosphere, to modernize our very successful Federal Deposit Insurance system. I have been asked to testify on the FDIC's impressive and comprehensive deposit insurance reform recommendations.

First, deposit insurance coverage levels have been badly eroded by inflation and must be increased and indexed for inflation. Today, in real dollars, deposit insurance is worth less than half what it was in 1980 and even less than what it was worth in 1974 when the coverage was raised to $40,000. The charts and table attached to my written testimony illustrate this dramatic loss in real value.

Higher coverage levels are critical to support local lending, especially to our small businesses and agricultural customers. They are critical to meet today's savings and retirement needs, especially with a graying population. A Gallup Poll showed that four out of five consumers think that deposit insurance should keep pace with inflation. And they are critical because many community banks increasingly face funding pressures, because funding sources other than deposits are scarce.

Examiners are warning against our growing reliance on Federal Home Loan Bank advances. We don't have access to the capital markets like the large banks do. In troubled times, we, unlike large banks, are too small to save.

A recent Grant Thornton survey revealed that four out of five community bank executives believe higher coverage levels will make it easier to attract and keep core deposits. The ICBA strongly supports the Hefley bill in the House and the Johnson-Hagel bill in the Senate. Both bills would substantially raise coverage levels

and index them for inflation. This feature of deposit insurance reform is essential for our support of the legislation.

The ICBA supports full FDIC coverage for municipal deposits and higher coverage for IRAs and retirement accounts.

The second issue that must be addressed is the free rider issue. Free riders, the Merrill Lynches and Salomon Smith Barneys, have moved more than $83 billion in deposits under the FDIC umbrella without paying a nickel in insurance premiums; and by owning multiple banks, they offer their customers multiple accounts and higher coverage levels than we can. This is a double-barreled inequity, which must be addressed.

Third, a risk-based premium system should be instituted that sets pricing fairly. Currently, 92 percent of the banks pay no premiums. The FDIC says this is because the current system underprices risk. This proposal, as well as a proposal to charge premiums even when the reserve ratio is above 1.25 percent, will face controversy. But we believe that as a part of an integrated reform package, most community bankers would be willing to pay a small, steady, fairly-priced premium. In exchange, we would get less premium volatility and a way to make sure the free riders pay their fair share. The ICBA generally supports a risk-based premium system.

Fourth, the FDIC proposes that the 1.25 percent hard target be eliminated and replaced with a flexible range with surcharges if the ratio gets too low and rebates if the ratio gets too high. We support the FDIC recommendation as a part of the integrated package that includes higher coverage levels. Using a more flexible target would help eliminate wild fluctuations in premiums. The statutory requirement that banks pay a 23 cent premium when the fund is below the designated reserve ratio should be repealed.

We also strongly support the FDIC proposal to base rebates on past contributions to the fund rather than on the current assessment base. This would avoid unjustly rewarding those who haven't paid their fair share, like the free riders.

Fifth, the FDIC proposes to merge the BIF and the SAIF. The ICBA supports the merger as part of an overall comprehensive reform package.

In conclusion, Mr. Chairman, now is the time to consider these important FDIC reforms. Thousands of communities across America and millions of consumers and small businesses depend on their local community banks. And without substantially increased FDIC coverage levels, indexed for inflation, community banks will find it increasingly difficult to meet the credit needs of our communities.

The less deposit insurance is really worth due to inflation erosion, the less confidence Americans will have about their savings in banks, and the soundness of our financial system will be diminished. Congress must not let this happen. We support the overall thrust of the FDIC's recommendations. We urge Congress to adopt an integrated reform package as soon as possible, and I will entertain questioning that you might have. Thank you very much.

[The prepared statement of Robert I. Gulledge can be found on page 130 in the appendix.]

Chairman BACHUS. Thank you.

Mr. Smith, in your testimony, you suggest that retirement accounts should have a higher level of deposit insurance coverage. What do you see as an appropriate level of insurance coverage for retirement accounts, 401(k)s, IRAs?

Mr. SMITH. Well, basically, in 1978, when we had insurance coverage of $40,000, Congress chose to give us insurance coverage on those types of accounts at $100,000. While insurance on regular accounts has risen to $100,000, the IRA accounts are still at a level that we think is too low. So we would like to see that that amount increased so we can encourage savings in our country, encourage our customers to save more; and I think this would be a great move that we could do to entice that.

Chairman BACHUS. For instance, going back to 1980 and increasing it according to the CPI increase?

Mr. SMITH. Well, it was 2½ times in 1978, so if we did it 2½ times today, the regular coverage would be $250,000 per account, and taking in inflation and indexing that to inflation, I think that would be a very appropriate number to look at.

Chairman BACHUS. You suggest we should eliminate the too-big-to-fail doctrine. Congress has repeatedly tried to limit that doctrine. How would you advise us, or what suggestions do you have for us in eliminating that doctrine?

Mr. SMITH. I don't know that I have any specific suggestions. I think this topic should be on the table to be addressed under comprehensive reform. It was looked at in FDICIA and FIRREA, and some steps were taken, some measures were taken, to eliminate it; but the fact is that it is still there to some extent, and I think whatever Congress can do to eliminate the too-big-to-fail doctrine and put that issue on the table, it would be appropriate.

Chairman BACHUS. OK. Thank you.

Mr. Bochnowski, your testimony doesn't address the issue of municipal deposits, which it wasn't required to do, but do America's Community Bankers have a position on proposals that would either increase the coverage limits on such deposits or permit institutions to purchase coverage in excess of $100,000?

Mr. BOCHNOWSKI. Mr. Chairman, we have been neutral on this in both speaking with our members and surveying them. It is not an issue which comes to the fore. A number of our States provide municipal deposit insurance—not privately, but at least through the State system, and it has not been an issue that has been a major concern to our members.

Chairman BACHUS. I thank you.

Mr. Gulledge, let me continue on that thought. In your testimony, you support further coverage of municipal deposits. Would that increase the risk to the Federal Deposit Insurance Fund, ultimately to other institutions or the taxpayer?

Mr. GULLEDGE. Well, we do support the 100 percent coverage of municipal deposits, and we do feel that this is very important because this is a great source of funding for community banks and a great source of the funds to make meaningful contributions to their community in providing the services that they are organized for. And we do feel that this is not going to be a detriment to the fund.

At the end of 2000, there were $162 billion in municipal deposits. Of that $162 billion, only $113.8 billion of those were uninsured at that time. The BIF has $31 billion in reserves, and it presently has a reserve ratio of 1.35. If the BIF-insured deposits were increased by that $113.8 billion, then that would bring down the ratio to a 1.28 ratio, which still is above the statutory minimum.

Chairman BACHUS. All right. Thank you.

At this time, Ms. Waters.

Ms. WATERS. Thank you very much. Let me just say to Mr. Gulledge that I appreciate the clearness of the case that you make about the free riders.

Mr. GULLEDGE. The case of what? I am sorry.

Ms. WATERS. The free riders must pay their fair share. I am surprised, even as I learn more about FDIC, that this has gone on for this long; and it must be corrected. And I strongly support the remedy to the free rider problem as you have articulated it. And I am anxious that we not allow the Merrill Lynches and the Smith Barneys or anybody else to be able to have that kind of an advantage. So I just wanted to say that so then you would understand that for at least one person here today, your testimony certainly has struck a very strong chord with me.

Let me just ask Mr. Smith, what were you referring to when you said that some of the recommendations would cause unacceptable increases? What were you referring to?

Mr. SMITH. The FDIC recommendations would advocate that we start assessing certain rated banks that are not now paying premiums. They would have to start paying premiums. Right now banks that are CAMEL-rated 1 or 2 pay no premiums if they are well capitalized, and so I think under the FDIC recommendations, they certainly would start charging 2-rated banks a premium; and possibly some portion of the 1-rated banks, I think they want to change.

Ms. WATERS. Did you hear what the chairwoman said about a 47 percent failure among 1- and 2-rated banks? I think that is what she said—within 2 years?

Mr. SMITH. She quoted a specific period of time, and I am not sure how that equates out. I could only say from a banker who experienced the ag depression in the 1980's, who was in an ag bank—I experienced the depression in our bank, and the risk assessment is very real and very important. And the fact now that we have 92 percent of the banks in the 1 and 2 category, I would say, hurrah, because I think that is a great incentive, at least for me.

I am in that category; I do not have to pay FDIC premiums. And so I try to run my bank to make sure we have the proper safety and soundness procedures in effect. I try to run my bank to make sure that we are taking care of our community properly, because that is my market. And at the same time, I want to try to make sure I don't have additional costs on my balance sheet with FDIC premiums.

So I am not sure what timeframe Chairman Tanoue was talking about when she said 47 percent of the banks that were rated 1 or 2 failed.

Ms. WATERS. Well, Congressman Watt just clarified exactly what she said. She said that 47 percent of those banks that drew on the FDIC had shown that—what was it, the last 2 years?

Mr. WATT. Rated either as 1 or 2 in the last 2 years. That is what she said.

Ms. WATERS. That is what she said. So I guess, you know, what I was asking you was, given the information, the facts that have been presented to us, I guess I am wondering how you can make the case that the large number of banks that are not participating should not be participating.

I just don't have an appreciation for the way the risk is determined, perhaps, whether or not it has been looked at as short-term risk or long-term risk, but I just don't see that you make the case that it would be unacceptable increases to have them pay in a small amount and spread the amount of the fund to be collected among all of the banks, small and large, so that no one small sector of the banking community is bearing all of the burden of capitalizing the fund.

I mean, I just don't see the case that you make.

Mr. SMITH. Well, I think what we are trying to say there, Congress will set a designated reserve level, whatever that level is. Our position is that banks that are well capitalized and CAMEL-rated 1 or 2 should not have to pay premiums if we have met the designated reserve level or exceeded it.

Obviously, we don't like the hard, designated reserve level of 1.25. We would like to have a softer level, maybe a range where we start paying if it falls down below, but also we could have the dividends on rebates if it gets above that. And I think two things have to happen. You have to be at the designated reserve level, and you have to be a well capitalized bank. And you have to be a CAMEL 1- or 2-rated by your regulatory agency.

And my bank just underwent a safety and soundness exam in January from the FDIC, and I think that is risk assessment, because they do come in and take a look at everything in your bank, and they give you a rating from that.

Ms. WATERS. Yeah. But you still don't answer the question that we are raising—some of us are raising—despite that kind of reserve and despite what appears to be low-risk situation, that you still fall within that 47 percent who have been rated 1 and 2 within 2 years before they drew on FDIC. I mean, the fact of the matter is, it could happen.

Mr. SMITH. Well, I don't know that I have an answer there, depending upon the timeframes that they are looking at, because that probably was during the ag depression or during the real estate crisis that we experienced, which was, I think, a combination of an oil crisis and a real estate crisis, and we had an ag crisis, almost a domino effect across the country. I think we have a better regulatory structure in place today; I think we are smarter. I know, as a banker, I feel like I am smarter and have more things in place today in order to assess the risk and be sure that I am out front of any problems that we are going to address in our banks.

Ms. WATERS. How do you answer the question of Merrill Lynch and Smith Barney and the others with banks that do not pay into the fund?

Mr. SMITH. Well, I think FDIC has said that they do not have the authority to charge them premiums at this time.

Ms. WATERS. They have banks, though.

Mr. SMITH. Pardon me?

Ms. WATERS. They have banking operations.

Mr. SMITH. That is correct, but I think if you are well capitalized and you fall under the criteria that are set, the FDIC is saying that if they fall under these criteria, we do not have the authority to charge them for the funds going into the system. You know, obviously, they are looking to capitalization and the things that are taking place there.

Ms. WATERS. Thank you.

Chairman BACHUS. In the FDICIA, the Congress actually set the criteria for their charging the premium and—with CAMEL ratings, when they are in the—either ranked 1 or 2. I might point out, we have heard that 47 percent of the banks who failed—now, we are talking about the banks who failed—47 percent of those that failed had a rating system of 1 or 2 in the 2 years prior.

Another way of saying that is that 53 percent of those banks that could have failed did not, and they were within—92 percent of the banks in this country are rated 1 or 2. So within the 92 percent of your total institutions, most—in other words, over 9 out of 10 banks do have a 1 or 2 rating; yet, less than 1 out of 2 failed within that category. So it actually confirms that we are doing, I think, a fairly good job of identifying the 8 percent, singling out the 8 percent who do not have a 1 or 2 rating. Most of the failures came from that group.

And I would predict that when you look at 6 months or a year, if you shorten that period to 6 months as opposed to 2 years, that you would probably find almost all of the banks who failed had a rating of 3 at the time they failed. Some do go down. You know, this can be a 2-year process.

Ms. WATERS. Mr. Chairman, if I may——

Chairman BACHUS. Do you understand what I am saying?

Ms. WATERS. Yes, I do.

Chairman BACHUS. That most of the failures came within that 8 percent?

Ms. WATERS. Well, you certainly can make that case.

I guess what I am looking at is the fact that while we are smarter and we can predict certain things, we are sitting here now and we don't know what the energy crisis is going to cause in this country.

I never would—nobody could have predicted that in the State of California we would be facing rolling blackouts. Nobody could have predicted we would be up to $3 per gallon of gasoline. Nobody could have predicted that NASDAQ took the dip that it took this year. So what we do know is that there is enough volatility in our economy where, even though we have calculated as best we can, anything can happen. And so I just kind of keep that as a reference when I look at whether or not we are, in some cases, spreading the risk, we are being fair to all.

The independent community banks are very important to me because, I think, despite the sophistication of banking, that these are the units that really keep middle America and small-town America

and small-city America running. And so I want to make sure that they are not disadvantaged, that they have the ability to—I am not sure, and I have to ask this one question: The calculation by the FDIC, did it also calculate the retention of the reserve requirements for the banks, along with spreading out the FDIC charges? What did they say about reserve rates for the banks?

Mr. SMITH. No. That is not included in it, because each bank holds their own reserves for any loan losses or any problem situations.

And I would like to clarify that we do advocate that those large, fast-growing institutions with funds from Merrill Lynch, and so forth, be charged a premium. I was merely stating that the FDIC has told us that they don't have the authority to charge those; but we do think that they should be charged and that should be addressed in this bill.

Ms. WATERS. Thank you very much, Mr. Chairman.

Chairman BACHUS. Thank you. So I think there is agreement there.

Mrs. Kelly.

Mrs. KELLY. Thank you, Mr. Chairman. I am sorry that I wasn't here earlier, because I am caught in a markup, but this is an important hearing and I wanted to know if I have permission to put a statement into the record and also if you are going to hold the hearing open, if I may have permission to submit written questions to the panels?

Chairman BACHUS. Yes. In fact, it is a good point. Mrs. Kelly, all Members will have 5 days with which to enter in written statements or any other material they have.

Mrs. KELLY. Thank you. I would like to yield my time to Mr. Weldon.

Mr. WELDON. I thank the gentlelady.

Mr. Gulledge, you are of the strong opinion that raising the coverage level on the deposit insurance will help ease the liquidity problems facing the small community bankers, members of your association. In your view, is there anything else that Congress can do to help stem the tide of core deposits leaving community banks? Are there new products, for example, that Congress could authorize or other measures that we could take to address the funding issues that I know are of tremendous importance to your association? And maybe some of the other members may want to comment on this as well.

Mr. GULLEDGE. Well, certainly I would voice the opinion that the increase of insurance coverage is the most important issue that is on the table at this point. This is very crucial to many, many community banks and particularly those in rural areas.

Now, last year, the work that was done with the Federal Home Loan Banks did make advances from the Home Loan Banks more available, and this has helped a great deal. But there are problems with that. Some of the examiners are now questioning the heavy use of withdrawing at the windows there. The program that we need is to develop stronger core deposits, and I do believe the increase in insurance coverage and particularly with the municipal coverage, if that can be extended to full coverage, and also the in-

creased coverage for the retirement accounts, I think that would be very helpful.

Mr. WELDON. Mr. Bochnowski, did you want to add to that at all?

Mr. BOCHNOWSKI. Thank you, Congressman. Yes, I would appreciate that opportunity.

We would basically see it a little bit differently. We think that indexing coverage in 1974 would put behind us the issue of advancing coverage as time goes by. We do not favor moving to $200,000. We think that current market conditions maybe prove the point slightly, because all of us at the community bank level are experiencing an influx of funds as a result of what is happening in the equity markets. So we are not totally sure that increasing coverage is what would trigger consumers to bring money in.

We think that the action of this subcommittee in the House in passing business checking was a very wise decision. We think that is a wonderful opportunity for all of us to bring in more deposits.

We would agree that to increase coverage for IRA accounts, 401(k) accounts, the Keogh accounts, that that could make a difference, particularly as time is going to go on, because so many of those accounts have built up great values in our institutions. And I think that those of us who are baby boomers, that as we age, we are going to see more and more of our funds go back into the banking system, and increased coverage there would be very helpful.

Mr. WELDON. Mr. Gulledge, opponents of raising the level of deposit insurance claim that it will not really lead to any more deposits, rather a consolidation of accounts. Thus, while one bank may gain from the consolidation, another may actually lose accounts. Do you have any response to that criticism?

Mr. GULLEDGE. My response would be that this goes straight to the area of competition, which banks should be strongly engaged in. My experience in my bank is that there are many customers who come in, and I see them take cashier's checks out of my bank to another bank simply and purely because we do not have the coverage of that. I think that it would make us all more competitive, and I think we would serve the public better if we had the additional coverage and we got out and had to work and compete for those deposits.

Mr. WELDON. Mr. Bochnowski, in your testimony, you talk about setting a 1.35 percent ceiling on the reserves in the fund and using the excess to pay off the FICO bonds. What are banks paying now on FICO bonds?

Mr. BOCHNOWSKI. I would have to ask. It is 2.1.

Mr. WELDON. 2.1?

Mr. BOCHNOWSKI. 2.1 basis points.

Mr. WELDON. Do you have any idea how much this would cost to do what you are talking about?

Mr. BOCHNOWSKI. In specific numbers, no. It is about $800 million a year.

Mr. WELDON. $800 million a year for the industry, or your members?

Mr. BOCHNOWSKI. For the industry.

Mr. WELDON. For the industry, industry-wide.

I know I am asking you a lot of detailed questions. You can ask the people behind you. How long would it take to pay off the FICO bonds in that scenario?

Mr. WATT. 217.

Mr. WELDON. Pardon me? Is that correct, 217,000? The gentleman from North Carolina says 217,000.

Mr. BOCHNOWSKI. Seventeen years of interest.

Mr. WELDON. Seventeen years of interest, OK.

I think my time has expired; is that right? I had one more question.

Chairman BACHUS. Go ahead and ask your—we will——

Mr. WELDON. No. I will yield back.

Chairman BACHUS. No. If you——

Mr. WELDON. Mr. Bochnowski, in your testimony, you call for a special premium on institutions that have grown rapidly.

Mr. BOCHNOWSKI. Right.

Mr. WELDON. Can you define "excessive growth"—I think that is the term you use—and isn't this going to be a penalty on banks that are successful if we implement something like this?

Mr. BOCHNOWSKI. I think "excessive growth" would be defined anything that is outside of the norm, and I think the FDIC can calculate for us what normal growth rates are across the banking industry.

I don't see it as a penalty. I think that they have not paid into the fund, and they are the free riders that we are describing. When I look at the impact of the free riders on the First Congressional District of Indiana—and this gets back to Mr. Bachus' question earlier.

The FDIC Chairman talked about the $65 billion impact on lending. We have 16 independent banks and thrifts left in our community; together, they have about $5 billion in deposits. If this 23-basis-points premium were imposed, if we fell over that cliff and we had to pay it because of what the outsiders are causing us to do, it would have an impact on $80 million of loans.

Mr. WELDON. That would be sucked out of the district?

Mr. BOCHNOWSKI. Correct, loans that we wouldn't be able to make. And what is astounding about that, Congressman, is that we haven't done anything.

Mr. WELDON. Right.

Mr. BOCHNOWSKI. We have just done our job, and someone from the outside can come in and cause that mischief. And that is why we think bill H.R. 1293 is important, because it goes to the heart of the problem immediately. And I think that that is an experience that we are all going to have.

Mr. WELDON. H.R. 1293? Is that what you are talking about?

Mr. BOCHNOWSKI. Yes, sir.

Chairman BACHUS. OK. Thank you.

Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman.

Let me just ask a couple of quick questions that I think I can get yes and no answers to, to try to get to a subsequent point.

Is there any prohibition against banks currently reinsuring deposits beyond $100,000?

Mr. SMITH. No, there is not.

Mr. WATT. Would there be any prohibition against banks advertising that if they chose to do that?

Mr. SMITH. Not that I am aware of, no.

Mr. WATT. Is there anybody out there who is writing reinsurance?

Mr. SMITH. I am.

Mr. WATT. A lot of people are?

Mr. SMITH. Yes.

Mr. WATT. Are doing reinsurance?

Mr. SMITH. It is a private insurance carrier, but we provide insurance if they want more coverage, over the $100,000 limit.

Mr. BOCHNOWSKI. Congressman, we do that a little bit differently. We don't do the reinsurance, but we do repurchase agreements where we can cover more than $100,000 by permitting our customer to buy a security that we own.

Mr. WATT. OK.

My visceral response is that I strongly favor indexing the $100,000 figure and moving it up and then indexing it.

My visceral response on either an unlimited coverage for retirement accounts or for municipal accounts being 100 percent insured is that that would be fairer done in some reinsurance or separate fund, because you are basically creating a different level of coverage for people, which I think ought to be the same. Can I just get your reaction to that?

I mean, I obviously haven't studied this to any great degree. I am just giving kind of a visceral, gut response to it. Is there anything wrong with the analysis that I am—with my visceral response, I guess is the question.

Mr. BOCHNOWSKI. We really haven't looked into that issue directly. I think the problem with reinsurance may be how the reinsurer rates each individual bank: Where are they going to get their information from; are they going to want access to our individual examination reports?

Mr. WATT. How are you doing it now?

Mr. BOCHNOWSKI. Well, we are not.

Mr. WATT. What would be the difference, Mr. Smith?

Mr. SMITH. No. Our banker bond carrier offers deposit insurance coverage, and they do not come in and rate the bank. Obviously, we have done business with this company for a number of years, and they provide the insurance level that we request. We have no criteria.

Mr. WATT. Does it cost you more than the premium would be into the FDIC?

Mr. SMITH. At this point, depending upon, of course, what level you would have to pay into the FDIC for the coverage, the premium now is costing about 4 cents.

Mr. WATT. And your FDIC premium—you are not in. But what is the typical——

Mr. SMITH. Well, out of the 23 cents, if you were paying the maximum, that would be very healthy plug for our bank. Depending upon what level, of course, risk that the FDIC——

Mr. WATT. Healthy level is what?

Mr. SMITH. The average level right now is, I think, about 6 cents for people falling out of the 1 or 2.

Mr. WATT. So you are actually paying less to fully insure municipal deposits than you would be paying if we just upped the coverage for municipal deposits under FDIC to full coverage; isn't that right?

Mr. SMITH. I think——

Mr. WATT. I mean, shouldn't that be a cost that you are passing basically factoring into the quotes you are giving to municipalities and factoring into whatever proposal you are making to a municipal government?

Mr. SMITH. Well, in the municipal deposits, every State is different, and I can only give you the example of my State of Missouri. We have to collateralize every dollar over the $100,000 that they have in the bank, so we pledge a security for that.

Now, that does not cost us anything in actual dollars except some opportunity costs, possibly. The cost there is the burden of bookkeeping and recordkeeping that we have to go through to pledge a specific security to, say, the school system. And, for instance, if that security matures or that security is called, we have to go get that security released, and then we have to reassign another security for the school system to cover their deposits. There is no specific dollar cost on my books for that.

What I was talking about, the additional deposit cost was if an individual comes in and they want to put $200,000 in the bank. They say, we would like to have coverage over the $100,000. We try to provide them that coverage.

Now, probably I would somehow try to give them a rate that would help pay some of the cost of that coverage, and they understand that, because I explain it up front; but they would prefer to have the additional coverage over the $100,000 limit and possibly have some sharing there.

Mr. WATT. Mr. Chairman, I am going to yield back, the point I am making is, I think in some of these individual municipal transactions, it seems to me that it would be fairer to think about building that into their costs rather than spreading it to all depositors, the cost of doing this.

I mean, I obviously haven't reached a conclusion on this, and maybe you all want to talk to me more about it if we move in that direction. But my kind of gut reaction is, I am not sure that I think it is necessarily a good idea for us to be 100 percent insuring any individual class of depositors and putting that class of depositors in some separate category than the regular insurance fund, because the whole idea of a regular insurance fund, an FDIC insurance fund, was to give kind of a Social Security theory more than it is insuring 100 percent, as I understand it.

Maybe I am just wrong about that.

Mr. BOCHNOWSKI. Mr. Watt, if I could add an observation. In Indiana we do have a public deposit insurance fund so, in theory, those deposits are covered. But insurance is not an issue. It is price-driven. The consideration of the depositor is—if the money is currently at a large securities firm right now, earning a certain yield, for us to bid on those funds successfully, we have to meet their price. Some days we want to meet that price, and some days we don't, and it is really a cost factor.

Insurance, I think, at least in our State, is not as significant to bringing those funds in as price.

Chairman BACHUS. Thank you.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Yeah, I—on the municipal—and I don't want to ask too much about that, but I am not sure I see the case yet to do that on municipal, and I am not sure we would want to get that confused if we were looking at doing an FDIC reform bill, because there are a lot of avenues for municipalities to set up their funds, and I think you intertwine yourself with different State codes, and even municipal codes, on how funds can be deposited.

But let me go back to the FDIC's proposal.

I looked at two out of three of the testimonies, but in listening to everyone's testimony, it would appear obviously that everyone is in favor of some broad concept of reform of the insurance system. And would it be fair to say—clearly, I think this is what the ABA is saying, and I didn't get a chance to go through the others—but, would it be fair to say that everyone is in favor of some form of a mutual insurance system, which is a term that the ABA uses in their testimony, as opposed to the current system?

And getting more specific—and I am not necessarily saying that the FDIC concept is the prototype or the ideal model, and I would ask this of Mr. Smith in particular—is the primary concern with the FDIC model that both the risk-based premium might result in a higher premium for some banks or thrifts and that the rebate mechanism might result in some banks and thrifts paying a net-net higher premium than they would under the current system?

And I guess I would add to that, is there an objection to having an ongoing payment, even if it is rebated back in a greater amount?

Mr. SMITH. Well, as I travel around the country, clearly I don't think we have a consensus among the bankers, because we find a lot of bankers want the $200,000 level. A lot of bankers want maybe a lesser level, and I have found a lot of bankers that don't want any increase in the insurance. So I think it is important that we have a consensus.

And if I don't get eaten up here, I think it is important that we have a consensus among the bankers, because I think cost is going to drive this consensus in order to get the bankers to agree upon a bill. And I think if we increase the cost to a significant number of bankers, then I think it is going to be difficult to get those bankers to agree upon.

Mr. BENTSEN. Excuse me.

In terms of cost—I am not focusing as much on the level of insurance of—I mean, I think we will work out the 100,000 to whatever at some point; but I guess I am focusing more on the premium mechanism for the funds.

Is the concern that the FDIC model would result in—I mean, on the one hand, it seems to me the FDIC model would bring everybody into the system; everybody who is accessing the fund would have some obligation to pay into the fund. And I think—and I would gather from what everyone said, there is consensus among this panel on that.

Where the consensus breaks down, or where the concern rises, is the way the rebate model is structured under the FDIC proposal, is that for some would end up paying more premium, or paying a premium, since someone is paying a premium right now, as opposed to the status quo. Is that the concern?

Mr. SMITH. We like the model, but basically we just don't necessarily like the numbers that they have put with the model. And I think—yes, I think we are interested in the model, in approving that model, but I think we would like to see what we can do about the numbers and how that would play out with the cost to our bankers across the United States.

Mr. BOCHNOWSKI. We would not object to certain parts of their model, but do object, obviously, to others. We think that the CAMEL–1-rated banks should not pay a premium at all. We would be open to CAMEL–2s paying some premium. But we think that, in the end, it gets back to what is the maximum level of the fund and how will rebates come back; and to the extent that the mutual model provides opportunity for all to participate in that, then that would be something we could support.

Mr. GULLEDGE. Well, in my testimony, I indicated earlier that it was our belief that our banks would be willing to pay a premium if it was small, steady and fairly priced.

And in order to get an integrated reform package, I would comment here also that the purpose of the study that the FDIC made is not to enhance revenues or total premiums. It is to find a more workable situation. And certainly—and I have testified earlier in my comments that the rebates should be based on what had been paid in previously by the banks rather than from the assessment base now.

So I approve of the model.

Mr. BENTSEN. Let me very quickly ask this, because I have been sitting here for a while.

Is it fair to say that everyone here would agree, though, with going to more of a risk based—and arguably we have that under FIRREA or FDICIA—but, to more of a risk-based premium model? Obviously, more details are critical, but also—and I think Mr. Gulledge answered this.

On the rebate, would you agree with what the FDIC talks about on historical payments, or would you see that there, as well, you would want to have a risk-based model for the level of rebates or who receives the rebates?

Mr. BOCHNOWSKI. I think that it is probably a hybrid. Again, if we have fast-growth institutions, should they be participating fully in the rebate? I am not sure that we are prepared to say that they should.

Mr. SMITH. And I would agree with that.

Mr. BENTSEN. Thank you.

Thank you, Mr. Chairman.

Chairman BACHUS. Thank you. Mrs. Maloney, and if you have additional time, you are going to yield to Mr. Crowley?

Mrs. MALONEY. Absolutely.

Chairman BACHUS. And then we will conclude with his questions.

Mrs. MALONEY. The FDIC indicated that the 23 basis points, that is currently required by law if the reserve ratio dips below 2.5 percent, would reduce lending by $65 billion. Do you have any idea what the impact on lending would be from the FDIC's proposal of risk-based pricing combined with rebates? Would it reduce lending?

Mr. SMITH. I can give you only the example of my bank during the early 1990's, when we had a 23-cent premium; it cost our bank about $120,000 a year. And if you extend that over a 10-year period, that is a lot of money. And if you loan that money in your community, and your customers buy goods and spend money, the United States Chamber of Commerce itself tells us every dollar turns over seven times, so I think you can see where this could—the multiplier effect could really have a big effect on what is available in our communities with these dollars.

Mr. BOCHNOWSKI. We know, Congresswoman, if we were to follow that 23 basis points in our company, it would impact us by not having approximately $5 million in lending, and that is 20 percent of our loan growth from last year.

On a smaller scale, though, if we have—for the 1- and 2-rated companies—some modest premium, I think it is possible to say that—and that is to suggest that it is, you know, a 2- or 3-basis points premium—it is not going to be that steep. It is the higher end that causes the problem.

Mr. GULLEDGE. Well, we believe that the enhancement in the safety and soundness of the banks resulting from these reforms would be good for everybody.

Mrs. MALONEY. Thank you very much, and I yield my time to my distinguished colleague from New York.

We have a vote taking place right now, so we don't have a lot of time.

Chairman BACHUS. We have about 9½ minutes, so you have plenty of time.

Mr. CROWLEY. OK. Thank you, Mr. Chairman.

I thank my colleague from New York, Mrs. Maloney. I have two questions, kind of playing a little bit of devil's advocate.

If you can say on the record or off the record—and Mr. Bochnowski, I hope I am——

Mr. BOCHNOWSKI. Bochnowski.

Mr. CROWLEY. Bochnowski. That is correct.

At least many of the large banks are saying that Gramm-Leach-Bliley was in part done to create this benefit for the consumer, their customers—I am talking about the free rider issue—to have access for their consumers and their customers, the protections of FDIC accounts and all the protections that go along with them.

Now, despite the fact that that may anger some, isn't that the argument they are making upon a fine argument?

Mr. BOCHNOWSKI. It is a curious argument. I had an opportunity earlier in my testimony to suggest that if we were to have a premium enforced upon us in the First Congressional District in Indiana, it would have an impact of reducing the available dollars for loans by $80 million. I hardly think that Congress intended when they passed that law to put those of us who are community bankers in the position of having an $80 million retraction of credit in

the First District of Indiana. And I don't know how that plays across the country and all other districts, but that is an example.

So I think it is a very specious and curious argument that they make.

Mr. CROWLEY. Thank you.

And this really is to the entire panel, if anyone wants to jump in: The increase in the amount of money that would come into these accounts and from these large banks, based on security brokerage accounts, common sense tells me that it would increase substantially the level of insured dollars within the FDIC; and because of that, the ratios would be changed and that although they are pretty flush at this point in time, right at this time, that there has been a slight decrease in the DRR since then, albeit they have only been around for about a year-and-a-half or so.

Is it your contention or the panel's contention that you expect you will see a further decrease in DRR?

Mr. BOCHNOWSKI. I believe that the numbers are that for every 100 billion that comes across the DR—declines by about 6 basis points. So there is approximately $180 million that the chairman has suggested that the bank security firms' combination have under their control that could move over.

Mr. CROWLEY. How much do we anticipate will be rolled in these FDIC accounts?

Mr. BOCHNOWSKI. I would have no way of knowing what they would do.

Mr. CROWLEY. Even if the return is going to be substantially less than what they could get?

Mr. BOCHNOWSKI. It depends on market conditions. It also depends on a fiduciary question that they face. If the return is the same on the——

Mr. CROWLEY. Insured accounts.

Mr. BOCHNOWSKI. They might take the insured account.

Mr. CROWLEY. Got you. Thank you.

Thank you, Mr. Chairman.

Chairman BACHUS. Thank you.

In conclusion, we are going to adjourn this hearing. I do want to say that we have some additional information. The FDIC indicated that the failure rate was actually significantly lower than what was initially indicated.

And let me also say this: Of over 10,000 banks last year, we had one bank failure of a small institution in West Virginia. So, I think when we talk about bank failures, we are talking about something that in the last few years—and we have passed additional regulations and put additional structures in place. They have been very successful.

A bank failure today is rare indeed. It is a very unusual event.

With that, the hearing is adjourned, and I thank you, gentlemen.

[Whereupon, at 12:27 p.m., the hearing was adjourned.]

A P P E N D I X

May 16, 2001

OPENING STATEMENT OF REP. SPENCER BACHUS
CHAIRMAN, SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
MAY 16, 2001 HEARING ON DEPOSIT INSURANCE REFORM

The Subcommittee meets today for the first of a planned series of hearings on the subject of reforming our country's deposit insurance system. The focus of today's hearing will be on a report prepared by the FDIC entitled *Keeping the Promise: Recommendations for Deposit Insurance Reform.*

Federal deposit insurance – established during the Great Depression to restore confidence in the nation's troubled banking system – is that rare product of the legislative "sausage-making factory" that has actually worked pretty much as it was intended to. It has enhanced economic stability; largely eliminated the prospect of panic-driven "runs" on banking institutions; and succeeded in minimizing the risk to taxpayers from bank failures.

Yet even the most effective government programs require periodic review and updating to ensure that they continue to serve the purposes for which they were originally created. Our objective this morning is to begin what I hope will be a constructive dialogue about the future of the deposit insurance system. I can think of no better starting-point for that discussion than the report unveiled by the FDIC last month. We are pleased to have FDIC Chairman Donna Tanoue with us this morning to present the agency's findings and recommendations.

The Subcommittee's consideration of deposit insurance reform comes at a time when the system itself is as healthy as it has been in more than 20 years. Thanks largely to sizable contributions by the banking and thrift industries in the 1990s, the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) are both fully capitalized, with combined balances exceeding $41 billion. The strong condition of the deposit insurance funds might cause some to conclude that the status quo should simply be maintained. Other factors, however, argue for a more proactive approach.

As the FDIC has correctly pointed out, the current system leaves open the possibility of sizable 23-basis point premium assessments on institutions if and when the designated reserve ratio falls below 1.25 percent. While there is significant debate within the industry about the factors that might cause a penetration of this 1.25 "hard target," there is no doubt that a 23-basis point assessment – which has been aptly compared to "falling off a cliff" – would have serious consequences, both for banks' profitability and for their ability to fund economic growth in the communities they serve, if it were to occur in a period of economic weakness. The FDIC's request for more flexibility in setting the reserve ratio therefore warrants the Committee's careful consideration.

Perhaps no deposit insurance issue has been more hotly debated than the question of whether to increase coverage levels above the current $100,000 per account limit. While several influential policymakers have been openly skeptical of the need for such an increase, all of us on this Committee have heard from community bankers in our districts who strongly believe that a substantial coverage increase is critical to their ability to attract core deposits and remain competitive in their local markets. In my view, devising solutions to the funding challenges faced by community banks should be this Committee's highest priority, and I will be reviewing the various reform proposals that we will consider in the coming months with that in mind.

In this regard, I am particularly interested in hearing from our witnesses on the issue of higher coverage levels for municipal deposits, which have historically been a vital source of funding for community banks but have become increasingly expensive to attract and maintain.

In closing, I want to commend Chairman Oxley for his leadership in placing the issue of deposit insurance reform on the Committee's agenda. I look forward to working with him and with other Members of the Committee to develop legislation that ensures the continued strength and vitality of a system that has served us well for almost 70 years.

I now recognize the Ranking Minority Member, Ms. Waters, for any opening statement she wishes to make.

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Congressman Joseph Crowley
Remarks - FI Subcommittee - FDIC Reform Hearing
May 16, 2001

I want to begin by thanking Chairman Bachus and Ranking Member Waters for holding this important hearing this morning.

Now, when our financial sector is strong and our depository institutions are sound, is the time for the FDIC and the Congress to review FDIC regulations and procedures and fix any problems.

As Chairwoman Tanoue has stated on a number of occasions, we should fix the roof when the sun is shining.

Like a number of my colleagues, I believe that we should seriously consider merging the SAIF and BIF insurance funds.

On that point, I want to recognize the Lead Democrat on this Committee, Mr. LaFalce, a great man and a good friend, who has been out front on this merger issue long before this Committee was even a twinkle in anyone's eyes.

This Committee should also examine the 23 basis point "punishment" on banks when the Designated Reserve Ratio falls below the arbitrarily established rate of 1.25 with an eye towards reforming this ratio requirement.

Furthermore, it is the obligation of this Committee to look into the serious concerns of our community bankers, such as Bill McKenna of the Ridgewood Savings Bank in my district in Ridgewood, Queens, New York, on the issue of the "free-rider" problem and its effects on the FDIC and the BIF insurance fund.

While our nation's banks enjoy unprecedented prosperity, we should take the time to plan ahead for the rainy days, as this is the best way in which we can prevent another debacle as the one that occurred to our nation's thrift industry in the late 1980's and early 1990's.

I also look forward to hearing from our witnesses if they believe it is time to begin indexing our FDIC insured ceiling of $100,000 for inflation

We have a number of important issues to cover today, and I very much look forward to a lively and spirited discussion and again want to thank Chairman Bachus and Ranking Member Waters for holding this hearing - the first in a series of hearings on the key issue of protecting the savings of all Americans.

Thank you.

Statement of Congresswoman Sue Kelly
House Committee on Financial Services Subcommittee on Financial Institutions; Subcommittee Hearing on Federal Deposit Insurance Reform
Wednesday, May 16, 2001 – 9:30 a.m. – 2129 Rayburn

Chairman Bachus, Ranking Member Waters I want to thank you both for agreeing to hold this hearing on the very important issue of the needed reform of Federal Deposit Insurance. As we are all aware FDIC insurance plays a critical role in our nations financial system ensuring both consumer confidence in banks and stability in the system.

Today community banks are facing serious funding challenges due to the lack of core deposits, which is why an increase in deposit insurance coverage levels is such an important issue to them. I support H.R. 746, bipartisan legislation which increases FDIC insurance coverage levels to about $200,000 and provides for automatic inflation adjustments. Increasing coverage levels would benefit communities, retirees, consumers, farmers, the economy and small business customers by enabling depositors to keep more of their money in local banks where it can be reinvested for community projects and local lending. However, this is not the sole solution, but one plank of a more comprehensive effort to address the current problems community banks and the FDIC face.

In addition, I believe another plank in this reform effort should include the merger of the BIF and SAIF funds and a rewrite of the law to ensure that the highest FDIC premiums are not paid during the slowest times in our economy.

I want to thank our distinguished witnesses for taking the time to join us here today to discuss these issues in detail. I look forward to exploring these issues with you all and working with my colleagues on both sides of the aisle to properly address these issues.

Statement of Congressman Bob Ney on the May 16, 2001 Hearing on FDIC Reform

I commend House Financial Institutions Subcommittee Chairman Spencer Bachus and Ranking Member Maxine Waters for holding today's hearing on federal deposit insurance reform. I would also like to thank our distinguished witnesses for taking the time from their busy schedules to testify before the committee. This is clearly a critical issue that should be addressed by Congress this year.

I have read with great interest the recommendations to be presented today by FDIC Chairman Donna Tanoue and the banking industry witnesses who will be testifying at the hearing. As today's hearing will demonstrate, Congress will have to wrestle with a number of complex and potentially controversial issues in developing a comprehensive deposit insurance reform plan. I believe that any proposal considered by Congress must first address some of the immediate problems that could jeopardize the health and stability of the federal deposit insurance system.

We are fortunate that the current strength in our banking system affords us the opportunity to examine how we can strengthen the safety net that insures the safety and soundness of our banks and thrifts, the Federal Deposit Insurance Corporation (FDIC). Like many members of Congress, I am concerned about the recent decline in the reserve ratio of the Bank Insurance Fund (BIF). While both the BIF and the Savings Association Insurance Fund (SAIF) are relatively healthy, there are some very realistic economic scenarios that could place either fund below the required 1.25 percent reserve ratio level. Prudence demands enhancing the stability of the federal deposit insurance system today -- at a time of relative economic health -- rather than wait for a financial crisis to develop.

That is why my colleague from Ohio, Rep. Stephanie Tubbs Jones, and I have introduced H.R. 1293, the "Deposit Insurance Stabilization Act." The bill contains several common-sense provisions to strengthen the deposit insurance system, such as merging the BIF and the SAIF, permitting the FDIC to impose a fee on institutions that threaten the stability of the insurance fund; and giving the FDIC flexibility in recapitalizing the deposit insurance fund if its reserve ratio falls below the required level.

Much of this bill reflects the recommendations found in the FDIC's testimony. H.R. 1293 has a bipartisan cosponsorship list of nearly 30 members of the House, and enjoys the support of a host of banking trade associations. More than just making some common sense reforms to the FDIC, H.R. 1293 provides this committee with a starting point for discussing further reforms to the deposit insurance. I believe that it should serve as the base for any comprehensive deposit insurance reform package considered by Congress. At the very least, its passage as a freestanding measure would establish a better foundation for debating other important issues related to deposit insurance reform.

I welcome the opportunity to discuss other ways in which we can strengthen our deposit insurance system so we may guarantee that future generations of Americans have the same faith in our banks and thrifts we now enjoy. I believe that this hearing is the right place to start a process that will lead to a stronger and better FDIC.

Again, I am pleased that the House Financial Institutions Subcommittee has taken this first important step in the direction of moving comprehensive deposit insurance reform through Congress this year.

16 May 2001
Congressman Paul E. Gillmor
Opening Statement for House Financial Services Subcommittee Financial Institutions and Consumer Credit, Hearing on Federal Deposit Insurance Reform

I would to take this opportunity to thank Chairman Bachus for holding this important hearing on reforming the Federal Deposit Insurance Corporation's current policies and the overall way our federal deposit insurance system operates in this country. As there is no current crisis in the banking system, this is the perfect opportunity to foster a dialogue on reform and implement changes before last-minute thinking prevails.

In my opinion, several main questions need to be answered during this process. (1) Should we increase the $100,000 coverage for deposits? (2) Should past and future inflation be used to index FDIC coverage? (3) Should we merge the BIF with the SAIF? (4) Should rapidly expanding banks, who have paid little or no assessments, be charged premiums to compensate the FDIC for its increased exposure to payouts and downward movement in the fund reserve ratios? (5) Finally, should FDIC insure deposits of municipalities at a greater level than other accounts?

I applaud my colleagues Congressman Joel Hefley of Colorado and Congressman Bob Ney of Ohio and support their reform proposals addressing the first four issues I mentioned. I also intend to address the issue of appropriate coverage of in-State municipal deposits with my own legislation in the next few days.

Again, thank you Mr. Chairman for holding this hearing and I look forward to the testimonies and important discussion to follow.

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Financial Institutions and Consumer Credit

May 16, 2001

"Keeping the Promise: Recommendations for Deposit Insurance Reform"

Thank you Chairman Bachus.

This hearing marks the beginning of the Financial Services Committee's review of Federal deposit insurance. For the last 67 years Americans have been reassured that when they put their hard earned money in the bank it will be there for them when the need it. From time to time we must remind ourselves how unique this is- in much of the rest of the world depositors have no guarantee that they will be able to get their money back if their bank becomes insolvent. This guarantee has in turn contributed to making our banking system the most advanced and efficient in the world. And as we all know, safe and sound banks are an indispensable part of a healthy, vibrant economy.

It is also important to remember that our Federal deposit insurance system has not remained static over these last 67 years. Changing times and market conditions have required that Congress remain vigilant in ensuring that our laws do not become outdated, or worse, prove to be a hindrance to guaranteeing American deposits and maintaining faith in our banking system. Congress has periodically revisited our deposit insurance laws to reflect our ever changing banking system, with the most recent sweeping changes occurring in 1991 at the end of the S & L crisis.

Our goals remain the same now as they were when Federal deposit insurance first became law: to reassure Americans in the safety of their deposits and the banking system, and to protect taxpayers from being on the hook during times of economic crisis.

I'd like to thank Chairman Tanoue for appearing here today, and for the hard work that went into the preparation of this report. I look forward to her providing us insight into the FDIC's findings and recommendations for reform of the Federal deposit insurance system.

Chairman Tanoue, thank you for the job you have done serving as Chair; all Americans owe you a debt of gratitude for your public service.

As we proceed cautiously and diligently in exploring possible changes to the Federal deposit insurance system there will be many more opportunities for input from regulators, industry participants and depositors.

Thank you for holding these hearings Chairman Bachus, and I look forward to hearing from all of our witnesses.

Oral Statement
Of
Donna Tanoue
Chairman
Federal Deposit Insurance Corporation

Before
The
Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
U.S. House of Representatives

May 16, 2001

Chairman Oxley, Chairman Bachus, Representative Waters and Members of the Subcommittee, the FDIC appreciates the Subcommittee recognizing the importance of federal deposit insurance reform and holding hearings so expeditiously. In addition, we appreciate the efforts of the several Members of Congress who have introduced or cosponsored legislative initiatives addressing deposit insurance issues. These efforts stimulate and further the debate.

Deposit insurance plays a vital role in promoting financial stability, assuring that banking problems do not become banking panics. And, as a recent survey from the Gallup Organization concluded, the security the FDIC provides is an important consideration when Americans weigh where to invest their money.

This morning I want to talk about why reforming our deposit insurance system is important, why reform should be addressed now, what our recommendations for reform are, and why reform of deposit insurance should be comprehensive.

Why is reform important? As good as it is, the current system has certain flaws – some of which undercut the very purpose for which it was created.

Under the current system, 92 percent of the insured institutions in the country pay no premium for coverage. Because deposit insurance has been free for strong institutions, the current system distorts incentives. The results: more than 900 institutions – about one out of 10 of the insured institutions in the country -- have never paid premiums. And major investment firms have begun sweeping large dollar volumes of brokerage accounts into deposit accounts in their FDIC-insured subsidiaries.

In addition, underpriced deposit insurance also promotes "moral hazard" – the incentive for insured banks to engage in riskier behavior than they would in the absence of insurance.

The current system could also have an injurious economic side effect -- a "procyclical bias" – that is, a tendency to make an economic downturn longer and deeper than it would otherwise be. How? During a severe downturn, it would require that we charge banks high premiums, thus limiting the availability of credit to people, businesses and communities when they need it most, thus impeding economic recovery.

If we don't reform our system, it is likely to take a toll on the safety and soundness of the banking industry and on the economy because a premium increase would hit when banks are less healthy and losses are depleting the insurance funds.

Why now?

Despite some recent trends that are of some concern, both the economy in general and the banking system in particular remain strong. We need to address the flaws in our deposit insurance system without the pressures and distractions that a downturn would bring – or the urgent demands for action that would arise in a crisis.

The FDIC has five recommendations.

RECOMMENDATION NUMBER ONE: THE FDIC SHOULD BE PERMITTED TO CHARGE ALL INSTITUTIONS PREMIUMS ON THE BASIS OF RISK, INDEPENDENT OF THE LEVEL OF THE DEPOSIT INSURANCE FUND. Insurers generally price their product to reflect their risk of loss. Today, because more than 92 percent of insured institutions are in the FDIC's best-risk category and pay no deposit insurance assessment, our premium system is ineffective in capturing or curbing risk.

RECOMMENDATION NUMBER TWO: CHANGE THE LAW TO ELIMINATE SHARP PREMIUM SWINGS. If the fund falls below a target level, the law should allow premiums to increase gradually. Charging premiums more evenly over time -- allowing the insurance fund to absorb some losses temporarily -- and increasing premiums more gradually than is required at present, would soften the blow of an economic downturn.

RECOMMENDATION NUMBER THREE: GIVE THE FDIC AUTHORITY TO REBATE PORTIONS OF DEPOSIT INSURANCE PREMIUMS – BASED ON PAST CONTRIBUTIONS TO THE FUND – WHEN THE DEPOSIT INSURANCE FUND IS ABOVE A SPECIFIED TARGET LEVEL. Tying rebates to the current assessment base would increase moral hazard. Fairness dictates that rebates should be based on past contributions to the fund. Allowing the FDIC to pay rebates would create a self-correcting mechanism to control the growth of the fund. The higher the fund gets, the larger the rebate. Thus, should the fund continue to grow, rebates eventually would exceed assessment income and provide a brake on the growth of the insurance fund.

RECOMMENDATION NUMBER FOUR: MERGE THE BANK INSURANCE FUND AND THE SAVINGS ASSOCIATION INSURANCE FUND. We have recommended this for years, in large part because the resulting fund would be a stronger, more diversified fund.

RECOMMENDATION NUMBER FIVE: INDEX DEPOSIT INSURANCE COVERAGE FOR INFLATION SO THAT DEPOSITORS DON'T SEE THE REAL VALUE OF THEIR COVERAGE ERODE OVER TIME. While Congress should decide on the initial coverage level, indexing would provide a systematic method of maintaining the real value of deposit insurance coverage.

It is important for these five recommendations to be implemented as a package. Picking and choosing among the parts of the proposal could weaken the deposit insurance system, magnify economic instability, and distort economic incentives. In particular, the ability to price for risk is essential to an effective deposit insurance system, and must be included in any reform package.

Thank you.

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FEDERAL DEPOSIT INSURANCE CORPORATION, Washington DC 20429

DONNA TANOUE
CHAIRMAN

May 16, 2001

Honorable Spencer Bachus
Chairman
Subcommittee on Financial Institutions
and Consumer Credit
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you for the opportunity to testify today before the Subcommittee on Financial Institutions and Consumer Credit on the subject of deposit insurance reform.

It has been brought to my attention that I misstated a statistic in response to a question regarding whether banks with CAMEL ratings of 1 or 2 pose a risk of loss to the deposit insurance fund. My response was that during the last banking crisis, approximately 47 percent of the banks that failed had a CAMEL rating of 1 or 2 just two years prior to failure. The correct statistic should have been that of the more than 1,600 banks that failed in 1980 – 1994, 36 percent had CAMEL 1 and 2 ratings two years before failure. Even under the corrected failure percentage, the facts clearly demonstrate that an institution's current high CAMEL rating is not a guarantee that an institution will not fail in the near future. Thus, we believe that all institutions should pay at least a small risk-based premium regardless of the level of the fund.

I apologize for this inaccuracy, and ask that the hearing record be corrected on this point.

Sincerely,

Donna Tanoue

Donna Tanoue
Chairman

cc: Honorable Maxine Waters

Testimony of

James E. Smith

On Behalf of the

American Bankers Association

Before the

Subcommittee on Financial Institutions and Consumer Credit
of the
Financial Services Committee

United States House of Representatives

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Mr. Chairman, I am James E. Smith, Chairman and CEO of Citizens Union State Bank and Trust, in Clinton, Missouri, and President-Elect of the American Bankers Association (ABA). I am pleased to be here today on behalf of the ABA. ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional, and money center banks and holding companies, as well as savings institutions, trust companies, and savings banks – makes ABA the largest banking trade association in the country.

I would like to thank you, Mr. Chairman, for holding this hearing to examine some key issues related to the Federal Deposit Insurance Corporation (FDIC). Assuring that the FDIC's deposit insurance funds remain strong is of the utmost importance to the banking industry. Over the past decade, commercial banks and savings associations have gone to extraordinary lengths to rebuild the insurance funds, contributing $36.5 billion to ensure that the insurance funds are well capitalized. With the Bank Insurance Fund (BIF) at nearly $31 billion and the Savings Association Insurance Fund (SAIF) at nearly $11 billion at year-end 2000 – ***representing over $41 billion in financial resources*** – it is safe to say that FDIC is extraordinarily healthy.

The outlook is also excellent. There have been few failures, and the interest income earned by BIF and SAIF (nearly $2.5 billion per year) is roughly three times the FDIC's cost of operation. As interest income continues to exceed expenses, the BIF and SAIF are likely to continue to grow further beyond the designated reserve ratio mandated by Congress. Moreover, the banking industry is extremely well capitalized, adequately reserved for potential losses, and profitable.

With the deposit insurance funds so strong, now is an appropriate time to consider how we might improve the overall system. Since testifying last year before this subcommittee, the ABA has

held extensive discussions with commercial banks and savings institutions, as well as with Members of Congress and their staffs, and the FDIC in order to facilitate the development of an approach that would both strengthen the system and be acceptable to a broad range of parties. The FDIC in particular, under the leadership of Chairman Tanoue, has done an excellent job developing an approach that addresses many of the key issues. While we do not agree with every detail in the FDIC's report – ***and are particularly concerned about the possibility of increasing premiums*** – we believe that the report can serve as a basis for congressional action.

The ABA has stated for the past year that a bill to strengthen the FDIC is likely to be enacted only if an industry consensus in support of such legislation can be developed. As you will see today, while some differences remain, the positions of the ABA, America's Community Bankers and The Independent Community Bankers of America are very similar. These three associations have agreed that we should discuss the issues together on an ongoing basis and work together with this committee to develop legislation that would have broad support.

I would add that while there is a general belief among most bankers that we should work with Congress to strengthen the FDIC, there is also concern that such legislation could evolve to increase banks' costs or to become a vehicle for extraneous amendments. If that were to be the case, we have no doubt that support would quickly dissipate. Fortunately, we also believe working together, we can see a consensus bill develop that can have broad bipartisan support.

In my testimony today, I would like to make several key points:

- ***Today's System is Strong and Effective, But Some Improvements Could Be Made***. It is the position of the ABA that we have a workable deposit insurance system that has the confidence of depositors and banks. However, there are areas that can be improved. Any reform should strengthen and improve the deposit insurance system, enhance the safety and soundness of the banking system, and improve economic growth.

- ***A Comprehensive Approach Is Required***. Because deposit insurance issues are intrinsically interwoven, any changes must consider the overall system. For example,

any consideration of changes to the risk-based authority of FDIC must be paired with a formula for rebating excesses in the insurance fund.

- ***Changes Should Only Be Adopted If They Do Not Create Large Additional Costs To The Industry.*** The ABA will work to develop and support a consensus position, but ABA will oppose deposit insurance legislation that imposes significant new insurance costs or contains negative add-on amendments not material to deposit insurance reform.

I would like to discuss these points more fully, and in the process, discuss specific issues.

Today's System is Strong and Effective, But Improvements Could Be Made

For over 65 years, the deposit insurance system has assured depositors that their money is safe in banks. The financial strength of the FDIC funds is buttressed by strong laws and regulations including prompt corrective action, least cost resolution, risk-based capital, risk-based premiums, depositor preference, regular exams and audits, enhanced enforcement powers and civil money penalties. Many of these provisions were added in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) and the FDIC Improvement Act of 1991 (FDICIA).[1] Taken together, these provisions should reduce the number of bank failures, lower the costs of those that do fail, and ensure that the FDIC will be able to handle any contingency. Even more important is that the ***banking industry has an unfailing obligation – set in law – to meet the financial needs of the insurance fund.***

Simply put, the system we have today is strong, well capitalized and poised to handle any challenges that it may encounter for decades to come. As with any system, there is room for improvement. We would propose three litmus tests for any reform: (1) it should strengthen and improve the deposit insurance system; (2) enhance the safety and soundness of the banking system; and (3) improve economic growth.

[1] See Apprendix A for details of these significant safeguards under current law that protect the FDIC funds.

A Comprehensive Approach Is Required

Last year in our testimony, we strongly urged that any approach to reforming the FDIC be done in a comprehensive manner. A piecemeal approach would not only leave some important reforms undone, but worse, could lead to unintended problems. Since last year, support for a comprehensive approach has clearly grown. We are pleased that the FDIC's proposal is comprehensive and acknowledges the important interactions between issues. In this section of my testimony, I want to give you ABA's perspective on what constitutes a comprehensive approach. We recognize that no bill is likely to cover in full all of the issues discussed below, but we respectfully suggest that all of them should be on the table for consideration.

Mutual Approach

The ABA believes consideration should be given to the ***concept*** of converting the current insurance program to a mutual approach in which banks are provided with some type of ownership interest. Under such an approach, dividends would be paid based on the ownership interest. These dividends can be used to offset premiums owed by individual institutions and would, under certain circumstances, exceed the premiums due. In addition, the mutual approach will help address the issue of new and fast growing institutions paying no premiums, since such institutions will not have the same dividend stream to offset premiums due. A great deal more work needs to be done to develop a specific proposal. We are pleased to see the outlines of such an approach in the FDIC's proposal.

Deposit Insurance Limit

As ABA stated last year before this subcommittee, the current $100,000 insurance limit – set in 1980 – has lost over half its value when adjusted for inflation. As a consequence, it is more difficult, particularly for smaller institutions, to raise sufficient amounts of funds to meet loan demand in their communities. For many banks, sources of funding is the number one issue. Recent increases in loan-to-deposit ratios demonstrate that many community banks are searching for funds to support loan demand. In discussing this issue, three items deserve consideration: (1) indexing

the insurance limit to account for inflation; (2) raising the insurance limit above the current $100,000; and (3) providing additional coverage to IRAs and other retirement accounts held at banks. Let me briefly discuss each in turn.

Indexing: There is general support within the banking industry for permanently indexing the level of deposit insurance coverage. Under an indexing system, the insurance limit would be automatically adjusted from time-to-time, based on changes in an appropriate index. These changes should be in level increments – e.g., five thousand dollars – to avoid consumer confusion. Without indexing, the insurance level constantly falls behind inflation, as Congress cannot be expected to regularly pass increases.

Base for Indexing: There has been a great deal of discussion within the banking industry, as well as in the Congress and the regulatory agencies, about the appropriate year to use as the base for beginning any inflation adjustment. For example, as the FDIC has pointed out, if the base chosen were 1980 (when the limit increased from $40,000 to $100,000), the insurance level would be approximately $200,000 today to account for inflation; if 1974 were chosen (when the limit was increased from $20,000 to $40,000), the new limit would be approximately $140,000.

In discussions with bankers over the last year on this topic, two questions emerged about increasing the coverage level: (1) what are the potential economic costs; and (2) how many new deposits might flow into the banking system? To help answer these questions, ABA hired Professor Mark Flannery of the University of Florida. Dr. Flannery's study was extremely helpful in understanding the potential economic benefits and costs of various increases in the deposit insurance level.

The study concluded – based on research conducted separately with bankers, individuals and small business owners – that doubling coverage could result in net new deposits to the banking industry of between 4 percent and 13 percent of current domestic deposits, with the lower end of the range more likely, in Flannery's opinion. These hypothetical new deposits, plus the added protection that existing deposits (between $100,000 and $200,000) would receive, would lower the BIF-SAIF reserve ratio below the required 1.25 percent. This would eliminate the $3 billion

cushion that exists today and would, under current law, require a 3-13 basis point assessment on all domestic deposits to return the ratio to 1.25 percent.[2]

This study – the first attempt to assign real numbers to a complicated and theoretical concept – stimulated considerable discussion in the banking industry. Several points of view emerged: First, there are many bankers who strongly believe an increase to $200,000 is important to improve their access to funding and that the benefit would exceed the potential cost. Second, there are also many bankers who are very concerned about the loss of the current buffer above the 1.25 percent reserve ratio and the potential for premium increases that would accompany a doubling of the insurance limit. Third, there are bankers who expressed concerns about the political acceptability of such an increase.

Taking these points of view into consideration, we believe that it is reasonable to increase the current limit to the maximum possible that can be achieved without incurring significant costs that would outweigh the value of the increase. However, the bottom line is that we need to develop a comprehensive bill that addresses the key issues outlined in this statement and in the FDIC's proposal and that can also be enacted. We do not know where many of you on this subcommittee stand on the issues, nor do we know the Administration's position. We do know this is a controversial issue and therefore want to work with you to see what approach can be developed that can have broad support.

Retirement Savings: The ABA believes Congress should also consider the possibility of a higher level of insurance for long-term savings vehicles, such as IRAs, Keoghs and any future private social security accounts. These are long-term investments that tend to grow considerably over time, frequently exceeding the current $100,000 limit. For example, at an interest rate of 6 percent, even an annual deposit of $2,000 in an IRA would grow with compounding to over $110,000 in 25 years. And because stock market volatility may be particularly worrisome to retirees, the security of insured deposits is very appealing. Moreover, these deposits represent a very important, stable funding source for bank lending.

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[2] The full study is available at aba.com.

A differential for retirement savings accounts is not a new concept. In fact, in 1978, Congress passed the Financial Institutions Regulatory and Interest Rate Act that provided IRA and Keogh accounts coverage up to $100,000 – ***two-and-a-half times*** the $40,000 limit that was in place at that time. The Senate Banking Committee Report on the Act justified the differential coverage this way: "The committee believes that an individual should not have to fear for the safety of funds being saved for retirement purposes." Such a concern is as important today as it was then.

Capping the Insurance Fund and Expanding the Rebate Authority

The ABA has long advocated that the insurance fund should be capped and the rebate authority expanded. Not only are the BIF and SAIF currently fully capitalized, they are $3.5 billion over the 1.25 percent designated reserve ratio (DRR) set by Congress following the difficulties in the 1980s. Moreover, with interest income exceeding the FDIC's operating expense by $1.5 billion a year, it is highly likely that the insurance funds will continue to grow. The compounding effect will mean even greater rates of growth in the future. We believe the FDIC's proposal – ***which for the first time acknowledges the importance of rebates as a check on excessive growth of the fund*** – is a tremendous step forward. While in the past we have advocated direct rebates, a dividend approach accomplishes the same purpose and ABA supports that approach.

The funds held in excess of the DRR are not necessary to ensure the soundness of the deposit insurance system. As I mentioned above, the FDIC has the authority to adjust premium levels and has significant regulatory powers over depository institutions to ensure that the FDIC can meet any funding contingency. Even more important, the ***banking industry is legally obligated to meet the financial needs of the insurance fund.*** Simply put, limiting the size of the fund and expanding the rebate or dividend authority will not affect the FDIC's ability to meet any future obligations to insured depositors.[3]

On the other hand, allowing the FDIC to continue to hold excess funds represents a significant loss of lendable funds for banks in the communities they serve. I can tell you as a banker that I certainly can put rebates to good use in my community providing loans and services to

[3] See Appendix A for details of additional FDIC powers and authorities.

my customers. This will have a far greater positive impact on economic conditions in Clinton, Missouri, than if that money sits in the government's coffers in Washington.

As noted above, we believe that viewing the FDIC more as a mutual insurer will naturally lend itself to a rebate system, through the payment of dividends from the fund. While the details of a cap and dividend system need to be worked out, we believe the 1.40 percent cap proposed in H.R. 4082 and S. 2293 (as introduced in the last Congress) is a reasonable point at which to cap the funds.

Premiums From New and Fast Growing Institutions

Most bankers believe there is an inherent unfairness in the current system that allows new and fast growing institutions to pay no premiums, even though their growth materially dilutes the coverage reserve ratio of the insurance funds. These new and fast growing institutions should be required to pay premiums. For many bankers this has become a top priority in FDIC reform. This problem can be addressed through a combination of a dividend/rebate system under the mutual approach and a newly structured risk-based system, such as that proposed by the FDIC.

Municipal Deposits

In a number of states municipal deposits are a significant source of funding, particularly for community banks. However, collateral requirements for municipal deposits often entail a costly administrative burden and have a very large opportunity cost by tying up funds in securities that could otherwise be used for additional lending in the community. This situation varies by state. The ABA will continue to work on suggestions for addressing collateral requirements.

A number of bankers advocate a hundred percent insurance on municipal deposits, or at least on local municipal deposits. The ABA recognizes that 100 percent raises significant economic and political concerns due to "moral hazard" questions and the political resistance to such an approach. Nevertheless, there is precedent under current deposit insurance practices for a differentiation between municipal and other deposits. Therefore, we believe consideration should be given to

providing additional coverage or perhaps granting banks the option to purchase additional insurance for municipal deposits. Any such additional insurance should be limited to some preset level and some definition of local deposits, and the cost of such additional insurance should fully cover any additional risk to the insurance fund.

Too Big To Fail

The ABA has long opposed the too-big-to-fail doctrine and worked with the Congress and regulators to include the limits on its use contained in FIRREA and FDICIA. Nevertheless, important aspects of this doctrine continue to exist. Deposit insurance reform provides an opportunity to revisit the too-big-to-fail doctrine, and hopefully, eliminate it fully.

Merger of the Funds

In the context of comprehensive reform, a merger of SAIF and BIF would be appropriate.

Risk-Based Premiums

In the context of comprehensive reform, the ABA is willing to work with the FDIC to develop an enhanced risk-based structure. However, we want to ensure that the new structure does not result in additional subjectivity or increased premium costs to the industry. Moreover, we oppose any change in the risk-based system that does not link the system to a cap and rebate/dividend plan.

Finally, we want to emphasize that we cannot support, and would oppose, any new approach that results in material additional premium costs to those banks which are currently paying no premiums and which grow at normal rates. The example used by the FDIC in its report would, for example, result in unacceptable material premium increases for many banks. We see no justification for such increases when the insurance funds are above the required reserve ratio.

Smoothing Out Premiums

The FDIC is recommending that the "hard" 1.25 percent designated reserve ratio trigger be softened so that the industry would not be charged very high premiums all at once if the fund falls significantly below the 1.25 percent level. The ABA believes there is merit to smoothing premiums as long as it does not result in additional net premium payments over the long run.

We are troubled by the suggestion in the FDIC's proposal that a band around the 1.25 DRR be established under which no rebate (if over-funded) or surcharge (if under-funded) would be provided. The FDIC would still charge regular premiums within this band. If the goal is always to return to the DRR level, then there should be no band around that level. Since the majority of the time there are few failures and losses, the fund will generally be above the upper level of the band. In effect, this would set a new *de facto* reserve level and would ignore the billions of dollars in lost lending opportunities of over-funding the FDIC.

Moreover, since it is more likely that the fund would be over- rather than under-capitalized, it may be appropriate to consider an asymmetric approach. We suggest a system that would have a more aggressive rebate provision (returning excess funding more quickly) and a less aggressive surcharge provision (thus rebuilding the fund at a slower pace). This kind of asymmetric approach recognizes the opportunity cost of excess funding and the negative impact on lending and the economy that high premiums can have under periods of economic stress.

Independent FDIC Board

Consideration should be given to changing the FDIC Board to make sure it is truly independent, as it is designated to be. The most direct way to do that would be to have three independent board members. Since the board was expanded to five members in FIRREA, more often than not, there have been vacancies on the board. The vacancies tend to be the "outside" seats because the seats held by the Comptroller of the Currency and the head of the Office of Thrift Supervision are always filled (either by the comptroller or the head of OTS or acting directors of those organizations). Thus the Administration has generally had half of the Directors. Such an

imbalance threatens the independence of the FDIC and could politicize decisions. Returning to a three-member independent board – which served the FDIC for well over 50 years – should be considered as part of a comprehensive approach to reform.

Conclusion

Mr. Chairman, we are prepared to work with you and the members of this subcommittee to find the best solution to these critical issues. We think this is an excellent time to begin that process – with the industry and the FDIC in excellent health. We sense there is a growing consensus on issues to be addressed and approaches to these issues. We look forward to working with you to see if we can develop legislation to make the FDIC insurance system even stronger.

Appendix A

Capping the insurance fund and providing rebates will not limit the FDIC's ability to meet any contingency. The FDIC has great flexibility to manage the funds to maximize effectiveness, and there are many existing laws that help protect the funds. For example, consider:

Reserves for Future Losses: FDIC has great flexibility to adjust reserves for future losses. This reserve fund is **subtracted** from the fund balance when calculating whether the fund is fully capitalized – i.e., if the fund balance is at least 1.25 percent of insured deposits. Obviously, the larger the reserve for future losses, the smaller the fund balance. Once the fund balance falls below 1.25 percent of insured deposits, premiums must be charged by the FDIC to fully capitalize the fund. Thus, if FDIC anticipates greater potential losses, it can merely set aside reserves, potentially creating a situation where banks would have to pay premiums to maintain the capitalization level of the fund. The FDIC has suggested that this "hard" target of 1.25 percent be "softened" allowing a slower recapitalization than possible under current law. It is important to note that even with such a change, the FDIC still would be able to set aside reserves for future losses, thereby affecting the level of the fund relative to the 1.25 percent level.

Authority to Raise the Designated Reserve Ratio (DRR): The FDIC has the authority to raise the DRR if it can document that it is justified for that year "by circumstances raising a significant risk of substantial future losses to the fund." By raising the DRR, the FDIC would likely be raising the assessments necessary to maintain that new higher level. Thus, if the FDIC foresees problems, it has this additional authority to easily deal with the situation.

Risk-Based Premiums: Risk-based premiums were authorized in 1991 by Congress and implemented in 1993. Several important points should be made: First, the risk-based system provides an automatic self-correcting mechanism. If industry conditions deteriorate and banks' capital falls or supervisory concerns arise, a higher risk-premium is charged and more income is received in the fund. The FDIC has been critical of the fact that nearly 92 percent of the industry falls in the top-rated category and therefore pays no premiums. On the contrary, the incentives are such that nearly all banks want to be in this top category, and given the economic performance of

the economy and the banking industry over the last decade, it's no wonder that such a high percentage enjoys the benefits of such a rating.

Second, the FDIC has made additional changes to the risk-based system designed to identify patterns that signal future problems for individual banks. This should serve to improve the sensitivity of the risk-based system to changes, and build in the automatic adjustments sooner than would otherwise have been the case.

Mandatory Recapitalization: If the reserve ratio falls below the DRR, the banking industry must immediately rebuild the fund back to the DRR. If the rebuilding is expected to take longer than one year, a mandatory recapitalization plan at very high assessment rates (minimum 23 basis points of domestic deposits) must be established. Thus, if the industry continues to grow, the practical impact is that the fund balance will never fall below 1.25 percent of insured deposits for any length of time. ***In dollar terms, the fund would therefore always be over $35 billion.*** We agree with the FDIC that in times of stress, high premiums that would be required to maintain the DRR may be counterproductive. Moreover, a "hard" 1.25 percent level means that the benefits of such a large fund cushioning the shock of bank failure losses is lost. While maintaining a level of capitalization is important to preserving depositor confidence, proposals that would require a slower re-building would be beneficial to maintaining credit availability during difficult economic times. Again, it is worth noting that the reserves of future losses, mentioned above, provide a cushioning effect and should mitigate large upward swings in premiums.

Additional Authorities that Protect FDIC

Beyond the flexibility to adjust the deposit insurance funds to meet any contingency, there are other important laws and regulations that have fundamentally changed the operating environment for FDIC. ***Taken together, these provisions lower the probability of banks failing and reduce the cost to the FDIC from those that do fail.***

- ***Prompt corrective action:*** This established mandatory regulatory actions as capital levels fall below the minimum requirements.

- ***Critically Undercapitalized institutions:*** This requires mandatory conservatorship or receivership of institutions with capital less than 2 percent. Theoretically, if receivership takes place, the FDIC should suffer no losses on the institution at all.

- ***Holding Company Guarantees/Cross Guarantees:*** This requires the holding company to guarantee compliance with recapitalization plans of the bank and puts losses on sister banking institutions of a holding company in the event that one bank subsidiary fails. By expanding the obligation to cover losses, the FDIC effectively reduces its loss exposure.

- ***Depositor Preference:*** This law elevates the FDIC's claim above general creditors (standing in place of the insured depositors that it has made whole) in the receivership of any failed bank. This superior claimant position will certainly lower resolution costs to the FDIC.

- ***Rules Restricting Too-Big-To-Fail:*** FDIC may not take any action, directly or indirectly, that causes a loss to the insurance fund by protecting depositors for more than the insured portion of deposits or by protecting creditors other than depositors.[4]

- ***Emergency Special Assessment Authority:*** This authority requires the industry to repay any borrowing by FDIC and for any other purpose deemed necessary.

- ***"Least-Cost Rule":*** This requires the FDIC to resolve failures in the least costly manner of all alternatives.

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[4] There is a "systemic risk" exception to advance funds if needed to prevent a severe economic effect (upon a determination by the Secretary of the Treasury, in consultation with the President and written recommendation from the FDIC and the Fed). Any costs would be an obligation of the banking industry on a broader base of assets minus tangible capital and sub debt. Also, the Federal Reserve is restricted from providing discount window lending to "undercapitalized" institutions or those with CAMEL 5 ratings. This has the effect of preventing delays that would allow large, uninsured deposits to run before the bank was closed. This provision also extends discount window lending to other nonbank firms for emergencies.

- ***Line of Credit Expanded:*** The 1989 law increased the FDIC's line of credit to the Treasury from $5 billion to $30 billion and made it mandatory for the industry to repay any borrowing.

Simply put, limits on the size of the insurance fund and expanding the rebate authority poses no concern to the FDIC funds – existing laws and regulations provide the needed flexibility to meet any financial obligation that may arise.

Oral Statement of James E. Smith
On Behalf of the American Bankers Association

May 16, 2001

I want to thank you, Mr. Chairman, for holding this hearing. Assuring that the FDIC remains strong is of the utmost importance to the banking industry. Over the past decade, the industry has gone to great lengths to assure the insurance funds are strong. In fact, with $41 billion in financial resources, the FDIC is extraordinarily healthy.

The outlook is also excellent. There have been few failures, and the interest income on BIF and SAIF easily exceeds the FDIC's cost of operation. Thus, now is a good time to consider how we might improve an already strong and effective system.

I would like to commend the FDIC, under the leadership of Chairman Tanoue, for developing an approach to the key issues. While we do not agree with every detail in the FDIC's report – ***and are particularly concerned about the possibility of increasing premiums*** – it provides a reasonable basis for congressional discussion.

An industry consensus is key to any bill being enacted. As you will see today, while some differences remain, the positions of the ABA, America's Community Bankers and The Independent Community Bankers of America are very similar. Our three associations have agreed to discuss the issues together and work with this committee to develop legislation that would have broad support.

I would add that while there is willingness to work with Congress, we do have concerns that such legislation could increase banks' costs or to become a vehicle for extraneous amendments. If that were to be the case, support among banks would quickly dissipate.

In my testimony today, I would like to make several key points:

First, ***today's system is strong and effective, but some improvements could be made.*** The current system of deposit insurance has the confidence of depositors and banks. Its financial strength is buttressed by strong laws and regulations, including prompt corrective action and enhanced enforcement powers, just to name a few. Even more important is that the ***banking industry has an unfailing obligation to meet the financial needs of the insurance fund.*** Simply put, the system we have today is strong, well capitalized and poised to handle any challenges that it may encounter.

Second, a comprehensive approach is required as improvements are considered.. Because deposit insurance issues are interwoven, any changes must consider the overall system. A piecemeal approach would not only leave some important reforms undone, but worse, could lead to unintended problems. Since last year, support for a comprehensive approach has clearly grown. We are pleased that the FDIC's proposal is comprehensive and acknowledges the important interactions between issues.

A comprehensive reform system should include, among other things, a mutual ownership approach for determining rebates; permanent indexing of the insurance limit; consideration of an increase in the $100,000 level, but one that does not result in significant costs that would outweigh the value of the increase; a higher level of coverage for IRAs and Keoghs; some method to address the issue of fast growing institutions; and a cap on the fund and expanded rebate authority. On this last point, I would like to thank Mr. Lucas and Mr. Watt for introducing their bill that caps the fund and uses rebates to pay the FICO premium.

My third point is that ***changes should only be adopted if they do not create material additional costs to the industry***. The current system is strong and we see no reason why changes should be made that impose significant new costs or additional burdens on the industry. For instance, the example used by the FDIC in its report would result in unacceptable premium increases for many banks. We see no justification for such increases when the insurance funds are above the required reserve ratio.

Mr. Chairman, we are prepared to work with you and the members of this subcommittee to pass a reform package that will enhance the safety and soundness of the deposit insurance system.

Testimony of

America's Community Bankers

on

Federal Deposit Insurance Reform

before the

Subcommittee on Financial Institutions and Consumer Credit

of the

Financial Services Committee

of the

United States House of Representatives

on

May 16, 2001

David Bochnowski
Chairman and CEO
Peoples Bank, SB
Munster, Indiana

and

Chairman
America's Community Bankers
Washington, DC

Mr. Chairman and Members of the Committee, I am David Bochnowski, Chairman, President and CEO of Peoples Bank in Munster, Indiana. Our headquarters are in northwest Indiana, near the industrial cities of Gary and East Chicago.

I am here today representing America's Community Bankers (ACB)[1] as ACB's chairman. ACB is pleased to have this opportunity to present our views on deposit insurance reform. Our testimony will cover the issue in three parts: 1) the current policy making climate; 2) the most urgent issue; and 3) key elements of ACB's comprehensive recommendations. Our complete recommendations, which we provided to the FDIC in December of last year, are included in "Deposit Insurance Reform for a New Century: A Comprehensive Response to FDIC Reform Options." A copy of that report is attached to my written testimony.

Bankers have varying views on deposit insurance reform, but let me assure this committee that we are engaged in an open and constructive a dialogue. The staffs of our associations have met to begin a more detailed discussion of our respective policy positions. The entire industry has every incentive to cooperate, because the safety and soundness of the deposit insurance system is important to our customers and the nation's economic health.

Current Climate

Congress faces a good policy making climate for deposit insurance reform. The deposit insurance system faces challenges and problems, but they are manageable provided that action is taken promptly on the most urgent matters. As FDIC Chairman Donna Tanoue has said, the time to fix the roof is when the sun is shining. From our point of view, the outlook is partly to mostly sunny – for now. What accounts for this favorable outlook? There are several economic and policy factors which help explain it:

- In 1989 and 1991 Congress significantly strengthened our financial system by requiring bank regulators to take prompt corrective action if an institution falls below specific capital levels.
- In 1995 the FDIC's Bank Insurance Fund (BIF) reached its statutory minimum reserve ratio of 1.25 percent of insured deposits and has remained above it ever since.
- In 1996 Congress enacted the Deposit Insurance Funds Act that required the industry to pay a one-time assessment of $4.5 billion that brought the FDIC's Savings Association Insurance Fund (SAIF) up to its statutory minimum reserve ratio, where it remains well above today.
- The strong economy has helped banks maintain strong capital levels, minimized the FDIC's losses from failures, and allowed the insurance funds to grow significantly through earnings.

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[1] ACB represents the nation's community banks of all charter types and sizes. ACB members pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

- The Gramm/Leach/Bliley Act of 1999 modernized the structure of the nation's financial system and resolved issues that had been sources of contention for decades.

Under Chairman Tanoue's leadership, the FDIC took advantage of this favorable climate to undertake a broad-based look at deposit insurance issues. The FDIC's August 2000 Options Paper provided the industry and other interested parties a thorough framework to use in sorting out their views on the issues. ACB commends Chairman Tanoue for taking this important initiative. Her work will leave a lasting legacy.

The Most Urgent Issue

The most urgent deposit insurance issue that we face today stems not from a weakness in the system, but ironically, from its strength. Both the BIF and SAIF are above their statutorily required 1.25 percent ratio, so the FDIC does not currently charge a premium to healthy institutions. A few companies are taking advantage of that situation by shifting tens of billions from outside the banking system into insured accounts at banks they control. Unfortunately, the magnitude of these deposit shifts dilutes the deposit insurance funds and reduces the designated reserve ratio. The problem is not that the FDIC is holding fewer dollars – BIF and SAIF balances are stable – but that those dollars are being asked to cover a rapidly rising amount of deposits in a few institutions. As FDIC Chairman Tanoue recently said, "other banks can rightly say that they are subsidizing insurance costs for these and other fast-growing banks."[2]

The situation could worsen. Under current law, if a fund falls below the 1.25 percent reserve requirement and the FDIC does not expect it to return within a year, all insured institutions would have to pay a 23 basis point premium (23 cents for every $100 of deposits). For a community bank with $100 million in deposits, that equals $230,000. For my bank the cost would be over $800,000. These premiums likely could come at the worst possible time – when the national economy and some local economies are shifting to a different pace. Whenever they might come, they would divert resources from communities and shift them to Washington.

How much does this free-rider problem amount to? In 2000, Merrill Lynch swept $36.5 billion from its Cash Management Accounts into insured accounts at its two affiliated banks, effectively reducing the BIF reserve ratio by 2.15 basis points. Merrill has swept an additional $11 billion into those banks this year. If all of that is insured, it would have reduced BIF's reserve ratio by another 0.65 basis points.

Another major firm, Solomon Smith Barney (an affiliate of Citigroup), has swept a total of $17 billion into its BIF- and SAIF-insured affiliates this year. Citigroup has a total of 6 separate FDIC-insured charters, making this program especially attractive to large investors seeking the protection of federal deposit insurance.

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[2] Speech, May 10, 2001 (p.2)

ACB does not object to a growth in insured deposits. These firms' activities are perfectly permissible under the current law. But they are diluting the funds and reducing the designated reserve ratio. Without this dilution, the reserve ratio could actually have increased, rather than fallen.

Because of these high-growth programs, long-established and stable institutions in every state could be forced to pay premiums. These institutions collectively paid billions into the FDIC in the late 1980s and 1990s. Each year, all FDIC-insured institutions paid approximately 23 basis points – again, $230,000 for each $100 million in deposits – $920 million for my bank. And in 1996 SAIF-insured institutions paid an additional 66 basis points – a total of $4.5 billion. My bank's share of that was $1.6 million. Those substantial payments brought the FDIC back to health. Now, these premiums are being used, in effect to cover new deposits at a few rapidly growing institutions.

What can be done about this situation? Fortunately, there is a ready solution to this problem. Reps. Bob Ney and Stephanie Tubbs Jones have introduced the Deposit Insurance Stabilization Act (H.R. 1293). This bill has three key features:

- **Permitting the FDIC to impose a fee on existing institutions for excessive deposit growth so that the required reserve ratio can be maintained.**
  Currently, the FDIC may impose an excessive deposit growth fee on new institutions or new branches. By allowing the FDIC to impose fees on existing institutions, H.R. 1293 would address the current "free-rider" problem.

- **Merging the BIF and the Savings Association Insurance Fund (SAIF).**
  According to the FDIC, merging the BIF and the SAIF would create a more stable, actuarially stronger deposit insurance fund. In addition, if the funds were merged today, the reserve ratio of the combined fund would be a healthy 1.37 percent (the BIF's reserve ratio has fallen to 1.35 percent, while the SAIF's reserve ratio is 1.44 percent).

- **Allowing for flexible recapitalization of the deposit insurance fund.**
  If the reserve ratio of the merged fund falls below the required level of 1.25 percent, the bill would give the FDIC flexibility in recapitalizing the fund over a reasonable period of time. By repealing the automatic assessment of 23 basis points, H.R. 1293 would give the FDIC authority to use a laser beam approach, rather than a sledgehammer, to recapitalize the insurance fund.

ACB believes that Congress should act quickly on this legislation to help ensure the continued strength of the FDIC and prevent the unnecessary diversion of billions of dollars away from community lending to homeowners, consumers, and small businesses. Acting on this bill now would not preclude action on broader deposit insurance reform. In fact, H.R. 1293 is an excellent place to begin the comprehensive reform process. Other issues could be taken up later this year or – if non-controversial – included in H.R. 1293. By stabilizing the system, this bill

would provide Congress an excellent starting point as it debates broader deposit insurance reform issues.

Overview of Comprehensive Reform

Like the FDIC, ACB strongly supports comprehensive deposit insurance reform. We were the first major trade association to provide the FDIC with a complete analysis and recommendations on all the issues the agency raised in its August 2000 Options Paper. Our complete recommendations are included in the booklet distributed to the subcommittee along with this statement.

We are pleased that many of the FDIC's recommendations are consistent with our own, though they differ in one key respect. We agree on: merging the Bank Insurance Fund and the Savings Association Insurance Fund; giving the FDIC flexibility to gradually recapitalize the fund in the event of a shortfall; establishing rebates based on past contributions; and indexing coverage levels.

However, unlike the FDIC, ACB does not believe that the highest-rated institutions should be required to pay premiums when there are ample reserves in the fund. Rather, as provided in the Ney/Tubbs Jones bill, ACB recommends that the FDIC have the authority to assess a special premium on the excessive growth by existing institutions (such as has occurred in banks owned by Merrill Lynch), if necessary to maintain an adequate reserve. (The law already gives the FDIC such authority for new institutions and branches.)

Summary of Recommendations

ACB's ideal scenario for the deposit insurance system includes creation of a single, stronger Deposit Insurance Fund through a merger of BIF and SAIF. The fund would continue to grow through a combination of earnings and risk-based premiums. The highest rated institutions would not be assessed as long as the fund remained above the statutory minimum of 1.25 percent of insured deposits. Once the fund reaches a new ceiling that would be set by Congress (after close consultation with the FDIC), the FDIC would provide risk-based rebates of any excess funds. The FDIC would have the discretion to adjust this ceiling well-defined strict standards and procedures.

If the fund fell below the statutory 1.25 percent reserve ratio, the FDIC should be allowed to spread the recapitalization over a reasonable period. (Current law requires the FDIC to impose a 23 basis point premium to make up a shortfall that it expects will persist for a year.) This would allow the FDIC to balance the goals of replenishing the fund and maintaining a healthy banking system. Furthermore, this would truly allow the FDIC to manage the insurance fund more effectively

To maintain the integrity of the system, institutions that grow at rates significantly above the industry average in a manner that significantly dilutes the fund should pay a special premium

on their excess growth. This would not apply to relatively small, *de novo* banks or to institutions that acquire existing insured deposits. It would not discourage regular competitive growth by established institutions or the formation of new competitors. However, it would deal with institutions that dilute the deposit insurance fund's reserve ratio by precipitately moving large amounts of funds under their effective control from uninsured to insured status.

ACB also recommends indexing the coverage levels to help maintain the role of deposit insurance in the nation's financial system. Congress should use as a base the last time it adjusted coverage primarily for inflation, which was done in 1974. At that time, it increased coverage to $40,000. If adjusted for inflation since that time, the current coverage limit would be approximately $135,000, according to the FDIC.

To recognize the increasingly important role that individual retirement savings plays in the economy and in our pension system, ACB recommends that Congress substantially increase the separate deposit insurance coverage for IRA, 401(k), and similar retirement accounts.

Detailed Recommendations

Congress should set a ceiling on the fund

ACB recommends that Congress set a ceiling on the deposit insurance fund's designated reserve ratio (DRR), giving the FDIC the ability to adjust that ceiling using well-defined standards after following full notice and comment procedures.

In deciding the actual ceiling amount, ACB recommends that Congress ask the FDIC to provide it with a firm recommendation on where it should set a statutory ceiling. The agency has already done considerable historical analysis on the level of the funds and income needed to maintain them.[3] Clearly, the agency could adapt that analysis to determine a reasonable ceiling to recommend to Congress.

ACB agrees with former Chairman Helfer's comment:

> I believe it is possible for the FDIC to develop analytical tools that will permit it to identify a ceiling on the funding needs of the deposit insurance system at any particular time -- a DRR that would change as circumstances change....The purpose of establishing a ceiling DRR is so that insurance funds will not grow beyond a size that can be justified on the basis of the needs of the deposit insurance system, thereby withdrawing capital from banks who could have contributed to economic growth by leveraging those funds to meet the economic needs of their communities. Amounts accumulated in the system over and above the DRR ceiling should be rebated to banks to facilitate economic activity, which benefits every one.[4]

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[3] 60 Fed. Reg. 42680 (Aug. 16, 1995).

[4] The Deposit Insurance System: What Reforms Make Sense?; Ricki Helfer, December 4, 2000; Address to America's Community Bankers, pp. 9-10 (Helfer, Dec. 4, 2000)

Congress should give the FDIC flexibility to adjust the ceiling. However, the agency should have to meet clearly stated standards before adopting a change. The FDIC should be required to find that a higher level is needed to meet a substantial and identifiable risk to the fund or the financial system. In addition, Congress should require the FDIC to follow a full notice and comment process under the Administrative Procedure Act before making any change to the ceiling. Any delay associated with this process should not cause undue concern, since the FDIC would, in all likelihood, be considering changes when the fund was near its ceiling, substantially above the current 1.25 percent minimum.

Excess reserves should be returned to institutions that paid premiums

Reserves in the fund that exceed the ceiling should be returned to insured institutions based on their average assessment base measured over a reasonable period and based on premiums paid in the past. As indicated later in this statement, the FDIC should also consider risk factors when calculating any rebate. Rebatable premiums would include the 1996 SAIF special assessment, but not the high-growth special assessments.

During the 106th Congress, ACB supported legislation introduced by Senators Rick Santorum (R-Penn.) and John Edwards (D-N.C.) and Reps. Frank Lucas (R-Okla.) and Mel Watt (D-N.C.) that would have set a 1.35 percent ceiling and used the excess to pay interest on FICO bonds.[5] Reps. Lucas and Watt have reintroduced that legislation in the current Congress (H.R. 557). Under their approach, once the FICO bonds were repaid, excess funds would be used to pay rebates. The bill would have given the FDIC authority to change the ceiling.

ACB continues to believe that this is a constructive solution to a serious potential problem that could be caused by a substantially overcapitalized insurance fund. However, the broader approach we outline in this testimony could lead to full rebates more promptly than provided in the Lucas/Watt bill. Whatever the mechanism Congress provides, resources not needed for reasonably foreseeable deposit insurance purposes should not remain in Washington.

Broaden Risk-Based Premium Authority

When the fund is above its statutory minimum level the highest rated institutions should continue to be exempt from premiums, but the FDIC should have authority to impose a justifiable risk-based premium on other institutions.[6] ACB supports this additional authority provided the other important reforms we recommend are included in the final package.

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[5] S. 2293 and H.R. 3278.

[6] Insured institutions rated 1A are not currently charged deposit insurance premiums. These institutions include those with supervisory CAMELS ratings of both 1 and 2. That is the examiner's composite rating of Capital, Assets, Management, Earnings, Liquidity, and Sensitivity to market risk. ACB believes that CAMELS 1 institutions should remain exempt from premiums, but the FDIC should be able to impose risk-based premiums on CAMELS 2 institutions, even if they are rated 1A for deposit insurance purposes.

The FDIC Options Paper states that, "If deposit insurance were priced according to risk, it is likely that every bank...would pay something for deposit insurance."[7] The FDIC's current recommendation paper states that the current "system both underprices risk and does not adequately differentiate among banks according to risk. The FDIC should be allowed to charge risk-based insurance premiums to all institutions. . . ."[8] These statements fail to take into account the fact that most insured institutions paid substantial premiums in the 1990s to capitalize the FDIC funds. Most BIF- and SAIF-insured institutions paid approximately 23-24 basis points annually for several years, and SAIF-insured institutions made an additional one-time, 66 basis point payment in 1996. Since those institutions have never caused insurance losses, ACB believes that they have already made advance payment to compensate the fund for risk that they pose.

ACB supports risk-based pricing as a means to discourage riskier behavior and maintain the integrity of the deposit insurance system. Such risk-based pricing justifiably might be set on a more steeply graduated schedule than is currently the case. However, such a premium should not extend to the highest rated institutions when the fund is above the statutory minimum. Not only have they already paid substantial premiums, they -- by definition – impose an extremely slight risk to the fund.

This broadened premium authority should not, however, be granted in isolation. ACB believes that a more reasonable recapitalization procedure, rebate authority, an excess-growth premium, indexed coverage levels, and greater coverage for retirement accounts are essential elements of a balanced plan.

Rebates should be reduced for riskier institutions

Institutions that pose substantial risk to the fund would have their rebates reduced or eliminated. Under the system we favor, the riskiest institutions would get no rebates, while the safest institutions would get higher than average rebates. Those in between could expect average rebates. These differential rebates would provide a similar risk-reduction incentive as the FDIC's proposed universal premium structure. All institutions would know that when the fund approached the ceiling, they could expect to benefit if they operated in a less risky manner.

FDIC should be able to impose an excess-growth premium

As discussed earlier in this testimony, institutions that grow at a rate significantly above the industry average in a manner that dilutes the fund should be required to compensate by paying a special premium on excess growth. This is a key element of the Ney/Tubbs Jones bill. A growth premium would avoid dilution of the fund by making the fund whole with respect to any excess growth, preventing the imposition of unnecessary premium costs on other institutions.

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[7] FDIC Options Paper, p. 3. (Options Paper)
[8] Keeping the Promise: Recommendations for Deposit Insurance Reform, April 2001 (p. i)

The special growth premium will not apply to smaller institutions for a reasonable period after they are chartered. It would also not apply to growth through merger or acquisition.

Assessing a special premium only on significant growth would allow premium-free growth by an institution that had developed a particularly successful business plan. But, it would address the case of, for example, a diversified financial firm that was simply transferring significant amounts of uninsured funds under its effective control into its insured bank.

ACB believes that the special premium should compensate the fund at the then-current reserve ratio to avoid dilution of the fund. The FDIC should have the flexibility to collect this premium over a reasonable period to avoid imposing an undue shock on the affected institutions. While the premium might be collected over time, it should be booked immediately as a receivable in the fund to maintain its coverage ratio.

Ironically, Congress permits the FDIC to impose special assessments on *de novo* institutions.[9] Congress recognized that these institutions can be expected to grow at rates that exceed the industry average and impose other risks. However, because of their relatively small size, they cannot be expected to dilute a multi-billion dollar deposit insurance fund. The same thing cannot be said about an existing institution – now effectively exempt from premiums – that embarks on a new business plan that could add tens of billions to the insured deposit base. So, while the law correctly recognizes the risk that a *de novo* institution may impose, it forces the FDIC to ignore the risk posed by an existing institution that begins growing at a rate significantly above the industry average.

As indicated above, the special excess growth premium should not apply to institutions that grow by acquiring existing deposits from other insured institutions. By definition, these deposits are already included in the insured deposit base, so shifting them from one institution to another does not dilute the fund.

The FDIC should have more flexible recapitalization authority

As provided in the Ney/Tubb Jones bill, if the fund falls below 1.25 percent designated reserve ratio (DRR), the FDIC should have the authority to spread the recapitalization over a reasonable period. This would be more responsible than the current law that requires the FDIC to impose a 23 basis point annual premium if the fund is expected to remain below 1.25 percent for a year.

ACB strongly supports changing the assessment system to address the case where the fund falls below 1.25 percent. As the FDIC Options Paper notes, the current system "amounts essentially to charging nothing in times of prosperity, and a lot in times of adversity, thereby potentially magnifying swings in the banking cycle."[10] Congress should correct this by giving

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[9] 12 U.S.C. 1815(d)(1)(A).
[10] Options Paper, p. 5.

the FDIC authority to spread any recapitalization over a reasonable period. The FDIC should impose these premiums on a risk-based basis.

Coverage levels should be indexed

ACB supports indexing coverage levels to maintain purchasing power. Congress should index coverage levels starting with the 1974 limit of $40,000. That would result in a coverage level of approximately $135,000. So long as the fund is above its statutory minimum of 1.25 percent of insured deposits, this modest increase in coverage should not require any more than a very minimal premium. If unacceptable premium increases are a condition for an immediate increase in coverage, Congress should at least index coverage from the current $100,000 level.

ACB also strongly supports substantially increasing coverage for retirement savings, such as IRA and 401(k) accounts. In either case, we support increases provided they are not accompanied by substantial additional premiums. Most ACB members are skeptical that increases in general deposit insurance coverage levels would significantly increase funding. Former FDIC Chairman Helfer is even more skeptical. Last year, she said, "there is very little evidence that doubling the coverage limits will expand the deposit base of smaller banks. Community bankers that I have talked to think that very little benefit will result from a significant increase in coverage limits."[11]

Even if coverage is increased to $200,000, the average account balance is certain to remain very substantially below that level. Small depositors with say, $1500 in checking and savings accounts are not going to increase their total deposits just because the upper insurance limit is increased. And, competitive factors suggest that substantially increased nominal coverage will not increase the overall deposit base by a large amount. Depositors with large sums may shift insured deposits from one bank to another to consolidate balances or take advantage of higher interest rates. But, one bank's gain may well be another bank's loss. ACB members who responded to our survey estimated only a net gain of 3 percent as a result of increasing insurance coverage to $200,000. Thus, doubling coverage levels is not the same as doubling the FDIC's risk.

Clearly, an adjustment accounting for inflation since 1974 is reasonable but such an increase would not justify a significant premium increase. If a large premium increase is the price for higher coverage, we would prefer to index coverage from the current level. We agree with former FDIC Chairman Helfer who said that, "Whatever the correct number, it is the principle of indexing that is important."[12]

Indexing on a going-forward basis would certainly not justify any premium increase and would have the clear advantage that the FDIC identified in its Options Paper – insulation from political cross currents and maintaining "the same relative importance of deposit insurance in the

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[11] Helfer, Dec. 4, 2000, p. 12
[12] ID, p. 14

economy over time...."[13] Indexing using the current level also avoids the debate over what year and level should be the basis for indexing. For better or worse, depository institutions and the economy have adjusted to the current level of coverage. Indexing would maintain that balance rather than seeking to recalibrate it based on a level that may have been appropriate in the past.

To simplify and reduce the cost of implementation, as well as to promote consumer understanding, we recommend that any increases be provided only in $10,000 increments. Some ACB members are especially concerned that frequent small adjustments would be more costly than any benefit they might realize from increased deposit funding.

Retirement accounts should have substantially more coverage

Congress should also provide substantial increases in coverage levels for retirement savings in conjunction with its work on social security or pension reform or as part of deposit insurance reform, provided this can be accomplished without an unacceptable premium increase.

Congress has provided substantial tax incentives to encourage individuals to accumulate retirement savings. These individual savings are often replacing resources that employers previously provided through defined-benefit pension plans. This shift in retirement funding has increased the burden on individuals to manage their own assets. As individuals respond to tax incentives, their retirement assets often exceed the current $100,000 coverage limit by substantial amounts. Since planners generally recommend that individuals shift these savings into more secure and stable investments as they approach retirement, ACB believes that Congress should substantially increase deposit insurance for retirement savings that meet the tax requirements established under the Internal Revenue Code.

Conclusion

Again, ACB appreciates this opportunity to present our views on these important issues. The deposit insurance system is strong today, but could be made even stronger. We hope that Congress will use the work the FDIC and the industry has done to craft legislation that will make the improvements necessary to ensure the continued stability of this key part of the nation's economy.

ACB would like to emphasize these points from our testimony:

- The deposit insurance system has been helped by legislation that Congress enacted since 1989, as well as by a strong economy.
- The system now faces a significant challenge – excessive growth by a few institutions – that Congress should address right away by acting quickly on the Ney/Tubbs Jones bill, H.R. 1293, which merges BIF and SAIF; provides for an excess growth premium; and permits more flexible recapitalization.

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[13] Options Paper, p. 44.

- ACB strongly supports comprehensive deposit insurance reform, and Congress should not delay action on H.R. 1293 while it debates broader issues.
- Comprehensive reform should include:
    - a ceiling on the merged fund;
    - risk-based rebates of past premiums;
    - risk-based premium authority for all but the highest-rated institutions;
    - general coverage levels indexed from the 1974/$40,000 level; and
    - substantially increased coverage for retirement accounts.

America's Community Bankers
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December 13, 2000

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/OES
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Re: Deposit Insurance Options Paper
August 2000

Dear Mr. Feldman:

America's Community Bankers (ACB) is pleased to comment on the issues presented in the FDIC's Deposit Insurance Options Paper.[1] ACB commends the FDIC for reaching beyond a few narrow deposit insurance issues and seeking comment on a wide range of concerns. ACB represents the nation's community banks of all charter types and sizes. ACB members pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

Merge BIF and SAIF

We also commend the FDIC for its continued strong advocacy of merging the Bank Insurance Fund and the Savings Association Insurance Fund. Simply stated, a combined fund would be stronger than either one standing alone. If Congress does nothing else regarding deposit insurance issues, it should merge the funds without delay. There is no reason to postpone this reform if broader issues cannot be resolved promptly. This is a particularly good time to merge the funds, since both are substantially above the statutory reserve ratio. The SAIF ratio is actually higher than BIF's, but each would benefit from the geographic and business diversity that the other would bring to a combined fund.

The Reform Process

Many of the options that the FDIC has raised would also require Congressional action, while some – particularly some changes to the risk-based premium system – could be implemented by the FDIC without further legislation. This letter provides ACB's views on the full range of issues raised in the Options Paper – pricing deposit insurance for

[1] Deposit Insurance Options Paper, August 2000 ("FDIC Options Paper").

individual banks, the FDIC structure most appropriate to fund any losses, and coverage levels.

We developed our positions by holding discussions with hundreds of our members in multiple forums, as well as seeking their views via survey. ACB's 32-member Deposit Insurance Team held 5 meetings, 4 by conference call and a final in-person session on December 4, 2000.[2] In addition, ACB's Community Institutions Committee, Mutual Institution Committee, and our Board of Directors examined these matters during our recent national convention. Throughout the year, ACB's officers discussed deposit insurance issues with our members at ACB management conferences, seminars, and state association meetings. We also met with the board of the American League of Financial Institutions, which represents minority thrifts, during their annual meeting to solicit their views.

How a Reformed System Would Work

ACB's ideal scenario for the deposit insurance system includes creation of a single, stronger Deposit Insurance Fund through a merger of BIF and SAIF. The fund would continue to grow through a combination of earnings and risk-based premiums. The highest rated institutions would not be assessed as long as the fund remained above the statutory minimum of 1.25 percent of insured deposits. Once the fund reaches a new ceiling that would be set by Congress (after close consultation with the FDIC), the FDIC would provide risk-based rebates of any excess funds. The FDIC would have the discretion to adjust this ceiling under strict standards and procedures.

If the fund fell below the statutory 1.25 percent reserve ratio, the FDIC should be allowed to spread the recapitalization over a reasonable period. (Current law requires the FDIC to impose a 23 basis point premium to make up a shortfall that it expects will persist for a year.) This would allow the FDIC to balance the goals of replenishing the fund and maintaining a healthy banking system.

To maintain the integrity of the deposit insurance fund, institutions that grow at rates significantly above the industry average should pay a special premium on their excess growth. This should not apply to relatively small, *de novo* banks or to institutions that acquire existing insured deposits. It would not discourage regular competitive growth by established institutions or the formation of new competitors. However, it would deal with institutions that dilute the deposit insurance fund's reserve ratio by precipitately moving large amounts of funds under their effective control from uninsured to insured status.

ACB also recommends indexing the coverage levels to help maintain the role of deposit insurance in the nation's financial system. Congress should use as a base the last time it adjusted coverage primarily for inflation, which was in 1974. At that time, it increased coverage to

[2] See Appendix for roster.

$40,000. If adjusted for inflation since that time, the current coverage limit would be between $115,000 and $130,000.[3]

To recognize the increasingly important role that individual retirement savings plays in the economy and in our pension system, ACB recommends that Congress substantially increase the separate deposit insurance coverage for IRA, 401(k), and similar retirement accounts.

Summary of ACB Positions

1. ACB recommends that Congress set a ceiling on the deposit insurance fund's reserve ratio, giving the FDIC the ability to adjust that ceiling using strict standards after following full notice and comment procedures.
2. Reserves in the fund that exceed the ceiling should be returned to insured institutions based on their average assessment base measured over a reasonable period and based on premiums paid in the past. Rebatable premiums would include the SAIF special assessment, but not the high-growth special assessments.
3. When the fund is above its statutory minimum level the highest rated institutions would continue to be exempt from premiums, but the FDIC should have authority to impose a small risk-based premium on other institutions. ACB supports this additional authority provided the other important reforms we recommend are included in the final package.
4. Institutions that pose substantial risk to the fund would have their rebates reduced or eliminated.
5. In measuring risk for rebate or premium purposes, the FDIC should rely on additional objective information and not increase its current reliance on subjective examiner judgment.
6. Institutions that grow at a rate significantly above the industry average should be required to compensate the fund by paying a special premium on excess growth. This would avoid dilution of the fund by making the fund whole with respect to any excess growth, preventing the imposition of unnecessary premium costs on other institutions.
7. The special growth premium will not apply to smaller institutions for a reasonable period after they are chartered. It would also not apply to growth through merger or acquisition.
8. If the fund falls below 1.25 percent designated reserve ratio (DRR), the FDIC should have the authority to spread the recapitalization over a reasonable period. This would be more responsible than the current law that requires the FDIC to impose a 23 basis point annual premium if the fund is expected to remain below 1.25 percent for a year.
9. ACB strongly supports the current FDIC role as a provider of deposit insurance and strongly opposes proposals to privatize deposit insurance coverage.
10. ACB supports indexing coverage levels to maintain purchasing power. Congress should index coverage levels starting with the 1974 limit of $40,000. That would result in a coverage level of between $115,000 and $130,000 in today's dollars.

[3] Raising the Deposit-Insurance Limit: A Bad Idea Whose Time Has Come? James B. Thomson; Federal Reserve Bank of Cleveland Research Department; April 15, 2000 ($115,000 in 1999 dollars); FDIC Options Paper, p. 45 ($130,000 in today's dollars).

11. So long as the fund is above its statutory minimum of 1.25 percent of insured deposits, this modest increase in coverage should not require any more than a very minimal risk-based premium. If unacceptable premium increases are a condition for an immediate increase in coverage, Congress should at least index coverage from the current $100,000 level.
12. Congress should also provide substantial increases in coverage levels for retirement savings in conjunction with its work on social security or pension reform or as part of deposit insurance reform, provided this can be accomplished without an unacceptable premium increase.

Our complete comments are organized below in accordance with the FDIC Options Paper.

Pricing Deposit Insurance

Should all banks pay some premium?

The Options Paper states that, "If deposit insurance were priced according to risk, it is likely that every bank…would pay something for deposit insurance."[4] This statement fails to take into account the fact that most insured institutions paid substantial premiums in the 1990s to capitalize the FDIC funds. Both BIF- and SAIF-insured institutions paid approximately 24 basis points annually for several years, and SAIF-insured institutions made an additional one-time, 66 basis point payment in 1996. Since those institutions have never caused insurance losses, ACB believes that they have already made advance payment to compensate the fund for risk that they pose.

Nevertheless, there may be some benefit to imposing risk-based premiums on a wider range of institutions than is now permitted. Under current law, the FDIC may not charge premiums if the fund is above the 1.25 percent reserve ratio, except on "institutions that exhibit financial, operational, or compliance weaknesses ranging from moderately severe to unsatisfactory, or are not well capitalized…."[5] ACB believes that giving the FDIC the authority to impose a very modest risk-based premium even when the fund is above the statutory minimum could discourage riskier behavior and pave the way for other reforms. Such a premium should not extend to the highest rated institutions. Not only have they already paid substantial premiums, they – by definition – impose an extremely slight risk to the fund.

This broadened premium authority should not, however, be granted in isolation. ACB believes that a more reasonable recapitalization procedure, rebate authority, an excess-growth premium, indexed coverage levels, and greater coverage for retirement accounts are essential elements of a balanced plan.

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[4] FDIC Options Paper, p. 3.
[5] 12 U.S.C. 1817(7)(b)(2)(A)(v).

Should there be a premium on excessive growth?

A special premium on excessive growth is essential to help prevent the fund from falling below 1.25 percent. As long as the fund remains above 1.25 percent, insured institutions can add an unlimited amount of insured deposits to the system without paying any premiums. This may lower the reserve ratio even if the absolute amount of money in the fund stays the same or if it grows modestly through earnings. It could even trigger an across-the-board premium if the fund were to fall below the 1.25 minimum. Therefore, ACB believes Congress should require the FDIC to assess growth-related premiums on institutions that grow at a rate significantly over the industry average. A growth-related premium would do two things. First, it would help the fund maintain its capitalization so that these institutions would not be "free riders" on premiums paid by long-standing members. Second, it would recognize that unusual growth is an important risk factor.

ACB believes this is an issue of great urgency. Therefore, we urge the FDIC to announce quickly that it will recommend that any premium be imposed as of the date it recommends that Congress impose such a premium. This procedure would be consistent with actions by Congress that have made new rules effective as of the date of a bill's introduction or the date of the first formal committee action.

Assessing a special premium only on significant growth would allow premium-free growth by an institution that had developed a particularly successful business plan. But, it would address the case of, for example, a diversified financial firm that was simply transferring significant amounts of uninsured funds under its effective control into its insured bank.

ACB believes that the special premium should compensate the fund at the then-current reserve ratio to avoid dilution of the fund. The FDIC should have the flexibility to collect this premium over a reasonable period to avoid imposing an undue shock on the affected institutions. While the premium might be collected over time, it should be booked immediately as a receivable in the fund to maintain its coverage ratio.

Ironically, Congress preserved the FDIC's ability to impose special assessments on *de novo* institutions.[6] Congress recognized that these institutions can be expected to grow at rates that exceed the industry average and impose other risks. However, because of their relatively small size, they cannot be expected to dilute a multi-billion dollar deposit insurance fund. The same thing cannot be said about an existing institution – now effectively exempt from premiums – that embarks on a new business plan that could add tens of billions to the insured deposit base. So, while the law correctly recognizes the risk that a *de novo* institution may impose, it forces the FDIC to ignore the risk posed by an existing institution that begins growing at a rate significantly above the industry average.

[6] 12 U.S.C. 1815(d)(1)(A).

Since the FDIC already has authority to impose a risk-based premium on *de novo* institutions, it is not necessary to impose special growth premiums on them. As indicated, they add little in absolute dollar terms to the insured deposit base, even if their rate of growth is very rapid. In addition, public policy should encourage the establishment of *de novo* institutions to increase credit availability to all segments of the economy. Finally, when the FDIC imposes a risk-based premium on these institutions where their level of growth or other factors impose significant risk, they already provide income to the fund.

As indicated above, the special excess growth premium should not apply to institutions that grow by acquiring existing deposits from other insured institutions. By definition, these deposits are already included in the insured deposit base, so shifting them from one institution to another does not dilute the fund.

Should the recapitalization schedule be modified?

ACB strongly supports changing the assessment system to address the case where the fund falls below 1.25 percent. The current system requires the FDIC to re-impose a minimum 23-basis-point premium if a fund falls below 1.25 percent and is expected to remain there for a year or more. As the Options Paper notes, the current system "amounts essentially to charging nothing in times of prosperity, and a lot in times of adversity, thereby potentially magnifying swings in the banking cycle."[7] Congress should correct this by giving the FDIC authority to spread any recapitalization over a reasonable period. The FDIC should impose these premiums on a risk-based basis.

The system we have outlined above introduces substantial risk-based incentives, while avoiding imposing premiums on the highest rated institutions when they are not needed. However, institutions would know that they could face premiums if the fund falls below 1.25 percent and could be rewarded with risk-based rebates once the fund exceeds the new ceiling. In between, institutions that impose some risk would pay modest premiums, while those that undermine the health of the fund by growing at extraordinary rates would pay a special premium.

Should the FDIC change the way it measures risk?

The Options Paper asks whether the FDIC should "rely on supervisory judgment, … other information," or "hybrid approaches."[8] ACB believes that the FDIC should base its judgments of risk on currently available, objective information. It should not increase its reliance on supervisory evaluations. ACB believes that the current CAMELS rating system already includes a sufficient amount of examiner judgment. The FDIC currently gathers a substantial amount of objective information via Call Reports. This information is far more consistent across the range of institutions than examiner judgments. While we recognize that there is no complete substitute for direct observation by trained examiners, no amount of training can completely eliminate

[7] FDIC Options Paper, p. 5.
[8] FDIC Options Paper, p. 11.

inconsistencies from one examiner team to the next. If call report data is not adequate, then the reporting requirement should be refined – unneeded reporting removed, worthwhile additional requirements added.

Should deposit insurance be priced from the bottom up or the top down?

In its options paper, the FDIC states "a 'bottom-up' view would set pricing at the individual bank level and let overall revenue result from the sum of payments across banks. A 'top-down' view would instead attempt to estimate appropriate aggregate funding needs and then allocate prices across banks based on risk."[9] ACB recommends against adopting either approach exclusively.

A bottom-up approach with no cap could lead to an ever-growing fund that would withdraw too much funding from the private market. Such a fund could also tempt policy makers to divert excess funding to non-insurance purposes.

Elsewhere in this letter, we recommend that Congress set a ceiling on the fund (while giving the FDIC some flexibility to adjust it under strict standards after following notice and comment procedures). To reach that ceiling the FDIC should rely on earnings and risk-based premiums. Though it would set a ceiling, a pure top-down approach also has drawbacks. It would limit the FDIC's ability to impose assessments and provide rebates in amounts that differ according to the relative risks posed by individual institutions.

Thus, we recommend a combination of the two approaches. From the top-down approach, we recommend imposing a cap on the fund (which the FDIC could adjust). From the bottom-up approach, we recommend a combination of risk-based premiums (where appropriate and needed), excess growth premiums, and risk-based rebates.

Should the FDIC use peer comparisons or absolute ratios?

ACB believes there is some value in measuring an institution's risk by comparing it with other, similar institutions. Comparisons would be useful in relatively good and stable times and outliers would tend to stand out. However, in times of general economic difficulty a peer comparison approach could be misleading. If most institutions were doing equally poorly and presenting serious risk, a pure peer analysis would fail to set off alarm bells. We also note that as each institution pursues increasingly diversified strategies, it is becoming harder to find true peers. As in the debate over bottom-up versus top-down premium structures, the answer has to be a careful combination of the two approaches.

Should the FDIC use market information to determine premiums?

The Gramm-Leach-Bliley Act requires a test of whether market mechanisms might help regulators measure and reduce risk among the largest institutions. Section 108 of the GLB Act

[9] FDIC Options Paper, p. 11.

directs the Federal Reserve and the Treasury to study the implications of requiring large insured depository institutions and depository institution holding companies to maintain a portion of their capital in the form of subordinated debt.[10]

This approach may be useful in comparisons among large institutions that pose a systemic risk and which may benefit from perceived too-big-to-fail protection unavailable to community banks. Nevertheless, ACB opposes using similar market-related tests for deposit insurance pricing. We share the concerns expressed in the Options Paper. First, the markets would likely take the too-big-to-fail implicit guarantee into account, giving higher ratings to larger institutions.

Second, the FDIC has more information about all banks than anyone in the private market. Unless the examination process is poorly conceived and implemented, it surely generates insights that are not available to the market. Market signals may be used to confirm or redirect examination resources, though any banking concern big enough to be the object of intense market scrutiny probably has a permanent examiner on site anyway.

Third, market pricing is a combination of a judgment about the particular institution involved and general conditions. During some periods institutions may not be able to issue debt at all. Finally, ACB does not believe that it is appropriate for the FDIC to rely on private firms' judgment when making an important public policy decision, e.g., the amount of premium to charge for federal deposit insurance and the level of rebates to provide.

Smaller institutions would be particularly disadvantaged by increased reliance on market judgment to assess premiums. It is rarely efficient for smaller institutions to issue debt of any type, and what may be issued is thinly traded. While the law permits the FDIC to establish separate pricing mechanisms for large banks,[11] we believe that widespread use of that authority is unnecessary and potentially divisive. ACB is concerned that such a system may discriminate against smaller institutions in certain geographic markets and those with concentrations in particular assets, e.g., home mortgage loans.

Should the FDIC enter into private reinsurance contracts to obtain market judgment about risk?

ACB understands that the FDIC has begun the process of studying this question with a private-sector firm. The issue is whether the FDIC could draw on information from the reinsurance markets for deposit insurance pricing. ACB believes the FDIC should look carefully to determine whether the private reinsurance market has the capacity to reinsure any substantial portion of depository institutions. It should also examine whether private reinsurance activities might impose an unwarranted insurance premium differential between large and small

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[10] Public Law 106-102, Nov. 12, 1999.
[11] 12 U.S.C. 1817(b)(1)(D).

institutions. Finally, private reinsurance firms might seek access to examination data generally not made available to private parties.

While not included as possibility in its Options Paper, ACB wishes to reiterate at this point that we strongly oppose proposals by others to privatize deposit insurance. The nation's economy has depended for decades on the FDIC and the ultimate backstop of the Federal Government. The private insurance market would be unable to engender the kind of public confidence made possible by the FDIC.

Structure of the Deposit Insurance Fund

Should deposit insurance be based on a User-Fee or Mutual model?

The Options Paper raises the question of whether the deposit insurance system should be reconfigured on a user-fee or mutual model. ACB believes it would not be useful to adopt a pure version of either. The terms themselves conjure up specific approaches from the past that may be misleading models for the future and could confuse more than clarify the debate. Instead, policy makers should decide the specific characteristics that they want today's system to have. It may be that the final product will look more like one than the other. We expect that it will have many elements more characteristic of a mutual arrangement. That is certainly how it has worked in the past. Congress has asked insured depository institutions to pay whatever it would take to pay the costs of running the system. And, for much of the history of the system, from 1950 until the 1980s, the law provided for rebates to insured institutions. Those certainly are characteristics of a mutual model.

Of course, when it became impossible for institutions insured by the Federal Savings and Loan Insurance Corporation to cover the losses of its fund, the government did step in. And, the Treasury advanced funding to the BIF when that became necessary. These actions were characteristic of the user-fee model. Even here, however, SAIF- and BIF- insured institutions had to pay substantial premiums to recapitalize their funds. In addition, Congress insisted that insured institutions – first SAIF-insured institutions and then all FDIC-insured institutions – pay the interest on Financing Corporation (FICO) bonds that were issued to pay depositors. This "mutual" feature will be with us for years to come.

It is very clear that under the current statutory scheme, insured institutions are members of an assessable mutual system, with only a reimbursable financing line of credit from the Treasury. The only effective constraint on assessments is when they are causing more new failures than they are paying to resolve.

Former FDIC Chairman Ricki Helfer recently answered the question of mutual versus user-fee model this way:

> *Those kinds of categorizations can be useful for analytical purposes perhaps, but sometimes they can also obscure rather than clarify the relevant issues. Neither categorization best represents the way the system operates now nor the way that it can best serve American depositors in the future. The short answer to the FDIC's questions is that there are elements of both in a system that has risk based deposit insurance and permits rebates from an over-capitalized fund. Buried in the terminology is the real issue: is there a maximum reserve ratio for each deposit insurance fund that can be identified at any particular time based on then existing circumstances? If there is, should banks enjoy rebates of reserves above that level, and can we design a rebate system that meets our second goal by maintaining a risk-based deposit insurance system and still provide rebates to banks from reserves above the ceiling?*[12]

The approach we suggest – pick the characteristics of the fund first and avoid artificial labels – also enables policy makers to avoid awkward proposals that would unnecessarily complicate their decision-making. For example, a pure mutual model might resemble the National Credit Union Share Insurance Fund (NCUSIF). Under that system, institutions maintain deposits in the fund and simultaneously carry them as assets on their books.[13] The General Accounting Office criticized this accounting treatment in 1991 and suggested that credit unions write off these assets over time.[14] Since credit unions are not publicly traded, this accounting issue is not heavily debated and does not affect investors. In contrast, stockholder-owned banks and savings institutions must be responsive to investor concerns. As a result, a pure mutual-model similar to NCUSIF might have to include a number of artificial constructs to conform to accounting rules. There does not seem to be any substantial public policy benefit to the exercise.

Many of the policies we recommend elsewhere in this comment – a cap on the fund, rebates, increased risk-based premium authority, and excess-growth premiums – tend to reinforce the mutual aspects of the system. But, we recommend them because we believe they will strengthen and improve the system, not to add new mutual features.

Should a rebate system be reinstated?

As indicated elsewhere in this comment, ACB strongly believes that Congress should set a ceiling on the fund and rebate excess payments on a risk-based basis. During the 106th Congress, ACB supported legislation introduced by Senator Rick Santorum (R-Penn.) and Representative Frank Lucas (R-Okla.) that would have set a 1.35 percent ceiling and used the excess to pay interest on FICO bonds.[15] Once the FICO bonds were repaid, excess funds would be used to pay rebates. The bill would have given the FDIC authority to change the ceiling.

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[12] The Deposit Insurance System: What Reforms Make Sense?; Ricki Helfer, December 4, 2000; Address to America's Community Bankers, pp. 8-9 (Helfer, Dec. 4, 2000)
[13] FDIC Options Paper, p. 31.
[14] Credit Unions – Reforms for Ensuring Future Soundness; GAO/GGD-91-85, July 1991, pp. 171-174
[15] S. 2293 and H.R. 3278.

ACB continues to believe that this is a constructive approach to a serious potential problem that could be caused by a substantially overcapitalized insurance fund. However, the broader approach we outline in this letter could lead to full rebates more promptly than provided for in the Santorum/Lucas bill. Whatever the mechanism Congress provides, resources not needed for reasonably foreseeable deposit insurance purposes should not remain in Washington.

ACB agrees with former Chairman Helfer's recent comment:

> *I believe it is possible for the FDIC to develop analytical tools that will permit it to identify a ceiling on the funding needs of the deposit insurance system at any particular time – a DRR that would change as circumstances change....The purpose of establishing a ceiling DRR is so that insurance funds will not grow beyond a size that can be justified on the basis of the needs of the deposit insurance system, thereby withdrawing capital from banks who could have contributed to economic growth by leveraging those funds to meet the economic needs of their communities. Amounts accumulated in the system over and above the DRR ceiling should be rebated to banks to facilitate economic activity, which benefits every one.*[16]

What levels should the Fund reach before the FDIC pays rebates?

ACB believes that Congress should adopt the approach taken in the Santorum/Lucas legislation and determine an appropriate ceiling for the fund. In deciding the actual ceiling amount, ACB recommends that Congress consult closely with the FDIC. The agency has already done considerable historical analysis on the level of the funds and income needed to maintain them.[17] Clearly, the agency could adapt that analysis to determining a reasonable ceiling to recommend to Congress. As provided in the Santorum/Lucas bill, Congress should give the FDIC flexibility to adjust the ceiling. However, the agency should have to meet clearly stated standards before adopting a change. The FDIC should be required to find that there is a higher level needed to meet a substantial and identifiable risk to the fund or the financial system.

In addition, Congress should require the FDIC to follow a full notice and comment process under the Administrative Procedure Act before making any change to the ceiling. Any delay associated with this process should not cause undue concern, since the FDIC would, in all likelihood, be making a change when the fund was near its ceiling, substantially above the 1.25 percent minimum.

How should rebates be allocated?

The Santorum/Lucas legislation would provide rebates to all insured institutions once the FICO obligation is met. Until that time, excess funds in BIF and SAIF, or a new DIF, would be used to offset all insured institutions' FICO obligation or would remain in the fund. ACB continues to believe that this approach has merit and would support the Santorum/Lucas bill as a stand-alone proposal. However, we also believe that there is considerable merit to providing for a risk-based

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[16] Helfer, Dec. 4, 2000, pp. 9-10

[17] 60 Fed. Reg. 42680 (Aug. 16, 1995).

rebate system that could provide rebates before the FICO obligation ends. Under the system we favor, the riskiest institutions would get no rebates, while the safest institutions would get higher than average rebates. Those in between could expect average rebates. These differential rebates would provide the same risk-reduction incentive as variations in premiums when the fund needs them to impose them on the bulk of insured institutions. All institutions would know that as the fund approached the ceiling, they could expect to benefit by operating in a less risky manner.

Should the Systemic Risk/Too-Big-to-Fail mechanism be changed?

In FDICIA, Congress substantially limited the FDIC's ability to provide unlimited protection to depositors in too-big-to-fail institutions. The FDIC may not protect uninsured depositors and creditors if that would increase costs above simply covering insured deposits. As the Options Paper notes, this least-cost test can be overcome only if "the Secretary of the Treasury, upon the recommendation of two-thirds of the Boards of the FDIC and the Federal Reserve, and after consultation with the President, determines that a threatened bank failure would pose serious adverse effects on economic conditions or financial stability, the least-cost requirements can be avoided....[18] This procedure has never been implemented, but it certainly appears to impose substantial procedural hurdles to further FDIC involvement in the too-big-to-fail process.

Nevertheless, it is still possible that at some point the FDIC will step in under the systemic-risk exception to the least-cost requirement. The law requires that the FDIC impose a special assessment on all fund members to defray the excess cost of a systemic-risk resolution. Unlike normal assessments, this special assessment is based on total assets (minus equity capital and subordinated debt). When adopted in 1991, it was thought that this would tend to shift costs to larger banks that relied less on deposits to fund their assets. This did not exempt banks that could never expect to benefit from a systemic-risk rescue, but it was hoped that it would rebalance the scales to some extent.

This analysis is becoming dated because community banks themselves rely more on funding from the Federal Home Loan Banks as the competition for deposits becomes more severe. The balance sheets of large and small banks – in terms of their reliance on deposits as compared to borrowed funds – are likely to become more similar over time. Therefore, Congress may wish to consider doing directly what they attempted to do indirectly in 1991 and exempt banks under a certain size from any systemic-risk special assessment.

Though the FDIC's role in the too-big-to-fail process may be reduced, the Federal government, particularly the Federal Reserve, continues to have a major role in dealing with financial crises. Under the new financial structure provided under the Gramm-Leach-Bliley Act, this implicit shift of much of the too-big-to-fail responsibility from the FDIC to the Federal Reserve has merit. The fact remains, that invoking this protection for larger financial firms provides benefits to a just a few firms. Policy makers should

[18] FDIC Options Paper, p. 33.

continue to explore ways to impose some cost for this benefit, recognizing it is difficult to explicitly price an implicit benefit.

Coverage Levels

Should Congress increase general coverage limits?

ACB supports indexing coverage to maintain purchasing power. We also strongly support substantially increasing coverage for retirement savings, such as IRA and 401(k) accounts. In either case, we support increases provided they are not accompanied by substantial additional premiums. Most ACB members are skeptical that increases in general deposit insurance coverage levels would significantly increase funding. Former FDIC Chairman Helfer is even more skeptical. She recently said that "there is very little evidence that doubling the coverage limits will expand the deposit base of smaller banks. Community bankers that I have talked to think that very little benefit will result from a significant increase in coverage limits."[19]

However, it could improve community bank funding in some markets. In addition, increased coverage can be a helpful accommodation to some customers who wish to deposit relatively large, one-time receipts from, for example, the sale of a home or an inheritance. This would be valuable to a consumer who values safety, but is unlikely to fuel substantial sustained deposit growth throughout the banking system. Residual concerns that excess growth could result can be dealt with by ensuring that rapidly growing institutions pay a deposit insurance premium that reflects the greater risk they pose to the system and maintains the capitalization level of the fund.

Most ACB members believe that they can more effectively increase funding by offering increased interest rates, not through increased deposit insurance coverage. However, they recognize that these deposits are not as "loyal" as core deposits. Similarly, ACB members are concerned that increasing coverage levels could increase the size of very large deposits, complicating banks' liquidity management. Large deposits attracted simply by relatively high rates of interest often leave just as quickly as they are attracted. This could be the case with larger deposits attracted by increased deposit insurance coverage.

Though ACB recommends that a premium be imposed on institutions that experience unusually high growth, we do not believe that even doubling nominal insurance coverage would justify a substantial premium increase on all institutions. Even if coverage is increased to $200,000, the average account balance is certain to remain very substantially below that level. Small depositors with say, $1500, in checking and savings accounts are not going to increase their total deposits just because the upper insurance limit is increased. And, competitive factors suggest that substantially increased nominal coverage will not increase the overall deposit base by a large amount. Depositors with large sums may shift insured deposits from one bank to another to consolidate balances or take advantage of higher interest rates. But, one bank's gain may well be another bank's

[19] Helfer, Dec. 4, 2000, p. 12

loss. ACB members who responded to our survey estimated only a net gain of 3 percent as a result of increasing insurance coverage to $200,000. Thus, doubling coverage levels is not the same as doubling the FDIC's risk.

Should coverage limits be indexed?

If a substantial increase in coverage is not feasible, ACB supports indexing of the $100,000 level to maintain its purchasing power. This would not completely address the loss of coverage to inflation experienced since coverage was increased to $40,000 in 1974 and $100,000 in 1980. If coverage had been indexed using 1974/$40,000 as a base, the current level would be between $115,000 and $130,000; if indexed using 1980/$100,000 as a base, the current level would be approximately $200,000. Clearly, an adjustment accounting for inflation since 1974 is reasonable but such an increase would not justify an unacceptable premium increase. Former FDIC Chairman Helfer believes this is a "better approach" than increasing coverage to $200,000. However, she indicated that, "Whatever the correct number, it is the principle of indexing that is important."[20]

Indexing on a going-forward basis would certainly not justify any premium increase and would have the clear advantage that the FDIC identified in its Options Paper – insulation from political cross currents and maintaining "the same relative importance of deposit insurance in the economy over time…."[21] Indexing using the current level also avoids the debate over what year and level should be the basis for indexing. For better or worse, depository institutions and the economy have adjusted to the current level of coverage. Indexing would maintain that balance rather than seeking to recalibrate it based on a level that had been appropriate in the past.

To simplify and reduce the cost of implementation, as well as to promote consumer understanding, we recommend that any increases be provided only in $10,000 increments. Some ACB members are especially concerned that frequent small adjustments would be more costly than any benefit they might realize from increased deposit funding.

Should coverage for retirement accounts be increased?

Congress has provided substantial tax incentives to encourage individuals to accumulate retirement savings. These individual savings are replacing resources that employers previously provided through defined benefit pension plans. This shift in retirement funding has increased the burden on individuals to manage their own assets. As individuals respond to tax incentives, their retirement assets often exceed the current $100,000 coverage limit by substantial amounts. Since planners generally recommend that individuals shift these savings into more secure and stable investments as they

[20] FDIC Options Paper, p. 14
[21] FDIC Options Paper, p. 44.

approach retirement, ACB believes that Congress should substantially increase deposit insurance for retirement savings that meet the tax requirements established under the Internal Revenue Code. Congress could provide increased coverage as part of deposit insurance reform, or in conjunction with enhancements to retirement savings incentives or social security reform.

Should coverage for municipal deposits be increased?

ACB members hold differing views on increased coverage for municipal deposits. This generally reflects differences in state and local practices. For example, in Minnesota local governments have joined together to form mutual funds for their liquidity needs, effectively bypassing insured depository institutions. New Jersey has a centralized and relatively straightforward system for collateralizing public deposits that makes it unnecessary for banks to match specific collateral with specific deposits. In other states banks are still able to compete for these deposits, but must follow complicated collateralization requirements. Bankers in those states believe they would benefit from increased deposit insurance for municipal deposits. Similarly, minority institutions also believe would benefit from increased deposit insurance for these deposits. However, policy makers must avoid imposing an across-the-board premium for increased coverage that would not benefit all institutions.

Should the FDIC make excess or co-insurance available as an option?

ACB does not support optional deposit insurance or co-insurance for amounts over the general coverage limit (whether the current $100,000 limit or some higher amount). ACB members believe that this could lead to confusion among depositors, with some banks offering more FDIC insurance than others. It would add an unnecessary complication to a system that the public understands fairly well, at least in broad outline. Other ACB members have commented that competitive pressure would eventually result in all institutions offering "optional" coverage. Finally, institutions that wish to provide additional protection for special cases can collateralize individual deposits or seek privately funded overline insurance. While private insurance could never substitute for basic FDIC coverage – no conceivable private firm could have the capacity – carefully targeted overline insurance is feasible and currently available.

Should the rules for determining coverage be further simplified?

In recent years, the FDIC has taken careful steps to simplify rules for coverage. ACB generally supported these changes, but we do not support further substantial changes in coverage rules. The Options Paper suggests that, "The most straightforward option would be to…eliminate the separate insurance coverage that is currently provided for accounts held in separate rights and capacities…."[22] (Note our view expressed above about the separate coverage of retirement

[22] FDIC Options Paper, p. 46.

accounts.) Any changes might simplify coverage computations, but would also tend to reduce the amount of coverage available. This would make it more difficult for institutions to attract deposits. In addition, further changes could actually complicate the work of new-accounts representatives in community banks. Too-frequent rounds of "simplification" would be costly to implement and provide too many opportunities for mistakes and misunderstandings.

Conclusion

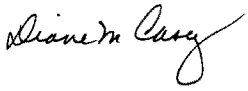
ACB appreciates the opportunity to comment on this important matter. We believe that it could lead to substantial improvements in the deposit insurance system.

These are ACB's key recommendations:

- BIF and SAIF should be merged without delay;
- Congress should set a ceiling on the merged fund and provide for rebates;
- If other important reforms are provided, the FDIC should have expanded authority to impose modest risk-based premiums;
- Highly rated institutions should continue to be exempt from premiums so long as the fund is above its statutory minimum level;
- If the fund falls below that level, the FDIC should have the flexibility to recapitalize it over a reasonable period;
- Institutions that grow at excessive rates should pay a special premium to maintain the integrity of the fund;
- The FDIC's current role should be maintained; deposit insurance must not be privatized;
- Congress should provide increased coverage by indexing coverage from the 1974 level of $40,000, without imposing significant additional premiums;
- Congress should substantially increase coverage levels for retirement savings.

If you have any questions, please contact Steve Verdier at (202) 857-3132.

Sincerely,



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America's Community Bankers®

DEPOSIT INSURANCE FOR A NEW CENTURY:

A COMPREHENSIVE RESPONSE TO FDIC REFORM OPTIONS

January 2001

Dear Community Bankers:

As you know, the FDIC released its Options Paper on Deposit Insurance last August. It is my pleasure to provide you ACB's comprehensive response on this issue. The options paper addressed issues raised by insured institutions and their representatives – proposals to set a ceiling on the fund, provide rebates, and increase coverage – it also asked for comments on a full range of deposit insurance issues. In addition to ACB's comprehensive views, this booklet includes the FDIC's introduction to its Options Paper, my cover letter to FDIC Chairman Tanoue, a brief history of deposit insurance, and a roster of ACB's Deposit Insurance Team.

On December 14, 2000, I led an ACB delegation which included our Second Vice Chairman Russ Taylor, Deposit Insurance Team Co-Chair Harry Doherty, ACB President and CEO Diane Casey and ACB Legislative Counsel Stephen Verdier, to meet with FDIC Vice Chairman Andrew Hove and FDIC staff to brief them on our letter.

While we discussed each major issue, each of us emphasized ACB's strong recommendation that the FDIC take immediate action to deal with the issue of excessive deposit growth. Our concern, expressed in the formal letter, is that unusually rapid growth in insured deposits could cause either the BIF or SAIF to fall below the statutory minimum of 1.25 percent of insured deposits, triggering a 23 basis point premium. Given the unease expressed by our members about this possibility, we urged the FDIC to also quickly seek more flexibility in any future fund recapitalization schedule.

We urged the FDIC to ask Congress to take quick action on these issues, as well as the long-standing FDIC and ACB priority of merging the two funds. That would allow longer-term deposit insurance reforms to take place in an orderly atmosphere.

Another issue we highlighted for the FDIC was our strong support for a substantial increase in deposit insurance coverage for retirement accounts. Americans are being asked to personally manage more and more of their retirement funds, so we believe it is essential that they be provided with far more than $100,000 coverage currently available. ACB also supports a modest increase of the non-retirement account coverage, indexing coverage from the 1974 level of $40,000. In today's dollars, that would provide coverage between $115,000 and $130,000. ACB believes that a more substantial increase, e.g., doubling coverage to $200,000, would trigger unacceptable premium increases.

ACB's positions are summarized on pages 2 and 3 of our comment letter to the FDIC.

ACB's Comprehensive Response to FDIC Reform Options, continued.

The concept of doubling deposit insurance has garnered a good deal of attention. ACB did not jump on that bandwagon. Instead we asked community bankers what they thought and as a result crafted a position that we have consistently been able to maintain. We asked to know whether the financial and regulatory costs to community banks would outweigh the benefits.

Our officers held discussions with hundreds of you in meetings throughout the year. We surveyed our members on the key issues. A 32-member Deposit Insurance Team – drawn from a number of ACB volunteer committees – held five meetings. (A roster of the team is included in this booklet.)

Former FDIC Chairman Ricki Helfer advised the team, which found her insights invaluable. Ms. Helfer retains the ability to take positions independent of ACB as the debate develops. ACB and former Chairman Helfer – as well as current Chairman Donna Tanoue – agree on one thing: the Bank Insurance Fund and the Savings Association Insurance Fund should be merged without delay or prior condition.

The team had to wrestle with a number of difficult questions, most prominent was the matter of increased coverage levels and how to pay for them. We concluded that the financial and regulatory costs of a doubling in coverage would likely be unacceptable. ACB's comment goes far beyond these issues, however. We agreed to some increase in the FDIC's authority to impose risk-based premiums on a broader range of institutions than is now permitted. However, we have two caveats:

1. The highest rated institutions should continue to be exempt from premiums while the deposit insurance fund remains above the 1.25 percent statutory minimum.
2. ACB supports this additional authority provided the other important reforms we recommend are included in the final package.

These are the essential elements of this package:

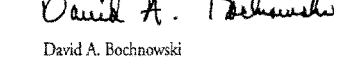
- Congress should set a ceiling on the deposit insurance fund (giving the FDIC the ability to adjust it).
- Reserves that exceed the ceiling should be returned to insured institutions on a risk-based basis.
- Institutions that grow at a rate significantly above the industry average should be required to compensate the fund by paying a special premium on excess growth.
- If the fund falls below 1.25 percent, the FDIC should have the authority to spread the recapitalization over a reasonable period.
- Congress should index coverage levels and provide substantial increases in coverage levels for retirement savings.

No one can predict the future of deposit insurance reform in the new Congress. While these issues generally do not cause partisan divisions, there are widely varying views within the industry and among policy makers in Washington.

Regardless of how this issue develops, I am confident that ACB's comments will provide a firm basis for testimony before the Congress and for comments to other interested parties. Read these comments and let the FDIC and your Members of Congress know what you think. Also, let ACB staff know what you think.

Finally, thank you for your support.

Sincerely,



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America's Community Bankers®

December 13, 2000

The Honorable Donna Tanoue
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Dear Chairman Tanoue:

Enclosed with this letter are the formal comments of America's Community Bankers in response to the Deposit Insurance Options Paper, which the FDIC issued in August.

We developed our positions by holding discussions with hundreds of our members in multiple forums, as well as seeking their views via survey. ACB's 32-member Deposit Insurance Team held 5 meetings, 4 by conference call and a final in-person session on December 4, 2000. In addition, ACB's Community Institutions Committee examined these matters during our recent national convention. Throughout the year, ACB's officers discussed deposit insurance issues with our members at ACB management conferences, seminars, and state association meetings. We also met with the board of the American League of Financial Institutions, which represents minority thrifts, during their annual meeting to solicit their views.

ACB strongly endorses the FDIC's position that the Bank Insurance Fund and the Savings Association Insurance fund should be merged immediately, without delay or prior condition. As you have repeatedly pointed out, this will result in a fund that is stronger than either is today.

In addition, ACB's comment covers the full range of issues raised in the Options Paper. This letter summarizes our major positions.

ACB would accept some broadening of the FDIC's authority to impose risk-based premiums on a broader range of institutions than is now permitted. However, we have two caveats:

1. The highest rated institutions should continue to be exempt from premiums while the deposit insurance fund remains above the 1.25 percent statutory minimum.
2. ACB supports this additional authority provided the other important reforms we recommend are included in the final package.

Letter to the Honorable Donna Tanoue, Chairman, FDIC, continued.

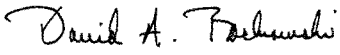
These are the essential elements of this package:

- Congress should set a ceiling on the deposit insurance fund (giving the FDIC the ability to adjust it).
- Reserves that exceed the ceiling should be returned to insured institutions on a risk-based basis.
- Institutions that grow at a rate significantly above the industry average should be required to compensate the fund by paying a special premium on excess growth.
- If the fund falls below 1.25 percent, the FDIC should have the authority to spread the recapitalization over a reasonable period.
- Congress should index coverage levels starting with the 1974 limit of $40,000. If unacceptable premium increases are a condition for an immediate increase in coverage, Congress should at least index coverage from the current $100,000 level.
- Congress should also provide substantial increases in coverage levels for retirement savings.

ACB believes that these changes would substantially strengthen the deposit insurance system by providing additional risk-based incentives; preventing an undue accumulation of reserves and returning funds to communities; preventing an unsafe dilution of the fund through excessive growth; providing for an orderly recapitalization of the fund when necessary; and maintaining the role of deposit insurance in our nation's savings and retirement systems.

ACB appreciates this opportunity to present our views. We look forward to working with the FDIC and the Congress on this important matter.

Sincerely,



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December 13, 2000

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/OES
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Re: Deposit Insurance Options Paper
August 2000

Dear Mr. Feldman:

America's Community Bankers (ACB) is pleased to comment on the issues presented in the FDIC's Deposit Insurance Options Paper.[1] ACB commends the FDIC for reaching beyond a few narrow deposit insurance issues and seeking comment on a wide range of concerns. ACB represents the nation's community banks of all charter types and sizes. ACB members pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

Merge BIF and SAIF

We also commend the FDIC for its continued strong advocacy of merging the Bank Insurance Fund and the Savings Association Insurance Fund. Simply stated, a combined fund would be stronger than either one standing alone. If Congress does nothing else regarding deposit insurance issues, it should merge the funds without delay. There is no reason to postpone this reform if broader issues cannot be resolved promptly. This is a particularly good time to merge the funds, since both are substantially above the statutory reserve ratio. The SAIF ratio is actually higher than BIF's, but each would benefit from the geographic and business diversity that the other would bring to a combined fund.

The Reform Process

Many of the options that the FDIC has raised would also require Congressional action, while some – particularly some changes to the risk-based premium system – could be implemented by the FDIC without further legislation. This letter provides ACB's views on the full range of issues raised in the Options Paper — pricing deposit insurance for individual banks, the FDIC structure most appropriate to fund any losses, and coverage levels.

[1] FDIC Deposit Insurance Options Paper, August 2000 ("FDIC Options Paper").

We developed our positions by holding discussions with hundreds of our members in multiple forums, as well as seeking their views via survey. ACB's 32-member Deposit Insurance Team held 5 meetings, 4 by conference call and a final in-person session on December 4, 2000.[2] In addition, ACB's Community Institutions Committee, Mutual Institution Committee, and our Board of Directors examined these matters during our recent national convention. Throughout the year, ACB's officers discussed deposit insurance issues with our members at ACB management conferences, seminars, and state association meetings. We also met with the board of the American League of Financial Institutions, which represents minority thrifts, during their annual meeting to solicit their views.

How a Reformed System Would Work

ACB's ideal scenario for the deposit insurance system includes creation of a single, stronger Deposit Insurance Fund through a merger of BIF and SAIF. The fund would continue to grow through a combination of earnings and risk-based premiums. The highest rated institutions would not be assessed as long as the fund remained above the statutory minimum of 1.25 percent of insured deposits. Once the fund reaches a new ceiling that would be set by Congress (after close consultation with the FDIC), the FDIC would provide risk-based rebates of any excess funds. The FDIC would have the discretion to adjust this ceiling under strict standards and procedures.

If the fund fell below the statutory 1.25 percent reserve ratio, the FDIC should be allowed to spread the recapitalization over a reasonable period. (Current law requires the FDIC to impose a 23 basis point premium to make up a shortfall that it expects will persist for a year.) This would allow the FDIC to balance the goals of replenishing the fund and maintaining a healthy banking system.

To maintain the integrity of the deposit insurance fund, institutions that grow at rates significantly above the industry average should pay a special premium on their excess growth. This should not apply to relatively small, *de novo* banks or to institutions that acquire existing insured deposits. It would not discourage regular competitive growth by established institutions or the formation of new competitors. However, it would deal with institutions that dilute the deposit insurance fund's reserve ratio by precipitately moving large amounts of funds under their effective control from uninsured to insured status.

ACB also recommends indexing the coverage levels to help maintain the role of deposit insurance in the nation's financial system. Congress should use as a base the last time it adjusted coverage primarily for inflation, which was in 1974. At that time, it increased coverage to $40,000. If adjusted for inflation since that time, the current coverage limit would be between $115,000 and $130,000.[3]

To recognize the increasingly important role that individual retirement savings plays in the economy and in our pension system, ACB recommends that Congress substantially increase the separate deposit insurance coverage for IRA, 401(k), and similar retirement accounts.

Summary of ACB Positions

1. ACB recommends that Congress set a ceiling on the deposit insurance fund's reserve ratio, giving the FDIC the ability to adjust that ceiling using strict standards after following full notice and comment procedures.
2. Reserves in the fund that exceed the ceiling should be returned to insured institutions based on their average assessment base measured over a reasonable period and based on premiums paid in the past. Rebatable premiums would include the SAIF special assessment, but not the high-growth special assessments.

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[2] See Appendix for roster.

[3] Raising the Deposit-Insurance Limit: A Bad Idea Whose Time Has Come? James B. Thomson; Federal Reserve Bank of Cleveland Research Department; April 15, 2000 ($115,000 in 1999 dollars); FDIC Options Paper, p. 45 ($130,000 in today's dollars).

3. When the fund is above its statutory minimum level the highest rated institutions would continue to be exempt from premiums, but the FDIC should have authority to impose a small risk-based premium on other institutions. ACB supports this additional authority provided the other important reforms we recommend are included in the final package.
4. Institutions that pose substantial risk to the fund would have their rebates reduced or eliminated.
5. In measuring risk for rebate or premium purposes, the FDIC should rely on additional objective information and not increase its current reliance on subjective examiner judgment.
6. Institutions that grow at a rate significantly above the industry average should be required to compensate the fund by paying a special premium on excess growth. This would avoid dilution of the fund by making the fund whole with respect to any excess growth, preventing the imposition of unnecessary premium costs on other institutions.
7. The special growth premium will not apply to smaller institutions for a reasonable period after they are chartered. It would also not apply to growth through merger or acquisition.
8. If the fund falls below the 1.25 percent designated reserve ratio (DRR), the FDIC should have the authority to spread the recapitalization over a reasonable period. This would be more responsible than the current law that requires the FDIC to impose a 23 basis point annual premium if the fund is expected to remain below 1.25 percent for a year.
9. ACB strongly supports the current FDIC role as a provider of deposit insurance and strongly opposes proposals to privatize deposit insurance coverage.
10. ACB supports indexing coverage levels to maintain purchasing power. Congress should index coverage levels starting with the 1974 limit of $40,000. That would result in a coverage level of between $115,000 and $130,000 in today's dollars.
11. So long as the fund is above its statutory minimum of 1.25 percent of insured deposits, this modest increase in coverage should not require any more than a very minimal risk-based premium. If unacceptable premium increases are a condition for an immediate increase in coverage, Congress should at least index coverage from the current $100,000 level.
12. Congress should also provide substantial increases in coverage levels for retirement savings in conjunction with its work on social security or pension reform or as part of deposit insurance reform, provided this can be accomplished without an unacceptable premium increase.

Our complete comments are organized below in accordance with the FDIC Options Paper.

Pricing Deposit Insurance

Should all banks pay some premium?

The Options Paper states that, "If deposit insurance were priced according to risk, it is likely that every bank...would pay something for deposit insurance."[4] This statement fails to take into account the fact that most insured institutions paid substantial premiums in the 1990s to capitalize the FDIC funds. Both BIF- and SAIF-insured institutions paid approximately 24 basis points annually for several years, and SAIF-insured institutions made an additional one-time, 66 basis point payment in 1996. Since those institutions have never caused insurance losses, ACB believes that they have already made advance payment to compensate the fund for risk that they pose.

[4] FDIC Options Paper, p. 3.

Nevertheless, there may be some benefit to imposing risk-based premiums on a wider range of institutions than is now permitted. Under current law, the FDIC may not charge premiums if the fund is above the 1.25 percent reserve ratio, except on "institutions that exhibit financial, operational, or compliance weaknesses ranging from moderately severe to unsatisfactory, or are not well capitalized...."[5] ACB believes that giving the FDIC the authority to impose a very modest risk-based premium even when the fund is above the statutory minimum could discourage riskier behavior and pave the way for other reforms. Such a premium should not extend to the highest rated institutions. Not only have they already paid substantial premiums, they – by definition – impose an extremely slight risk to the fund.

This broadened premium authority should not, however, be granted in isolation. ACB believes that a more reasonable recapitalization procedure, rebate authority, an excess-growth premium, indexed coverage levels, and greater coverage for retirement accounts are essential elements of a balanced plan.

Should there be a premium on excessive growth?

A special premium on excessive growth is essential to help prevent the fund from falling below 1.25 percent. As long as the fund remains above 1.25 percent, insured institutions can add an unlimited amount of insured deposits to the system without paying any premiums. This may lower the reserve ratio even if the absolute amount of money in the fund stays the same or if it grows modestly through earnings. It could even trigger an across-the-board premium if the fund were to fall below the 1.25 minimum. Therefore, ACB believes Congress should require the FDIC to assess growth-related premiums on institutions that grow at a rate significantly over the industry average. A growth-related premium would do two things. First, it would help the fund maintain its capitalization so that these institutions would not be "free riders" on premiums paid by long-standing members. Second, it would recognize that unusual growth is an important risk factor.

ACB believes this is an issue of great urgency. Therefore, we urge the FDIC to announce quickly that it will recommend that any premium be imposed as of the date it recommends that Congress impose such a premium. This procedure would be consistent with actions by Congress that have made new rules effective as of the date of a bill's introduction or the date of the first formal committee action.

Assessing a special premium only on significant growth would allow premium-free growth by an institution that had developed a particularly successful business plan. But, it would address the case of, for example, a diversified financial firm that was simply transferring significant amounts of uninsured funds under its effective control into its insured bank.

ACB believes that the special premium should compensate the fund at the then-current reserve ratio to avoid dilution of the fund. The FDIC should have the flexibility to collect this premium over a reasonable period to avoid imposing an undue shock on the affected institutions. While the premium might be collected over time, it should be booked immediately as a receivable in the fund to maintain its coverage ratio.

Ironically, Congress preserved the FDIC's ability to impose special assessments on *de novo* institutions.[6] Congress recognized that these institutions can be expected to grow at rates that exceed the industry average and impose other risks. However, because of their relatively small size, they cannot be expected to dilute a multi-billion dollar deposit insurance fund. The same thing cannot be said about an existing institution – now effectively exempt from premiums – that embarks on a new business plan that could

[5] 12 U.S.C. 1817(7)(b)(2)(A)(v).

[6] 12 U.S.C. 1815(d)(1)(A).

add tens of billions to the insured deposit base. So, while the law correctly recognizes the risk that a *de novo* institution may impose, it forces the FDIC to ignore the risk posed by an existing institution that begins growing at a rate significantly above the industry average.

Since the FDIC already has authority to impose a risk-based premium on *de novo* institutions, it is not necessary to impose special growth premiums on them. As indicated, they add little in absolute dollar terms to the insured deposit base, even if their rate of growth is very rapid. In addition, public policy should encourage the establishment of *de novo* institutions to increase credit availability to all segments of the economy. Finally, when the FDIC imposes a risk-based premium on these institutions where their level of growth or other factors impose significant risk, they already provide income to the fund.

As indicated above, the special excess growth premium should not apply to institutions that grow by acquiring existing deposits from other insured institutions. By definition, these deposits are already included in the insured deposit base, so shifting them from one institution to another does not dilute the fund.

Should the recapitalization schedule be modified?

ACB strongly supports changing the assessment system to address the case where the fund falls below 1.25 percent. The current system requires the FDIC to re-impose a minimum 23-basis-point premium if a fund falls below 1.25 percent and is expected to remain there for a year or more. As the Options Paper notes, the current system "amounts essentially to charging nothing in times of prosperity, and a lot in times of adversity, thereby potentially magnifying swings in the banking cycle."[7] Congress should correct this by giving the FDIC authority to spread any recapitalization over a reasonable period. The FDIC should impose these premiums on a risk-based basis.

The system we have outlined above introduces substantial risk-based incentives, while avoiding imposing premiums on the highest rated institutions when they are not needed. However, institutions would know that they could face premiums if the fund falls below 1.25 percent and could be rewarded with risk-based rebates once the fund exceeds the new ceiling. In between, institutions that impose some risk would pay modest premiums, while those that undermine the health of the fund by growing at extraordinary rates would pay a special premium.

Should the FDIC change the way it measures risk?

The Options Paper asks whether the FDIC should "rely on supervisory judgment, … other information," or "hybrid approaches."[8] ACB believes that the FDIC should base its judgments of risk on currently available, objective information. It should not increase its reliance on supervisory evaluations. ACB believes that the current CAMELS rating system already includes a sufficient amount of examiner judgment. The FDIC currently gathers a substantial amount of objective information via Call Reports. This information is far more consistent across the range of institutions than examiner judgments. While we recognize that there is no complete substitute for direct observation by trained examiners, no amount of training can completely eliminate inconsistencies from one examiner team to the next. If call report data are not adequate, then the reporting requirement should be refined — unneeded reporting removed, worthwhile additional requirements added.

[7] FDIC Options Paper, p. 5.

[8] *Ibid.* p. 11.

Should deposit insurance be priced from the bottom up or the top down?

In its options paper, the FDIC states "a 'bottom-up' view would set pricing at the individual bank level and let overall revenue result from the sum of payments across banks. A 'top-down' view would instead attempt to estimate appropriate aggregate funding needs and then allocate prices across banks based on risk."[9] ACB recommends against adopting either approach exclusively.

A bottom-up approach with no cap could lead to an ever-growing fund that would withdraw too much funding from the private market. Such a fund could also tempt policy makers to divert excess funding to non-insurance purposes.

Elsewhere in this letter, we recommend that Congress set a ceiling on the fund (while giving the FDIC some flexibility to adjust it under strict standards after following notice and comment procedures). To reach that ceiling the FDIC should rely on earnings and risk-based premiums. Though it would set a ceiling, a pure top-down approach also has drawbacks. It would limit the FDIC's ability to impose assessments and provide rebates in amounts that differ according to the relative risks posed by individual institutions.

Thus, we recommend a combination of the two approaches. From the top-down approach, we recommend imposing a cap on the fund (which the FDIC could adjust). From the bottom-up approach, we recommend a combination of risk-based premiums (where appropriate and needed), excess growth premiums, and risk-based rebates.

Should the FDIC use peer comparisons or absolute ratios?

ACB believes there is some value in measuring an institution's risk by comparing it with other, similar institutions. Comparisons would be useful in relatively good and stable times and outliers would tend to stand out. However, in times of general economic difficulty a peer comparison approach could be misleading. If most institutions were doing equally poorly and presenting serious risk, a pure peer analysis would fail to set off alarm bells. We also note that as each institution pursues increasingly diversified strategies, it is becoming harder to find true peers. As in the debate over bottom-up versus top-down premium structures, the answer has to be a careful combination of the two approaches.

Should the FDIC use market information to determine premiums?

The Gramm-Leach-Bliley Act requires a test of whether market mechanisms might help regulators measure and reduce risk among the largest institutions. Section 108 of the GLB Act directs the Federal Reserve and the Treasury to study the implications of requiring large insured depository institutions and depository institution holding companies to maintain a portion of their capital in the form of subordinated debt.[10]

This approach may be useful in comparisons among large institutions that pose a systemic risk and which may benefit from perceived too-big-to-fail protection unavailable to community banks. Nevertheless, ACB opposes using similar market-related tests for deposit insurance pricing. We share the concerns expressed in the Options Paper. First, the markets would likely take the too-big-to-fail implicit guarantee into account, giving higher ratings to larger institutions.

[9] FDIC Options Paper, p. 11.

[10] Public Law 106-102, Nov. 12, 1999.

Second, the FDIC has more information about all banks than anyone in the private market. Unless the examination process is poorly conceived and implemented, it surely generates insights that are not available to the market. Market signals may be used to confirm or redirect examination resources, though any banking concern big enough to be the object of intense market scrutiny probably has a permanent examiner on site anyway.

Third, market pricing is a combination of a judgment about the particular institution involved and general conditions. During some periods, institutions may not be able to issue debt at all. Finally, ACB does not believe that it is appropriate for the FDIC to rely on private firms' judgment when making an important public policy decision, e.g., the amount of premium to charge for federal deposit insurance and the level of rebates to provide.

Smaller institutions would be particularly disadvantaged by increased reliance on market judgment to assess premiums. It is rarely efficient for smaller institutions to issue debt of any type, and what may be issued is thinly traded. While the law permits the FDIC to establish separate pricing mechanisms for large banks,[11] we believe that widespread use of that authority is unnecessary and potentially divisive. ACB is concerned that such a system may discriminate against smaller institutions in certain geographic markets and those with concentrations in particular assets, e.g., home mortgage loans.

Should the FDIC enter into private reinsurance contracts to obtain market judgment about risk?

ACB understands that the FDIC has begun the process of studying this question with a private-sector firm. The issue is whether the FDIC could draw on information from the reinsurance markets for deposit insurance pricing. ACB believes the FDIC should look carefully to determine whether the private reinsurance market has the capacity to reinsure any substantial portion of depository institutions. It should also examine whether private reinsurance activities might impose an unwarranted insurance premium differential between large and small institutions. Finally, private reinsurance firms might seek access to examination data generally not made available to private parties.

While not included as a possibility in its Options Paper, ACB wishes to reiterate at this point that we strongly oppose proposals by others to privatize deposit insurance. The nation's economy has depended for decades on the FDIC and the ultimate backstop of the Federal Government. The private insurance market would be unable to engender the kind of public confidence made possible by the FDIC.

Structure of the Deposit Insurance Fund

Should Deposit Insurance be Based on a User-Fee or Mutual Model?

The Options Paper raises the question of whether the deposit insurance system should be reconfigured on a user-fee or mutual model. ACB believes it would not be useful to adopt a pure version of either. The terms themselves conjure up specific approaches from the past that may be misleading models for the future and could confuse more than clarify the debate. Instead, policy makers should decide the specific characteristics that they want today's system to have. It may be that the final product will look more like one than the other. We expect that it will have many elements more characteristic of a mutual arrangement. That is certainly how it has worked in the past. Congress has asked insured depository institutions to pay whatever it would take to pay the costs of running the system. And, for much of the history of the system, from 1950 until the 1980s, the law provided for rebates to insured institutions. Those certainly are characteristics of a mutual model.

[11] 12 U.S.C. 1817(b)(1)(D).

Of course, when it became impossible for institutions insured by the Federal Savings and Loan Insurance Corporation to cover the losses of its fund, the government did step in. And, the Treasury advanced funding to the BIF when it became necessary. These actions were characteristic of the user-fee model. Even here, however, SAIF- and BIF- insured institutions had to pay substantial premiums to recapitalize their funds. In addition, Congress insisted that insured institutions – first SAIF-insured institutions and then all FDIC-insured institutions – pay the interest on Financing Corporation (FICO) bonds that were issued to pay depositors. This "mutual" feature will be with us for years to come.

It is very clear that under the current statutory scheme, insured institutions are members of an assessable mutual system, with only a reimbursable financing line of credit from the Treasury. The only effective constraint on assessments is when they are causing more new failures than they are paying to resolve.

Former FDIC Chairman Ricki Helfer recently answered the question of mutual versus user-fee model this way:

> *Those kinds of categorizations can be useful for analytical purposes perhaps, but sometimes they can also obscure rather than clarify the relevant issues. Neither categorization best represents the way the system operates now nor the way that it can best serve American depositors in the future. The short answer to the FDIC's questions is that there are elements of both in a system that has risk-based deposit insurance and permits rebates from an over-capitalized fund. Buried in the terminology is the real issue: is there a maximum reserve ratio for each deposit insurance fund that can be identified at any particular time based on then existing circumstances? If there is, should banks enjoy rebates of reserves above that level, and can we design a rebate system that meets our second goal by maintaining a risk-based deposit insurance system and still provide rebates to banks from reserves above the ceiling?* [12]

The approach we suggest – pick the characteristics of the fund first and avoid artificial labels – also enables policy makers to avoid awkward proposals that would unnecessarily complicate their decision-making. For example, a pure mutual model might resemble the National Credit Union Share Insurance Fund (NCUSIF). Under that system, institutions maintain deposits in the fund and simultaneously carry them as assets on their books.[13] The General Accounting Office criticized this accounting treatment in 1991 and suggested that credit unions write off these assets over time.[14] Since credit unions are not publicly traded, this accounting issue is not heavily debated and does not affect investors. In contrast, stockholder-owned banks and savings institutions must be responsive to investor concerns. As a result, a pure mutual-model similar to NCUSIF might have to include a number of artificial constructs to conform to accounting rules. There does not seem to be any substantial public policy benefit to the exercise.

Many of the policies we recommend elsewhere in this comment – a cap on the fund, rebates, increased risk-based premium authority, and excess-growth premiums – tend to reinforce the mutual aspects of the system. But, we recommend them because we believe they will strengthen and improve the system, not to add new mutual features.

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[12] The Deposit Insurance System: What Reforms Make Sense?; Ricki Helfer, December 4, 2000; Address to America's Community Bankers, pp. 8-9 (Helfer, Dec. 4, 2000)

[13] FDIC Options Paper, p. 31.

[14] Credit Unions – Reforms for Ensuring Future Soundness; GAO/GGD-91-85, July 1991, pp. 171-174

Should a Rebate System be Reinstated?

As indicated elsewhere in this comment, ACB strongly believes that Congress should set a ceiling on the fund and rebate excess payments on a risk-based basis. During the 106th Congress, ACB supported legislation introduced by Senator Rick Santorum (R-Penn.) and Frank Lucas (R-Okla.) that would have set a 1.35 percent ceiling and used the excess to pay interest on FICO bonds.[15] Once the FICO bonds were repaid, excess funds would be used to pay rebates. The bill would have given the FDIC authority change the ceiling.

ACB continues to believe that this is a constructive approach to a serious potential problem that could be caused by a substantially overcapitalized insurance fund. However, the broader approach we outline in this letter could lead to full rebates more promptly than provided for in the Santorum/Lucas bill. Whatever the mechanism Congress provides, resources not needed for reasonably foreseeable deposit insurance purposes should not remain in Washington.

ACB agrees with former Chairman Helfer's recent comment:

> *I believe it is possible for the FDIC to develop analytical tools that will permit it to identify a ceiling on the funding needs of the deposit insurance system at any particular time — a DRR that would change as circumstances change.... The purpose of establishing a ceiling DRR is so that insurance funds will not grow beyond a size that can be justified on the basis of the needs of the deposit insurance system, thereby withdrawing capital from banks who could have contributed to economic growth by leveraging those funds to meet the economic needs of their communities. Amounts accumulated in the system over and above the DRR ceiling should be rebated to banks to facilitate economic activity, which benefits every one.*[16]

What Level Should the Fund Reach Before the FDIC Pays Rebates?

ACB believes that Congress should adopt the approach taken in the Santorum/Lucas legislation and determine an appropriate ceiling for the fund. In deciding the actual ceiling amount, ACB recommends that Congress consult closely with the FDIC. The agency has already done considerable historical analysis on the level of the funds and income needed to maintain them.[17] Clearly, the agency could adapt that analysis to determining a reasonable ceiling to recommend to Congress. As provided in the Santorum/Lucas bill, Congress should give the FDIC flexibility to adjust the ceiling. However, the agency should have to meet clearly stated standards before adopting a change. The FDIC should be required to find that there is a higher level needed to meet a substantial and identifiable risk to the fund or the financial system.

In addition, Congress should require the FDIC to follow a full notice and comment process under the Administrative Procedure Act before making any change to the ceiling. Any delay associated with this process should not cause undue concern, since the FDIC would, in all likelihood, be making a change when the fund was near its ceiling, substantially above the 1.25 percent minimum.

[15] S. 2293

[16] Helfer, Dec. 4, 2000, pp. 9-10

[17] 60 Fed. Reg. 42680 (Aug. 16, 1995).

How Should Rebates be Allocated?

The Santorum/Lucas legislation would provide rebates to all insured institutions once the FICO obligation is met. Until that time, excess funds in BIF and SAIF, or a new DIF, would be used to offset all insured institutions' FICO obligation or would remain in the fund. ACB continues to believe that this approach has merit and would support the Santorum/Lucas bill as a stand-alone proposal. However, we also believe that there is considerable merit to providing for a risk-based rebate system that could provide rebates before the FICO obligation ends. Under the system we favor, the riskiest institutions would get no rebates, while the safest institutions would get higher than average rebates. Those in between could expect average rebates. These differential rebates would provide the same risk-reduction incentive as variations in premiums when the fund needs them to impose them on the bulk of insured institutions. All institutions would know that as the fund approached the ceiling, they could expect to benefit by operating in a less risky manner.

Should the Systemic Risk/Too-Big-to-Fail Mechanism be Changed?

In FDICIA, Congress substantially limited the FDIC's ability to provide unlimited protection to depositors in too-big-to-fail institutions. The FDIC may not protect uninsured depositors and creditors if that would increase costs above simply covering insured deposits. As the Options Paper notes, this least-cost test can be overcome only if "the Secretary of the Treasury, upon the recommendation of two-thirds of the Boards of the FDIC and the Federal Reserve, and after consultation with the President, determines that a threatened bank failure would pose serious adverse effects on economic conditions or financial stability, the least-cost requirements can be avoided....[18] This procedure has never been implemented, but it certainly appears to impose substantial procedural hurdles to further FDIC involvement in the too-big-to-fail process.

Nevertheless, it is still possible that at some point the FDIC will step in under the systemic-risk exception to the least-cost requirement. The law requires that the FDIC impose a special assessment on all fund members to defray the excess cost of a systemic-risk resolution. Unlike normal assessments, this special assessment is based on total assets (minus equity capital and subordinated debt). When adopted in 1991, it was thought that this would tend to shift costs to larger banks that relied less on deposits to fund their assets. This did not exempt banks that could never expect to benefit from a systemic-risk rescue, but it was hoped that it would rebalance the scales to some extent.

This analysis is becoming dated because community banks themselves rely more on funding from the Federal Home Loan Banks as the competition for deposits becomes more severe. The balance sheets of large and small banks – in terms of their reliance on deposits as compared to borrowed funds – are likely to become more similar over time. Therefore, Congress may wish to consider doing directly what they attempted to do indirectly in 1991 and exempt banks under a certain size from any systemic-risk special assessment.

Though the FDIC's role in the too-big-to-fail process may be reduced, the Federal government, particularly the Federal Reserve, continues to have a major role in dealing with financial crises. Under the new financial structure provided under the Gramm-Leach-Bliley Act, this implicit shift of much of the too-big-to-fail responsibility from the FDIC to the Federal Reserve has merit. The fact remains, that invoking this protection for larger financial firms provides benefits to a just a few firms. Policy makers should continue to explore ways to impose some cost for this benefit, recognizing it is difficult to explicitly price an implicit benefit.

[18] FDIC Options Paper, p. 33.

Coverage Levels

Should Congress Increase General Coverage Limits?

ACB supports indexing coverage to maintain purchasing power. We also strongly support substantially increasing coverage for retirement savings, such as IRA and 401(k) accounts. In either case, we support increases provided they are not accompanied by substantial additional premiums. Most ACB members are skeptical that increases in general deposit insurance coverage levels would significantly increase funding. Former FDIC Chairman Helfer is even more skeptical. She recently said that "there is very little evidence that doubling the coverage limits will expand the deposit base of smaller banks. Community bankers that I have talked to think that very little benefit will result from a significant increase in coverage limits."[19]

However, it could improve community bank funding in some markets. In addition, increased coverage can be a helpful accommodation to some customers who wish to deposit relatively large, one-time receipts from, for example, the sale of a home or an inheritance. This would be valuable to a consumer who values safety, but is unlikely to fuel substantial sustained deposit growth throughout the banking system. Residual concerns that excess growth could result can be dealt with by ensuring that rapidly growing institutions pay a deposit insurance premium that reflects the greater risk they pose to the system and maintains the capitalization level of the fund.

Most ACB members believe that they can more effectively increase funding by offering increased interest rates, not through increased deposit insurance coverage. However, they recognize that these deposits are not as "loyal" as core deposits. Similarly, ACB members are concerned that increasing coverage levels could increase the size of very large deposits, complicating banks' liquidity management. Large deposits attracted simply by relatively high rates of interest often leave just as quickly as they are attracted. This could be the case with larger deposits attracted by increased deposit insurance coverage.

Though ACB recommends that a premium be imposed on institutions that experience unusually high growth, we do not believe that even doubling nominal insurance coverage would justify a substantial premium increase on all institutions. Even if coverage is increased to $200,000, the average account balance is certain to remain very substantially below that level. Small depositors with say, $1500, in checking and savings accounts are not going to increase their total deposits just because the upper insurance limit is increased. And, competitive factors suggest that substantially increased nominal coverage will not increase the overall deposit base by a large amount. Depositors with large sums may shift insured deposits from one bank to another to consolidate balances or take advantage of higher interest rates. But, one bank's gain may well be another bank's loss. ACB members who responded to our survey estimated only a net gain of 3 percent as a result of increasing insurance coverage to $200,000. Thus, doubling coverage levels is not the same as doubling the FDIC's risk.

Should Coverage Limits be Indexed?

If a substantial increase in coverage is not feasible, ACB supports indexing of the $100,000 level to maintain its purchasing power. This would not completely address the loss of coverage to inflation experienced since coverage was increased to $40,000 in 1974 and $100,000 in 1980. If coverage had been indexed using 1974/$40,000 as a base, the current level would be between $115,000 and $130,000; if indexed using 1980/$100,000 as a base, the current level would be approximately $200,000. Clearly, an adjustment accounting for inflation since 1974 is reasonable but such an increase would not justify an unacceptable premium increase. Former FDIC Chairman Helfer believes this is a "better approach" than increasing coverage to $200,000. However, she indicated that, "Whatever the correct number, it is the principle of indexing that is important."[20]

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[19] Helfer, Dec. 4, 2000, p. 12

[20] Helfer, p. 14

Indexing on a going-forward basis would certainly not justify any premium increase and would have the clear advantage that the FDIC identified in its Options Paper – insulation from political cross currents and maintaining "the same relative importance of deposit insurance in the economy over time...."[21] Indexing using the current level also avoids the debate over what year and level should be the basis for indexing. For better or worse, depository institutions and the economy have adjusted to the current level of coverage. Indexing would maintain that balance rather than seeking to recalibrate it based on a level that had been appropriate in the past.

To simplify and reduce the cost of implementation, as well as to promote consumer understanding, we recommend that any increases be provided only in $10,000 increments. Some ACB members are especially concerned that frequent small adjustments would be more costly than any benefit they might realize from increased deposit funding.

Should Coverage for Retirement Accounts be Increased?

Congress has provided substantial tax incentives to encourage individuals to accumulate retirement savings. These individual savings are replacing resources that employers previously provided through defined benefit pension plans. This shift in retirement funding has increased the burden on individuals to manage their own assets. As individuals respond to tax incentives, their retirement assets often exceed the current $100,000 coverage limit by substantial amounts. Since planners generally recommend that individuals shift these savings into more secure and stable investments as they approach retirement, ACB believes that Congress should substantially increase deposit insurance for retirement savings that meet the tax requirements established under the Internal Revenue Code. Congress could provide increased coverage as part of deposit insurance reform, or in conjunction with enhancements to retirement savings incentives or social security reform.

Should Coverage for Municipal Deposits be Increased?

ACB members hold differing views on increased coverage for municipal deposits. This generally reflects differences in state and local practices. For example, in Minnesota local governments have joined together to form mutual funds for their liquidity needs, effectively bypassing insured depository institutions. New Jersey has a centralized and relatively straightforward system for collateralizing public deposits that makes it unnecessary for banks to match specific collateral with specific deposits. In other states banks are still able to compete for these deposits, but must follow complicated collateralization requirements. Bankers in those states believe they would benefit from increased deposit insurance for municipal deposits. Similarly, minority institutions also believe they would benefit from increased deposit insurance for these deposits. However, policy makers must avoid imposing an across-the-board premium for increased coverage that would not benefit all institutions.

Should the FDIC Make Excess or Co-Insurance Available as an Option?

ACB does not support optional deposit insurance or co-insurance for amounts over the general coverage limit (whether the current $100,000 limit or some higher amount). ACB members believe that this could lead to confusion among depositors, with some banks offering more FDIC insurance than others. It would add an unnecessary complication to a system that the public understands fairly well, at least in broad outline. Other ACB members have commented that competitive pressure would eventually result in all institutions offering "optional" coverage. Finally, institutions that wish to provide additional protection for special cases can collateralize individual deposits or seek privately funded overline insurance. While private insurance could never substitute for basic FDIC coverage – no conceivable private firm could have the capacity – carefully targeted overline insurance is feasible and currently available.

[21] FDIC Options Paper, p. 44.

Should The Rules for Determining Coverage be Further Simplified?

In recent years, the FDIC has taken careful steps to simplify rules for coverage. ACB generally supported these changes, but we do not support further substantial changes in coverage rules. The Options Paper suggests that, "The most straightforward option would be to…eliminate the separate insurance coverage that is currently provided for accounts held in separate rights and capacities…."[22] (Note our view expressed above about the separate coverage of retirement accounts.) Any changes might simplify coverage computations, but would also tend to reduce the amount of coverage available. This would make it more difficult for institutions to attract deposits. In addition, further changes could actually complicate the work of new-accounts representatives in community banks. Too-frequent rounds of "simplification" would be costly to implement and provide too many opportunities for mistakes and misunderstandings.

Conclusion

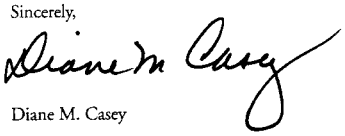
ACB appreciates the opportunity to comment on this important matter. We believe that it could lead to substantial improvements in the deposit insurance system.

These are ACB's key recommendations:

- BIF and SAIF should be merged without delay;
- Congress should set a ceiling on the merged fund and provide for rebates;
- If other important reforms are provided, the FDIC should have expanded authority to impose modest risk-based premiums;
- Highly rated institutions should continue to be exempt from premiums so long as the fund is above its statutory minimum level;
- If the fund falls below that level, the FDIC should have the flexibility to recapitalize it over a reasonable period;
- Institutions that grow at excessive rates should pay a special premium to maintain the integrity of the fund;
- The FDIC's current role should be maintained; deposit insurance must not be privatized;
- Congress should provide increased coverage by indexing coverage from the 1974 level of $40,000, without imposing significant additional premiums;
- Congress should substantially increase coverage levels for retirement savings.

If you have any questions, please contact Steve Verdier at (202) 857-3132.

Sincerely,



Diane M. Casey

[22] FDIC Option Paper, p 46.

FDIC Deposit Insurance Options Paper Introduction

This options paper is part of a comprehensive review of the U.S. deposit insurance system by the Federal Deposit Insurance Corporation (FDIC). We are undertaking this review to assure the ability of the system to meet its responsibilities over the next decade. Industry consolidation, expanded activities, global-ization and the use of technology have advanced the business of banking and the products and services offered to American depositors. The FDIC wants to ensure that the deposit insurance system continues to protect depositors and contributes to its full extent to the stability of the banking system.

The United States has the oldest federal deposit insurance system in the world, established in 1934 to put an end to the devastating bank runs that shut down businesses and contributed to the Great Depression. The system proved to be a success; following its introduction, deposit insurance restored public confidence in the banking system. For the next three generations, the system served its purpose by helping prevent banking problems from becoming banking panics. In the 1980s, when hundreds of banks and thrifts failed, deposit insurance acted as the anchor for public confidence in the banking system.

In good times and bad times, deposit insurance provides a safe and certain place for people to put their money. By eliminating the disruption caused by bank runs, deposit insurance contributes to the foundation necessary for a robust banking system and by extension, a dynamic financial system. In turn the general economy benefits from the stabilizing influence of deposit insurance.

The success of the U.S. system of federal deposit insurance is particularly evident in contrasting the U.S. experience during the 1980s crisis with recent crises in Asian and Latin American countries that lacked explicit deposit insurance systems. During the U.S. crisis, there were no depositor runs on banks, and bank failures were resolved through a well-established, orderly process. This was not the case for countries without explicit deposit insurance, and it is perhaps sufficient to note that more than 30 countries chose to implement new, explicit deposit insurance systems during the 1990s. The benefits of deposit insurance are appreciated worldwide, and the U.S. system has become a model for the rest of the world.

Nevertheless, the 1980s crisis in the U.S. also provides a sobering reminder that a flawed deposit insurance system can be extremely costly. U.S. taxpayers were billed for more than $130 billion to clean up the savings and loan crisis following the demise of the Federal Savings and Loan Insurance Corporation (FSLIC). This demonstrates that deposit insurance raises complicated issues and requires a careful balancing of competing public policy concerns.

Today, the bank and thrift industries have never been healthier. Bank capital levels are at an all time high, profitability has climbed for the ninth year in a row, and the insurance funds have substantial combined reserves of $42 billion. There will never be a better time to address the latent flaws in the system. Reforms now will also help us maintain the proper incentives for risk and reward to insured institutions, as well as fairness among institutions that present different levels of risk to the system.

The FDIC has identified three fundamental areas for review: the processes for pricing risks, funding insurance losses, and setting coverage limits. This options paper describes various ways in which we might make improvements to the deposit insurance system. The options are intended to prompt analysis and comment from individuals and organizations that have an interest in the issue

The Need for Reform

With the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), Congress passed a number of significant reforms to shore up the deposit insurance system. These included prompt corrective action, least-cost resolutions,

scaling back of too-big-to-fail, the introduction of risk-based premiums, and a mandate to maintain adequate insurance funds. With the Deposit Insurance Funds Act of 1996 (DIFA), Congress ensured that members of the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) would not face significant and arbitrary differences in deposit insurance pricing.

Despite these significant improvements, the current deposit insurance system has several features that work against the effective and equitable functioning of the system:

- The continued existence of two separate insurance funds based on an anachronistic distinction;
- The current pricing system that creates inappropriate incentives and raises fairness issues;
- The requirement that banks are required to fund insurance losses when they can least afford it; and
- Uncertainty for depositors as to the future real value of FDIC coverage.

Over the past decade the FDIC has stated its view that the two insurance funds the FDIC administers should be merged. The distinction between the funds is increasingly arbitrary; a combined fund would be stronger and more efficient; and the time to merge them is when they are both healthy. These arguments are laid out in detail in Attachment A. This options paper will not address this flaw, other than to state the FDIC's position that a merger of the funds is good public policy either on a stand-alone basis or as the prerequisite for any other changes to the deposit insurance system.

The second and third of these problems result from the conflicting mandates of the FDICIA: to price deposit insurance premiums according to the risk posed by individual institutions, and to maintain a target level of reserves within the insurance funds. The tension between the dual mandates of risk-based pricing and a fixed fund level became far more explicit in 1996 as DIFA severely limited the FDIC's ability to price according to risk.

Because of current restrictions on pricing deposit insurance, most banks and thrifts pay no insurance premiums when they are doing well, but pay high premiums when the industry is weak and banks are failing. This does not make sense for the banks or for the communities they serve. It is possible that, in difficult times, deposit insurance premiums could reduce the pre-tax net income of insured institutions by almost $9 billion. Based on current average capital and loan-to-assets ratios for all insured institutions, this reduction in income could lead to a contraction in lending of more than $65 billion at the precise time in the business cycle when loans are most needed.

The current process for setting deposit insurance coverage limits has brought the issue before Congress on a somewhat arbitrary and ad hoc basis. This has resulted in significant fluctuation in the real value of insurance for depositors. The current coverage limit of $100,000 has declined in real value by half since it was established in 1980. This raises the question of whether Congress wishes to continue providing the same level of insurance protection for consumers in real terms, or to allow the coverage level to erode in value by maintaining the status quo. The current deposit insurance arrangements lead to several questions:

How Should the FDIC Price Risk?

Through a combination of legislative changes, regulatory choices and economic events, the pricing and funding of deposit insurance evolved during the 1980s and 1990s into something fundamentally different from what existed during the first 50 years of the FDIC's history. Banks that are paying for deposit insurance at the end of the 1990s are those that have run afoul of capital regulations or the supervisory process. This is a significant departure from past practice. Pricing of deposit insurance has evolved into a penalty system for the few, rather than a priced service for all.

Thus, a decade that began with a legislative mandate for risk-based insurance premiums ended with the FDIC providing a free guarantee of almost three trillion dollars in bank and thrift liabilities. As a result, the moral hazard problems

FDICIA intended to address with risk-based deposit insurance may have become more firmly entrenched than ever. (Moral hazard problems are discussed in more detail in Section IV, "Coverage Limits.") A striking feature of a zero premium is that not only may the rate paid by vastly disparate banks be identical, but the dollar amount as well: a bank with $100 billion in deposits and a complex risk profile can be billed the same amount for its insurance as the smallest and most conservatively run community bank. Presumably, the rationale behind a statutory zero premium is that, as long as a fund is above its target level, it does not need additional funds. However, aside from raising money for the insurance funds, premiums also serve to align economic incentives. When a valuable product is offered at zero cost, it leads to that product being overused, causing distortions throughout the marketplace and, in the case of deposit insurance, potentially exacerbating moral hazard.

If deposit insurance were priced according to risk, it is likely that every bank in the U.S. with insured deposits would pay something for deposit insurance, for the same reason that every bank pays at least some spread over Treasuries for unsecured debt. However, since shortly after the BIF was recapitalized in May 1995, its members that are in the best-rated, 1A-assessment category have not been required to pay deposit insurance premiums. Members of the SAIF that are rated 1A have paid no premiums since January 1997.[1]

At year-end 1999, only 7 percent of all banks and thrifts paid premiums into the deposit insurance funds. Ninety-three percent, or more than 9,500 institutions, do not pay premiums. This stands in stark contrast to the first 50 years of the federal deposit insurance program, when every insured institution paid an annual rate of 3.3 to 8.3 cents for every $100 of insured deposits.

Despite the uniform assessment ratings given to these 1A institutions, they do not all present uniform risks to the deposit insurance funds. The current premium matrix does not recognize institutions that, by objective measures and historical experience, have a higher risk profile, unless the institution fails to maintain the minimum level of capitalization to be considered "well-capitalized" as defined for prompt corrective action purposes or is subject to heightened supervision.[2] In a less favorable economic environment, many of these 1A-rated institutions would deteriorate faster than others, yet that higher degree of risk is not built into the current assessment scheme.

How Should New Deposits be Treated?

Most banks and thrifts established since the recapitalization of the insurance funds have never paid for deposit insurance. Through March 2000 this included 844 new banks and thrifts whose insured deposits totaled more than $44 billion. The responsibility for maintaining the $550 million needed to capitalize these deposits at a 1.25 percent DRR falls on the other members of the deposit insurance system.

Similarly, institutions that are rated 1A can grow their insured deposits without paying assessments. This zero marginal cost of insurance clearly differs from the private insurance industry, in which higher coverage amounts entail higher charges. With the marginal cost of deposit insurance at zero, the same issues of fairness arise that occur under the new bank scenario: all insured institutions eventually are assessed to cover deposit growth at the fastest-growing, 1A-rated institutions. In a deteriorating financial environment, it will be necessary to raise assessment rates earlier or by a greater amount to make up for the dilution of the reserve ratio attributable to unfunded insured-deposit growth. Under some circumstances, insured-deposit

[1] More details on the risk categories in the current premium system are presented in Attachment C.

[2] Federal supervisors rate insured institutions on six factors: Capital; Asset Quality; Management; Earnings; Liquidity; and Sensitivity to market risk (CAMELS). Institutions receive an overall rating ranging from 1 to 5, with 1 being the best rating.

The original decision by the FDIC to lump CAMELS 1- and 2-rated institutions into the same risk category for premium purposes was largely codified into law in 1996 by the DIFA. Federal Deposit Insurance Funds Act, Pub. L. No. 104-208, §§ 2708(b) and 2708(c) (1996) (codified at 12 U.S.C. §§ 1817(b)(2)(A)(iii) and (v)). As a result, the FDIC is largely prohibited from distinguishing between CAMELS 1- and 2-rated institutions for determining premiums.

growth could occur rapidly, accelerating the need to raise assessment rates for all insured institutions. This could happen even in a favorable economic environment in which deposit-insurance losses remain low. In early 2000, an investment company announced plans to convert some of its customers' funds into FDIC-insured accounts. Reports in the media suggested that as much as $100 billion could be converted in this manner in a relatively short period of time. Sudden growth of this magnitude at 1A-rated banks, with no corresponding growth in the fund balance, would dilute the fund's reserve ratio. In this example, the BIF reserve ratio would fall by 5 basis points. With a reserve ratio of 1.35 percent as of March 31, 2000, such a decline would leave the fund's reserve ratio above the statutory minimum of 1.25 percent, but the industry would be closer to mandatory rate increases for all insured institutions, depending on insured-deposit growth and insurance losses. From March 31, 2000, through June 30, 2000, insured deposits at the banks affiliated with the investment company grew by $12 billion.

There is also the possibility of a large shift of household assets into insured deposit accounts in the event of financial market volatility. There is currently more than $11 trillion outstanding in U.S. equity holdings (including mutual fund shares) alone. In a protracted bear market, some of these funds could be transferred to insured deposits. And it is still too early to gauge the probable impact of electronic banking on insured deposit growth. Obviously, the likelihood of deposit inflows from these examples, as from a myriad of other possibilities in an era of financial modern-ization, cannot be known. The question is whether the current deposit insurance system is capable of addressing the issues raised by these possibilities.

Conversely, institutions that shrink their deposits are not compensated for the indirect benefit they confer on other members of the system. Most BIF members have paid no premiums since 1995, and most SAIF members have paid none since 1996, but all insured institutions paid very high rates in the earlier 1990s. The issue of deposit growth and shrinkage becomes important in any discussion of rebates (other than the refunding of current assessment income). Any such program would require legislation, but the question of who is entitled to how much is complicated by the existence of institutions whose deposit growth or shrinkage was atypical. For example, aggregate BIF-insured deposits grew by 10.5 percent from year-end 1995 to year-end 1999, during which time one bank grew its insured deposits (without any acquisitions) from $19 million to $1.2 billion (up 6,140 percent), and another bank reduced its insured deposits from $763 million to $423 million (down 45 percent). Of these two banks today, the one with a lower level of insured deposits paid considerably higher total assessments in the 1990s.

How Should Losses be Funded?

In reaching a point where the FDIC does not collect assessment revenue from most institutions during good times, we have clearly departed from any concept of spreading insurance losses over time by collecting revenue on an ex ante or long-run expected loss basis. In contrast, prior to 1989 it could be argued that Congress intended the FDIC to operate under a form of long-term expected loss pricing. During the period 1933-1989, when premiums were set by statute and never departed from a range of between 3 and 8.3 basis points per annum, accumulated premiums and the investment income on those balances enabled the system to roughly pay for itself. The system in place today, in contrast, amounts essentially to charging nothing in times of prosperity, and a lot in times of adversity, thereby potentially magnifying swings in the banking cycle.

The current "cushion" in the BIF, the amount by which the fund exceeds 1.25 percent, is $2.3 billion.[3] If insurance losses not covered by the systemic risk exception were to exceed this amount—as they did in each year from 1988

[3] Despite growth of the fund during the first quarter of 2000, this cushion fell from $2.5 billion at year-end 1999 because of insured-deposit growth in the first quarter.

through 1992[4]—and the fund fell below 1.25 percent and was expected to remain there for a year or more, the FDIC would be forced to raise average assessment rates to a minimum of 23 basis points. Therefore, all banks would be forced to pay substantially higher premiums at a time when many banks were under stress. On a strict pay-as-you-go basis, banks would have had to pay approximately 62 basis points in 1991.

If the FDIC had more latitude in setting rates when the reserve ratio falls short of the DRR, the recapitalization period could be extended with rates less than 23 basis points. This would help to avoid a credit crunch and to moderate the negative impact of deposit insurance premiums on real economic activity.

How Should the Coverage Levels be Determined?

The current process for setting deposit insurance coverage limits has brought the issue before Congress on a somewhat arbitrary and ad hoc basis. This has resulted in significant fluctuation in the real value of insurance for depositors. Deposit insurance has a simple, but important purpose: to provide a safe place for depositors to keep their money, as a way to prevent bank runs and maintain the stability of the banking and financial system.

Since 1934, the basic coverage amount has increased five times, from $5,000 to $100,000. Most of the increases more or less reflected cost-of-living adjustments, but the most recent increase is an exception. The 1980 jump from $40,000 to $100,000 had more to do with attracting deposits to insured institutions in a competitive market of very high interest rates. Today, 20 years later, $100,000 of deposit insurance has lost about half its value, based on the Consumer Price Index.

The next several decades will be a time in which the population is aging, retirement costs are increasing, and the supply of federally-backed investment vehicles, such as Treasury notes and bonds, may decline. Thus, a long-term perspective may argue for allowing for the coverage limit to keep up with changes in the price level, household wealth, or other measures relevant to households.

However, there are trade-offs to consider. Higher coverage limits can increase moral hazard. The 1980 increase is widely viewed as contributing to the high cost of the savings and loan crisis. Also, the impact of higher coverage limits on insured deposit growth is difficult to predict, and the likely distribution of benefits is subject to debate.

Overview of Options Paper

This remainder of this paper organizes the discussion into three major areas: pricing risk, funding insurance losses, and coverage levels.

Section II of this paper discusses the pricing of deposit insurance for individual banks. If deposit insurance is viewed as a service that banks use, the question is how this service should be priced. One answer is that the price should reflect the risk that the bank presents to the deposit insurance system. This expected loss approach to pricing is consistent with the best practices that have developed in the banking industry in recent years.

The next question is what information should serve as the basis for pricing. Supervisory ratings are appealing because they are based on quality information and reflect the judgment of experienced supervisors; however, too great a reliance on ratings raises concerns about consistency and subjectivity. This suggests the appeal of more objective information, which could include non-public information (such as credit exposures), Call Report information, and market information. Finally, the FDIC could generate pricing information through risk-sharing contracts with market participants.

Section III deals with how deposit insurance losses are funded from an aggregate perspective. The funding of FDIC losses has evolved over the years from a system that featured steady premiums with a fluctuating reserve ratio to a system that

4 Annual losses ranged from $2.7 billion to $6.9 billion during this five-year period. These are actual losses and not loss provisions, which were even higher but were partially recovered when many projected failures did not occur.

targets a specific reserve ratio and results in volatile premiums. The mandate to maintain a particular ratio can lead to steep premiums during bad times and calls for rebates during good times.

One general approach is a user fee system in which banks have no claim on past premiums. Under such an approach, the question is whether premiums will be relatively stable and consistent with expected loss pricing, or whether premiums will be more closely tied to current losses or the reserve ratio in order to guard against premiums that are too high or too low.

A mutual approach would differ from the user fee system in that banks would have some claim on past premiums. This could take the form of rebates when the insurance fund is viewed as too large; this raises the question of how to allocate these rebates. Alternatively, banks could hold claims on the insurance fund, similar to mutual fund shares. This could address concerns about free rider and pricing problems. Under mutual arrangements, the cash flow between a bank and the insurance fund could have two components: one to price risk at the margin and the other to reflect the bank's claim on the fund.

Section IV discusses the appropriate extent of deposit insurance coverage. The section begins with a review of the history of coverage levels in nominal and real terms. This is followed by preliminary estimates of how an increase in the coverage limit would be expected to increase the amount of insured deposits. This depends on the behavior of households and businesses, and further study would allow more confidence in these estimates.

It is widely recognized that there is a tradeoff between the stability that deposit insurance brings and the potential for distortion of the market process. Coverage levels speak directly to that tradeoff: higher coverage may provide greater stability during difficult times, while lower coverage may enhance market discipline and minimize distortion. The section addresses this tradeoff with a discussion of moral hazard, implicit protection, and industry structure.

The options in the coverage section include continuing the existing system of ad hoc statutory adjustments; indexing for inflationary adjustments; or simplifying the current system to limit a particular level of coverage to one account per person. Other ideas for changes to coverage include extending higher coverage to municipal and other public deposits; this raises issues similar to those posed by brokered deposits. The section ends with excess coverage options including increased use of private coverage, new excess coverage through the FDIC, FDIC-backed private insurance, or coinsurance systems.

Source: FDIC Deposit Insurance Options Paper, August 2000, Introduction, pages 1-7.

Origins and Purposes of Deposit Insurance Funds: A Brief History

The states were the first to establish state deposit insurance programs. The first was proposed in New York in 1829 by Governor Martin Van Buren.[1] From 1829 to 1917, 14 states had established deposit insurance programs for their state-chartered banks. These programs had two purposes: to protect communities from the economic disruptions caused by bank failures and to protect depositors against losses.

While the states had taken the lead, a number of members of Congress were interested in establishing a federal deposit insurance system. The first bill was introduced in 1866.[2] Between 1886 and the establishment of the FDIC in 1933, 150 proposals for deposit insurance or guaranty were introduced in the Congress.[3]

The stock market crash of 1929 and the ensuing banking crisis in the early 1930s provided the necessary impetus for Congress to create a system of federal deposit insurance. In the four years after the crash about 9,000 banks closed, resulting in losses to depositors of over $1.3 billion.[4] Conditions deteriorated further during the winter of 1932-33. By March 4, 1933, the date of President Roosevelt's inauguration, every state in the union had declared a bank holiday. One of Roosevelt's first official acts was to declare a nationwide bank holiday to begin on March 6th.[5] Congress then passed the Emergency Banking Act, which legalized the national bank holiday and set standards for reopening banks.[6]

Having passed the emergency legislation, Congress turned its attention to the issue of deposit insurance. The House had passed a deposit insurance bill in 1932, but the Senate had adjourned without acting on it.[7] The chief proponent of federal deposit insurance was House Banking Committee Chairman Henry Steagall who faced strong opposition from the Roosevelt Administration, most of the banking industry, and Chairman of the Senate Banking Committee, Carter Glass.[8]

Opponents of federal deposit insurance pointed to the failure of the state deposit insurance programs and argued that a federal program would not work. They said it would remove penalties for bad management, that it would be too expensive, and would be an unwise intrusion by the federal government into the private sector.

In May of 1933, both Senator Glass and Representative Steagall introduced bills including deposit insurance provisions. Senator Glass apparently yielded to public opinion indicating that voters wanted deposit insurance. After a heated but short conference, a compromise was reached with the House conferees agreeing to accept the two controversial provisions of the Senate bill. They required Federal Reserve System membership for insured banks and made deposit insurance a temporary program.[9] Both houses passed the conference report on June 13, 1933 and the President signed the bill on June 16, 1933.[10]

The 1933 Act created the Federal Deposit Insurance Corporation by amending the Federal Reserve Act.[11] Capital to establish the FDIC was to come from the Treasury and the 12 Federal Reserve Banks. Treasury contributed $150 million and each of the Reserve Banks was required to buy stock in an amount equal to half of its surplus as of January 1, 1933.[12]

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1 *Political Science Quarterly*, June 1960, p. 182.
2 *Ibid.* p. 186.
3 FDIC, The First 50 Years, 1984 – p. 31.
4 *Ibid.* p. 36.
5 *Ibid.* p. 38.
6 *Ibid.*
7 *Ibid.* p. 40.
8 *Ibid.*
9 *Ibid.* p. 43.
10 *Ibid.*
11 *Ibid.*
12 *Ibid.* p.44

The temporary plan limited deposit insurance protection to $2,500 for each depositor.[13] Banks admitted to the plan were to be assessed an amount equal to one-half of one percent of insurable deposits.[14]

The permanent plan set forth by the 1933 Act was replaced by the Banking Act of 1935 which made several major changes in the deposit insurance program. The 1935 Act adjusted the annual assessment rate to a one-twelfth of one percent annual assessment rate on total deposits.[15] The Act also continued the coverage of $5,000 per account, rather than the increased sliding scale version of the "original" permanent plan.[16]

The $5,000 per account limit remained until 1950, when it was raised to $10,000. It was increased to $15,000 in 1966, to $20,000 in 1969, to $40,000 in 1974, and to $100,000 in 1980.[17]

Representative Steagall outlined the purposes of the deposit insurance program as follows: . . . the purpose of this legislation is to protect the people of the United States in the right to have banks in which their deposits will be safe. They have a right to expect of Congress the establishment and maintenance of a system of banks in the United States where citizens may place their hard earnings with reasonable expectation of being able to get them out again upon demand . . . . This bill seeks to establish a mutual insurance system supported and maintained by the banks themselves, in their own interests as well as for the benefit of their depositors . . . . We cannot have a normal use of bank credit in the United States until people are willing to put their deposits in banks. Deposits constitute the basis for bank credit, and bankers can never be free to extend credit accommodations for the support of trade and commerce until they are permitted to retire at night without fear of mobs at their doors the next morning demanding cash for their deposits.[18]

As indicated, President Roosevelt and Senate Banking Committee Chairman Carter Glass both initially opposed federal deposit insurance. Roosevelt felt that the use of tax revenues to finance such a system was unacceptable. However, because of the weakened condition of the banking industry, policy makers recognized that at least some of the initial capitalization would have to come from government sources.

During Senate debate, Senator Glass repeatedly emphasized that this was to be an insurance fund, but not a government guarantee. He stated: "I am not standing here as an advocate. For 35 years in the other House, and up to this time in the Senate, I have opposed guaranteeing deposits, but this is not a Government guaranty of deposits . . . . The Government is only involved in an initial subscription to the capital of a corporation that we think will pay a dividend to the Government on its investment. It is not a Government guaranty."[19]

The financial crisis of the 1920s and the 1930s also led to the current regulatory system for thrifts. The National Housing Act of 1934 established the Federal Savings and Loan Insurance Corporation (FSLIC) as a permanent government corporation and placed it under the supervision and authority of the Federal Home Loan Bank Board.[20]

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[13] *Ibid.*

[14] *Ibid.*

[15] Banking Act of 1925, Conference Report No. 742

[16] *Ibid.*

[17] FDIC, First Fifty Years, p. 69.

[18] Congressional Record, 1933; Conference Report No. 742, p. 3037.

[19] *Ibid.* p. 3727.

[20] "A Guide to The Federal Home Loan Bank System" p. 47.

The differences between a bank and thrift charter allowed the Act's supporters to argue that the creation of FSLIC was more related to housing policy than monetary or economic policy. The threat to thrifts was not deposit losses, but rather that a lack of public confidence might prevent an adequate inflow of new funds to maintain home lending.

In a statement to the Senate Banking Committee on May 16, 1934, Bank Board Chairman John Fahey argued that FSLIC was a matter of equity for thrifts: "The advent of deposit insurance for banks has resulted in substantial deflection of wage earners' savings from investment in building and loan associations to deposit in banks where they will be insured. Not only principles of fair treatment, but the economic necessity of keeping funds from flowing out of institutions where they are needed and into institutions where they will presently be unused calls for the erection of a system of insurance for building and loan associations comparable to that presently in operation for the proteciton of bank depositors.[21]

Despite this concern, the thrift industry initially resisted the new deposit insurance. Federally chartered thrifts were required to carry it, but coverage was optional for state-chartered thrifts, most of which refused to sign up.[22] It was not until 1951 that FSLIC-insured thrifts outnumbered non-FSLIC-insured thrifts.

Under the 1934 Act, savings accounts in FSLIC-insured thrifts were guaranteed up to $5,000. Due to the different nature of the account, in event of a failure, a depositor was entitled to receive 10 percent of his or her account in cash immediately, 50 percent of the remainder within one year and the balance within three years of the default.[23]

The 1934 Act established the FSLIC premium rate at one-fourth of one percent of total deposits.[24] That Act also permitted a special assessment, also at the one-fourth of one percent rate. Both assessments were reduced to one-eighth of one percent in 1935.[25]

In 1950, the regular premium was reduced to 1/12 of one percent.[26] Although on the books since 1934, the special assessment was not imposed by FSLIC until 1985. The one-eighth of one percent was levied quarterly from 1985 through 1988.

The limits of FSLIC insurance coverage increased concurrently with FDIC insurance, from $5,000 in 1934 to $100,000 in 1980.[27]

[21] Congressional Record, May 16, 1934, p. 33.
[22] *Ibid.* p.47.
[23] *Ibid.*
[24] *Ibid.* p.48
[25] *Ibid.*
[26] *Ibid.*
[27] *Ibid.*

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On behalf of the

INDEPENDENT COMMUNITY BANKERS OF AMERICA

Before the

FINANCIAL INSTITUTIONS AND CONSUMER CREDIT SUBCOMMITTEE
HOUSE FINANCIAL SERVICES COMMITTEE

Washington, D.C.
May 16, 2001

Good morning Chairman Bachus, Ranking Member Waters, and members of the Committee. My name is Robert I. Gulledge, and I am chairman, president and CEO of Citizens Bank, a community bank with $75 million in assets, located in Robertsdale, Alabama. I also serve as Chairman of the Independent Community Bankers of America (ICBA)[1] on whose behalf I appear before you today. I want to thank you for giving me the opportunity to testify today on the very important issue of deposit insurance reform.

I want to commend you, Chairman Bachus, and full committee Chairman Oxley, for scheduling this hearing and giving this matter priority attention. Deposit insurance is of enormous importance to community banks and their customers—and to the safety and soundness of our financial system.

Few would dispute that federal deposit insurance has been an enormously successful program, enhancing financial and macro-economic stability by providing the foundation for public confidence in our banking and financial system. It has done what it was established to do—it has prevented bank runs and panics, and reduced the number of bank failures. Even at the height of the S&L crisis, there was no panic or loss of confidence in our financial system. The financial system and our economy are stronger and less volatile because of Federal deposit insurance.

But it has now been more than 10 years since the last systematic congressional review of our deposit insurance system, and it must be modernized and strengthened. In the past two decades since deposit insurance levels were last increased, inflation has ravaged the value of deposit insurance coverage. The less deposit insurance is really worth due to inflation erosion, the less confidence Americans will have in the protection of their money, and the soundness of the financial system will be diminished.

The system currently remains strong, the industry is strong and the overwhelming majority of institutions are healthy, but as the FDIC states in its report *"Keeping the Promise: Recommendations for Deposit Insurance Reform"* (FDIC Report), there are emerging problems and room for improvement.

The financial services trade associations have been discussing deposit insurance reform issues. And we share a common goal to work together, and to work with this committee, on areas of mutual concern, to craft a bill and pass legislation.

Now, while we can do it in a non-crisis atmosphere, is the time to consider improvements to enhance the safety and soundness of our federal deposit insurance system and ensure that the effectiveness of this key element of the safety net is not undermined.

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[1] ICBA is the primary voice for the nation's community banks, representing 5,500 institutions at nearly 16,700 locations nationwide. Community banks are independently owned and operated and are characterized by attention to customer service, lower fees and small business, agricultural and consumer lending. ICBA's members hold more than $491 billion in insured deposits, $589 billion in assets and more than $344 billion in loans for consumers, small businesses and farms. They employ nearly 232,000 citizens in the communities they serve. For more information, visit www.icba.org.

Emerging Issues
The major deposit insurance reform issues that have emerged and should be addressed by legislation include:

- preserving the value of FDIC protection and coverage for the future by substantially increasing coverage levels and indexing these new base levels for inflation;
- establishing a pricing structure so that rapidly growing "free-riders" pay their fair share into the deposit insurance funds (these free riders like Merrill Lynch and Salomon Smith Barney also offer coverage levels well beyond the reach of community banks);
- smoothing out premiums to avoid wild swings caused by the hard target reserve ratio (so banks do not pay unreasonably high premiums when they and the economy can least afford it); and
- providing appropriate rebates of excess fund reserves.

FDIC RECOMMENDATIONS

The recommendations contained in the FDIC report address each of the foregoing issues. Mr. Chairman, I will structure my testimony today around the recommendations and key issues outlined in the FDIC report.

1. Deposit Insurance Coverage Levels Have Been Badly Eroded By Inflation And Should Be Increased And Indexed For Inflation

For community bankers, the issue of increased deposit insurance coverage has been front and center in the deposit insurance debate. More coverage would benefit their communities, and their consumer and small business customers. It would help address the funding challenges and competitive inequities faced by community banks and ensure that they have lendable funds to support credit needs and economic development in their communities. For community bankers, any reform package will fall far short if it does not include a substantial increase in coverage levels and indexation.

FDIC Recommendation: ***"The deposit insurance coverage level should be indexed to maintain its real value."***
The FDIC proposes to increase coverage levels to make up for inflation's devaluing effects. The agency suggests making coverage levels more predictable by automatically adjusting the levels every five years based on the Consumer Price Index. But it did not make a recommendation on what to use as the "base year," saying this decision should be left to the Congress. Using 1980 as the base year would raise coverage levels to nearly $200,000 (see **Chart 1** attached); using 1974 as the base year—the year coverage levels were raised to $40,000—would boost coverage to around $137,000 today.

ICBA Position
The ICBA strongly supports legislation introduced by Rep. Joel Hefley (R-CO) and Sens. Tim Johnson (D-SD) and Chuck Hagel (R-NE) to raise federal deposit insurance coverage levels. Both bills (H.R. 746 and S. 128) would increase FDIC coverage levels to around $200,000 and provide for automatic inflation adjustments (based on an IRS index) every three years rounded up to the nearest thousand dollars. Both bills have garnered substantial bi-partisan support. Fifty-one Representatives have signed onto the Hefley bill, consisting of 30 Republicans and 21 Democrats. Thirteen Senators are on the Johnson bill, five Republicans and eight Democrats.

Coverage Levels Ravaged by Inflation
The general level of income, prices and wealth in our Nation has been steadily increasing for decades. As a consequence, inflation is severely eroding the value of FDIC protection. The current deposit insurance limit is economically inadequate and unacceptable for today's savings needs, particularly growing retirement savings needs as the boomer generation reaches retirement age.

The real value of $100,000 coverage is only about half what it was in 1980 when it was last increased. **Chart 2**, which is attached, shows that simply adjusting for inflation, the $100,000 limit set in 1980 represents only $46,564 in coverage today. Worse yet, as **Table 1** shows, in real terms, today's deposit insurance limit is worth $20,000 **less** than it was in 1974 when the deposit insurance limit was doubled to $40,000.

Looked at another way, in 1934, when federal deposit insurance was established, the coverage level was 10 times per capita annual income. Today, it is only four times per capita income. During the last two decades, while deposit insurance levels remained unchanged, financial asset holdings of American households have quadrupled, from $6.6 trillion in 1980 to $30 trillion in 1999.

Deposit insurance coverage levels have been increased six times since the program was created in 1934. But the increases have been done on an ad hoc basis with no predictability either on timing or the size of the increase. We need to move away from ad hoc increases, and move to a system that is predictable and grows with inflation.

Gallup Poll Shows Consumers Want Increase
A recent survey conducted by The Gallup Organization [2], on behalf of the FDIC, revealed that Federal deposit insurance coverage is a "significant factor" in investment decisions, especially to more risk-averse consumers and those making decisions in older and less affluent households.

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[2] The Gallup Organization conducted telephone interviews with a randomly selected, representative sample of 1,658 adults who identified themselves as the people most knowledgeable about household finances age 18 or older, living in households with telephone service in the continental United States. The interview period ran from November 20 to December 23, 2000. The margin of error is plus or minus 3 percent.

Fifty-seven percent of respondents said deposit insurance is "very important" in determining where to invest.

Six in ten respondents said they would be likely to put more of their household's money into insured bank deposits if the coverage level of deposit insurance were raised. And six in ten said they would move their money into insured accounts as they neared retirement age or during a recession. The survey also showed that one in eight households keep more than $100,000 in the bank, and about one-third of all households reported having more than $100,000 in the bank at one time or another.

And importantly, the Gallup survey indicated that nearly 4 out of 5 (77%) respondents thought deposit insurance coverage should keep pace with inflation.

Small Business Customers Support Increase
Small businesses are key customers of community banks, which in turn are premier providers of credit to these businesses. A recent [3] study commissioned by the American Bankers Association (ABA) found that half of small business owners think the current level of deposit insurance coverage is too low. When asked what actions they would take if coverage were doubled, 42 percent said they would consolidate accounts now held in more than one bank; 25 percent would move money to smaller banks; and 27 percent would move money from other investments into banks.

Consumers and small businesses shouldn't have to spread their money around to many banks to get the coverage they deserve. They should be able to support their local banks, and local economies, with their deposits.

Deposit Insurance a Critical Tool to Support Local Lending
An adequate level of deposit insurance coverage is vital to community banks' ability to attract core deposits, the funding source for their community lending activities. Many community banks are facing funding pressures and are finding it difficult to keep up with loan demand as they lose deposits to mutual funds, brokerage accounts, the equities markets and "too-big-to-fail" banks.

The growth in bank loans is outpacing the growth in deposits by about 2 to 1. Average loan-to-deposit ratios are at historical highs. In turn, community bankers are encountering growing liquidity problems. According to Grant Thornton's "Eighth Annual Survey of Community Bank Executives,"[4] 77 percent of community bankers favor raising the insurance coverage from its current level of $100,000 in order to make it easier to attract and retain core deposits.

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[3] "Increasing Deposit Insurance Coverage: Implications for the Federal Insurance Funds and for Bank Deposit Balances," Mark J. Flannery, December 2000 (study commissioned by the ABA).

[4] "The Changing Community of Banking," 2000 Seventh Annual Survey of Community Bank Executives, published by Grant Thornton LLP, March, 2001.

Some banks have seen a surge in deposit activity during the last quarter. The instability of the stock market has caused some weary investors to pull out of the equities market and return to the safety and stability of banks. But most observers believe this is an aberration that may not continue when the market turns back up. Moreover, this phenomenon provides deposits to banks in a down economy when loan demand is weakened; it does not help address the need for funding when loan demand is strong.

Large complex banking organizations (LCBOs) have an inherent funding and deposit gathering advantage over community banks because they have the ultimate subsidy—the systemic risk their failure poses to the financial system makes them "too-big-to-fail." Depositors in too-big-to-fail banks, where uninsured depositors are made whole, may not have to worry about the safety of their deposits, regardless of how much they exceed $100,000.[5] The Gramm-Leach-Bliley Act of 1999, permitting the common ownership of banks, insurance companies and securities firms, is fostering the creation of even more LCBOs of nationwide scope.[6]

Community banks will never achieve true competitive equity with too-big-to-fail banks because their depositors will never be afforded the same protection that depositors at too-big-to-fail megabanks enjoy. But increased deposit insurance coverage levels will help community banks compete for deposits with large banks.

Alternative funding sources for community banks are scarce. Because of our small size, we have limited access to the capital markets for alternative sources of funding. Liberalized access to the Federal Home Loan Bank System advance window under the Gramm-Leach-Bliley Act of 1999 will help. But Federal Home Loan Bank advances are not a substitute for deposits. Bankers must pay higher rates for advances and other non-traditional funding than they do for deposits, putting pressure on net interest margins. Examiners are warning community banks against over-reliance on FHLB advances.

Full Coverage For Public Deposits
The ICBA also supports full deposit insurance coverage for public deposits.

States require banks to collateralize public deposits by pledging low-risk securities to protect the portion of public deposits not insured by the FDIC. This makes it harder for community banks to compete for these deposits with larger banks. Many community banks are so loaned-up that they do not have the available securities to use as collateral.

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[5] Thomas M. Hoenig, president of the Federal Reserve Bank of Kansas City, noted in a speech on March 25, 1999, *"To the extent that very large banks are perceived to receive governmental protection not available to other banks, they will have an advantage in attracting depositors, other customers and investors. This advantage could threaten the viability of smaller banks and distort the allocation of credit."*

[6] In a speech before the National Bureau of Economic Research Conference on January 14, 2000, Federal Reserve Board Governor Laurence H. Meyer said, *". . . the growing scale and complexity of our largest banking organizations. . . raises as never before the potential for systemic risk from a significant disruption in, let alone failure of, one of these institutions."*

And those that do have to tie up assets in lower yielding securities which could affect their profitability and ability to compete. In addition, collateralizing public deposits takes valuable resources away from other community development and lending activities.

FDIC Recommendation. The FDIC did not make a recommendation on insurance coverage for public deposits. Rather, it said it should be explored further. FDIC did state, however, that "Raising the coverage level on public deposits could provide banks with more latitude to invest in other assets, including loans. Higher coverage levels might also help community banks compete for public deposits and reduce administrative costs associated with securing these deposits."

Providing 100 percent coverage for public deposits would free up the investment securities used as collateral, enable community banks to offer a more competitive rate of interest in order to attract public deposits, and enable local governmental units to keep deposits in their local banks as a valuable source of funding that can be used for community lending purposes.

Full Coverage For IRAs And Retirement Accounts
Retirement savings require a deposit insurance limit higher than $100,000. Today, accumulating $100,000 in savings for education, retirement, or long-term care needs, is not a benchmark of the wealthy. With the graying of the population, safe savings opportunities are needed more than ever. An insured savings option is becoming even more crucial now that budget surpluses are reducing the supply of Treasury securities.

FDIC Recommendation. The FDIC did not take a position on this topic. However, the report stated: "Because retirement accounts tend to be long-term investments, over time they can reach relatively large balances that exceed the coverage provided by FDIC insurance. Thus, raising the coverage level on IRAs could encourage depositors to invest more of their retirement savings in insured bank deposits."

FDICIA Reforms Minimize Taxpayer Exposure
Critics of proposals to substantially increase and index coverage levels contend that the 1980 increase to $100,000 was unjustified and increased the resolution costs of the savings and loan crisis. Overlooked, perhaps, is the fact that the Federal Reserve Board advocated this increase at the very time its monetary policies were driving the prime rate over 20 percent to wring inflation out of the economy. Also overlooked is the fact that the new $100,000 coverage limit helped stem depositor panic as thousands of thrifts holding long-term, fixed-rate loans failed from the resulting severe asset-liability mismatch.

Higher limits will not necessarily increase exposure to the FDIC or the taxpayer. There are a variety of factors that serve to minimize any increase in exposure to the FDIC or the taxpayer from bank failure losses due to an increase in deposit insurance coverage levels.

The reforms in bank failure resolutions instituted by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) -- including prompt corrective action,

least cost resolution, depositor preference, and a special assessment when a systemic risk determination is made -- are designed to reduce losses to the FDIC.

Prompt corrective action helps ensure swift regulatory action when a bank becomes critically undercapitalized so that losses do not increase while the bank's condition further deteriorates. Least cost resolution requires that—except in the case where the systemic risk exception is invoked—the FDIC uses the least costly method when a bank fails to meet its obligations to pay insured depositors only. And depositor preference minimizes the FDIC's losses by requiring that assets of the failed institution are first used to pay depositors, including the FDIC standing in the shoes of insured depositors, before other unsecured creditors are paid. And when a systemic risk determination is made, the FDIC must charge all banks an emergency special assessment to repay the FDIC's costs for the rescue.

Perhaps most importantly, the coverage issue must be considered in conjunction with the pricing and hard reserve ratio issues. As the FDIC seeks to ensure that deposit insurance premiums adequately reflect the risk profiles of individual banks, whether there is a higher or lower coverage limit becomes less relevant. Former Federal Reserve Vice Chairman Alan S. Blinder, in a recently released study of FDIC reforms[7], said : "In a world of properly-priced deposit insurance, it seems more appropriate to ask. . . :Why have *any* coverage limits at all?" Mr. Blinder added that it is "axiomatic" that the new coverage limit, "wherever it is set initially, should be indexed."

2. "Free Riders" Must Pay Their Fair Share

FDIC Recommendation: ***"The FDIC should charge regular premiums for risk regardless of the level of the fund."***
The FDIC recommends that the current statutory restriction on the agency's ability to charge risk-based premiums to all institutions should be eliminated, and the FDIC should be allowed to charge premiums, even when the fund is above the 1.25 percent designated reserve ratio (DRR).

Currently, the FDIC is restricted from charging premiums to well-capitalized, highly rated banks so long as the reserve level remains above the target. As a result, 92 percent of the industry does not pay any premiums, and the more than 900 banks that were chartered within the last five years have never paid any premiums. According to the FDIC, this system underprices risk and does not adequately differentiate among banks according to risk.

Remedy to Free Rider Problem Needed
Because of the current premium restrictions, rapidly growing institutions do not pay their fair share for deposit insurance coverage. By the end of the first quarter of 2001, Merrill Lynch and Salomon Smith Barney had moved a total of $83 billion in deposits under the

[7] "Reform of Deposit Insurance – A Report to the FDIC," by Alan S. Blinder and Robert F. Wescott, March 20, 2001.

FDIC-BIF umbrella through two banks that Merrill owns and six banks affiliated with Salomon Smith Barney, without paying a penny in deposit insurance premiums. This dilutes the FDIC-BIF's reserve ratio, which is already lagging behind the FDIC-SAIF's which doesn't face a similar inflow problem. Every $100 billion of insured deposit inflows drops the reserve ratio of the FDIC-BIF—which stood at 1.35 percent on December 31, 2000—about six basis points.

Once the 1.25 percent reserve ratio is breached, FDIC is required by law to assess banks a minimum average of 23 cents in premiums unless a lower premium can recapitalize the fund within one year. How long it will be before the 1.25 percent designated reserve ratio is breached and premiums are triggered for all banks is not known. Today, past assessments on banks are subsidizing the insurance coverage for Merrill Lynch and Salomon Smith Barney! This inequitable situation must be remedied.

Because Merrill Lynch and Salomon Smith Barney own multiple banks, they can offer their customers more than $100,000 in insurance coverage. Merrill with two banks can offer $200,000 in FDIC coverage, and Salomon Smith Barney is offering each of its customers $600,000 in FDIC protection. This could have a significant negative impact on the funding base of community banks. Most community banks cannot offer their customers more than $100,000 in deposit insurance coverage in this manner. Additionally, these huge institutions are too-big-to-fail, which gives them another advantage over community banks in gathering deposits.

If the FDIC were able to charge premiums to all banks, even when the reserve level is above 1.25 percent, it could collect premiums from Merrill Lynch and Salomon Smith Barney as they move deposits under the insurance umbrella. As it now stands, the FDIC is prohibited from charging them anything. Furthermore, if their banks grew at a particularly fast rate, posing a greater risk, they could be charged premiums at a higher rate.

Ney Bill

Legislation introduced by Rep. Bob Ney (R-OH) would address the free rider problem by giving the FDIC the authority to impose a special assessment on the free riders—indeed, any depository institution whose deposits grow at a rate faster than a rate determined by the FDIC—to pay for the insurance coverage.

ICBA Position on Regular Premiums

The recommendation to charge premiums to all banks, even when the fund is fully capitalized, faces controversy. However, we believe that in a carefully constructed, integrated reform package which includes substantial increases in deposit insurance coverage levels, bankers would be willing to pay a small, steady premium in exchange for increased coverage levels and less volatility in premiums. With a small, steady premium, bankers will be better able to budget for insurance premiums and avoid being hit with an unexpected high premium assessment during a downturn in the business cycle. Also, the premium swings will be less volatile and more predictable. It is also one

way to extract some level of premiums from the free riders and reduce the dilution of the reserve ratio.

3. Risk Based Premium System Should Set Pricing Fairly

FDIC Recommendation: ***"The current statutory restriction on the FDIC's ability to charge risk-based premiums to all institutions should be eliminated"***
The current method of determining a bank's risk category for premiums looks at two criteria—capital levels and supervisory ratings. The FDIC argues that this risk weighting system is inadequate since it allows 92 percent of all banks to escape paying any premiums when the fund is fully capitalized. The FDIC says that it cannot price risk appropriately under this method.

The FDIC has proposed a sample "scorecard" to charge premiums based on a bank's risk profile. The FDIC is quick to point out that this example is not etched in stone, and the factors to be used to stratify banks by risk deserves more analysis and discussion. But the FDIC model can be used as a starting point.

The FDIC proposes to disaggregate the highest-rated category of banks that currently do not pay any insurance premiums (92%) into three separate risk categories based on a scorecard using examination ratings, financial ratios and, for large banks, possibly certain market signals as inputs to assess riskiness.

Under this system, three premium subgroups would be created--42.7 percent of the currently highest-rated institutions would pay a 1 cent premium, 26.5 percent would pay 3 cents, while another 23 percent would pay a 6 cent premium.

The eight percent of institutions that are currently charged premiums under the current system would fall into higher-risk categories and pay premiums ranging from 12 to 40 cents, as contrasted to the 3 to 27 cents they pay under the current system.

Under this example, the FDIC would collect $1.4 billion in annual premiums for an industry average of 3.5 cents.

ICBA Position
The ICBA and community bankers generally support a risk-based premium system. However, we believe more study is needed to determine the appropriate risk factors and risk weighting to be used in the matrix. Reaching consensus on the factors to be used to stratify banks into risk categories and the premiums to be charged in the various categories will take more thought and discussion.

We are concerned that under the FDIC proposal, nearly 50 percent of banks that do not pay any insurance premiums now would be paying either a 3 or 6 cent premium (before rebates) during good times. We are also concerned that this system could create a reverse-moral hazard by encouraging banks to squeeze risk out of their operations and in

the process reduce the amount of lending they do in their communities. Banking is not a risk-free enterprise. Appropriate stratification of banks by risk and appropriate premium levels are issues that our policy bodies will continue to study over the next several months.

We do recommend, however, that while it would be appropriate for Congress to establish parameters or guidelines for a risk based premium structure, the details of the structure should be set by the FDIC through the rule-making process with notice and comment from the public. The FDIC is in a better position to judge the relative health of the insurance funds and the industry and can react more quickly to make changes in the premium structure as necessary.

4. Premiums Should Be Smoothed Out And Volatility Reduced

FDIC Recommendation: ***"Sharp premium swings triggered by deviations from the DRR should be eliminated. If the fund falls below a target level, premiums should increase gradually. If it grows above a target level, funds should be rebated gradually. Rebates should be based on past contributions to the fund, not on the current assessment base."***

The current statutory requirement of managing the fund to the hard 1.25 percent DRR can lead to volatile premiums with wide swings in assessments. As already noted above, under the current system, well-capitalized and well run banks cannot be charged premiums so long as the reserve ratio is above the DRR of 1.25 percent. However, when the reserve level falls below 1.25 percent, the law requires the FDIC to charge an average of 23 cents in premiums unless the fund can be recapitalized at a lower premium in one year.

This means there could be wild fluctuations in premium assessments, depending on the extent of bank failure losses. The current system is dangerously pro-cyclical with premiums the highest when banks and the economy can least afford it. Premiums could rise rapidly to 23 cents when economic conditions deteriorate, potentially exacerbating the economic downturn, precipitating additional bank failures and reducing credit availability by removing lendable funds from banks.

The FDIC recommends that the 1.25 percent hard target be eliminated, and the reserve ratio be allowed to fluctuate within a given range. The FDIC argues that the deposit insurance system should work to smooth economic cycles, not exacerbate them. For example, maintaining the current DRR of 1.25 percent as a target, the reserve ratio could be allowed to fluctuate between 1.15 percent and 1.35 percent. Regular risk-based premiums would be charged so long as the ratio is within that range.

However, in years when the ratio is below 1.15 percent, the FDIC suggests a "surcharge," for example, equal to 30 percent of the difference between the reserve ratio and 1.15 percent. Alternatively, in years when the ratio is above 1.35 percent, there would be a

rebate equal to 30 percent of the difference between the reserve level and 1.35 percent. This would ensure that premiums rise and fall more gradually than under the current system.

ICBA Position

The ICBA supports eliminating the hard 1.25 percent DRR and instituting a range within which the funds can fluctuate without penalty or reward as part of a comprehensive reform package. Under the current system, banks could be faced with steep deposit insurance payments when earnings are already depressed. Such premiums would divert billions of dollars out of the banking system and raise the cost of gathering deposits at a time when credit is already tight. This in turn could cause a further cutback in credit, resulting in a further slowdown of economic activity at precisely the wrong time in the business cycle. The agency says it would be preferable for the fund to absorb some losses and for premiums to adjust gradually, both up and down, around a target.

The FDIC also makes a strong case for maintaining 1.25 percent as the mid-point of such a range. The FDIC report showed that under various loss scenarios (no loss, moderate loss and heavy loss), the fund never drops below .80 percent and it never goes above 1.5 percent. Gradual surcharges and gradual rebates help to keep the fund within this range.

Rebates. Pricing and rebates go hand-in-hand. If premiums are charged to all institutions regardless of the fund's size after deposit insurance levels are substantially increased, rebates represent a critical safety valve to prevent the fund from growing too large. FDIC notes that in the best years, the rebate could result in a bank receiving a net payment from the FDIC. In an economy as relatively strong as we have today, more than 40 percent of banks would receive a net rebate.

Importantly, under the FDIC proposal, the rebates would be based on past contributions to the insurance fund, and not on the current assessment base. This would have two advantages. It would not create a moral hazard which would encourage banks to grow just to get a higher rebate. And it would not unjustly enrich companies like Merrill Lynch and Salomon Smith Barney, which have transferred large deposits under the insurance umbrella without paying any premiums.

We strongly support this recommendation on rebates. It is only fair to those institutions who have paid into the insurance fund for years. And it would prevent free riders like Merrill Lynch and Salomon Smith Barney from earning rebates on premiums they never paid.

5. Merge the BIF and SAIF As Part of Comprehensive Reform Plan

Historically, banks and thrifts have had their own insurance funds. The FDIC-BIF and the FDIC-SAIF offer identical products, but premiums are set separately. Since the S&L crisis, when many banks acquired thrift deposits, many institutions now hold both BIF- and SAIF- insured deposits. More than 40 percent of SAIF-insured deposits are now held by banks.

FDIC Recommendation: ***"The Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) should be merged now."***
The FDIC proposes to merge the BIF and the SAIF as part of an overall reform package. The agency argues that the lines between savings and loans and banks have blurred to the point where it is difficult to tell them apart.

They argue that merging the two funds would make the combined fund stronger, more diversified and better able to withstand industry downturns than two separate reserve pools. FDIC says costs also would go down since the FDIC would not need to track separate funds.

ICBA Position
The ICBA supports a merger of the BIF and SAIF so long as it is part of a comprehensive and integrated deposit insurance reform package that includes an increase in coverage levels.

Conclusion

In summary, Mr. Chairman, the ICBA believes it is critical to review the federal deposit insurance system now in a non-crisis atmosphere. An ongoing strong deposit insurance system is essential for future public confidence in the banking system and to protect the safety and soundness of our financial system. The effectiveness of this key government agency should not be permitted to be undermined or eroded away by a failure to preserve the value of its protection.

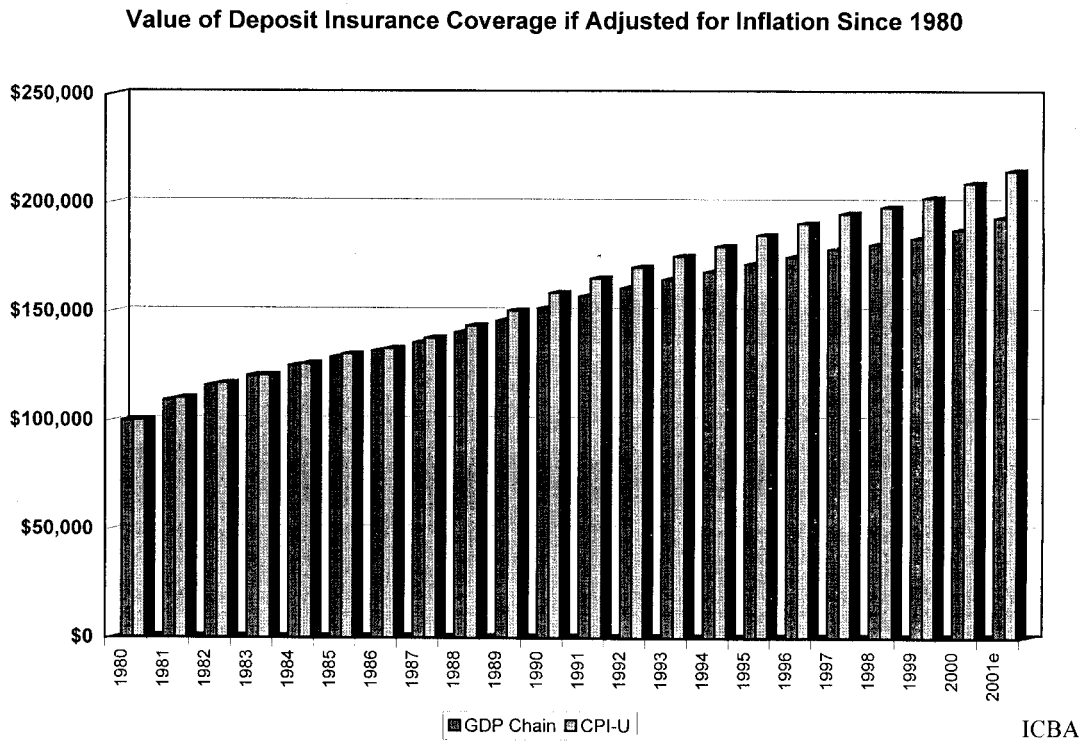
Deposit insurance is critical to the thousands of communities across America that depend on their local community bank for their economic vitality. Without substantially increased deposit insurance coverage levels indexed for inflation, community banks will find it increasingly difficult to meet the credit needs of their communities and compete fairly for funding against too big to fail institutions and non-bank providers.

We support the overall thrust of the FDIC's recommendations and agree that deposit insurance reform should be comprehensive. Coverage levels should be raised and indexed for inflation. The 1.25 percent designated reserve ratio should be scrapped in favor of a flexible range. The statutory requirement that banks pay a 23 cent premium when the fund drops below the DRR should be repealed. A pricing structure that fairly evaluates the relative risks of individual banks should be instituted. Full deposit insurance coverage should be accorded to public deposits. And IRAs, savings and retirement accounts should be accorded higher coverage levels. We urge Congress to adopt such an integrated reform package.

We commend you, Mr. Chairman, and Chairman Tanoue for moving the debate forward. The ICBA pledges to work with you, the entire committee, and our industry partners, to craft a comprehensive and integrated deposit insurance reform bill that can work and can pass.

Thank you, Mr. Chairman, for the opportunity to express the views of our nation's community bankers.

CHART 1


Value of Deposit Insurance Coverage if Adjusted for Inflation Since 1980
$250,000
$200,000
$150,000
$100,000
$50,000
$0
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
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GDP Chain
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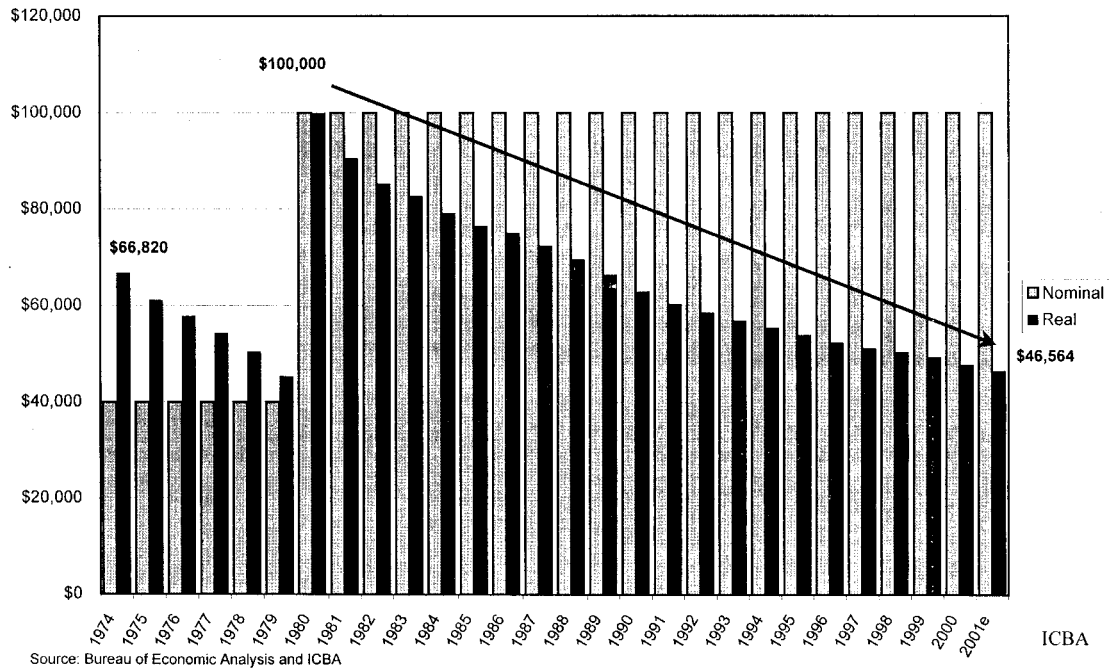
ICBA

CHART 2

Real Value of Deposit Insurance Eroded by Inflation



Source: Bureau of Economic Analysis and ICBA

ICBA

Table 1

TABLE 1

Federal Deposit Insurance Limit
Adjusted for Inflation
$1980 Dollars

Year	GDP Chain Price Index 1996=100	Adjusted GDP Chain Price Index 1950=100	CPI-U 82-84=100	Adjusted CPI-U 1980=100	Nominal Dollar Deposit Insurance Limit 1974 - Present	Real Dollar Deposit Insurance Limit (GDP Chain) 1974 - Present	Real Dollar Deposit Insurance Limit (CPI-U) 1974 - Present
1974	36.61	64.2	49.3	59.9	**$40,000**	**$62,344**	**$66,820**
1975	40.03	70.2	53.8	65.3	$40,000	$57,013	$61,223
1976	42.30	74.1	56.9	69.1	$40,000	$53,957	$57,881
1977	45.02	78.9	60.6	73.6	$40,000	$50,696	$54,363
1978	48.23	84.5	65.2	79.2	$40,000	$47,319	$50,510
1979	52.24	91.6	72.6	88.1	$40,000	$43,685	$45,401
1980	57.05	100.0	82.4	100.0	**$100,000**	**$100,000**	**$100,000**
1981	62.37	109.3	90.9	110.4	$100,000	$91,478	$90,598
1982	66.26	116.1	96.5	117.2	$100,000	$86,107	$85,342
1983	68.87	120.7	99.6	120.9	$100,000	$82,838	$82,728
1984	71.44	125.2	103.9	126.2	$100,000	$79,864	$79,268
1985	73.70	129.2	107.6	130.6	$100,000	$77,417	$76,564
1986	75.32	132.0	109.7	133.1	$100,000	$75,744	$75,104
1987	77.57	136.0	113.7	138.0	$100,000	$73,547	$72,446
1988	80.22	140.6	118.4	143.7	$100,000	$71,122	$69,610
1989	83.27	146.0	124.0	150.5	$100,000	$68,515	$66,425
1990	86.53	151.7	130.8	158.7	$100,000	$65,934	$63,008
1991	89.66	157.2	136.3	165.4	$100,000	$63,630	$60,457
1992	91.85	161.0	140.4	170.4	$100,000	$62,118	$58,674
1993	94.05	164.9	144.6	175.5	$100,000	$60,660	$56,990
1994	96.01	168.3	148.3	180.0	$100,000	$59,425	$55,542
1995	98.10	172.0	152.5	185.1	$100,000	$58,156	$54,022
1996	100.00	175.3	157.0	190.5	$100,000	$57,053	$52,487
1997	101.95	178.7	160.6	195.0	$100,000	$55,963	$51,287
1998	103.23	180.9	163.1	198.0	$100,000	$55,270	$50,508
1999	104.77	183.6	166.7	202.3	$100,000	$54,454	$49,432
2000	106.99	187.5	172.3	209.1	$100,000	$53,328	$47,821
2001e	109.87	192.6	176.93	214.8	**$100,000**	**$51,926**	**$46,564**

e Estimate

Source: Department of Commerce, Bureau of Economic Analysis, GDP Chain-Type Price Index, Bureau of Labor Statistics, Consumer Price Index CPI-U, and ICBA calculations.