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VIEWPOINTS OF SELECT REGULATORS ON DEPOSIT INSURANCE REFORM

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

JULY 26, 2001

Printed for the use of the Committee on Financial Services

Serial No. 107–39

U.S. GOVERNMENT PRINTING OFFICE

74–493 PS WASHINGTON : 2001

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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VIEWPOINTS OF SELECT REGULATORS ON DEPOSIT INSURANCE REFORM

THURSDAY, JULY 26, 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 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Spencer Bachus, [chairman of the subcommittee], presiding.

Present: Chairman Bachus; Representatives Bereuter, Barr, Biggert, Grucci, Hart, Capito, Tiberi, Waters, C. Maloney of New York, Watt, Sherman, Meeks, Mascara, Moore, Gonzalez, Kanjorski, Hooley, Hinojosa and Lucas.

Chairman BACHUS. The Subcommittee on Financial Institutions and Consumer Credit will come to order. Without objection, all Members' opening statements will be made a part of the record.

The subcommittee meets today for a second hearing in this Congress on reforming the Federal deposit insurance system. At our first hearing on this subject in mid-May, Donna Tanoue, the outgoing Chairman of the Federal Deposit Insurance Corporation, (FDIC), presented the agency's recommendations for reform. Today, we will hear the perspectives of the other Federal bank regulators as well as the Treasury Department.

Since the subcommittee last met to consider these issues, there have been significant developments. First, President Bush chose to replace Ms. Tanoue at the FDIC. His choice was Don Powell, who has been confirmed by the Senate and is expected to assume his responsibilities shortly. My hope is that Chairman Powell will appear before the subcommittee in September to share his views on deposit insurance reform.

Second, the FDIC released data last month reflecting that in the first quarter of this year, the ratio of reserves to insured deposits in the Bank Insurance Fund, (BIF), dropped from 1.35 percent to 1.32 percent. That ratio now stands at its lowest point since 1996. As most of the people in this room are well aware, once the number falls below the current "hard target" of 1.25 percent, every bank in America faces a 23-basis-point premium assessment. It is estimated that such an assessment would require banks to pay billions of dollars in premiums, a rude awakening after an extended period in which over 90 percent of banks paid no premiums at all. Such a massive outflow of funds from the banking system would curtail lending to consumers and small businesses with potentially dev-

astating consequences for our economy and for communities and families throughout America.

By contrast, the FDIC reports that the designated reserve ratio in the Savings Account Insurance Fund, (SAIF), which covers thrifts, held steady in the first quarter at 1.43 percent, unchanged from the last report at the end of 2000. Assuming that current trend continues, the possibility exists that banks will face sizable premium assessments at a time when most of their thrift counterparts are paying no premium.

The significant growth in insured deposits that has triggered the decline in this reserve ratio in the first quarter is, in some respects, a "good news/bad news" story. The bad news is obvious for banks. They could find themselves on the receiving end of a multi-billion-dollar premium payout if current patterns persist and the current law remains in effect.

The "good news" is an apparent reversal of the trend of core deposits leaving the banking system in recent years, in search of higher returns elsewhere. As we all know, those higher returns did not always materialize.

The outflow of deposits made it difficult for some banks to meet loan demand in their local communities. The $84 billion jump in insured deposits in the first quarter reported by FDIC—coming on the heels of a substantial increase in deposits in the fourth quarter of last year—is a welcome development for those concerned about the future of small community banks in America. Whether this flow of funds back into the banking system will be sustained or prove to be temporary, driven by investors seeking safe haven from more speculative investments, remains to be seen.

Another contributor to the declining BIF ratio has been the subject of heated debate: large infusions of money by large brokerage firms from uninsured cash management accounts to insured accounts at banks owned by those same brokerage firms.

Former Chairman Tanoue addressed the so-called "free rider" issue and made it a centerpiece in her reform proposal. I, for one Member, welcome that. We will learn at today's hearing whether the other banking regulators share her concerns in this regard.

Let me now recognize the Ranking Minority Member, Ms. Waters, for her opening statement.

[The prepared statement of Hon. Spencer Bachus can be found on page 32 in the appendix.]

Ms. WATERS. Good morning. I'd like to thank Chairman Bachus for calling this hearing, the second in a series on Federal deposit insurance reform. 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 will yield back the balance of my time.

Chairman BACHUS. I want to welcome our panel today. The first panelist, going from my left, is Governor Laurence Meyer, Gov-

ernor of the Board of Governors of the Federal Reserve, who has testified before our subcommittee on several occasions, and we welcome you back and look forward to your testimony. It's always insightful. We appreciate that.

We have a new Madam Assistant Secretary for Financial Institutions, Ms. Bair. We want to welcome you to the subcommittee and look forward to a long and cooperative relationship with you.

Ms. BAIR. Thank you.

Chairman BACHUS. I talked to her earlier and she brought her daughter to the Senate confirmation hearings, and I was, for one, looking forward to meeting her, but I think it's probably better that she's in a more comfortable environment than here.

Ms. BAIR. There will be future opportunities, I'm sure.

Chairman BACHUS. Thank you. I want to welcome back an old friend of this subcommittee, the Honorable John D. Hawke, the Comptroller of the Currency. And then the Honorable Ellen Seidman, who is the Director of the Office of Thrift Supervision, (OTS). And Ms. Seidman, I appreciate the service that you have given to the OTS.

At this time we will welcome opening statements from the witnesses. You do not have to limit yourselves to 5 minutes, if you want to go over that. We would rather hear from you rather than enforce some arbitrary limit, and we have time.

STATEMENT OF HON. LAURENCE H. MEYER, MEMBER, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. MEYER. Thank you. Mr. Chairman, Congresswoman Waters, Members of the subcommittee, it's a pleasure to appear before you to present the views of the Board of Governors of the Federal Reserve System on deposit insurance reform as proposed by the FDIC this past spring.

Deposit insurance has played a key role, sometimes a critical one, in stabilizing banking and financial markets. In addition, deposit insurance has provided a safe and secure place for those households and small businesses with relatively modest amounts of financial assets to hold their transactions and other balances.

But these benefits have not come without cost. The very same process that has ended deposit runs has made insured depositors largely indifferent to the risks taken by their banks. It has thus increased the ability of insured depository institutions to take risks while reducing market monitoring of that risk, necessitating greater governmental supervision. The crafting of reforms of the deposit insurance system must therefore struggle to balance the tradeoffs between these benefits and costs. The FDIC has made five broad recommendations.

The Board strongly supports the FDIC's proposal to merge the BIF and SAIF funds. Because the charters and operations of banks and thrifts have become similar, it makes no sense to continue the separate funds.

The Board also strongly endorses the FDIC recommendations that would require a premium be imposed on every insured depository institution and eliminate the statutory restrictions on risk-based pricing. The current rule requires the Government to give away its valuable guarantee to well-capitalized and well-rated

banks when the fund reserves meet some ceiling level. At the end of last year, 92 percent of banks and thrifts were paying no premium. Included in this group are new banks that have never paid any premium for their, in some cases substantial, coverage, and fast-growing entities whose past premiums were extraordinarily small relative to their current coverage.

Although the establishment of a robust risk-based premium system would be technically difficult to design, a closer link between insurance premiums and individual bank and thrift risk would reduce banks' incentive to take risk. We note, however, that for risk-based premiums to do their job of inducing behavioral change, a substantial range of premiums is required. Thus, if a cap is required, as the FDIC recommends, it should be set quite high so that risk-based premiums can be as effective as possible in deterring excessive risk-taking.

The current rules can result in sharp changes in premium when the reserves of the fund rise above or fall below 1.25 percent of insured deposits. These rules are clearly procyclical, lowering or eliminating fees in good times and abruptly increasing fees sharply in times of weakness. We strongly support the FDIC's proposal for increased flexibility and smoothing of premiums by the establishment of a targeted fund reserve range. However, we recommend that the FDIC's suggested target reserve range should be widened in order to further reduce the need to change premiums sharply.

The FDIC proposals would be coupled with rebates for stronger entities when the fund approaches the upper end of the target range, and surcharges when the fund trends below the lower end of the range. The FDIC also recommends that the rebates vary with the size and duration of past premiums and the scale of the current FDIC exposure to the entity. These proposals make considerable sense, and the Board endorses them.

The FDIC recommends that the current $100,000 ceiling on insured deposits be indexed. The Board does not support this recommendation and believes that, at this time, the current ceiling should be maintained. In the Board's judgment, it is unlikely that increased coverage today, even by indexing, would add measurably to the stability of the banking system. Thus, the problem that increased coverage is designed to solve must be either with the individual depositor, the party originally intended to be protected by deposit insurance, or the individual bank or thrift, clearly, both of which would prefer higher coverage if there were no costs. But Congress needs to be clear about the problem for which increased coverage would be the solution.

Our surveys of consumer finances suggest that depositors are adept at achieving the level of deposit insurance coverage they desire by opening multiple accounts. Such spreading of asset holdings is perfectly consistent with the counsel always given to investors to diversify their assets across different issuers.

Does the problem to be solved by increased deposit insurance coverage concern the individual depository institutions? If so, the problem necessarily would be concentrated at smaller banks that generally do not have access to the money market or to foreign branch networks for supplementary funds. Since the mid-1990s, and adjusted for the effect of mergers, the smaller banks, those

below the largest 1,000, have actually grown almost twice as rapidly as all banks. Most important, the uninsured deposits at the smaller banks have grown nearly twice as rapidly, over a 20 percent annual rate, compared to the larger banks. Clearly, small banks have a demonstrated skill and ability to compete for uninsured deposits.

With no obvious problem to be solved, the Board, as I noted, has concluded that there is not a case for increasing the current $100,000 level for insured deposits, even by indexing. There may come a time when the Board finds that households and businesses with modest resources are finding difficulty in placing their funds in safe vehicles, and/or that there is a reason to be concerned that the level of deposit coverage could endanger financial stability. Should either of those events occur, the Board would call our concerns to the attention of Congress and support adjustments to the ceiling by indexing or other methods.

Thank you.

[The prepared statement of Hon. Laurence H. Meyer can be found on page 35 in the appendix.]

Chairman BACHUS. Madam Assistant Secretary Bair.

STATEMENT OF HON. SHEILA C. BAIR, ASSISTANT SECRETARY FOR FINANCIAL INSTITUTIONS, U.S. DEPARTMENT OF THE TREASURY

Ms. BAIR. Thank you, Mr. Chairman, Congresswoman Waters, and Members of the subcommittee, I appreciate the opportunity to comment on the Federal Deposit Insurance Corporation's recent paper recommending reform of the deposit insurance system.

The Treasury Department has a substantial interest in this issue, as we have a critical role to play in deposit insurance. The deposit insurance funds have authority to borrow up to $30 billion from the U.S. Treasury. In addition, Congress has assigned to the Secretary of the Treasury the final responsibility for determining whether the resolution of a failing bank poses a systemic risk to the financial system.

My comments this morning will be general in nature, focusing on the key policy issues raised in the FDIC paper, and I would add that even though we are not in complete agreement with those recommendations, we think it's an excellent piece of work. The FDIC staff should be commended. It certainly provides an excellent starting point, a framework for considering this important issue.

We are in general agreement with the FDIC report on three points. First, the potential procyclical effects of deposit insurance pricing and reserving should be reduced. Reserves should be allowed to grow when conditions are good in order to better absorb losses under adverse conditions without sharp increases in premiums. Allowing growth above a designated reserve ratio in good times or growth within a wide range would afford greater room for the insurance fund to handle bank failures without exhausting its resources. It also would allow for more stable premiums that would smooth over time the costs borne by the industry.

Second, all insured depository institutions should pay premiums on current deposits, with potential rebates taking into account each institution's recent history of premium payments. Banks and

thrifts benefit every day from deposit insurance, and they should compensate the FDIC for that benefit, preferably through relatively small, steady premiums. Most banks and thrifts now pay no premiums for deposit insurance, which creates incentives to increase deposits and thus raises the FDIC's uncompensated risk exposure.

Third, the bank and thrift insurance funds should be merged. A larger combined insurance fund would have a greater ability to diversify its risks than either fund separately. A merger would underscore the fact that BIF and SAIF are already hybrid funds. Each one insures the deposits of commercial banks, savings banks, and savings associations.

We have different views from the FDIC report in two areas. First, while we agree with the FDIC report on the conceptual appeal of risk-based premiums, at this stage we would give priority to reforms that would charge every institution a premium on current deposits that is relatively stable over time. We would defer development of a new risk-based premium structure, a process that promises to be complex and time consuming, for a later time.

Second, and most importantly, we have a different view with respect to insurance coverage. We believe that the deposit insurance coverage level should remain unchanged. We see no clear evidence that the current limit on deposit insurance coverage is burdensome to consumers, nor do we see clear evidence that increasing coverage across the board would enhance competition for the banking industry. Moreover, an increase in the coverage level would increase risks to the FDIC and ultimately taxpayers. In other words, there would be little if any tangible benefit and definite risk and excess costs to the fund and ultimately taxpayers.

Finally, two issues not addressed in the FDIC report should be considered. While we recommend that all institutions pay premiums assessed on current deposits, we also feel that it would be a missed opportunity not to consider what should constitute the assessment base. In particular, reform efforts should consider whether the existing assessment base should be modified to account for the effect of liability structure on FDIC's expected losses.

Also, we support Comptroller Hawke's and Director Seidman's call for addressing the uneven distribution of supervision costs between national and State-chartered banks. We believe that the Office of the Comptroller of the Currency's proposal is an interesting approach that deserves further consideration, and there may be other approaches and considerations that should also be explored.

We look forward to working with the incoming FDIC Chairman Powell and the FDIC Board to devise a solution to this problem.

Thank you, Mr. Chairman, again for the opportunity to appear before you today, and I look forward to working with you in my new capacity.

[The prepared statement of Hon. Sheila C. Bair can be found on page 50 in the appendix.]

Chairman BACHUS. We appreciate your testimony.

Comptroller John Hawke.

STATEMENT OF HON. JOHN D. HAWKE, JR., COMPTROLLER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. HAWKE. Thank you, Chairman Bachus, Congresswoman Waters and Members of the subcommittee, I appreciate this opportunity to discuss reform of our Federal deposit insurance system. Too often, reform occurs against the backdrop of a crisis. Fortunately, we are not in that position today. The deposit insurance funds and the banking industry are strong. Nevertheless, the flaws in the current deposit insurance system pose an unnecessary risk to the stability of the banking system and so merit a careful and timely review by the Congress.

Let me summarize our positions on the major issues that have been raised in connection with reform proposals. We think the Bank Insurance Fund and the Savings Association Insurance Fund should be merged. A merged fund would enable the FDIC to operate more efficiently and to realize the benefits of diversification.

Deposit insurance premiums should be more sensitive to risk.

Chairman BACHUS. Comptroller, several on the panel are having problems hearing you. I don't know whether that mike is on. If you'll just pull it closer. I think there's something wrong with the mike.

Ms. BAIR. Do you want to use mine?

Chairman BACHUS. If you can just substitute.

Mr. HAWKE. Thank you.

Chairman BACHUS. Oh, that's much better.

Mr. HAWKE. Saved by the Treasury Department once again.

[Laughter.]

Mr. HAWKE. Deposit insurance premiums should be more sensitive to risk. Today, 92 percent of all insured institutions pay no premiums, yet common experience, as well as the markets, tell us that these institutions have widely varying risk characteristics.

The requirement that the premium for banks in the lowest risk category be set at zero whenever the insurance fund reserve ratio equals or exceeds 1.25 percent of insured deposits should, in our view, be eliminated. Furthermore, we believe that to compensate the Government for the benefits conferred by deposit insurance on all banks, even the least risky banks should pay some reasonable minimum insurance premium.

We strongly support eliminating the current designated reserve ratio (DRR) of 1.25 percent of insured deposits. Instead, we favor empowering the FDIC to establish a range for the fund based on the FDIC's periodic evaluation of the risks borne by the fund and its assessment of potential losses. The FDIC should have the authority to pay rebates when the upper end of the range is exceeded and to impose surcharges when the ratio falls below the lower end of the range.

We see no compelling case for an increase in deposit insurance coverage. There is no evidence that depositors are demanding increased coverage, nor is there a reliable basis for projecting whether an increase would bring new deposits into the system or simply result in a disruptive reshuffling of deposits among banks.

There is one further set of issues that should be considered in the context of deposit insurance reform, in our view: the way the insurance fund is used, and should be used, to support the cost of

bank supervision and the inequitable treatment of national banks in the way the BIF is currently used to pay the costs of supervision of State banks. These same issues apply to the way the SAIF fund is used with respect to thrift institutions.

Under the current system, the FDIC draws on the insurance funds for about $600 million a year to fund the cost of its supervision of State non-member banks, that is, its costs of performing for State banks exactly those functions that the OCC performs for national banks. None of these costs are passed on to State banks in the form of direct assessments. By contrast, the OCC must charge national banks directly for the full cost of their supervision.

This disparity is compounded by the fact that more than half of the funds spent by the FDIC for Federal supervision of State non-member banks are attributable directly to the accumulated contributions of national banks to the insurance fund. Thus, the earnings of a fund that has been built up by all banks finance the supervisory costs of only a portion of the banking industry. In other words, for every dollar that the FDIC spends on the supervision of State banks, national banks, by our estimates, effectively contribute about 55 cents. And, that is in addition to paying the full cost of their own supervision to the OCC.

Fee disparity presents a constant incentive for national banks to convert to the heavily-subsidized State charter. And, that incentive can be strongest when the banking system is under stress and the OCC faces the need to expand its supervisory resources—and thus its assessments—to deal with an increased level of problem banks.

A key principle at the heart of deposit insurance reform is that the premiums paid by individual institutions should be closely related to the expected costs they impose on the funds. The objective is to identify and eliminate subsidies in the current system that, among other things, result in healthy, well-managed banks bearing the costs and risks presented by less well-managed. riskier banks. Similarly, bank supervision should not be based on a system of subsidies—such as those embedded in the current deposit insurance system—that result in national banks paying a substantial portion of the FDIC's cost of supervising State banks, because one of the main purposes of bank supervision is to protect the insurance fund. Ensuring that supervision is funded in a fair and equitable manner is inextricably related to the subject of deposit insurance reform.

Attached to my written testimony is a paper that discusses the disparity in funding supervision in greater detail and proposes a remedy. We believe it would make sense to extend the existing arrangement to cover the costs of both State and national bank supervision from the FDIC fund, just as the fund today is used to cover the FDIC's costs of supervision. In other words, instead of funding supervision through direct assessments on banks, we propose that it be funded by payments to supervisors from the insurance fund, to which all banks contribute. This would ensure that all supervisors have access to the resources needed to deal with stresses in the system and could eliminate the perverse situation we have today in which our resources can be significantly depleted at the very time when the heaviest supervisory demands may be placed on us.

Thank you, Mr. Chairman.

[The prepared statement of Hon. John D. Hawke Jr. can be found on page 59 in the appendix.]

Chairman BACHUS. Thank you.

Director Ellen Seidman.

STATEMENT OF HON. ELLEN SEIDMAN, DIRECTOR, OFFICE OF THRIFT SUPERVISION

Ms. SEIDMAN. Thank you. Good morning, Chairman Bachus, Ranking Member Waters, and Members of the subcommittee. Thank you for the opportunity to testify about Federal deposit insurance reform.

Over the past several years, those of us who have worked closely with the deposit insurance system have come to realize that while it is very important to serve the American people well, it is not optimal. Several areas are in need of reform if the system is to continue to serve the American people.

The current economic period, with few failures and adequate reserves, provides a perfect opportunity to improve the system. The FDIC has done a fine job of both laying out the areas in which the system needs improvement and suggesting possible solutions. Nevertheless, I believe there are some refinements in thinking about risk parameters that might usefully be added to the discussion. And there is one additional issue—how supervisory costs are paid for—that needs to be part of the discussion of deposit insurance reform.

The FDIC has identified four areas of weakness in the Federal deposit insurance system: Maintenance of two separate funds that provide identical insurance; inadequate pricing of insurance risks, which distorts incentives and increases moral hazard; excessive premium volatility and a tendency for premiums to increase in economic downturns; and coverage levels that do not adjust on a regular basis.

On the first point, the FDIC recommends merging the funds. We agree. There are still very real differences between the operations of banks and thrifts, who remain overwhelmingly residential mortgage lenders. Nevertheless, experience since the BIF and SAIF were established in 1989 argues strongly in favor of fund merger. Because, while the differences between banks and thrifts remain, those between the BIF and the SAIF have become increasingly artificial and tenuous.

The two funds no longer insure distinct types of institutions, with many banks and thrifts holding deposits insured by both funds. The funds provide identical products. Yet keeping them separate raises the possibility of premium differentials that could handicap institutions that happen to be insured by the fund that charges the higher premiums.

Industry consolidation has also increased the funds' exposure to their largest institutions. Merging the funds will alleviate these problems and strengthen the entire system by diversifying risks and eliminating the possibility of fund premium differentials.

To address the inadequate pricing of insurance risks, the FDIC recommends implementing a system of risk-based premiums under which all institutions would be required to pay annually for the

cost of insurance. I believe this is an extremely important part of comprehensive reform. Deposit insurance is a valuable good to institutions as well as to depositors. And like all casualty insurance, it should be paid for even if the eventuality insured against does not arise.

The most glaring problem in our current system is that it provides free deposit insurance coverage to the vast majority of institutions. Risk-based premiums would provide risk management incentives to institutions and allocate insurance costs based on the individual institution's risk profile. The system that prices appropriately would reward those who minimize fund exposure, but not impose too great a cost on those with a more aggressive, but still not unreasonable risk profile.

Implementing an effective risk-based system will entail enhancing the current risk groupings for insured institutions. The FDIC's proposed scorecard is an attractive approach for refining existing risk groupings. The approach permits the incorporation of information beyond the prompt-corrective action (PCA) category and safety and soundness ratings into the risk classifications. This is increasingly important as non-traditional activities and funding, including asset securitization and collateralized funding sources, play a greater role in defining the relationship between deposits and the risk of loss to the fund.

While the FDIC's approach is a good start, my experience over the past several years leads me to be interested in an enhancement that would focus on whether an institution, particularly a larger institution, presents a heightened risk of sudden failure. Sudden failure presents a problem that often frustrates the use of supervisory tools. A sudden failure can put maximum pressure not only on the deposit insurance fund, but also on the financial system as a whole.

One way to address this issue would be to identify indicia of high risk for sudden failure and charge higher premiums for those who present such risks. This could help discourage such risks as well as shift the costs of sudden failure risks to those who take them.

The current pricing structure, which restricts how the FDIC sets fund targets and insurance premiums, also tends to promote premium volatility and make the system procyclical. In good times, the FDIC levies no premiums on most institutions. When the system is under stress projected to last more than a year, the FDIC is required to charge high premiums, which can exacerbate problems at weak institutions and reduce lending at sound ones.

Increasing the FDIC's flexibility to set fund targets and premiums would reduce premium volatility and institutions' exposure to overall economic conditions and to sectoral industry problems. Authorizing the FDIC to rebate excess funds is also an important element of an effective risk-based pricing system, as it allows the FDIC to charge premiums to all institutions at all times, but also avoids the possibility of the fund building to an excessive level.

I believe the most important point in addressing the issue of raising or indexing deposit insurance coverage levels is not whether it should be done, but how and when. Improved risk-based pricing and other reforms should be regarded as preconditions to even considering any action to raise or index the deposit insurance ceiling. Optimally, any action to increase deposit insurance coverage levels

would be considered only as a part of the comprehensive deposit insurance reform package.

The final point I want to address is the importance of allocating costs within the insurance system based on a structure that preserves the integrity of the system's pricing mechanism. Currently more than 40 percent of the FDIC's operating budget, which comes from the insurance funds, is used to pay for the supervisory costs relating solely to the FDIC's role as primary Federal regulator of State non-member banks. This is particularly ironic as premiums paid by OTS and OCC-supervised institutions and the earnings on those premiums account for the bulk of the current balance of the insurance fund.

Whether the costs of day-to-day bank supervision should be paid from the insurance funds can certainly be debated. However, I think there are really only two logical conclusions. Either all bank supervision is an insurance function for all charters, in which case all supervisory costs, Federal and State, should be paid from the insurance funds, or it is not. And if it is not, the only costs of supervision that should be paid from the insurance funds are the often considerable costs that arise when there is a higher risk of failure. And in such cases, again, all supervisory costs, not just those of the FDIC, should be paid from the insurance fund.

Since the issue affects the proper pricing of insurance, it is an integral element in getting deposit insurance reform right.

I thank you for this opportunity to testify on the subject of Federal deposit insurance reform. As you know, this may be my last opportunity to testify before this subcommittee. I want to thank each and every one of you for the opportunity to work with you over the past 3½ years. I've enjoyed my time as OTS Director, and I appreciate having had the opportunity to meet individually with many of you to discuss some of the issues facing the thrift industry, OTS, and the financial system as a whole. Thank you very much.

[The prepared statement of Hon. Ellen Seidman can be found on page 86 in the appendix.]

Chairman BACHUS. Thank you.

We certainly appreciate the testimony of all our witnesses. Let me read back over just a portion of Governor Meyer's testimony. And I'd like maybe a comment on this issue. You said: "At the end of last year, 92 percent of banks and thrifts were paying no premium. Included in this group were banks that have never paid any premium for their, in some cases substantial, coverage and fast-growing entities whose past premiums were extraordinarily small relative to their current coverage. We believe that these anomalies were never intended by the framers of the Deposit Insurance Fund Act of 1996 and should be addressed by the Congress."

What are your suggestions for Congress addressing this change?

Mr. MEYER. I think that, first of all, all banks should have to pay a premium, as opposed to now, where we have 92 percent of banks paying zero premium. And the way this is accomplished in the FDIC proposal is to have a range, rather than a point. And as long as the fund was within that range, the premiums are stable and all the banks are paying.

If the reserves would go above the upper end, then there would be a flexible approach to gradually returning the funds to within

that range by rebates. But those rebates would be small enough so that the banks would generally still be paying some premium, and we would be having both risk-based premiums and never having a zero cost for the Federal guarantee.

Chairman BACHUS. Thank you.

OK, Assistant Secretary.

Ms. BAIR. We would certainly agree that the current statutory restriction on the FDIC's inability to charge premiums to well-capitalized banks that have a high CAMEL rating be eliminated. All banks pose some risk to the fund. All banks derive a benefit from deposit insurance, and all banks should pay a premium.

Chairman BACHUS. Comptroller Hawke.

Mr. HAWKE. I would just note, Mr. Chairman, that the so-called "free rider" problem that you're alluding to of banks getting the benefit of deposit insurance despite never having paid into the fund is kind of a slippery issue to deal with. Banks that have paid into the fund over the years have had the benefit of deposit insurance in return. It is a little bit like a term life insurance policy, though, where once the policy comes to an end, you generally have to pay more premium. So, any bank that has increased its deposits at a time when it isn't paying any premiums is, in a sense, getting a free ride.

I think the real problem here is not the free ride. It's the fact that we have a hard-wired designated reserve ratio of 1.25 percent that really aggravates the problem. Banks that have paid in over the years see the potential for dilution of the fund down below that reserve ratio, with the consequent imposition of costs on them, and they understandably are concerned about that. We would prefer to see the 1.25 ratio eliminated and instead have the FDIC set a range for the fund, which I think would mitigate to a great extent the concerns about free riders. Of course, that should be combined with a new approach to premium setting and a basic minimum premium for the benefit of deposit insurance.

Chairman BACHUS. Director Seidman.

Ms. SEIDMAN. I think substantively, everything has been said. I would like to say that this is a very good example of how everything is interconnected. For example, simply removing the restriction that the 1996 Act put on the FDIC's ability to charge premiums when the fund is at 1.25 percent will generate new problems, and in particular, could generate very fast fund growth.

So I think that it really is a good example of the interconnectedness of the whole system.

Chairman BACHUS. The subcommittee assembled at least one estimate of the cost of the premiums. I almost hesitate to use this figure, but I'm going to throw it out—$65 billion of premiums. When I first saw that, I questioned it. I sent it back and said, this can't be right. But apparently, that would be the cost of tripping that 1.25. But, do you have a comment? Have the agencies looked at the actual cost?

Ms. SEIDMAN. Let me just say that I was surprised when I saw that number also and traced it back to what, I think, was to some extent a piece of rhetoric in the FDIC's original options paper. It is a calculation that starts with the fund ratio not only falling down below 1.25, but falling low enough for long enough that the

trigger that says you have to do 23 basis points would come into play. As you know, if, for example, the fund goes down to 1.22, that trigger will probably not come into play. You'll be able to have a much smaller premium amount that will bring it back to 1.25 within a year.

So first it assumes that it falls low enough for long enough so that the projection is you can't bring it back within a year at anything less than 23 basis points. The 23 basis points generates about $7 billion in premiums. And the theory is that that full $7 billion would then, with a multiplier effect, result in $65 billion less lending.

Well, the problem is that the full multiplier effect is also subject to a lot of questions. First of all, it is quite clear that any number of banks would react to having to pay greater premiums the way they react to any increase in cost—they reduce other costs, they reduce dividends, they do something other than reduce lending. Second, the multiplier is largely an effect of the capital of the bank. In the current situation, many banks are heavily overcapitalized, and it is therefore unclear that the full multiplier would apply in any event. And third, banks might take the premium increase out of some other part of their operations, not lending.

So, I think it is a number that got thrown out there. It's a very big number. It's a very scary number. I think it's one of these numbers where a whole chain of very bad things all have to occur for it to really be true. But I do think, again, it is a reason for us to think about the kind of structure we've created and to recognize that while $65 billion may not be the number, it is likely that some decline in lending would indeed, occur.

Chairman BACHUS. I appreciate that. Let me compliment you on that answer. Does any other panelist wish to comment?

Ms. BAIR. I would just say whatever the right number is, we need to get rid of the 23 basis point cliff. I think that's the important thing, especially for small banks. You'd be taking tremendous amounts of capital out to rebuild the fund, probably in an economic downturn, which is the worst possible time to be taking the money out. So I think, again, I would agree with Ellen, whatever the right number is, we need to get rid of that cliff.

Chairman BACHUS. All right. Because I think we know that these deposits are fleeing the stock market on a downturn and they're going back to deposits. So it would occur in all likelihood during a downdraft in the economy.

Governor Meyer.

Mr. MEYER. I certainly agree that we should get rid of the cliff. We don't want to extend that argument and say, therefore, banks shouldn't have to pay for deposit insurance.

Chairman BACHUS. Thank you.

The Ranking Member is recognized.

Ms. WATERS. Thank you very much. I too, would like to thank our panelists today for sharing with us the information they have shared relative to reform of Federal deposit insurance.

I'd like to know what risk factors do you believe should be used in determining risk-based premiums. I'd like you to be as specific as you can be. I'd like to know what factors should be accorded the most weight in determining deposit insurance rates. And would you

consider certain activities to be part of that risk calculation? What behaviors would you seek to discourage by classifying them as risks? And if you don't mind, I'd like you to discuss this in relationship to the expanded activities of financial institutions, such as proposed real estate brokerage and management. I'll start with the Honorable John Hawke.

Mr. HAWKE. Thank you, Congresswoman Waters. I think your question shows how complex the issue of setting truly risk-related deposit insurance premiums is. A risk-related premium system that is really prospective would have to get into enormous detail, looking at the quality and risk presented by different kinds of assets. That is one of the reasons we think that what's really needed here is a better tuning of the existing system, which is essentially based on a matrix that takes into account the CAMEL rating of the institution and the capital adequacy level of the institution. It is risk-related, but it's not prospective in nature the way I think you were suggesting it might be done.

The real problem with the risk relationship in the present system is that the matrix is too coarse. It treats 92 percent of the banks as presenting an equivalent risk to the fund when we know, and the market tells us, that there are very significant variations in the risks presented by those banks.

So we are not proposing that the FDIC attempt to create a very finely tuned, forward-looking mechanism for determining risk, for example, along the lines of what the Basel Committee is presently considering, which is enormously complicated, and looks at the prospective risks, the expected loss and unexpected loss that attach to different types of assets.

Ms. WATERS. I'd like to hear from Assistant Secretary Bair on that question.

Ms. BAIR. Thank you, Congresswoman. The Treasury Department has a slightly different view on the necessity for extending risk-based premiums at this time.

We believe that that process, though in an ideal world, would have premiums that accurately reflect the risk that the institution posed to the fund. In practice, developing complex risk-based premium matrices is quite difficult and we think promises to be quite time consuming.

We believe it's more important to, again, as I said, get rid of the cliff for those 92 percent of the banks that currently are paying no premiums. They should start to pay some premium, a small premium that would remain constant over time to gradually build up the fund to some range that needs to be determined in lieu of the 1.25 DRR, but save for a later day, really extending dramatically the risk-based structure that we currently have. Because we just think, though again it sounds like a nice idea, in practice it could be quite complicated and bog down the urgency of other reforms.

Ms. WATERS. How would you calculate any premiums? How would you do that? How would you determine the premium for any given institution?

Ms. BAIR. I think that's a difficult job. The FDIC sets out some criteria. It leaves several issues open. If you read Director Seidman's testimony, if you read Governor Meyer's testimony, they have a little different approach on some of these issues.

Another problem, I think, is to come up with a matrix that would accurately assess risk for each institution, the spread among premiums that would accurately reflect risk may be so wide as to be politically impractical, and that is acknowledged in the FDIC study, that for some reason the premiums would be so high that they would cap it. The Fed may have a different view. That's just one of many issues, I think, which would need to be worked out if we're going to extend risk-based premiums, which is why we're saying hold that for a later time.

Ms. WATERS. Mr. Meyer.

Mr. MEYER. Thank you. We do support a risk-based pricing structure, and we recognize that it would be a challenging task, but we believe that the FDIC is pointed in a reasonable direction. They've identified three kinds of information that could be used to differentiate the risk across banks. One they call objective factors, the second, supervisory information, and the third, market signals.

In objective factors, we could use such information as the amount of capital that the bank has relative to their assets, their net income relative to assets, because earnings are the first cushion if there are problems in the loan portfolio, the amount of non-performing loans relative to assets that indicate the risk exposure in the current portfolio, the amount of liquid assets relative to assets, because liquidity is also a very important factor in problems, and the degree of asset growth, because there is a correlation between very rapidly growing banking organizations and risks.

And then, in terms of market information, when available—and for the larger banks, this information is available—we have information coming from subordinated debt spreads and information that can be gleaned from equity prices about the probability of default for the bank.

Now, this information can be used to separate the banks into risk class. Once you identify the different risk classes, you would use information the FDIC suggested on the historical pattern of losses within each group to identify the premiums that would just, on average, pay for those losses over, they suggested, a 5-year period.

So I think this is a very reasonable methodology. I think it's a challenging one. I think it can be refined over time. But I think we have a good direction to move in here.

Ms. WATERS. Thank you very much.

I would also like to hear from Director Seidman on this question. But I'd also like to ask you to add a little something and discuss it in relationship to small banks. And if you use the general kind of criteria that was just described, would this not disadvantage small banks, small financial institutions?

Ms. SEIDMAN. Could I add something about large banks first?

Ms. WATERS. Yes, of course.

Ms. SEIDMAN. Let me just say that we not only have the example in the FDIC options paper, our neighbors to the North have done a rather good job of this. This does not have to be as enormously complicated, as Comptroller Hawke has said, as the Basel proposal.

I would suggest that the concentration of activities is an area the Canadians take into account that is not mentioned in the FDIC matrix, and it's one that I would think would be quite important.

Now, with respect to small versus large institutions, I'm not sure how it cuts precisely. I realize that there are certain issues like the extent to which small institutions, particularly small institutions down the midsection of the country, are fully lent up, that would make them come out worse on the FDIC's matrix. On the other hand, other small institutions, particularly on the coasts, have a tendency, in fact, to have very high amounts of deposits and less reliance on non-deposit funds and fewer problem assets, and things like that, than large institutions. So I'm not sure it's purely a small versus large issue. I think it's worth running the numbers and seeing how they come out and seeing whether when you do get the answer it looks right. That's always an important thing to do when you're doing detailed mathematical calculations.

But the lending up problem, I think, is the one that everyone is focused on. It is a serious issue in the midsection of the country for small institutions, and I think it's worth taking a look at.

Ms. WATERS. Mr. Chairman, if I may just get another minute here. The S&L scandals have led us to understand what happens when institutions get away from the concentration of activities, kind of the terminology you used, their basic core activities. We're looking now at institutions that may be delving into all kinds of commercial activity. Doesn't this make it extremely difficult to do the kind of assessments to determine the risk that we would like to know about in order to develop pricing for the premiums?

Ms. SEIDMAN. Because you mentioned the S&L situation, I guess I have to take the first answer here, but then I'm going to leave it to my colleagues to finish up. I think we're talking about concentration in two somewhat different ways. There's no doubt but that a significant portion of what happened at the beginning of the 1980s with respect to the S&Ls was that they went beyond what they had traditionally done.

On the other hand, they went beyond what they had traditionally done in an era of a good deal less supervision, when they were trying to fight a very bad interest rate risk problem that was causing them to want to bet the farm in ways that they should never have been allowed to do. The ones that stuck to their knitting, that stuck to the residential mortgage lending that they had always done, in general, came through it. At least where they didn't have a massive real estate bubble to deal with, they came through it OK.

However, some diversification of activities is definitely a good idea. A diversified portfolio, as Governor Meyer pointed out, is the traditional recommendation about how you reduce risk. It is important, however, to diversify into activities that you know how to do, and to do them well, and to monitor them thoroughly, and to make sure you have the systems that support them.

Chairman BACHUS. Thank you.

Mr. Bereuter.

Mr. BEREUTER. Thank you, Mr. Chairman. I'd like to, of course, add my welcome to the panel today. I think I must share some of the concerns the gentlelady from California has from her comments about small banks. It seems you agree that you don't like the statutory restrictions on premiums imposed in 1996. You're not interested in increasing the deposit coverage, and you want to merge

the BIF and the SAIF. But I think, if I may say so, you're not very explicit about giving us a good rationale for doing those things.

I also had the view that "free rider" is an interesting, and sort of negative, term to use, which might not be altogether appropriate.

Governor Meyer, may I start with you and talk about your opposition to the 1996 statutory restrictions on premiums? As you know, in that legislation, which Congressman Vento and I had something to do with that limitation, you indicate the two variables—capital strength and examiner overall rating—do not capture all the risks that banks and thrifts could create for the insurer. The Board believes that FDIC should be free to establish risk categories based on well-researched economic variables and to impose premiums commensurate.

But "well-researched economic variables" is a very vague term. I'm very hesitant to extract very large amounts of money out of the economy that is available for lending in our institutions. And I'm very concerned about keeping our commercial banks competitive with other kinds of financial institutions. Can you be a little more explicit in your opposition to the current 1996 Act's limitation on premiums?

Mr. MEYER. Maybe the way to think about this is to make a contrast with what Congress did in 1991, when it passed the Federal Deposit Insurance Corporation Improvement Act (FDICIA), and what it did in 1996, because in 1991, Congress passed a bill that mandated that the FDIC implement a risk-based structure of premiums.

Now what's valuable about such a system is, it's more equitable, because then, safer banks are not subsidizing riskier banks as they are when everybody pays the same premium, and it avoids the problem with the zero premium giving away the Government guarantee. Everybody should pay an appropriate amount related to their risk for the insurance coverage.

Mr. BEREUTER. Why should every bank pay some? The least risky, why should they?

Mr. MEYER. Because every bank, no matter what their risk is, imposes some risk to the fund, and therefore should pay some premium. It should pay a lower premium when it imposes very little risk, and it should pay a higher premium when it imposes more risk, and it should pay a considerably higher premium when it imposes a considerably higher risk. That's the view.

Now I understand the intent of the 1996 Act. The problem with FDICIA was that it set a designated reserve ratio, but then the question is, what happens if the fund rises above that reserve ratio? Should there be any limit to the fund?

Mr. BEREUTER. We made the assessment, Mr. Governor, that when you have capital strength and you have examiner overall ratings that are very good, that these banks therefore do not impose a high risk on the insurance fund. And we're just basically saying this is a category. Yes, we can believe in risk assessment and properly adjusted premiums, but by these two measures, the risk is so small that these banks ought not be assessed a premium at all.

Mr. MEYER. That would be the view that there is no difference in the risk across those banks. We believe there is a difference in

the risks across those banks. We believe even the safest banks impose some risk, and that's really what the issues are, I believe.

Mr. BEREUTER. I'll move to Secretary Bair and ask with respect to deposit insurance coverage, you say: "It is not surprising, therefore, that we found no evidence of consumers expressing concerns about the existing deposit insurance limits." And I would just suggest that's not the relevant factor. Consumers can find other places to take their deposits. What the concern is that we see, because of the limits which have not been adjusted for quite some period of time, can go back to one of two dates, appropriately, that they are finding other places for their money, typically outside the community where the deposits are generated. At least that's the experience in my own State.

And whether consumers can find a place or not is not really the relevant question. The relevant question is, is it inappropriate to adjust the levels so that these commercial banks can be competitive with other financial services institutions and whether or not you are in the process by not adjusting the limit, forcing money out of those communities that should be available for lending in those communities?

And relatedly, I would ask you your views on whether or not there should be some change in requirements with respect to municipal or other political subdivision deposits, because that is particularly sensitive to small communities when they see that those funds are necessarily leaving the community when there is perhaps only one or two commercial banks in that particular community or region.

Ms. BAIR. There are many components to your question. One consistent theme in your question is the thought that funds are flowing out of community banks, because of the coverage limit, and I guess that's where we'll have to agree to disagree. We don't see evidence that that's the case that the coverage limit has anything to do with it. To the extent that it's happening, higher yields may be driving that dynamic.

Number two is, as the Fed points out in its testimony and Governor Meyer in his oral statement as well, small banks are highly competitive right now. They are getting insured deposits and uninsured deposits. The number of uninsured depositors is only 2 percent of the universe of depositors, so presumably it's only those 2 percent that would benefit immediately from a rise in the coverage limit. Those people—they are higher income folks, there is no evidence that they are concerned that some measure of their deposits in federally-regulated banks is uninsured. To the extent we're dealing with those 2 percent, you're dealing with the higher income levels. The income level for that 2 percent is double the median income for those whose deposits are completely insured by the $100,000 limit.

Again, to the extent people are uncomfortable with having uninsured deposits, there are so many ways to address this. You can go to multiple banks. You can open up multiple accounts in different legal capacities at the same bank.

For all those reasons, Congressman, we just don't see a clear case has presented that this is going to help. I will say our door is open. We are happy to discuss this. I'm happy to discuss this fur-

ther with you. Any additional data you may have, I'm happy to take a look at. But based on what has been presented to us at this point, we just don't see a convincing case has been made.

Mr. BEREUTER. Mr. Chairman, I know my time has expired. But I would just say the experience I have in visiting with the bankers in my district and to consumers and to depositors is not the same that you suggest. These consumers, these depositors are very smart, and they're taking their money out, and they're very risk-averse. And so if it's not covered beyond $100,000, they're taking it outside the area.

Chairman BACHUS. We appreciate that, Mr. Bereuter.

Mrs. Maloney.

Mrs. MALONEY. I thank you, Mr. Chairman, and thank all of the panelists for joining the subcommittee today. I particularly want to mention Ellen Seidman's fine service to the country. This will probably be our last opportunity to hear your testimony. Personally, I regret that you are not allowed to fulfill your entire term. But believe me, we all appreciate your fine service.

I believe ensuring the future safety and soundness of the banking system and the health of the insurance funds is the most important responsibility of this subcommittee. And I deeply believe that we all owe outgoing FDIC Chairwoman Tanoue a debt for beginning the debate on deposit insurance reform.

I am, however, concerned that the FDIC proposal would lead to additional premiums on banks. Any additional premium, we all know, would have a direct impact on the amount of loans that institutions can make in all of our communities. Given the relative health of the banking industry and the prospect of a strengthened merged insurance fund, why should Congress consider raising deposit insurance premiums? I'd just like to ask all the panelists.

Mr. MEYER. I think we have indicated that we think that insurance should not be priced at zero. Every bank poses a risk, riskier banks pose more risks. Every bank should pay for its insurance in relationship to the amount of risk that it implies for the fund.

Now I think all industries would appreciate being subsidized, and all industries would be larger if they're subsidized. But we think that it is more equitable and it is more efficient that banks pay for insurance according to risk and that that behavior is a factor that helps to control the risk-taking of those institutions. If you support and want a safe and sound banking system, a risk-based structure of the premiums is a very important component of a program that supports that safety and soundness.

Mrs. MALONEY. Would you like to comment? Go right ahead.

Ms. BAIR. I would just say, to me the question is not so much whether, but when, they will have to pay. I think now you have a situation where 92 percent of all banks pay no premiums. But, as the Chairman pointed out in his opening remarks and his later follow-up questions, if we fall below that 1.25 percent, and it looks like we're going to be there beyond a year, there's going to be a 23 basis point cliff that's going to hit all banks square in the face, and at that point, they are going to be paying. You're going to be taking significant amounts of capital out of those banks and sending it to Washington to replenish the fund.

We believe that system should be replaced with a system where you have a wide range as opposed to a DRR, small basis point premiums for all banks, gradually build up the fund to whatever that higher range should be with a system of rebates once you pass that higher range. And through that you will ease out the potential volatilities that you have with the current system where you go from paying no premiums to paying a really whopping sum.

So I don't think it's a question of whether. I would like to say the fund is never going to fall below 1.25, but we all realistically know that we're running a danger here, and I think the question is whether we want a system where you have a cliff or whether you have a smoothing out of premiums over time.

Mrs. MALONEY. Thank you.

Mr. Hawke, in your testimony you have this report on reforming the funding of bank supervision. And you've mentioned in your testimony, and you've mentioned to me and others, your concern about the disparity in the cost of bank regulation between the State and national banks. Could you comment on the impact this has had on the State and national charters and on deposit insurance reform?

And I must say that a number of colleagues and professionals in the industry have mentioned that reforming the funding of bank supervision should not be part of this debate or this particular bill. And if you believe it should be part of this debate and this particular bill, why do you believe it should be part of it?

Mr. HAWKE. Thank you, Congresswoman Maloney, for allowing me to address that issue.

First of all, the basic problem is that there is a very significant disparity in what State and national banks pay today. The average $500-million national bank will pay about $113,000 in assessments, while a comparably sized State-chartered bank in an average State that has strong supervision would pay only $43,000. That presents a constant incentive for national banks to consider converting to a State charter, and we see it all the time.

We calculate that over the last year-and-a-half or two years, about $60 billion in assets have left the national banking system for State charters, motivated solely, or virtually entirely, by that cost saving. And that cost saving is attributable only to the fact that the FDIC and the Federal Reserve absorbed the cost of their supervision of State-chartered banks while national banks have to pay the entire cost. Only a fraction of the cost of State bank supervision is recovered from State banks, whereas virtually the entire cost of national bank supervision is recovered directly from national banks.

We think this is an issue that's integrally related to deposit insurance reform for a couple of reasons. First, it relates to what the optimum size of the fund should be. You can't, it seems to me, consider what the size of the fund should be without taking into account the fact that, at the present time, the FDIC takes about $600 million a year out of the fund to cover the cost of its supervision of State-chartered banks. That has a direct relationship to what the size of the fund is or should be.

Second, it relates to rebates. Today, national banks, in effect, pay 55 cents of every dollar that the FDIC spends on State bank supervision. If there are going to be refunds or rebates from the fund,

we think that the inequity of national banks contributing to the cost of State bank supervision should be addressed; national banks should get rebates that make them whole, in effect, for their contribution to the subsidization of State-chartered banks, before rebates are paid to other banks.

So I think these are issues that are integrally related to deposit insurance reform. One of the general principles underlying deposit insurance reform is eliminating some of the cross subsidies that exist today in the deposit insurance system, and this inequity in funding is clearly in that category.

Mrs. MALONEY. My time is up. Thank you, Mr. Chairman.

Chairman BACHUS. Ms. Hart.

Ms. HART. Thank you, Mr. Chairman.

My first question actually is for the Assistant Secretary, Ms. Bair. In the testimony that you gave, you questioned whether or not the Federal Home Loan Bank advances should have priority over other bank liabilities in the event of a failure of a bank. Do you recommend that the subcommittee should change this? And if so, in what way? Should we prioritize differently or do something else that you might suggest?

Ms. BAIR. I don't think we suggest that the priorities should be eliminated. What we suggest is that those advances should be included in the assessment base so that they're reflected in the premiums that are charged the depository institution.

Ms. HART. So the current priorities, as far as you're concerned——

Ms. BAIR. Well, as you know, the fact that the Federal Home Loan Banks have a priority claim over a bank's assets over the FDIC, then to the extent a bank increasingly relies on advances from the Federal Home Loan Bank in lieu of insured deposits, it is increasing risk to the fund.

So we think some consideration should be made as to whether you include those advances in the assessment base that's used to calculate premiums, whereas now it's just insured deposits.

Ms. HART. OK. And this is just for the panel in general, actually especially probably for Treasury and maybe the Fed. We had an earlier hearing on the issue of Gramm-Leach-Bliley's opening up the financial services market and perhaps allowing banks to be involved in real estate brokerages. In light of that change, if you would see that as it seemed that day of the hearing, which is basically it should be wide open, would you think that there should be some change regarding FDIC and coverages or any other thing in the market that would change, because of that pretty significant, as I would see it, change in the responsibilities of those institutions?

Mr. MEYER. I wouldn't see any necessary change there. We are talking about an agency activity, which in our view would be a relatively low-risk activity. So I wouldn't see that that would have any implications for Federal deposit reform.

Ms. BAIR. I have nothing to add to that other than I was just sworn in as the new Assistant Secretary for Financial Institutions at six o'clock last night in my new office, where there are stacks of boxes containing 32,000 letters on that particular rule proposal. So assuming it's going to take me a while to filter through those,

obviously I can't comment on the rule, because it's pending, but certainly it's an agency activity, so at least on that particular issue, I wouldn't see that it would impose excess risks.

Ms. HART. One more just sort of to clarify a little bit. I understand it's not necessarily just an agency activity, however. It goes beyond that. Would it not give them also the power of management and other powers that I know some of them are currently involved in and would be actually responsible for in the liability arena?

Mr. MEYER. Well, management, but not the ownership of the assets. And the real risks come when you own assets whose value is variable and where you're subject to loss. So, again, I don't think that either of those activities would involve the kinds of risks that would make a material difference in the assessment of what the overall size of the fund should be or what the risk-based premium should be.

Ms. HART. Does anybody else on the panel have an opinion on that one? Sure.

Mr. HAWKE. I would just add that one of the objectives of bank supervision today is to try to help banks diversify the sources of their revenue. Banks have traditionally been very heavily dependent on net interest spreads as their source of revenue. One of the motivating features behind Gramm-Leach-Bliley was to help diversify revenue streams within the area of financial and financially-related activities, to the extent that that can be done in a safe and sound way. We think an agency activity that doesn't present risk to the bank, but helps diversify the bank's income stream works toward the reduction of overall risk.

Ms. HART. Anybody else? OK. Thank you. I yield back my time, Mr. Chairman.

Chairman BACHUS. Thank you.

Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman.

Chairman BACHUS. You get an extra 20 seconds of her time.

Mr. WATT. I appreciate that very much. There seems to be a substantial amount of agreement in your testimony, and I want to go to one area where there, I guess, potentially is some disagreement, and that's this question of how you fund supervision. I know Mr. Hawke's opinion on that. I have not heard Mr. Meyer express any opinion on it. And I'm wondering whether you have an opinion on it and if you would care to share it?

Mr. MEYER. Thank you. I think that Comptroller Hawke has made a very good case that there are problems associated with the current funding arrangements for bank supervision specifically affecting the OCC and the OTS. And I think there are two elements here. The first is the funding arrangements where the funds depend upon examination fees that come from your assessment base. That funding is potentially unstable, because it depends upon charter choice decisions. And second, there's a disparity across the various banking agencies in terms of how supervision is funded.

Having said that, our view would be that, notwithstanding the fact that there's some relation to the FDIC fund, it would be a mistake to try to tackle this issue as part of deposit reform. And the reason for that is that we have reservations about the specific solution. We agree that there is a problem. We agree that we ought to

work to resolve that problem, but we have reservations about the particular solution that the Comptroller has suggested.

Mr. WATT. OK. I got that. Let me put a slightly different spin on this since we're at the very beginning stage of starting to talk about a solution to this disparity and maybe make a slightly different view about this.

It seems to me that one can make the argument that the deposit insurance fund is about premiums for insuring the $100,000 of deposits that we are, in fact, insuring. The question of supervision of banks is a separate issue which—and it seems to me, if we are taking the general supervision cost out of the fund, the insurance fund, which is designed to pay for losses up to $100,000, basically you have lower income, lower amount depositors paying the full cost of supervision for banks and higher income people and other activities that really have nothing to do with the insurance fund.

So one approach to this might be to take all of the supervision out, both your supervision and the national banks' supervision, and to create a separate supervision fund so that lower-level depositors, people who are depositing $100,000 or less, are not really paying the cost of the overall supervision of everything that the bank is doing.

Now maybe I could get your preliminary reaction. I know this is kind of a radical theory. But maybe you could give me your preliminary reactions to that. And then I'd like to hear from Mr. Hawke on the same question and Ms. Seidman on the same question.

Mr. MEYER. First of all, our supervision costs are not paid out of the FDIC fund. They're paid from our earnings on our portfolio of securities.

But second, that approach still encounters the following problem: You have to come up with a mechanism for funding. If that mechanism is Federal funding——

Mr. WATT. But it's not on the backs of $100,000-or-less depositors.

Mr. MEYER. Right. That's fair. But you have to come up with a mechanism, and you have to deal with—if it is going to be Federal financing—can you maintain the viability of the dual banking system and have Federal financing of State examinations?

Mr. WATT. Mr. Hawke.

Mr. HAWKE. Mr. Watt, the most straightforward way of dealing with this problem would, of course, be for the Federal Reserve and the FDIC to impose assessments for the cost of their supervision, just as we do with national banks. National banks pay us the entire cost of their supervision. State-chartered banks only pay assessments to their State regulators, which really accounts for only a small portion of the cost of their supervision. The predominant component of the supervision of State-chartered banks comes from the FDIC and the Fed.

So the problem is created by the fact that State-chartered banks are not charged by their Federal supervisors. Year after year, OMB has sent to the Hill a proposal to require the Fed and the FDIC to charge assessments for their supervision, but that's basically been dead on arrival.

Mr. WATT. So what you're saying is actually consistent with what I'm saying?

Mr. HAWKE. Yes. The most desirable way to do it doesn't seem to be politically feasible.

Mr. WATT. Ms. Seidman.

Ms. SEIDMAN. It is an intriguing proposal. I would like to point out that currently, $600 million a year is taken out of the insurance funds to supervise State non-member banks. So currently, we have exactly the situation that you're talking about. It's just that we only have it with respect to one kind of charter.

Mr. WATT. Mr. Meyer said that wasn't the case, though.

Ms. SEIDMAN. It isn't for the Fed. It is for the FDIC. The Fed just takes it out of, in essence, general revenues. Now the issue of whether supervision is related to insurance is one that, I think, is critical.

Mr. WATT. I acknowledge that there is some relation—don't get me wrong. I know there is some relation—supervision of the insurance costs something, but it doesn't cost the whole insurance package is the point I'm making.

Ms. SEIDMAN. And that's why I think that as long as we're putting alternatives on the table, you'll notice that in my testimony there's another alternative, which is, in essence, that as soon as we get banks that get into trouble, 3-rated banks and lower, that at that point, all the supervisory costs should come out of the insurance fund. Because there you can say we are really running a risk here. We're running an insurance risk that is really immediately quantifiable in a much bigger way than the risk of 1- and 2-rated banks, as to which the risk is more attenuated. I support the notion that insurance should not be free. But we're talking about 1 basis point premium ideas for top-rated banks. When you get to 3- and 4- and 5-rated institutions, you're talking about a much more immediate kind of risk.

And I will tell you as a bank supervisor, our job is to keep those banks out of the insurance fund.

Mr. WATT. Thank you, Mr. Chairman.

Chairman BACHUS. Mr. Tiberi.

Mr. TIBERI. A quick question for the Assistant Secretary. On page 4 of your testimony, you suggest that we examine the assessment base for the payment of deposit insurance premiums. Could you explain what you mean and give us suggestions?

Ms. BAIR. That was mainly a reference to Congresswoman Hart's earlier question about the increasing reliance that some banks are placing on secured liabilities and also, because Gramm-Leach-Bliley gave community banks the ability to get advances from the Federal Home Loan Banks, regardless of whether they're using the money for any activity, not just home mortgage financing. Because the secured liabilities take precedence, take priority over the FDIC's claims in the case of a bank failure, they're posing additional risk to the fund.

So the question is whether the secured liability should be included in the assessment base, which would, by broadening the assessment base, also increase the premium for the particular institution.

[The following information was provided at a later time by Hon. Sheila Bair:

[As a matter of clarification, a broader assessment base may be accompanied by lower premium rates to achieve the desired revenue for FDIC. Thus, a bank's premium may or may not rise with a change in the base.]

Chairman BACHUS. All right. Thank you. Let me ask this question. We're just going to keep going and hope that people come back. You had a lot of questions about the small community banks. And the concern is that they will be able to generate deposits. One source of funding has been the Federal Home Loan Bank. Assistant Secretary Bair, you mentioned that funding from that source may create a special risk or reliance on that funding they have a preference in case of a failure. At the same time, where do they go to generate deposits or funding? And that is one of the places they're going. But where do they go for growth?

And I would like you to—maybe all of you ought to consider—and the small banks are telling us in this equation that they want an increase in deposit insurance. That is where they feel like the growth can be.

Two other areas that they've suggested to us are municipal deposits and IRA or retirement accounts. Now let me say on municipal deposits that I don't think that's just speculation on their part. What we're talking about, and Governor Meyer, you talked about the whole universe of smaller or newer institutions, some of these institutions are in big cities. But when we talk about the institutions in the small towns, I doubt if you took those out of the universe that you came up with the growth of 12 or 13 percent, I'm not sure that that would be true. Because I think when you have a rural county with one hometown bank or one bank in the county, or in the county seat, that those banks are not tending to grow.

This is a long question, but you can have a long answer. One possible suggestion concerns municipal deposits, because of the collateral requirement. And I can tell you that school boards, county school boards, city governments are saying we would like to do business with our only hometown bank, but we really are limited by insurance coverage. The State of Massachusetts, particularly, has a State program where they can buy additional insurance to cover municipal deposits. And I don't know whether it's just to increase their coverage. I'd just like your comments on what we could do to benefit these banks.

Mr. MEYER. I think the first thing to do is let's not try to solve a problem that doesn't exist. You focus on an important area that many people are talking about of whether small banks are under competitive pressure and they can't fund their assets. So let's look at some of the facts: 1995 to 2000, insured deposit growth, how fast was it? 9.6 percent a year. Let's compare that to the largest banks. These are the small banks, 1,000 and below, OK? These are relatively small institutions. The 100 largest banks had average deposit growth of less than one-half a percentage point.

Chairman BACHUS. Let me interrupt you and just ask you, did you break that out into rural banks?

Mr. MEYER. I didn't. These are small banks. We could look further at that. But if you say that there's a problem, what's the prob-

lem? Their insured deposits were growing at 9.6 percent, but their assets were growing at 13 percent, OK? That's more than twice as fast, or about twice as fast, as larger banks were growing adjusted for mergers.

So the problem—and we don't think this is a problem—is that small banks are growing very rapidly, and they're not able to fund all of that rapid growth from insured deposits. So what are they doing? That's the legitimate question. Well, they're funding a lot of it from uninsured deposits. How fast were they growing? At a 20.5 percent annual rate, again, twice as fast as they were growing at large banks.

So now, the final analysis is that these small banks were funding almost 85 percent of their assets from their deposits, insured and uninsured deposits. But their amount of funding from total deposits did go down a little bit, 2 percentage points over this period, and that was made up by Federal Home Loan Bank advances. That's what filled the gap.

Chairman BACHUS. All right.

Mr. MEYER. But, we just don't see that there's a problem to be solved here.

Chairman BACHUS. All right. I understand. Now you would be willing maybe to revisit that and see whether we're talking about urban institutions or——

Mr. MEYER. It's a very good question, and I'll see what we can do to come up with some data there.

Chairman BACHUS. Madam Assistant Secretary.

Ms. BAIR. Well, we consider our primary role in this debate is the advocate of the taxpayer and I guess the concomitant to that is, you know, we want to minimize the risk exposure of the fund, because ultimately, that is the best way to represent the taxpayers' interest on this issue.

So we go into the question of whether you should raise coverage limits with deep skepticism. However, if there's additional evidence to be presented that would show that there would be a competitive benefit, or a benefit to consumers pointing to the various proposals that have been on the table, we're willing to look at it.

On the specific question of whether to provide 100 percent insurance for municipal deposits, I think that also raises some other policy issues that need to be considered. One is, I think, it kind of goes to what's the core purpose of deposit insurance? Is it to protect small depositors, or are we going to broaden that to specified categories that go beyond the traditional small depositors which the system was designed to protect?

Second of all, I think there's an issue as to if you provide 100 percent coverage, do you decrease incentives on the part of municipal officials to make sure that the institution where they're putting the taxpayers' money is a safe institution? So I think those are two things that need to be considered.

That said, we are deeply skeptical, but if there's data or evidence, we'd be interested to know what the rural bank breakout on the statistics is that this would help consumers or improve competition. But we're open to hearing those arguments. But right now, we just have not heard them.

Chairman BACHUS. Yes. And let me say this. When we're talking about municipal deposits or governmental deposits, what in my mind we're also talking about, at least I can't express the sense of the Congress, but public policy behind a county government or a city government being able to keep more than $100,000 worth of their deposits in a local-based financial institution. I think there is a certain public policy argument that that option ought to be open to them. If we can create—and I'm not talking about unlimited. Obviously I understand moral hazard. I'm not talking about uninsured. But if we can create an insurance fund for municipal deposits of some amount, and whether we're talking about half-a-million, or a million, but I would at least like us to look at that, particularly in that the small banks—and what you've proposed also is that we look at part of the risk basis, how much they rely on the Federal Home Loan Bank, and obviously, we're going to probably find that the small banks may be impacted by that, although I don't know.

But I would approach it from a public policy standpoint and see what remedy could be fashioned.

Ms. BAIR. That suggestion extends to all secured liabilities. Federal Home Loan Bank advances were given as an example because it is a recent change. But we're talking about all secured liabilities.

Chairman BACHUS. OK.

Mr. HAWKE. Mr. Chairman, we regulate more than 2,200 community banks, so we have a very strong interest in the welfare of community banks. And I must say that as our community bankers come through and visit with us, for every community banker who thinks he or she would be advantaged by raising deposit insurance limits, there's another one who thinks that it might be disadvantageous. I don't think anybody really knows with certainty what the consequences would be for community banks of a significant increase in deposit insurance limits. It may simply result in a very disruptive shuffling of deposits among banks with no net winners or losers.

One of the facts that affects my thinking about this is that today there are more than $2 trillion invested in money market mutual funds, and over $1 trillion in uninsured deposits in banks. That suggests that people who have liquidity and wealth to put out in reasonably safe investments are not being highly motivated by deposit insurance. Today, with a minimum of inconvenience, anybody who wants to maximize deposit insurance coverage can do so by going to multiple institutions or multiplying accounts within a single institution.

But there's so much uninsured liquidity outside the banking system today that I think one has to be skeptical about what the consequences would be of increasing coverage limits in terms of bringing new deposits into the system.

Chairman BACHUS. Even your proposal that we balance the examination fee, I think, will result in more smaller banks or State-chartered in these communities. So we're again talking about a thing——

Mr. HAWKE. Our proposal would be a significant benefit for State-chartered banks. It would relieve them of the burden of having to pay assessments to their State supervisor. Today, State-char-

tered banks pay roughly $160 million in assessments to their State supervisors throughout the country. Our proposal would shift that expense to the FDIC fund. So it would result in significant benefits to State-chartered banks, as well as relieving the inequity for national banks.

Chairman BACHUS. And that would probably be the smaller banks you think would benefit?

Mr. HAWKE. Any State-chartered bank that's paying assessments today—and they all pay assessments to their States—would be relieved of that burden.

Chairman BACHUS. Let me ask you one final question. Is there any policy prescription that you could offer the subcommittee that might address—and I know, Governor Meyer, you're saying there aren't any liquidity problems with the small banks—but with the smaller banks? Can you offer any possible solutions or proposals which might help them raise deposits?

Mr. HAWKE. I think, Mr. Chairman, that there's room for the market to work here. Today, the $2 trillion in money market mutual funds suggests that people who have wealth to put out to work don't see a significant difference in the risk characteristics between banks and money market mutual funds and are willing to take whatever that risk differential is to get the higher yield. So, I think, as Assistant Secretary Bair suggested, this may really be a question of yield.

Ms. SEIDMAN. May I also suggest something else? Your questions have been focused on the liability side of the balance sheet—on deposits and Federal Home Loan Bank advances. The bigger question, I think, that all small institutions, and particularly small institutions in relatively small communities face, how to fund loans in general. I go out there and see this happening with respect to home loans for some of the smaller rural thrifts. That is the big question. How do I fund these loans? And so I think to some extent one of the issues that we all ought to be working on is whether there are techniques that some of these very traditional smaller institutions can begin to use that some of the bigger ones have been using to make it possible to fund more lending activity with less on the liability side.

Now I'm not suggesting that all of them should get into massive asset securitization, or should all go into commercial and industrial loan syndications. But we work a lot putting together consortia of small institutions to participate in larger multifamily lending, or even in some of the riskier kinds of single-family lending. There are opportunities to do things like that.

That's not as quick and widespread a solution as raising the deposit insurance level seems to be, but I will say that one of my real concerns about whether raising the deposit insurance level could possibly be as effective as some of the institutions think it is—and certainly some of the institutions we regulate have said this to me—if you don't fix the problem of multiple accounts in multiple banks, there's no particular reason to believe that raising the level will benefit the community banks more than it will benefit the larger banks. And in fact, it might lead to some further consolidation away from the smaller banks.

Chairman BACHUS. Governor Meyer.

Mr. MEYER. Mr. Chairman, I think there is one thing that the Congress could do that would benefit small banks, and that is to allow the payment of interest on demand deposits. As you know, this is an issue that affects small banks relative to the larger banks, because the larger banks have found a way to in effect pay interest on demand deposits through sweeps. Allowing small banks to pay interest on demand deposits would make them more competitive not only with larger banks, but also with non-bank financial institutions.

So as you think about this problem and keep in mind the health of our small banks in this country, I think that's very much something that would be a benefit to the broader economy, but also would accrue specifically and especially to smaller banks.

Chairman BACHUS. And, that measure has passed the House and is awaiting action in the Senate.

Mr. MEYER. I appreciate that.

Chairman BACHUS. I would——

Ms. BAIR. Mr. Chairman, if you don't mind, if I could add one thing? I would come full circle to where you started this hearing, which is the 23 basis point cliff. I think getting rid of that—I think that, in particular, is a tremendous threat to smaller banks, and replacing that with some type of system where you have a smoothed out system of premiums would be tremendously helpful.

I also want to clarify, after going back and reading the written testimony on this Federal Home Loan Bank advance question, I don't want anyone to think that the Treasury is suggesting that we don't think a bank should have Federal Home Loan Bank advances as a source of capital. We do. We just note it in context of other secured liabilities.

Chairman BACHUS. I didn't see any suggestion that you did.

Ms. BAIR. OK, good. Treasury has long had the position—the previous Administration had urged Congress in the context of insurance reform to take a look at the whole question of what should be in the assessment base and how you treat secured liabilities in the assessment base.

Chairman BACHUS. One comment I would add to your comment. And I think all of you have more or less said that raising the insured amount of deposits might not help small banks. But the small banks are telling the Members of Congress where those banks reside that it would help them. So we have the regulators saying it wouldn't help them, but we have the people that own the banks and operating them telling us that it would help them.

Mr. MEYER. Mr. Chairman, if you price insurance at zero, I think banks are going to want the most that they can get, and I don't blame them.

[Laughter.]

Chairman BACHUS. Thank you. Maybe we ought to quit on that.

[Laughter.]

Chairman BACHUS. I'm not sure that I want to adjourn the hearing. I was hoping Members might come back.

[Pause.]

We very much appreciate your testimony today. I would ask that this be a continuing process, that we continue to meet informally, continue to try to build a consensus.

One thing that we all agree is that the Federal deposit insurance system needs to be reformed, and there is a consensus around certain measures. My caution would be—and sometimes there are Members of Congress that are saying to you, "address this limited issue"—but let me give you some inconsistent advice with that.

We don't want to overcomplicate any regulatory scheme, because no bank or no institution is going to benefit from a complicated formula, one that's hard to interpret and has tremendous discretion, which they will all assume works to their disfavor.

Mr. HAWKE. Mr. Chairman, wait until you see the Basel proposal.

[Laughter.]

Chairman BACHUS. I think that is why we ought to keep it as simple as we can. Keep it as workable as we can without additional paperwork and requesting all sorts of information that we don't presently request and actually end up stepping up the regulation above what needs to be done.

We will leave the record open for 30 days to allow Members to submit questions for the record and appreciate your testimony. The hearing is adjourned.

[Whereupon, at 11:50 a.m., the hearing was adjourned.]

A P P E N D I X

July 26, 2001

OPENING STATEMENT OF CHAIRMAN SPENCER BACHUS ON DEPOSIT INSURANCE REFORM JULY 26, 2001

The Subcommittee meets today for its second hearing in this Congress on reforming the Federal deposit insurance system. At our first hearing on this subject in mid-May, Donna Tanoue, the outgoing Chairwoman of the FDIC, presented the agency's recommendations for reform. Today, we will hear the perspectives of the other Federal banking regulators, as well as the Treasury Department.

Since the Subcommittee last met to consider these issues, there have been several significant developments. First, President Bush's choice to replace Ms. Tanoue at the FDIC, Don Powell, has been confirmed by the Senate, and is expected to assume his responsibilities shortly. My hope is that Chairman Powell will appear before the Subcommittee in September to share his views on deposit insurance reform.

Second, the FDIC released data last month reflecting that in the first quarter of this year, the ratio of reserves to insured deposits in the Bank Insurance Fund (BIF) dropped from 1.35% to 1.32%. The reserve ratio for the BIF now stands at its lowest point since 1996.

As most of the people in this room are well aware, once that number falls below the current "hard target" of 1.25%, every bank in America faces a 23-basis point premium assessment. It is estimated that such an assessment would require banks to pay billions of dollars in premiums -- a rude awakening after an extended period in which over 90% of banks have paid no premiums at all. Such a massive outflow of funds from the banking system would curtail lending to consumers and small businesses, with potentially devastating consequences for our economy and for communities across America.

By contrast, the FDIC reports that the (designated) reserve ratio in the Savings Association Insurance Fund (SAIF), which covers thrifts, held steady in the first quarter at 1.43%, unchanged from December 31, 2000. Assuming that current trends continue, the possibility therefore

exists that banks will face sizable premium assessments at a time when most of their thrift industry counterparts are paying nothing.

The significant growth in insured deposits that triggered the decline in the BIF's reserve ratio in the first quarter is, in some respects, a "good news, bad news" story. The bad news is obvious for banks that could find themselves on the receiving end of a multi-billion dollar bill from the FDIC if current patterns persist and current law remains in effect.

The "good news" is an apparent reversal of a trend of core deposits leaving the banking system in recent years in search of higher returns elsewhere, making it difficult for some banks to meet loan demand in their local communities. The $84 billion jump in insured deposits in the first quarter reported by the FDIC - coming on the heels of a substantial increase in the fourth quarter of last year - is a welcome development for those concerned about the future of small community banks in America. Whether this flow of funds back into the banking system can be sustained - or proves to be a temporary blip driven by investors seeking safe haven from more speculative incidents remains to be seen.

Another contributor to the declining BIF ratio has been the subject of heated debate in the industry: large infusions of money by large brokerage houses from uninsured cash management accounts to insured accounts at banks owned by those same brokerage firms. Former Chairwoman Tanoue made addressing this so-called "free-rider" issue a centerpiece of her reform proposal. We will learn at today's hearing whether the other banking regulators share her concerns in this regard.

Let me now recognize the Ranking Minority Member, Ms. Waters, for an opening statement.

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Financial Institutions and Consumer Credit
July 26, 2001

"Viewpoints of Select Regulators on Deposit Insurance Reform"

Thank you Chairman Bachus.

This hearing is the second in a series of the hearings the Financial Services Committee will be holding on the issue of federal deposit insurance reform.

In May, the Subcommittee heard testimony on a variety of reform proposals from outgoing FDIC Chairwoman Donna Tanoue. Today, it is with great eagerness we await the testimony of the Federal Reserve Board, the Treasury, the Office of the Comptroller of the Currency and the Office of Thrift Supervision. The viewpoints of these federal regulators are incredibly important to consider in the process of reforming the deposit insurance system.

Federal deposit insurance reform is a ripe issue at this time. The funds are healthy, so it's time to make some decisions on merging the funds, risk-based insurance premiums, coverage limits and the elimination of sharp premium swings. Recent FDIC statistics have shown that banks could be facing a 23 basis point hike in premiums if the current trends persist. This would reduce lending by billions of dollars.

Reforming the deposit insurance system is of great importance to the Committee and warrants careful and thoughtful consideration. It is our intention not to lose sight of the goal of Federal deposit insurance: 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. The system is meeting this goal today and we intend to make certain that it continues to meet this goal for the future.

Finally, I would like to extend a special thanks to Director Seidman for appearing here today. I look forward to her providing us her views and recommendations for reform of the Federal deposit insurance system. Director Seidman, thank you for the job you have done serving as Director of the OTS; all Americans owe you a debt of gratitude for your public service.

Once again, Mr. Chairman thank you for holding this hearing, and I look forward to hearing from all of our witnesses.

Insert T.1

For release on delivery
10 a.m. EDT
July 26, 2001

Statement of

Laurence H. Meyer

Member

Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions and Consumer Credit

of the

Committee on Financial Services

of the

U.S. House of Representatives

July 26, 2001

It is a pleasure, Mr. Chairman, to appear before this subcommittee to present the views of the Board of Governors of the Federal Reserve System on deposit insurance reform as proposed by the Federal Deposit Insurance Corporation (FDIC) this past spring. At this point, the Federal Reserve Board's views are necessarily general because the FDIC's recommendations were purposefully quite broad.

That said, on behalf of the Board I want to compliment the FDIC for an excellent report that highlights the issues and develops an integrated framework for addressing them. We urge the Congress to use that framework for promptly developing a detailed legislative proposal that addresses the most important deficiencies in our current deposit insurance system. I hope my comments this morning will be helpful in doing so.

Benefits and Costs of Deposit Insurance

As background to our suggestions, the Board believes it is important first to understand the benefits and costs of deposit insurance. Deposit insurance has played a key--at times even critical--role in achieving the stability in banking and financial markets that has characterized the past almost seventy years. Deposit insurance, combined with other components of our banking safety net--the Federal Reserve's discount window and payment system guarantees--and with enhanced macroeconomic stability resulting from monetary and fiscal policies, has meant that periods of financial stress are no longer characterized by depositor runs on banks and thrifts. Quite the opposite: Asset holders now seek out deposits as safe havens when they have strong doubts about other financial assets.

Looking beyond the contribution of deposit insurance to overall financial stability, we should not minimize the security it has brought to millions of households

and small businesses. Deposit insurance has provided a safe and secure place for those households and small businesses with relatively modest amounts of financial assets to hold their transaction and other balances.

These benefits of deposit insurance, as significant as they are, have not come without cost. The very same process that has ended deposit runs has made insured depositors largely indifferent to the risks taken by their banks because their funds are not at risk if their institution is unable to meet its obligations. As a result, the market discipline to control risks that insured depositors would otherwise have imposed on banks and thrifts has been weakened. Relieved of that discipline, banks and thrifts naturally feel less inhibited from taking on more risk than they would otherwise assume. No other type of private financial institution is able to attract funds from the public without regard to the risk it takes with its creditors' resources. This incentive to take excessive risks is the so-called moral hazard problem of deposit insurance, the inducement to take risk at the expense of the insurer.

Because of the reduced market discipline and moral hazard, there is an intensified need for government supervision to protect the interests of taxpayers and, in essence, substitute for the reduced market discipline. Deposit insurance and other components of the safety net also enable banks and thrifts to attract more resources than would otherwise be the case. In short, insured banks and thrifts receive a subsidy in the form of a government guarantee that allows them both to attract deposits at lower interest rates than would be required without deposit insurance and to take more risk without the fear of losing their deposit funding. Put another way, deposit insurance misallocates resources by breaking the link between risks and rewards for a select set of market competitors.

From the very beginning, deposit insurance has involved a tradeoff. On the one hand, there are benefits from the contribution of deposit insurance to overall financial stability and the protection of small depositors. On the other hand, deposit insurance imposes costs from the inducement to risk-taking, the misallocation of resources, and the increased need for government supervision to protect the taxpayers' interests. The crafting of reforms of the deposit insurance system must struggle to balance these tradeoffs. Moreover, the Board urges, we should be reasonably certain that any reforms are aimed primarily at protecting the public interest and not the profits or market shares of particular businesses.

The Federal Reserve Board believes that deposit insurance reforms should be designed to preserve the benefits of heightened financial stability and the protection of small depositors without at the same time increasing moral hazard or reducing market discipline. This view underpins the response of the Federal Reserve Board to the FDIC's recommendations. In addition, although at this time we are responding to very broad recommendations, we urge that the implementing details be kept as straightforward as possible to minimize the risk of unintended consequences that comes with complexity.

Recommendations for Reform

The FDIC has made five broad recommendations.

1. **Merging BIF and SAIF.** The Board strongly supports the FDIC's proposal to merge the BIF and SAIF funds. Because the charters and operations of banks and thrifts have become so similar, it makes no sense to continue the separate funds. Separate funds reflect the past, but neither the present nor the future. Equally important, the insurance products provided to the two sets of institutions are identical, and thus the premiums

should be identical as well. Under current arrangements, the premiums could differ significantly if one of the funds fell below the designated reserve ratio of 1.25 percent of insured deposits and the other fund did not. Merging the funds would also diversify their risks and reduce administrative expenses.

2. **Statutory Restrictions on Premiums.** Current law requires the FDIC to impose higher premiums on riskier banks and thrifts but restricts its ability to impose *any* premium on well-capitalized and highly-rated institutions whenever the corresponding fund's reserves exceed 1.25 percent of insured deposits. The Board strongly endorses the FDIC recommendations that would (1) require that a premium be imposed on every insured depository institution, no matter how well capitalized and well rated it may be or how high the fund's reserves, and (2) eliminate the statutory restrictions on risk-based pricing.

The current statutory requirement that free deposit insurance be provided to well-capitalized and well-rated banks when FDIC reserves exceed a predetermined ratio maximizes the subsidy provided to these institutions and is inconsistent with efforts to avoid inducing moral hazard. Put differently, the current rule requires the government to give away its valuable guarantee when fund reserves meet some ceiling level. This free guarantee is of value to banks and thrifts even when they themselves are in sound financial condition and when macroeconomic times are good. At the end of last year, 92 percent of banks and thrifts were paying no premium. Included in this group were banks that have never paid any premium for their, in some cases substantial, coverage and fast-growing entities whose past premiums were extraordinarily small relative to their current

coverage. We believe that these anomalies were never intended by the framers of the Deposit Insurance Fund Act of 1996 and should be addressed by the Congress.

The Congress did intend that the FDIC impose risk-based premiums, but the 1996 Act limits the ability of the FDIC to impose risk-based premiums on well-capitalized and well-rated banks. And these two variables--capital strength and examiner overall rating--do not capture all of the risk that banks and thrifts could create for the insurer. The Board believes the FDIC should be free to establish risk categories based on any well-researched economic variables and to impose premiums commensurate with these risk classifications. Although a robust risk-based premium system would be technically difficult to design, a closer link between insurance premiums and individual bank or thrift risk would reduce moral hazard and the distortions in resource allocation that accompany deposit insurance.

We note, however, that significant benefits in this regard are likely to require a substantial range of premiums but that the FDIC has concluded in its report that premiums for the riskiest banks would probably need to be capped in order to avoid inducing failure at these weaker institutions. We believe that capping premiums may end up costing the insurance fund more in the long run should these weak institutions fail anyway, with the delay increasing the ultimate cost of resolution. The Board has concluded, therefore, that if a cap is required, it should be set quite high so that risk-based premiums can be as effective as possible in deterring excessive risk-taking.

3. **Designated Reserve Ratios and Premiums.** The current law establishes a designated reserve ratio for BIF and SAIF of 1.25 percent. If that ratio is exceeded, the statute requires that premiums on well-capitalized and well-rated banks must be

discontinued. If the ratio declines below 1.25 percent, the FDIC must develop a set of premiums to restore the reserve ratio to 1.25 percent; if it appears that the fund ratio cannot be restored to its statutorily designated level in twelve months, the law requires that a premium of *at least* 23 basis points be imposed on the *least* risky category of banks.

These requirements are clearly procyclical, lowering or eliminating fees in good times when bank credit is readily available and fund reserves should be built up, and abruptly increasing fees sharply in times of weakness when bank credit availability is under pressure and fund resources are drawn down to cover the resolution of failed banks. The FDIC recommends that surcharges or rebates should be used to bring the fund back to the target reserve ratio gradually. The FDIC also recommends the possibility of a target *range* for the designated reserve ratio, over which the premiums may remain constant, rather than a fixed target reserve ratio and abruptly changing premiums.

We strongly support such increased flexibility and smoothing of premiums. Indeed, we recommend that the FDIC's suggested target reserve range be widened in order to reduce the need to change premiums sharply. Any floor or ceiling, regardless of its level, could result in requiring that premiums be increased at exactly the time when banks and thrifts could be under stress and, similarly, that premiums be reduced at the time that depositories are in the best position to fund an increase in reserves. Building a larger fund in good times and permitting it to decline when necessary are prerequisites to less variability in the premium. In addition to widening the range, the Board would recommend that the FDIC be given the latitude to temporarily relax floor or ceiling ratios

on the basis of current and anticipated banking conditions and expected needs for resources to resolve failing institutions.

4. **Rebates.** Since its early days, the FDIC has rebated "excess" premiums whenever it felt its reserves were adequate. This procedure was replaced in the1996 law by the requirement that no premium be imposed on well-capitalized and highly rated banks and thrifts when the fund reaches its designated reserve ratio. The FDIC proposals would re-impose a minimum premium on all banks and thrifts and a more risk-sensitive premium structure. These provisions would be coupled with rebates for the stronger entities when the fund approaches what we recommend be a higher upper end of a target range than the FDIC has suggested, and surcharges when the Fund trends below what we suggest be a lower end of a target range.

The FDIC also recommends that the rebates not be uniform for the stronger entities. Rather, the FDIC argues that rebates should be smaller for those banks that have paid premiums for only short periods or that have in the past paid premiums that are not commensurate with their present size and hence FDIC exposure.

The devil, of course, is in the details. But this latter proposal makes considerable sense, and the Board endorses it. There are over 900 banks--some now quite large--that have *never* paid a premium, and without this modification they would continue to pay virtually nothing, net of rebates, as long as their strong capital and high supervisory ratings were maintained. Such an approach is both competitively inequitable and contributes to moral hazard. It should be addressed.

5. **Indexing Insured-Deposit Coverage Ceilings.** The FDIC recommends that the current $100,000 ceiling on insured deposits be indexed. The Board does not support this recommendation and believes that, at this time, the current ceiling should be maintained.

In the Board's judgment, it is unlikely that increased coverage, even by indexing, today would add measurably to the stability of the banking system. Macroeconomic policy and other elements of the safety net, combined with the current, still-significant level of deposit insurance, continue to underpin the stability of the financial system. Thus, the problem that increased coverage is designed to solve must be related to either the individual depositor, the party originally intended to be protected by deposit insurance, or to the individual bank or thrift. Clearly, both groups would prefer higher coverage if there were no costs. But Congress needs to be clear about the problem for which increased coverage would be the solution.

Depositors. At the Federal Reserve, we frequently receive letters from banks urging that we support increased deposit insurance coverage. But we virtually never receive similar letters from depositors, who are not shy about sharing their many other concerns. This experience may reflect the fact that, as our surveys of consumer finances suggest, depositors are adept at achieving the level of deposit insurance coverage they desire by opening multiple accounts. Such spreading of asset holdings is perfectly consistent with the counsel always given to investors to diversify their assets--whether stocks, bonds, or mutual funds--across different issuers. The cost of diversifying for insured deposits is surely no greater than doing so for other assets. An individual bank would clearly prefer that the depositor maintain all of his or her funds at that bank, and

would prefer to eliminate the need for depositor diversification by being able to offer higher deposit insurance coverage. Nonetheless, the depositor appears to have no great difficulty--should he or she want insured deposits--in finding multiple sources of fully insured accounts.

In addition, the singular characteristic of postwar household financial asset holdings has been the increasing diversity of portfolio choices. The *share* of household financial assets in bank deposits has been declining steadily throughout the postwar period as households have taken advantage of innovations that make available to them attractive financial instruments with market rates of return. There has been no break in that trend that seems related to past increases in insurance ceilings. Indeed, the most dramatic substitution out of deposits in recent years has been from both insured and uninsured deposits to equities and mutual funds. It is difficult to believe that a change in ceilings during the 1990s would have made any measurable difference in that shift. In fact, bankers' comments and the data indicate that the weakness in stock prices in recent quarters has been marked by increased flows into bank and thrift deposits.

Depository Institutions. Does the problem to be solved by increased deposit insurance coverage concern the individual depository institution? If so, the problem would necessarily be concentrated at smaller banks that generally do not have access to the money market or foreign branch networks for supplementary funds. Since the mid-1990s, banks' U.S. assets have grown at an average annual rate of 7.7 percent. Adjusted for the effects of mergers, the smaller banks, those below the largest 1,000, have actually grown at a more rapid average annual rate of 13 percent. Uninsured deposits at these smaller banks have also grown more rapidly than at larger banks--at average annual rates

of 20.5 percent at the small banks versus 10.9 percent at the large banks, both on the same merger-adjusted basis. Clearly, small banks have a demonstrated skill and ability to compete for uninsured deposits. To be sure, uninsured deposits are more expensive than insured deposits, and bank costs would decline if their currently uninsured liabilities received a government guarantee. But that is a different matter, and raises the issue of a subsidy in its starkest terms. I might add that throughout the 1990s, small banks' return on equity was well maintained. Indeed, the attractiveness of banking is evidenced by the fact that 1,363 banks were chartered during the past decade, two-thirds since 1995, when bank credit demands began to intensify.

Some small banks argue that they need enhanced deposit insurance coverage to equalize their competition with large banks because depositors prefer to put their uninsured funds in an institution considered too big to fail. As I have noted, however, small banks have more than held their own in the market for uninsured deposits. In addition, the Board rejects the notion that any bank is too big to fail. In FDICIA, Congress made it clear that the systemic-risk exception to the FDIC's least-cost resolution of a failing bank should be invoked only under the most unusual circumstances. Moreover, the resolution rules under the systemic-risk exception do not require that uninsured depositors and other creditors, much less stockholders, be made whole. Consistent with this view, the market clearly believes that large institutions are not too big for uninsured creditors to take at least some loss, with spreads on their subordinated debt larger than those on similar debt of large and highly rated nonbank financial institutions. Indeed, there are no Aaa-rated U.S. banking organizations.

Another argument often raised by smaller banks regarding the need for increased deposit insurance coverage is their inability to match the competition from those large securities firms and bank holding companies with multiple bank affiliates, offering multiple insured accounts through one organization. While the Board believes that such offerings are a misuse of deposit insurance, raising the coverage limit for *each* account would also increase the *aggregate* amount of insurance coverage that large multibank organizations would be able to offer, so the disparity would remain.

Conclusion

The Board commends the FDIC for its review, analysis, and recommendations for reform of the deposit insurance system. There are several aspects of that system that need reform. The Board supports, with some modifications, all of the FDIC's recommendations except indexing of the current $100,000 ceiling. The thrust of our proposed modifications would call for a wider permissible range for the size of the fund relative to insured liabilities, reduced variation of the insurance premium as the relative size of the fund changes with banking and economic conditions, and a premium net of rebates.

There may come a time when the Board finds that households and businesses with modest resources are finding difficulty in placing their funds in safe vehicles and/or that there is reason to be concerned that the level of deposit coverage could endanger financial stability. Should either of those events occur, the Board would call our concerns to the attention of the Congress and support adjustments to the ceiling by indexing or other methods.

But today, in our judgment, neither financial stability, nor depositors, nor depositories are being disadvantaged by the current ceiling. Raising the ceiling now would extend the safety net, increase the government subsidy to banking, expand moral hazard, and reduce the incentive for market discipline, without providing any real public benefits. With no clear public benefit to increasing deposit insurance, the Board sees no reason to increase the scope of the safety net. Indeed, the Board believes the time has come to draw the line on expanding government guarantees.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

LAURENCE H. MEYER
MEMBER OF THE BOARD

August 21, 2001

The Honorable Frank Mascara
House of Representatives
Washington, D.C. 20515

Dear Congressman:

I am pleased to enclose my response to the question you submitted following the July 26 hearing before the Subcommittee on Financial Institutions and Consumer Credit.

For your information, a copy has also been forwarded to the Committee on Financial Services for inclusion in the hearing record.

Sincerely,

Laurence H Meyer

Enclosure

Governor Meyer submitted the following in response to a written question received from Congressman Frank Mascara in connection with the July 26, 2001, hearing before the Subcommittee on Financial Institutions and Consumer Credit:

Since the passage of Gramm-Leach-Bliley (GLB), some of the larger brokerage firms have dumped huge amounts of money into insured deposits. Is it fair to have smaller community banks, who already paid high premiums as a result of the S&L bailout a few years ago, to contribute premiums to cover this huge infusion of cash into these insured deposits?

Recent FDIC proposals concerning the reform of deposit insurance are designed to lessen the negative effects of rapidly growing institutions, which dilute the reserve ratio and which may pay nothing for deposit insurance when the reserve fund is high. Institutions that bring large amounts of insured deposits into the banking system, as discussed in your question, also would be affected by these proposals. Under the FDIC proposal, the assessment system would move gradually when the reserve ratio fell below a certain level, so that the entry of a few large institutions with substantial insured deposits would not trigger a large increase in insurance payments for all banks. In addition, regular risk-based premiums for all banks would mean recent entrants would also pay deposit insurance premiums, particularly if these institutions added significantly to the risk of the fund. Finally, if rebates are based upon past contributions, recent entrants would get smaller rebates than established institutions. As I stated in my testimony, the Board generally supports all of the FDIC's recommendations except indexing of the current $100,000 ceiling.

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

For immediate release:
July 26, 2001

DEPOSIT INSURANCE REFORM

Testimony of Sheila C. Bair
Assistant Secretary for Financial Institutions
U.S. Department of the Treasury

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

July 26, 2001

Mr. Chairman, Congresswoman Waters, and Members of the Subcommittee, I appreciate the opportunity to comment on the Federal Deposit Insurance Corporation's recent paper recommending reform of the deposit insurance system. The FDIC staff and former Chairman Donna Tanoue should be commended for initiating the policy discussion of deposit insurance reform. The FDIC staff report is a thoughtful document that provides a useful starting point for this important review.

We are also grateful for the Subcommittee's initiative in holding a series of hearings on the FDIC's report. The Treasury Department has a substantial interest in this issue as we have a critical role to play in deposit insurance. The deposit insurance funds have authority to borrow up to $30 billion from the U.S. Treasury. In addition, Congress has assigned to the Secretary of the Treasury the responsibility for determining, upon the recommendation of the FDIC Board and the Federal Reserve Board and in consultation with the President, whether the resolution of a failed bank poses a systemic risk to the financial system. Our comments, at this time, are general in nature, focusing on the key policy issues raised in the FDIC paper. We look forward to working with the Subcommittee on the details of implementing reforms in the near future.

We are in *general agreement* with the FDIC report on three points. First, the potential pro-cyclical effects of deposit insurance pricing and reserving should be reduced; reserves should be allowed to grow when conditions are good in order to better absorb losses under adverse conditions without sharp increases in premiums. Second, all insured depository institutions should pay premiums on current deposits, with potential rebates taking into account each institution's recent history of premium payments. Third, the bank and thrift insurance funds should be merged.

However, we have *different views* in two areas. First, we would give priority to reforms that would charge every institution a premium on current deposits that is relatively stable over

time, and we would prefer not to extend the complexity of the risk-based premium structure at this stage. Second, the deposit insurance coverage level should remain unchanged.

Reducing the Pro-cyclical Effects of Deposit Insurance Pricing and Reserve Policies

The potential pro-cyclical effects of deposit insurance pricing and reserving should be reduced; reserves should be allowed to grow when conditions are good in order to better absorb losses under adverse conditions without sharp increases in premiums. The existing designated reserve ratio of 1.25 percent of reserves to insured deposits was historically derived roughly as the average reserve ratio over part of the FDIC's history. As such, it is reasonable to first ask whether it is representative of the FDIC's current and prospective risks.

The reforms that the Congress adopted in the late 1980s and early 1990s have in important ways served to protect taxpayers and should in principle have reduced the FDIC's loss exposure. Congress required the FDIC to maintain reserves equal to 1.25 percent of insured deposits and, if losses cause the fund to fall below that target, to assess the banking industry whatever is necessary to replenish reserves. Furthermore, reforms that raised bank capital requirements, mandated supervisors to take prompt corrective action when a bank becomes troubled, and required the FDIC to resolve failures in the least costly manner all have served to reduce the risk of loss to the insurance funds. While these reforms have likely lowered the FDIC's risks, they have not yet been tested in a severe adverse environment.

It should also be noted that some trends during the past decade have probably increased certain risks that the FDIC faces. Banking industry consolidation has increased the probability that reserves could be depleted by the failure of a few very large banks. And increased industry dependence on secured borrowings in recent years may also reduce the FDIC's ability to recover funds from a failed bank.

Even if the current designated reserve ratio is retained, it should be noted that it was originally based on the *average* reserve ratio over some historical period. Thus it is logical to provide for reserve growth above that level when conditions are good (and for reserves to decline below that level when conditions are unfavorable).

Allowing growth above a designated reserve ratio in good times, or growth within a wide range, would not only afford greater room for the insurance fund to handle bank failures without exhausting its resources, but it would allow for more stable premiums that would smooth over time the costs borne by the industry. The FDIC would be better able to avoid imposing sharp premium increases on the industry, which could have a counterproductive pro-cyclical effect when the economy is under stress. In this context, the Treasury believes that it would be appropriate to eliminate the existing requirement that premiums rise to a minimum of 23 cents per $100 of domestic deposits when the fund is expected to fall short of the designated reserve ratio for more than a year.

The FDIC's recommendations suggest two ways to mitigate the pro-cyclical effects of deposit insurance pricing: (1) allow the reserve ratio to fluctuate within a (relatively narrow) range, within which premiums would not change; and (2) whether or not a range is established, allow for surcharges or rebates that are designed to bring reserves back to the designated reserve ratio – or back within the target range – gradually over a period of years. The FDIC's suggested range (only 10 basis points above or below the designated reserve ratio) is quite narrow, and we believe that a much wider range would more effectively smooth premium expenses over time. Furthermore, the FDIC Board should have some discretion to adjust the range within which the reserve ratio may fluctuate in response to changes in industry risks and conditions.

While we believe that premiums should be structured to limit pro-cyclical effects, designing potential means to accomplish this will be a challenge. Even with an ample range within which the reserve ratio can fluctuate, the existence of a target ceiling and floor on reserves, in itself, imposes a pro-cyclical bias in pricing – due to the necessity that some surcharge would have to apply when reserves fall below the floor. To offset this pro-cyclical bias, it may be necessary to give the FDIC Board discretion to modulate increases in premiums in some manner consistent with the overall health of the banking industry. Considerable attention will be required to develop practical formulas to achieve the desired counter-cyclical effects.

Charging All Institutions a Premium Based on Current Deposits

All insured depository institutions should pay premiums on current deposits, with potential rebates taking into account each institution's recent history of premium payments. Banks and thrifts benefit every day from deposit insurance, and they should compensate the FDIC for that benefit, preferably through relatively small, steady premiums. Most banks and thrifts now pay no premiums for deposit insurance, which creates incentives to increase deposits and thus raises the FDIC's uncompensated risk exposure.

The FDIC's existing capacity to absorb losses comes primarily from the high premiums paid by institutions in the first half of the 1990s. More recently, some institutions have been able to rapidly increase their reliance on insured deposits without providing any compensation to the FDIC. In addition, hundreds of other banks and thrifts chartered within the past few years have never paid deposit insurance premiums.

A deposit insurance system where all banks and thrifts pay modest premiums could still allow for rebates when reserves grow beyond some upper bound. If such a system were designed, we would agree with the FDIC staff's suggestion that any rebates be based on each bank's past contributions to the insurance fund. In addition, having premiums based on current deposits combined with rebates based on past contributions would over time require proportionally greater net payments from institutions with rapidly increasing deposits than from institutions with deposits growing more slowly or declining.

While we agree with the FDIC staff report to this point, the FDIC goes further in advocating a substantial refinement of the current system of risk-based premiums. In fact, a revised risk-based premium structure is central to the FDIC proposal.

Although the idea of risk-based premiums has conceptual appeal, we would give priority to reforms that would charge every institution a premium on current deposits that is relatively stable over time, and we would prefer not to extend the complexity of the risk-based premium structure at this stage. Congress authorized the FDIC in 1991 to establish risk-based premiums, and the FDIC developed a matrix of rates that at present range from zero to 27 basis points based on an institution's capital and supervisory rating. Statutory restraints imposed in 1996, however, have prevented the FDIC from charging most banks and thrifts any premium.

Ideally, an institution's risk-based premium should account for the riskiness of its assets, the structure of its liabilities, the strength of its capital base and management, and the effect that its failure would have on insurance fund reserves. Differences in premiums between a very healthy, low-risk bank and a weak bank may have to be quite large to have the desired behavioral effects. Risk adjustments to premiums should also consider the interaction between risk-based capital requirements, prompt corrective action and bank closure rules, and deposit insurance. Given these considerations, we think that the calibration of risk-based premiums to provide the desired incentives would prove very challenging. Thus, while the FDIC should have authority to charge every institution a premium on current deposits that is not subject to sharp fluctuations over time, we would recommend that any further adjustments to risk-based premium categories and rates be pursued at a later stage.

While we recommend that all institutions pay premiums assessed on current deposits, we also feel that it would be a missed opportunity not to consider what should constitute the assessment base. Under the current structure, to the extent that banks are assessed at all, they are charged only on banks' total domestic deposits. Yet, in the event of bank failure, secured liabilities have a higher claim than domestic deposits (and the FDIC, which would assume the claims of insured depositors) on bank assets. Thus increased reliance on secured liabilities by depository institutions may increase the FDIC's loss exposure. The Gramm-Leach-Bliley Act, by giving community banks broader access to Federal Home Loan Bank (FHLB) advances, has accentuated our concerns about these potential risks. Reform efforts should consider whether the existing assessment base should be modified to account for the effect of liability structure on FDIC's expected losses.

Merging the Bank and Thrift Insurance Funds

The bank and thrift insurance funds should be merged. We strongly support a merger of the bank (BIF) and thrift (SAIF) insurance funds. A larger, combined insurance fund would have a greater ability to diversify its risks than either fund separately. It would make sense to merge the funds while the industry is strong and while a merger would not unduly burden either BIF or SAIF members. A merged fund would also prevent the possibility that institutions posing similar risks could pay significantly different premiums for the same FDIC insurance, as was the case in 1995 and 1996. Incentives created by a premium disparity could result in a wasteful expenditure of industry resources in order to avoid higher assessments. Finally, a merger would underscore the fact that BIF and SAIF are already hybrid funds: each one insures the deposits of commercial banks, savings banks, and savings associations. Indeed, commercial banks now

account for over 40 percent of all SAIF-insured deposits. A merger would simply recognize the commingling of the funds that has already taken place and that is likely to continue.

Deposit Insurance Coverage Level

The deposit insurance coverage level should remain unchanged. We see no evidence that the current limit on deposit insurance coverage is burdensome to consumers. Nor do we see evidence that increasing coverage across the board would enhance competition in the banking industry. Moreover, an increase in the coverage level would increase risk to the FDIC and, ultimately, taxpayers. Thus it would be imprudent to increase the FDIC's exposure at this time by raising the deposit insurance limit.

Increasing the deposit insurance limit would do little for the typical saver, given that the median deposit balance is far below the current ceiling. According to the most recent consumer finance survey data from the Federal Reserve, only 2 percent of households with deposit accounts held any uninsured deposits. The median income of these households was approximately double the median income of households with deposits under $100,000. Thus, any potential benefit from expanding deposit insurance coverage would likely accrue primarily to upper-income individuals.

Ample opportunities already exist for savers with substantial deposits to obtain FDIC coverage equal to several multiples of $100,000. Without much difficulty, they may place deposits in several FDIC-insured institutions or establish accounts within the same institution under different legal capacities that qualify for separate coverage (individual, joint, and IRA accounts). In addition, many consumers feel completely comfortable putting substantial amounts into uninsured but relatively safe money market mutual funds. It is not surprising, therefore, that we have found no evidence of consumers expressing concern about the existing deposit insurance limits.

Competition is critical to keeping banks vital and promoting consumer benefits. Since the existing coverage limit does not appear to restrain consumer benefits, we are deeply skeptical that an increase in the coverage level would promote competition and have a meaningful impact on the ability of community banks to obtain funds.

To the extent that an increase in coverage does result in a conversion of uninsured liabilities to insured deposits, the resulting financial safety net expansion would reduce incentives for market discipline and potentially increase financial system risk. The large increase in insurance coverage at the beginning of the 1980s was, of course, only one of several factors leading to the subsequent savings and loan and commercial bank problems. Nonetheless, it surely contributed to excessive risk-taking by many depository institutions that failed and raised the ultimate cost of those failures.

Funding of Supervision Costs

In considering reform of deposit insurance pricing, it is important to recognize that a significant portion of insurance fund expenditures is not for the resolution of failing institutions,

but for the FDIC's supervision of almost 5,600 state-chartered commercial and savings banks. While these state banks pay fees for the fraction of supervision performed by state authorities, they are not charged fees for the significant share of supervision that is performed by the FDIC. National banks and savings associations, by contrast, are charged for 100 percent of their supervision, and in addition must subsidize FDIC's costs to supervise state banks through their contributions to the insurance funds (and the fund's earnings on those contributions). This uneven distribution of supervision costs is a real problem that should be addressed. All of the federal and state bank supervisory agencies should continue to have the resources necessary to promote safety and soundness. We believe that the OCC's proposal is an interesting approach that deserves further consideration, and there may be other approaches and considerations that should also be explored. We look forward to working with incoming FDIC Chairman Powell and the FDIC Board to devise a solution to this problem.

Thank you for the opportunity to appear here today. I look forward to working with the Subcommittee on these issues.

Question for the Record from
Chairman Spencer Bachus

Question:

As you know, because of intense competition for deposits from Wall Street and elsewhere, small community banks have had to rely increasingly in recent years on advances from the Federal Home Loan Banks and other non-core funding sources to meet loan demand. Banking regulators have raised red flags about banks becoming too heavily dependent upon such sources of funding, which are more expensive than homegrown deposits and carry greater interest rate and credit risk.

At the Subcommittee's July 26, 2001, hearing, you testified that one consequence of greater reliance on Federal Home Loan Bank funding is to increase the FDIC's loss exposure when banks fail, because "secured liabilities have a higher claim than domestic deposits (and the FDIC, which would assume the claims of insured depositors) on bank assets." You also recommended in your testimony that premium assessments under a reformed deposit insurance system should account for the FDIC's increased exposure to risk due to reliance by banks on secured funding.

Small community banks can be excused, in my view, for believing that Treasury's position in this regard places them between the proverbial "rock and a hard place." In the absence of other funding sources, their reliance on Federal Home Loan Bank advances will continue to grow, subjecting them to higher deposit insurance premiums. The policy prescription that community banks believe will ease their funding difficulties – higher coverage limits on deposit insurance – is opposed by the Treasury Department.

Do you agree that reducing community banks' reliance upon Federal Home Loan Bank advances would, under Treasury's approach to deposit insurance reform, result in lower premiums for those institutions and higher recoveries by the FDIC in the event of bank failures? If so, doesn't that argue for serious consideration of at least some modest increase in coverage levels?

Answer:

In my testimony of July 26, 2001, I expressed the view that deposit insurance reform presents an opportunity to evaluate what should constitute the assessment base. Under the current system, to the extent banks are assessed premiums at all, they are assessed only on their domestic deposits. In the event of a bank's failure, however, secured liabilities are paid from the proceeds of the bank's assets ahead of the FDIC (standing in for insured depositors).

Failed banks that are identical in every respect except for the mix of funding from insured deposits and secured liabilities would generally impose on the FDIC the same resolution cost (i.e., the difference between what the FDIC pays to protect insured depositors and what it recovers from the bank's assets). Yet under the current assessment base, the FDIC would collect fewer premiums prior to failure from the bank that relied more on secured liabilities than from the other bank. Including secured liabilities in the assessment base would be one option for

mitigating an increase in the FDIC's uncompensated risk exposure as banks expand their reliance on these sources of funds. With an assessment base that includes both domestic deposits and secured liabilities, premium rates should be lower than what they would be with a narrower assessment base.

The FDIC acknowledged the problem raised by secured liabilities under the current assessment structure in its August 2000 *Deposit Insurance Options Paper*: "Thus, if the banking industry as a whole increases its use of secured borrowing, the BIF and the SAIF are exposed to higher levels of risk."[1] Indeed, the hypothetical risk-based premium structure included in the FDIC's April 2001 recommendations potentially would have banks pay higher premium rates as their dependence on noncore funding increases.[2] Such noncore funding would presumably include secured liabilities as well as other nondeposit liabilities.

Federal Home Loan Bank (FHLB) advances are one type of secured liability upon which banks of all sizes, not just community banks, rely.[3] Any determination of the appropriate assessment base should take into account all types of secured liabilities, not just FHLB advances. Other secured liabilities, such as repurchase agreements and collateralized exposures on derivatives contracts, are more typically a source of financing for larger banks than for community banks. Indeed, our preliminary analysis shows that larger banks rely relatively more on secured liabilities than do smaller banks.

We do not see a link between the issue of the appropriate assessment base and the deposit insurance coverage limit. Even if the assessment base were broadened in order to better compensate the deposit insurance funds for their risks, we see no evidence that this would make the current coverage limit burdensome to customers of banks generally, or customers of community banks in particular. Nor do we see evidence that increasing coverage across the board would enhance competition. As my testimony indicated, increasing the deposit insurance limit would do little for the typical saver; any potential benefit from would likely accrue primarily to upper-income individuals.

Since the existing coverage limit does not now appear to restrain consumer benefits, we are deeply skeptical that an increase in the coverage level would have a meaningful impact on the ability of community banks to obtain funds. The Federal Reserve recently reported that small banks (defined as those not among the top 1,000 in asset size) located in metropolitan areas and not specialized in agricultural lending had average rates of insured and uninsured deposit growth over the past five years considerably higher than the growth rates of the top 1,000 banks. Small non-agricultural banks outside of metropolitan areas had average rates of insured deposit growth exceeding those of larger banks, and uninsured deposit growth rates roughly similar to those of larger banks. Only agricultural banks, while faring reasonably well in insured deposit growth, had rates of uninsured deposit growth that substantially lagged those of banks among the top 1,000. As the Federal Reserve noted, however, this may have more to do with developments in the farm sector during the past few years that are independent of banking.

While we would be happy to discuss this issue further with the Subcommittee and examine any new data available, we do not find a convincing case thus far for increasing the coverage limit.

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[1] Federal Deposit Insurance Corporation, *Deposit Insurance Options Paper*, August 2000, p. 73.

[2] Federal Deposit Insurance Corporation, *Keeping the Promise: Recommendations for Deposit Insurance Reform*, April 2001, p. 10.

[3] As of March 2001, FHLB advances to commercial banks with assets less than $100 million and to commercial banks with assets greater than $10 billion equaled 2 percent of their aggregate assets. Advances equaled 4 percent of aggregate assets for commercial banks between $100 million and $1 billion in asset size, and 6 percent for commercial banks between $1 billion and $10 billion.

Question for the Record
from Congressman Frank Mascara

Question:

Since the passage of Gramm-Leach-Bliley (GLB), some of the larger brokerage firms have dumped huge amounts of money into insured deposits. Is it fair to have smaller community banks, who already paid high premiums as a result of the S&L bailout a few years ago, to contribute premiums to cover this huge infusion of cash into these insured deposits?

Answer:

The FDIC's existing capacity to absorb losses comes primarily from the high premiums paid by institutions in the first half of the 1990s. More recently, some institutions have been able to rapidly increase their reliance on insured deposits without paying the FDIC for this increased benefit. In addition, hundreds of other banks and thrifts chartered within the past few years have never paid deposit insurance premiums. The Treasury Department believes that this inequitable distribution of the assessment burden may be remedied in the following ways:

First, all insured depository institutions should pay premiums on current deposits. Banks and thrifts benefit every day from deposit insurance, and they should compensate the FDIC for that benefit, preferably through relatively small, steady premiums. Most banks and thrifts now pay no premiums for deposit insurance, which creates an incentive to increase deposits and thus raises the FDIC's uncompensated risk exposure.

Second, a deposit insurance system where all banks and thrifts pay modest premiums could still allow for rebates when reserves grow beyond some upper bound. If such a system were designed, we would base rebates on each bank's past contributions to the insurance fund. Having premiums based on current deposits combined with rebates based on past contributions would over time require proportionally greater net payments from institutions with rapidly increasing deposits than from institutions with deposits growing more slowly or declining.

Finally, the Treasury believes that the ratio of reserves to insured deposits should be allowed to fluctuate within a wide range. A wide range for the reserve ratio would not only help to avoid sharp premium increases when the economy or banking system is under stress, but would also reduce the likelihood that banks would face higher premium rates in the event that insured deposit growth lowers the reserve ratio.

For Release Upon Delivery
July 26, 2001, 10:00 a.m.

TESTIMONY

OF

JOHN D. HAWKE, JR.

COMPTROLLER OF THE CURRENCY

BEFORE THE

SUBCOMMITTEE ON

FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

OF THE

UNITED STATES HOUSE OF REPRESENTATIVES

JULY 26, 2001

Statement required by 12 U.S.C § 250

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Chairman Bachus, Congresswoman Waters, and Members of the Subcommittee, I appreciate this opportunity to discuss reform of our Federal deposit insurance system. Too often reform occurs against the backdrop of a crisis. Fortunately, we are not in that position today. The deposit insurance funds and the banking industry are strong. Nonetheless, the flaws in the current deposit insurance system pose an unnecessary risk to the stability of the banking system and so merit a careful and timely review by the Congress.

For the past year-and-a-half, the Federal Deposit Insurance Corporation (FDIC) staff has engaged in an inclusive and thoughtful process to identify and analyze deficiencies in the deposit insurance system and to recommend solutions to those problems. A staff paper released by the FDIC in April 2001, and recent testimony by former FDIC Chairman Tanoue, identified what they believe to be four significant flaws in the existing deposit insurance system:

> First, even though the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) provide an identical product--deposit insurance--for virtually identical institutions, the law requires the FDIC to administer the two as separate insurance funds, sacrificing both operating efficiencies and opportunities for risk diversification.

Second, the current system of deposit insurance premiums does not adequately reflect the risk that individual depository institutions pose to the deposit insurance system. Currently 92 percent of all FDIC-insured institutions pay no deposit insurance premiums at all. More than 900 banks chartered within the last five years have never paid any deposit insurance premiums. The FDIC's inability to price deposit insurance according to risk results in a "free ride" for riskier banks, distorts management incentives to limit risks, and increases the moral hazard to the funds. It results in less risky banks effectively subsidizing the activities of riskier banks--the exact opposite of what was intended by the legislation that mandated a Federal risk-based deposit insurance system.

Third, deposit insurance may be "procyclical." Under the present system, when a deposit insurance fund falls below its designated reserve ratio (DRR) of 1.25 percent of insured deposits, the FDIC must raise premiums sufficiently to bring the reserve ratio back to 1.25 percent within a year. If that cannot be done, it must charge every bank a premium of at least 23 basis points of its total domestic deposits until the reserve ratio reaches 1.25 percent. Thus, if an economic downturn leads to a decline in insurance fund reserves, banks could face dramatically higher deposit insurance premiums at the very time that bank earnings and capital are under pressure.

> Fourth, the FDIC staff paper observes that the real value of the level of deposit insurance coverage, set in 1980 at $100,000 per account, has not kept pace with changes in the price level over the past 20 years. Those who seek a safe repository for their savings can offset this reduced coverage in a number of ways. They can, for example, open multiple accounts at a single institution or accounts at multiple institutions. Nonetheless, some banks have argued for an increase in the current coverage limit and the adoption of a framework for periodically adjusting the level of deposit insurance coverage.

There are also several other issues that should be considered in the context of deposit insurance reform. These include the appropriate size of the insurance fund, the desirability of having a fixed designated reserve ratio, and the prospect of issuing rebates when the size of the funds exceeds a specified limit.

The OCC strongly believes that one further set of issues should be considered in this connection. That is the use of the insurance fund to support the cost of bank supervision, and the inequitable treatment of national banks in the way the BIF is currently used to pay the costs of supervision of state nonmember banks.

In my testimony, I review a series of recommendations that I believe will strengthen the insurance fund while reducing the inherent cross subsidization and distortions that arise among institutions under the current deposit insurance system.

Merger of the Insurance Funds

Currently, the FDIC administers the BIF and the SAIF separately. The OCC recommends that the BIF and SAIF be merged. A merged fund would enable the FDIC to operate more efficiently and to realize the benefits of diversification.

The maintenance of separate deposit insurance funds is a historical anomaly that traces its roots back to the 1930s, when the FDIC and the Federal Savings and Loan Insurance Corporation (FSLIC) were created in separate acts of Congress. When the FSLIC was abolished in 1989, and its functions were taken over by the FDIC, there were significant differences in the powers of commercial banks and thrifts. The thrift industry was just emerging from a period of extraordinary problems, and the risk profiles of banks and thrifts differed significantly. Over time, however, those differences have diminished. Significant commingling of the insurance funds, in the form of SAIF-insured deposits held by BIF members and BIF-insured deposits held by SAIF members, has further blurred the distinctions between BIF and SAIF. As of March 31, 2001, 874 banks and thrifts were members of one fund, yet held deposits insured by the other fund. BIF-member institutions held 41 percent of SAIF-insured deposits.

Industry consolidation has led to an increased concentration of insured deposits in relatively few institutions, which increases the risks to the deposit insurance funds. According to the FDIC staff, the share of SAIF-insured deposits held by the three largest institutions increased from 8.7 percent to 15.5 percent between June 1990 and March

2001, while the corresponding share for BIF-insured deposits increased from 5 percent to 13.7 percent. Merging the funds would reduce these concentration risks; for a merged fund, the share of deposits held by the three largest institutions would have been 12.4 percent.

A combined fund would also have better geographic and product diversification. Although the portfolios of banks and thrifts have become more similar in recent years, thrifts are still more highly concentrated in single family mortgages, while banks hold much higher percentages of commercial loans.

Pricing Deposit Insurance

In 1991, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) mandated a risk-based premium system and maintenance of required reserve levels, while providing the FDIC broad discretion to implement these goals. Five years later, the Deposit Insurance Funds Act of 1996 (DIFA) eliminated the FDIC's discretion. DIFA mandated zero premiums for banks in the lowest risk category when the fund equals or exceeds 1.25 percent of insured deposits. Further, it required the FDIC to charge a premium of at least 23 basis points on total domestic deposits when the fund falls below 1.25 percent for more than one year. The result is a pay-as-you-go system in which losses are determined after the fact and survivors are required to pay for the losses incurred in resolving insolvent institutions. Thus, while the size of the fund remains relatively stable, insurance premiums faced by individual banks can be extremely

variable, regardless of the risk these banks present. Currently, the vast majority of banks and thrifts pay nothing for deposit insurance.

The OCC concurs with the FDIC staff's recommendation to eliminate the constraints introduced by DIFA on the FDIC's ability to set premiums, particularly the mandated zero premiums for banks in the lowest risk category whenever the insurance fund reserve ratio equals or exceeds 1.25 percent of insured deposits. The OCC further supports the FDIC exploring revisions to the deposit premium structure to improve the actuarial accuracy of the differential premiums paid by banks with different risk profiles. This does not necessarily mean that there is a need for a dramatically new and more complex approach to setting premiums. Even within the context of the FDIC's current matrix of premiums, we believe there are opportunities to make premiums more risk sensitive.

Under the current deposit insurance premium structure, 92 percent of banks (those that are well-capitalized with CAMELS 1 or 2 ratings) pay the same deposit insurance premiums. The risks those banks pose to the insurance funds, however, can vary greatly.[1] That these banks currently pay nothing for deposit insurance is even more troubling. The net result is a pricing system that has severed almost completely any connection between risk and the price of deposit insurance. To maintain a proper incentive structure and to compensate the government for the benefits conferred by deposit insurance on all banks,

[1] The FDIC staff noted in its Deposit Insurance Reform Options paper that "the 5-year failure rate for CAMELS 2-rated institutions since 1984 was more than two-and-a-half times the failure rate for 1-rated institutions."

even the least risky banks should pay some reasonable minimum insurance premium, regardless of the level of the fund.

Any effort to reform the pricing of deposit insurance should consider the appropriate range of insurance premiums. The premium structure initially adopted by the FDIC under FDICIA, which charged banks in the highest risk category 31 basis points on domestic deposits, seems to have taken into account factors other than risk, including the likelihood that weaker banks would be unable to afford higher premiums. During the banking crisis of the early 1990s, however, the spread between the yields on the debt of the most and least risky banks was at times as much as 700 basis points. While we would not suggest that deposit insurance premiums should exhibit as broad a range as market prices for bank debt, we note that in the current environment spreads on subordinated debt can be as much as 150 basis points among banks that today pay no insurance premiums.

There are, of course, challenges to improving the risk-sensitivity of deposit insurance premiums. Nonetheless, I believe it would be desirable to move incrementally, recognizing that perfection is not the relevant standard. Although measuring risk is an inexact science, I believe that, with the removal of some of the statutory constraints on pricing, the FDIC could implement in a reasonable time a risk-based system that improves significantly upon the existing system.

The Size of the Fund, Rebates and Surcharges

Determining the appropriate size of the insurance funds and deciding when and how to pay rebates or impose surcharges if the funds get too large or too small, are two of the most important issues in deposit insurance reform. The current system is flawed in that the current designated reserve ratio of 1.25 percent of insured deposits has no clear actuarial basis--that is, it has no particular relationship to the risks borne by the funds. Rather, it is based on the actual range of the reserve ratio in the 1960s and 1970s. Recent experience would support consideration of a higher level, although we would prefer that there be no statutorily fixed ratios.

The OCC strongly supports eliminating the current DRR of 1.25 percent. We favor empowering the FDIC to establish a size range for the fund, based on the FDIC's evaluation of the risks borne by the funds and its assessment of potential losses. The FDIC should have the flexibility to adjust that range as the health of the banking system and the risks to the fund change through time. In this context we would support authority for the FDIC to pay rebates when the upper end of the range is exceeded and to impose surcharges when the ratio falls below the lower end of the range. We also believe that the FDIC should have the discretion in addressing the need for surcharges, to take into account the effect such surcharges might have on the performance or health of the banking system. As a corollary, in order to mitigate the procyclical effects of increasing premiums in times of stress, the appropriateness of maintaining a strongly capitalized fund in good times should be recognized.

With the introduction of minimum deposit insurance premiums, it is likely that reserve balances in the funds will periodically exceed the upper end of the target range for the reserve ratios. As a result, it may be appropriate for the funds to pay rebates to insured institutions. To ensure that rebates paid to insured institutions are equitable, it is first necessary to consider the nature of insured institutions' claims on the funds. For instance, institutions that have paid little, if anything, into the funds may have a lesser claim on any rebates compared with institutions that have contributed to building up the funds.

To preserve the integrity of risk-based premiums, rebates to individual banks should be based on a factor that is unrelated to their current premiums. In other words, high-risk banks that pay large premiums should not receive higher rebates per dollar of insured deposits than banks that pose a low risk to the fund. One approach to the calculation of rebates would be to base the rebates on past levels of domestic deposits on which a bank paid premiums.

Any program of rebates should also reflect the benefits that are presently received by FDIC-supervised state nonmember banks in the form of cost-free supervision and examination. Under the current system of bank supervision, the FDIC covers its costs of operations out of the BIF and SAIF. The FDIC spends approximately $600 million dollars a year to supervise state nonmember banks--that is, to perform for state banks exactly those functions the OCC performs for national banks. None of these costs is

passed on to state banks in the form of direct assessments. By contrast, the OCC charges national banks for the full cost of their supervision.

This disparity is compounded by the fact that more than half of the funds spent by the FDIC for Federal supervision of state nonmember banks are attributable directly to the accumulated contributions of national banks to the BIF. The earnings of the insurance funds--provided by all banks--finance the supervisory costs of only a portion of the banking industry. In other words, for every dollar the FDIC spends on the supervision of state banks, national banks, by our estimates, effectively contribute about 55 cents.

A key principle at the heart of deposit insurance reform is that the premiums paid by individual institutions should be closely related to the expected costs they impose on the funds. The objective is to identify and eliminate subsidies in the current system that can distort decision making. As the FDIC staff notes in its arguments for a risk-based pricing system, healthy, well-managed banks should not be required to bear the costs and risks presented by less well-managed, riskier banks. Similarly, banking supervision should not be based on a system of subsidies--such as those embedded in the current deposit insurance system--that results in national banks paying a substantial portion of the FDIC's cost of supervising state banks. As a matter of equity among banks, regardless of charter, the OCC believes that reform of our system of deposit insurance should recognize that the *current* system requires that national banks cover a significant portion of the cost of supervising state nonmember banks. Because one of the main purposes of

bank supervision is to protect the insurance fund, ensuring that supervision is funded in a fair and equitable manner is inextricably related to the subject of deposit insurance reform.

Attached to my testimony is a paper that discusses the disparity in funding supervision in greater detail and proposes a legislative remedy. Our proposal recognizes that effective supervision is a critical component of a sound deposit insurance system. Because the FDIC insurance fund currently funds Federal supervision of state nonmember banks, we believe that it would make sense to extend the existing arrangement to cover the costs of both state and national bank supervision from the FDIC fund. In other words, instead of funding supervision through direct assessments on banks, we propose that it be funded by payments to supervisors--the OCC and state supervisors--from the insurance fund, to which all banks contribute. This approach would strengthen both Federal and state supervision by ensuring that all supervisors have adequate, predictable resources available to carry out effective supervisory programs.

Coverage Limits

The erosion of the real value of the nominal deposit insurance coverage limit by inflation since 1980 has generated proposals to increase the coverage limit from its current level of $100,000 per account. Opponents of such an increase argue that it is not needed and that it would increase the exposure of the funds and would reduce market discipline.

While this is clearly an issue that deserves consideration by the Congress, the OCC is concerned that an increase in coverage might have unintended effects that most would judge to be undesirable, including an increase in moral hazard. We are fortunate today to have a very strong banking industry, but conditions may not always be so positive. Increasing deposit insurance coverage effectively allows weaker institutions to expand their risk-taking at a time when they should be retrenching--a lesson that we learned painfully during the savings and loan crisis. Increasing deposit insurance coverage also raises the cost to the insurance funds in the event of a bank failure. Reducing the risk of loss for large depositors may undermine market discipline and result in a haphazard reshuffling of existing deposits. We are not persuaded that an increase in coverage is necessary for deposit insurance to fulfill its purposes of preventing depositor runs on banks and providing a basic level of risk-free protection for depositors. Nor have we seen compelling evidence that depositors are demanding increased coverage.

The simple fact is that anyone who wants to use insured bank deposits as a means of holding their wealth can do so today virtually without limits--subject only to the inconvenience of having to open accounts at multiple banks. Of course, one may argue that, because of the relative ineffectiveness of the existing coverage limit, an increase may not have any substantial adverse consequences. But, it is precisely because of the dangers that attend legislating in the presence of uncertainty that the OCC would favor a cautious approach in this area.

The lack of consumer demand for increased deposit insurance coverage is evidenced by the fact that, despite the ability of depositors to achieve virtually unlimited coverage, there is over $1 trillion of uninsured deposits in the banking system, compared with over $3 trillion in insured deposits. This does not suggest, however, that large numbers of Americans are adversely affected by the existing coverage limit; the Federal Reserve's 1998 Survey of Consumer Finances reported that 98.0 percent of all households that held any deposits were fully insured. Moreover, money market mutual funds, which have some of the same features as bank transactions accounts and generally offer higher returns than bank deposits, today hold over $2 trillion, which suggests that many Americans do not see the additional risk involved in holding money market fund shares as particularly significant. Against this background a relevant question for the Congress is whether deposit insurance should be converted into a governmentally protected all-purpose investment vehicle.

Another argument put forth in favor of an increase in the coverage limit is that it would significantly assist community banks in meeting their liquidity and funding needs, and would counteract the competitive disadvantage that community banks believe they face vis-à-vis large banks. Those who hold this view attribute the continuing increase in the average size of deposits at large banks, in both nominal and real terms, to the widespread belief that a "Too-Big-To-Fail" doctrine protects large banks. While it is exceedingly difficult to know whether or to what extent the perception of such potential support for large banks actually affects depositor behavior, the vast holdings of liquid

assets in money market mutual funds suggest that yield, rather than safety may be a more significant motivating factor.

Whether an increase in the coverage limit would in fact enhance community bank funding is speculative at best. It is not at all clear that increasing the limit would result in a net increase in the deposits of the banking system. Depositors who multiply insurance coverage today by using multiple banks might simply consolidate their deposits in a single bank if coverage were raised, and there is no way of determining who would ultimately, when the switching process ended, benefit. Similarly, if a coverage increase did attract new funds into the system, it is not at all clear that the benefits would flow to smaller banks. Large, aggressive institutions might simply use the expanded coverage to offer an even more extensive governmentally protected investment vehicle to wealthy customers, with the consequence of increasing the liquidity pressures felt by smaller banks.

If there is a compelling case to be made for increasing the insurance limit and indexing it to inflation, it remains to be made. Consequently, we believe that Congress should move very cautiously in this area, and while it is certainly true that a coverage increase would be less problematic in the context of properly priced deposit insurance coverage, we think this proposal raises some fundamental questions that need to be addressed.[2]

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[2] One such question is whether insuring virtually a limitless amount of funds is part of the intent of deposit insurance. Clearly, it would be much easier to decide what to do with the existing $100,000 insurance limit if it were a hard and fast upper bound on coverage that was strictly enforced. There have been efforts to devise ways to limit the total coverage or lifetime payouts that could be obtained by any one individual

Conclusion

Today we have the opportunity to undertake comprehensive Federal deposit insurance reform when both the banking industry and the deposit insurance funds are strong. A primary goal of reform should be to reduce the current cross subsidization embedded in the current system, including the inequitable treatment of national banks in the current use of the fund to pay the costs of state nonmember bank supervision.

The OCC supports the FDIC staff recommendations to merge the BIF and SAIF and to eliminate the current constraints on premiums, particularly the mandated zero premiums for well-managed, well-capitalized banks. We favor elimination of the fixed DRR of 1.25 percent of insured deposits and the empowerment of the FDIC to establish a size range for the fund, based on an assessment of the risks the fund faces. Regarding proposals to increase the insurance coverage limit of $100,000, we have not seen compelling evidence to date that increasing the insurance coverage would either further the purpose of Federal deposit insurance or help to alleviate the liquidity and funding pressures of community banks.

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which have generally been rejected on grounds of administrative complexity. In light of the advances that have been made in information technology, those proposals may deserve a second look.

Comptroller of the Currency
Administrator of National Banks

Reforming the FUNDING OF BANK SUPERVISION

July 2001

Introduction

This paper addresses a fundamental flaw in our system of bank supervision — the way supervision is funded. It also offers a proposal for fixing this flaw. The proposal not only would enhance the resources available to assure quality supervision of our nation's banking system, but would reduce the assessments now imposed on both national and state banks to pay for their own supervision — with no additional cost to taxpayers.

Background

Under the present system, national banks pay the full costs of their supervision, through assessments levied on them by the Office of the Comptroller of the Currency (OCC), the federal agency that charters and supervises national banks.

State-chartered banks, by contrast, pay only for that small fraction of their supervision that is provided by state supervisory agencies. The predominant part of state bank supervision actually comes from two *federal* agencies, the Federal Reserve System (FRS) and the Federal Deposit Insurance Corporation (FDIC).[1] These federal agencies perform exactly the same supervisory functions for state banks as the OCC performs for national banks. The main difference is that the FRS and the FDIC do not assess state banks for the costs of their supervisory services.

In 2000, these two federal agencies spent almost $1 billion on state bank supervision, none of which was recovered from the banks they supervise.

[1]The FRS supervises state banks that have elected to become members of the Federal Reserve System. The FDIC supervises federally insured nonmember state banks.

The current situation is a problem that Congress needs to fix because:

It's Unfair. The present system is doubly unfair to national banks: they not only are fully charged for the costs of their supervision, but they also have contributed a substantial portion of the deposit insurance premiums that the FDIC relies on to fund its supervision of state nonmember banks. The present system also unfairly imposes on taxpayers and on the FDIC insurance fund the costs of federal supervision of state banks.

It Distorts the Dual Banking System. Healthy competition in the quality of supervision and innovation in meeting the needs of banks and their customers should lie at the heart of our dual banking system. Unfortunately, today a primary focus of this competition is on price. Because state banks receive a federal subsidy for the predominant part of their supervision, there is a cost incentive for banks to avoid or depart from the national charter in favor of the heavily subsidized state charter. This inevitably tends to undermine a vigorous and healthy dual banking system.

It Compromises Safety and Soundness. The present system of funding bank supervision works pro-cyclically. It threatens national banks with additional cost burdens in times of economic stress, and it imposes constraints on supervisory resources at the very time they are most likely to be needed. When there is widespread stress in the banking system, as there was in the late 1980s and early 1990s, significantly increased supervisory attention is demanded and supervisory costs rise. As this occurs, healthy national banks, which already pay more than their state counterparts, face the prospect of substantial increases in assessments to pay the costs of more intensive supervision of problem banks. This creates a strong incentive to convert to a state charter. Such conversions, in turn, reduce the resources available to OCC to fund increased supervisory needs.

It's Inconsistent with Deposit Insurance Reform. A fundamental principle at the heart of deposit insurance reform is that subsidies should be eliminated. Healthy, well-managed banks should not be required to bear the costs and risks presented by less well-managed, riskier banks. By the same token, national banks should not be forced to bear the costs of supervising and insuring state banks. Any proposals to reform the deposit insurance system must inevitably come to grips with this inequity in the system, just as they must focus on such fundamental issues as the appropriate size of the insurance fund and how rebates, if any, should be distributed. Since the principal purpose of bank supervision is to protect the insurance fund, the manner in which supervision is funded is inextricably bound up with the subject of reform of the deposit insurance system.

The following discussion elaborates on each of these points.

The Present System is Unfair to National Banks and to Taxpayers

The three federal bank supervisory agencies — the OCC, the FRS, and the FDIC — perform virtual identical functions with respect to the banks they supervise, as is demonstrated by Table 1. Indeed, for more than 30 years, whenever Congress has enacted new bank regulatory laws,

Table 1 **The Federal regulatory agencies have similar supervisory responsibilities.**

Responsibilities	OCC	FDIC	FED
Safety and soundness exams	X	X	X
CRA Exams	X	X	X
Fair Lending Exams	X	X	X
Enforce Bank Secrecy Act	X	X	X
Regulation	X	X	X
Entry	X	X	X
FFIEC	X	X	X
Enforce the Securities Exchange Act of 1934	X	X	X
Branch Applications	X	X	X
Merger & Consolidation Applications	X	X	X
Enforce Capital Requirements and PCA	X	X	X
Truth in Lending Act Examinations	X	X	X
Right to Approve Directors and Senior Execs	X	X	X
Authority to Prescribe Oper and Mgrl Stds	X	X	X
Supervisory Enforcement Actions	X	X	X
Supervise Foreign Activities	X	X	X

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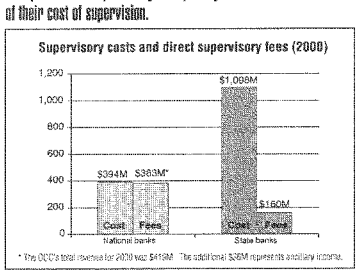
it has almost always parceled out identical supervisory and enforcement responsibilities to the three federal agencies. As a result, the FRS and the FDIC today perform the predominant part of state bank supervision.

Yet the burden of funding supervision falls with vastly disproportionate weight on national banks. As shown in Table 2, virtually the entire amount of the cost of national bank supervision in

Table 2 **Supervisory fees paid by national banks cover 100% of their cost of supervision. Supervisory fees paid by state banks cover 15% of their cost of supervision.**



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2000 was borne by national banks. By contrast, only 15 percent of the total cost of state bank supervision — that is, the costs of both state and federal supervisors — was paid by state banks, in the form of assessments by their state supervisors. The lion's share of these costs — 85 percent — reflecting the costs of the FRS and the FDIC, were absorbed by those federal agencies.

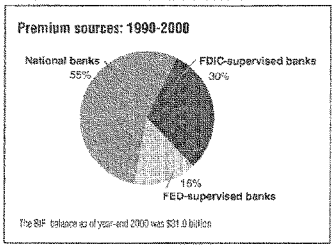
To understand how this federal subsidy unfairly impacts taxpayers and national banks, it is important to understand how the FRS and the FDIC are funded and how those funds are spent.

The FRS derives most of its revenues from open market operations — that is, from the earnings on its portfolio of government securities. Any portion of those earnings remaining after the FRS subtracts its costs of operation are paid over to the U.S. Treasury for the benefit of taxpayers. In 2000, the FRS spent about $300 million (out of $31 billion in total revenue) on its supervision of state banks. Thus, the costs of supervision of state banks by the FRS are, in practical effect, borne by all American taxpayers.

The FDIC's operating revenues are taken out of the deposit insurance funds, which have been built up over the years through the payment of premiums by all insured banks. In 2000, the FDIC tapped into the funds for a total of $1.2 billion, of which $638 million was spent on the supervision of state banks. Of this amount, $568 million was attributable to the FDIC's supervision of state-chartered commercial banks, and $70 million to its supervision of state-chartered thrift institutions.

As the holders of the largest share of the nation's bank deposits, national banks have always been the largest contributors to the bank insurance fund, and therefore to FDIC revenues. As shown in Table 3, national bank contributions today account for almost 55 percent of the funds in the FDIC's

Table 3 **Over one-half of the premiums paid into the bank insurance fund since 1990 came from national banks.**



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Bank Insurance Fund — and, by extension, 55 percent of the earnings that are used by the FDIC to supervise state nonmember commercial banks. ***In other words, 55 cents of every dollar expended by the FDIC on state nonmember commercial bank supervision is attributable to payments by national banks.***

To be sure, state banks have contributed to the insurance funds just as have national banks. *But the fact remains that state banks receive their federal supervision free of cost, while national banks bear the full cost of their supervision.*

There is no justification for a federal policy that subsidizes state banks, yet leaves national banks to bear the full cost of their supervision. Such a policy is especially unwarranted when the majority share of that subsidy is involuntarily funded by national banks through their contributions to the FDIC insurance fund.

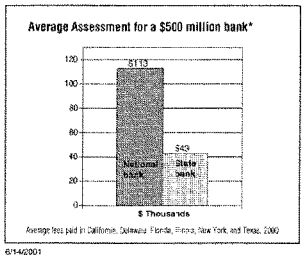
The Present System Undermines the Dual Banking System

Historically, the choice between a national or state charter centered on such things as supervisory philosophy and responsiveness, examination quality, and the scope of permissible activities. The cost of supervision was generally a minor factor. But that's no longer the case.

Today the costs of supervision have increased by orders of magnitude, largely because of laws that Congress has put in place over the past three or four decades to strengthen supervision and to increase protections for consumers — laws that Congress has charged the *federal* supervisors with the responsibility for enforcement. Since the FRS and the FDIC absorb those costs for state banks, while the OCC must pass them on to national banks, the disparity in supervisory costs paid by state and national banks has increased commensurately.

Thus, as shown in Table 4, state banks today pay supervisory costs on average less than half of what comparably sized national banks pay.

Table 4 **Because state banks pay only for supervision costs incurred by states, their supervisory fees average less than half those of national banks.**



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To compound the unfairness, many state bank supervisors today actively proselytize for charter conversions on the basis of the fee differential, in effect exploiting the value of the subsidy provided to state banks by the taxpayers and the FDIC. Thus, the fee disparity creates a significant incentive for a banker to choose a state over a national charter — to opt, in effect, to be the recipient, rather than the donor, of a subsidy.

If large numbers of banks were to make that choice — and the current pressures for cost reduction gives them a strong incentive to do so — the national bank charter could be seriously undermined. The result, perversely, would ultimately be to *increase* the cost to taxpayers and the insurance fund, since banks that convert from national to state charters would no longer pay the full costs of their federal supervision, and it would fall to the FRS and the FDIC to pick up *all* of the additional supervisory costs.

The Present System Compromises Safety and Soundness

The current funding system works pro-cyclically to *reduce* supervisory resources precisely when they are most likely to be needed and to increase the cost burdens on national banks at the very time they are grappling with an economy under stress. Of all the perversities in our system, none is more serious.

We saw this process at work during the wave of large bank failures in the late 1980s and early 1990s — a period of stress in the banking system not seen since the Great Depression. Supervisors were under mounting pressure to monitor and manage the crisis. Yet each bank failure translated into a reduction in the base on which assessments could be levied to support the agencies' increased costs. At the OCC this meant significant increases in assessment rates — 14 percent in 1989, another 11 percent in 1991, and a whopping 30 percent in 1992.

Assessment rates were subsequently lowered when the crisis subsided and the industry returned to health. But it is unfair that our system requires well-managed banks to provide the additional supervisory resources needed to deal with problem institutions. *This is a flaw in the system that must be addressed.*

Moreover, even in times of relative economic calm, the present system can adversely affect the supervision of national banks. Given the concentration of assets in the banking system today, the loss of even a single large national bank — whether due to merger, conversion, or failure — could have a huge impact on the OCC's operating budget. Faced with the loss of a substantial part of its assessment base, the OCC would have only two choices: either to reduce its supervisory resources or to increase assessments on the remaining institutions.

State bank supervisors face a similar problem. In almost half the states, a single bank accounts for 25 percent or more of the asset base on which state supervisors base the assessments they need to fund their offices. Thus, the loss of such a large bank could have a crippling effect on a state supervisor's ability to provide quality supervision.

Deposit Insurance Reform Offers an Opportunity to Mend the Present System

A fundamental principle on which all of the current proposals for deposit insurance reform are based is that cross-subsidies in the system should be eliminated. Banks should contribute to the insurance funds based on the risks they present, and healthy banks should not be required to bear the costs and risks of providing deposit insurance to poorly managed, troubled banks.

Eliminating the fee disparity between national and state banks is an inextricable component of deposit insurance reform. National banks have, in effect, been forced to contribute more to the deposit insurance fund than they rightfully should, because more than half of their contributions to the fund go not for insurance coverage, but to defray the FDIC's costs of supervising state banks. *Any proposal to reform deposit insurance must deal with this cross-subsidy as much as it must deal with the risk subsidy provided by less risky banks.*

The FDIC's initiative to review and revise the deposit insurance system has focused on a number of fundamental issues relating to such questions as how deposit insurance premiums should be set, what the appropriate size of the deposit insurance funds should be, and how rebates, if any, should be distributed once the size of the fund exceeds some specified limit. Although some aspects of the FDIC's proposal are controversial, the debate over deposit insurance reform has

been characterized by broad agreement that any reform program should advance the goals of efficient and equitable distribution of the costs and benefits of deposit insurance.

In that context, it's particularly important that we address the supervisory funding issue. *As long as premium income or the revenue it generates is used to fund the federal supervision of only one part of the industry, the FDIC's deposit insurance premium structure — even a revised one — cannot equitably price insurance coverage.* Remedying this inequity and separating the actual costs of the FDIC's supervisory functions from the costs of providing deposit insurance is an essential step toward efficient and rational pricing of both.

How to Fix the Problem

Any proposal for reform of our system of supervisory funding must pass several basic tests. It should

- Strengthen both the federal and state supervisory processes, and protect them from the impact of random structural changes in the banking system;
- Enhance the *qualitative* aspects of competition within the dual banking system;
- Promote a fair and efficient deposit insurance system, and
- Ensure that all supervisors, state and national, have adequate, predictable resources available to carry out effective supervisory programs.

While there have been many different proposals to those ends, we believe that the most straightforward solution would be to develop a common approach to funding supervision. Since effective supervision is a critical component of a sound deposit insurance system — and since state nonmember supervision is already funded from the FDIC insurance fund — it makes sense to extend the existing arrangement to cover the costs of both state *and* national bank supervision from the FDIC fund. In other words, instead of funding supervision through direct assessments on banks, it should be funded by payments to supervisors — the OCC and state supervisors — from the insurance fund, to which *all* banks contribute.

How Would It Work?

Under a proposal the OCC has developed, the costs of both national bank supervision by the OCC and state bank supervision by the states would be paid from the FDIC insurance funds, as follows:

- Working with the FDIC, the OCC and state supervisors would jointly develop a formula for allocating funding based initially on current levels of funding.
- The formula would take into account both the number of institutions and total assets under supervision, as well as the financial condition and growth of the institutions.
- In subsequent years, the baseline allocation would be no less than the supervisors' costs for the preceding year, unless the baseline were adjusted to take account of changes in relevant factors.
- In no event would allocations exceed the investment earnings of the insurance funds for the preceding year. If earnings were insufficient to cover the baseline allocations, payments would be reduced pro rata. No payments could be made from the funds' principal.

- The agencies would retain the authority to impose supplemental assessments on their banks to meet unusual demands.

In short, this proposal would transfer the direct costs of supervision from the assessment process to the insurance funds — which, of course, have been built up by the very same banks that have paid national and state assessments.

The proposal would not involve any new costs for state banks. Indeed, the proposal envisages that assessments on state banks would be eliminated or reduced significantly.

Can the Funds Afford It?

It is clear that the FDIC funds could easily carry the costs of these allocations. In fact, the Bank Insurance Fund (BIF) alone could support the additional OCC and state supervisory costs. Today BIF holds over $31 billion in assets. Over the past five years, BIF's investment income — that is, excluding any premium income — has averaged more than $1.6 billion a year, or nearly 140 percent of the *combined* 2000 supervisory expenses of the OCC, FDIC, and the 50 state supervisors. Thus, even in the absence of premium payments, BIF is currently generating more than enough investment income to defray the supervisory expenses of the OCC and the states, and the FDIC as well.

What Benefits Would It Bring?

There would be enormous benefits to such a new approach to the funding of supervision, with no perceptible downside. Specifically,

- It would place supervision on a sounder and fairer footing, relieving national banks of the burden of subsidizing their state bank competitors, without threatening FDIC resources.
- It would be a step toward allocating the costs and benefits of deposit insurance in an equitable and efficient manner, thus facilitating deposit insurance reform.
- It would ensure that all supervisors have the resources necessary to provide effective bank supervision, regardless of changes in the economy or the structure of the banking system.
- It would revitalize the dual banking system to move beyond the current charter price competition and recapture the elements of the dual banking system that have made it vital to the fabric of our nation's banking system: creativity, efficiency, and healthy competition.

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

September 24, 2001

The Honorable Frank Mascara
U.S. House of Representatives
Washington, D.C. 20515

Dear Representative Mascara:

After the July 26, 2001, hearing on Federal deposit insurance reform held by the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services, you submitted the following question to all of the panelists:

> *"Since the passage of Gramm-Leach-Bliley (GLB), some of the larger brokerage firms have dumped huge amounts of money into insured deposits. Is it fair to have smaller community banks, who already paid high premiums as a result of the S & L bailout a few years ago, contribute premiums to cover this huge infusion of cash into these insured deposits?"*

I gave this question considerable thought and attention in developing my July 26 testimony. Indeed, I agree with the implied premise of the question that it is unfair for large brokerage firms--or any other financial institution, for that matter--to obtain the benefits of deposit insurance at no cost. It has to be recognized, of course, that most banks have enjoyed the benefits of deposit insurance without the payment of premiums for several years. While many of these banks contributed to the build up of the insurance fund in earlier years, they also received the benefits of deposit insurance as they were doing so. Thus, it may not be all that easy to distinguish between banks that increased their insured deposits during a time when they were not paying premiums on one hand, and brokerage firms that brought large volumes of deposits into insured affiliate banks, on the other.

As I noted in my statement, the primary problem stems from the constraints on insurance pricing contained in the Deposit Insurance Funds Act of 1996. The FDIC is prohibited from charging a positive premium to any depository institution in the highest rated category when the insurance funds are at or above the designated reserve ratio of 1.25 percent of insured deposits. Additionally, when the insurance fund falls below the designated reserve ratio, the FDIC is

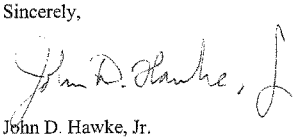
required to charge every institution a premium equal to the lesser of 0.23 percent of total domestic deposits or the minimum premium that is high enough to bring the insurance fund up to the designated ratio of 1.25 percent.

I believe the problem could be alleviated by giving the FDIC the flexibility to charge every insured depository institution a positive insurance premium regardless of the size of the insurance funds, and permitting the size of the insurance funds to fluctuate within a range determined by the FDIC that reflects the level of risk presented to the funds. Institutions could receive rebates when reserves exceeded the upper end of the reserve range and could be required to make additional payments to the FDIC whenever the insurance funds' reserves fell short of the lower end of the range.[1]

To maintain the integrity of the system of insurance premiums and prevent undesirable incentive effects, any rebates and surcharges should be based on past levels of insured deposits, rather than the current insured deposit levels and risk positions used to calculate banks' current insurance premiums. Finally, basing surcharges on past deposits means that, with the passage of time, those institutions responsible for large increases in deposits would eventually have to contribute to bringing the reserve ratio of the insurance fund back within the designated range. How quickly this would occur would depend on how wide the range is, how much of the shortfall from the bottom of the range banks are required to make up within the year, and how many past years of insured deposits are used in calculating surcharges and rebates.

I hope that this letter has been responsive to your question. Please do not hesitate to ask us any other questions you may have as you consider proposals to reform Federal deposit insurance.

Sincerely,



John D. Hawke, Jr.
Comptroller of the Currency

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[1] The payment of rebates also raises an important issue that I discussed in my testimony: the inequity of using insurance premiums paid by national banks, and the earnings on those accumulated premiums, to fund the FDIC's supervision of state nonmember banks. This inequity should be addressed in conjunction with any proposal that would provide for rebates from the insurance funds.

Infe: HR37.2

EMBARGOED
until July 26, 2001 at 10:00 am

Statement
of

Ellen Seidman, Director
Office of Thrift Supervision

concerning

Federal Deposit Insurance Reform

before the

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

United States House of Representatives

July 26, 2001

Office of Thrift Supervision
Department of the Treasury

1700 G Street N.W.
Washington, D.C. 20552
202-906-6288

Statement required by 12 U.S.C. 250:

The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent those of the President.

Testimony on Federal Deposit Insurance Reform
by
Ellen Seidman
Director, Office of Thrift Supervision
before the
Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
United States House of Representatives

July 26, 2001

I. Introduction

The Office of Thrift Supervision (OTS) welcomes this opportunity to testify about federal deposit insurance reform. Over the past several years, those of us who have worked closely with the deposit insurance system have come to realize that the current system is not optimal, and that several areas are in need of reform if the system is to continue to serve the American people well. The current economic period, with few failures and adequate reserves, provides a perfect opportunity to improve the system.

Federal deposit insurance has become an essential part of our financial system. The federal deposit insurance program has been in place in various forms since 1934. The previous system, which split administration of insurance of bank and thrift deposits, has been replaced by a two-fund system administered exclusively by the Federal Deposit Insurance Corporation (FDIC). The program has done much to enhance financial stability and provide depositors with safe savings vehicles. It has also offered considerable benefits to the broader economy by providing a steady source of loanable funds. While we have enjoyed the benefits of federal deposit insurance, during the 1980s and early 1990s we also learned that a poorly designed or malfunctioning deposit insurance system can entail substantial costs. It is, therefore, in our interest to monitor the system and address problems as they arise, and incorporate innovations that improve or enhance its structure and operation.

The last several years have been good for our country's insured depository institutions. At present, both the Savings Association Insurance Fund (SAIF) and the Bank Insurance Fund (BIF) exceed their capitalization targets and the number of problem institutions is low. Nevertheless, led by the work of the FDIC under former Chairman Donna Tanoue, many, including many in the bank and thrift industries, have concluded that changes are needed. The funds' and industries' current healthy state suggests this is a good time to make those changes.

The most obvious flaw of the current system is that the rules governing deposit insurance premiums have eliminated premiums for most institutions for over four years. The combination of a favorable economic climate, responsible lending practices, sound supervision, and laws that require regulators to act when necessary have produced a system that, if all goes well, provides free deposit insurance coverage. We should know better, however, than to buy into the notion that insurance coverage should be free. Most of us, if we are fortunate, will never have to call upon our hazard insurance carrier to cover the costs of a home lost to fire or other disaster. But who is willing to do without it? And who expects to get it for free?

Similarly, federal deposit insurance is intended to cover a contingency that, with good management, and effective laws and supervision, we have become conditioned to think will rarely occur. But failures, isolated in good times and more common in times of economic stress, do occur. Deposit insurance, like any other insurance product, is there to cover a risk. Thus, it should not be free. Conversely, cost should be based on a responsible assessment of risk, with those who take fewer risks paying less, and those stretching the envelope—even within the bounds of regulatory acceptability—paying more. A system that prices appropriately will reward those who minimize fund exposure. It will also not impose too great a cost on those with a more aggressive, but not unreasonable, risk profile. Flexibility is needed to be able to strike the appropriate balance.

The federal deposit insurance system also needs to keep pace with the changing business strategies of insured institutions. There is a growing disconnect between deposits and FDIC losses due to increased reliance on nondeposit funding, including collateralized funds, and increased off-balance-sheet exposures. These developments might require a more fundamental rethinking of some of the system's basic tenets, including the assessment base.

The FDIC staff has done an admirable job of framing the issues involved in deposit insurance reform and in developing recommendations to address these issues. I particularly want to thank former FDIC Chairman Tanoue for her leadership on this issue the last several years. Now is a good time to proceed with deposit insurance reform because we can consider these issues in a judicious manner. We should not let this opportunity pass.

II. Problems With the Current System: Principles for Reform

The structure of our current deposit insurance system is the result of a development process guided at various times by changes in our insured institutions, improvements in our ability to measure and monitor risk, and by

modifications to the regulatory landscape. Some characteristics are artifacts of the history of the banking and thrift industries and of a regulatory environment that has evolved considerably over time. Other features represent early steps in the development of a better system. With experience, we have also found that some elements of the system are not working as intended. Our goals in reforming deposit insurance should be to modernize areas where the system can adapt to changing times, to enhance areas where it can benefit from further development, and to modify features to improve the system's effectiveness.

As we embark on the process of deposit insurance reform, it is important to resist the temptation to take a piecemeal approach. The system's components are highly integrated. Reforms designed to address narrow, individual issues can have unintended consequences to other components and the system as a whole. It is important to attempt to deal with these issues on a comprehensive basis.

The FDIC has identified four areas of weakness in the current system:

- Maintenance of two separate funds that provide identical insurance;
- Inadequate pricing of insurance risks, which distorts incentives and increases moral hazard;
- Excessive premium volatility and a tendency for premiums to increase in economic downturns; and
- Coverage levels that do not adjust on a regular basis.

The FDIC's reform proposals focus on changes to address these weaknesses and improve the system.

Changes in the banking and thrift industries and our experience since the BIF and SAIF were established in 1989 argue strongly in favor of merging the funds. Maintaining the BIF and SAIF as separate funds reduces the FDIC's capacity to deal with problems and introduces unnecessary risks that can compromise insured institutions and the deposit insurance system.

The distinctions between the BIF and the SAIF have become increasingly artificial and tenuous. The two funds no longer insure distinct types of institutions and many banks and thrifts have deposits insured by both funds. The funds provide identical products, but keeping them separate raises the possibility of premium differentials that could handicap institutions that happen to be insured by the fund that charges higher rates. Consolidation in both the banking and thrift industries has increased the funds' exposure to their largest institutions. Merging the funds can alleviate these problems. Fund merger would strengthen the entire system by diversifying risks, reducing the exposure to the largest institutions, and eliminating the possibility of non-risk-related premium differentials.

Risk-based premiums are an important element of deposit insurance. Risk-based premiums would provide risk-management incentives to insured institutions and allocate deposit insurance costs based on the risk profile of individual institutions. A system with inadequate risk-based pricing mechanisms must rely more heavily on regulatory restrictions and direct supervisory oversight to control risk taking. Risk-based pricing provides more effective risk control at a lower cost than these alternatives, and is particularly important in ensuring a sound and stable future for the deposit insurance system.

The current risk-based premium system was implemented in 1993. Our experience since then has revealed several areas that would benefit from improvement. The most glaring problem is that the current system provides free deposit insurance coverage to the vast majority of insured institutions. This has been the case since the funds reached their statutory capitalization targets in 1995 (BIF) and 1996 (SAIF). Since that time, institutions in the lowest risk group have paid no deposit insurance premiums. Yet the protections afforded by federal deposit insurance have significant value to insured institutions as well as to depositors. Risk-based pricing would compensate the government for its ongoing risk exposure, as well as provide appropriate incentives for insured institutions.

The current pricing structure, which restricts how the FDIC sets fund targets and insurance premiums, tends to promote premium volatility. These restrictions not only hamper risk-based pricing but also make the system procyclical. Thus, in good times, the FDIC levies no premiums on most institutions. When the system is under stress, the FDIC is required to charge high premiums, which exacerbates problems at weak institutions and handicaps sound institutions. Increasing the FDIC's flexibility to set fund targets and premiums would reduce insured institutions' exposure to overall economic conditions and to sectoral problems within the banking and thrift industries. Authorizing the FDIC to rebate excess funds is an important element of an effective risk-based pricing system.

Some discussions of deposit insurance reform focus on coverage levels, pointing out that they have not changed since 1980. Opponents of changing the existing cap cite the 1980 increase as a contributing factor in the thrift and banking industry problems that ensued. We note that those problems arose in a system with no risk-based pricing and no prompt-corrective-action (PCA) capital rules. The unintended consequences of the 1980 increase serve as an important warning about the hazards of piecemeal reform in an interactive system. Improved risk-based pricing and other reforms must be considered along with raising or indexing the deposit insurance ceiling and, in fact, should be regarded as preconditions to consideration of any such action.

III. The Elements of Reform

1. Fund Merger

Changes in the universe of insured institutions have made maintaining two separate funds unnecessary and counterproductive. Merging the BIF and SAIF will strengthen the entire system and reduce regulatory burden.

In the aftermath of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the BIF insured the deposits of commercial banks and a much smaller number of BIF-member state savings banks and the SAIF covered federal and state savings associations.[1] Subsequent mergers, branch acquisitions, and charter conversions have significantly complicated the picture.

- Between 1990 and 2000, BIF-member institutions paid approximately 31 percent of SAIF insurance premiums.

- As of December 31, 2000, 41 percent of SAIF-insured deposits were in BIF-member institutions and only slightly more than half—52 percent—of SAIF-insured deposits were in OTS-supervised institutions.

- As of December 31, 2000, almost one-third of savings association deposits were insured by the BIF, including 18 percent of the deposits of OTS-regulated institutions.

Industry consolidation has also greatly increased both funds' risk concentration, *i.e.*, the possibility that one event, or one insured entity, will trigger a significant and disproportionate loss.

- When the insurance funds were established in 1989, the largest commercial bank held only 4.0 percent of all commercial bank deposits and the largest OTS-regulated thrift held only 2.9 percent of all thrift deposits.

- As of December 31, 2000, Bank of America, the largest BIF-insured institution, accounted for 8.1 percent of BIF-insured deposits, while Washington Mutual, the largest SAIF-insured institution, held 7.3 percent of SAIF-insured deposits. The five largest BIF-insured institutions held 17.5 percent of BIF-insured deposits; and the five largest SAIF-insured

[1] Pursuant to FIRREA, institutions insured by the sole FDIC fund prior to FIRREA were placed in the BIF and institutions insured by the former Federal Savings and Loan Insurance Corporation (FSLIC) were placed in the SAIF.

institutions held 19.2 percent of SAIF-insured deposits.[2] Two institutions—Bank of America and First Union—that do not currently have a thrift in their corporate family, were among the top five deposit-holders in each fund.

- A merged fund would face significantly less concentration risk. Had the funds been merged as of December 31, 2000, Bank of America would have accounted for only 7.1 percent of combined deposits and Washington Mutual would have held only 1.8 percent of combined deposits. The five largest institutions in a combined fund would have held 15.5 percent of total insured deposits.[3]

Maintaining separate funds means that institutions with identical risk profiles, but holding deposits insured by different funds, could pay different prices for the same insurance coverage. The BIF-SAIF premium differential that existed in 1995 and 1996 put institutions at a significant competitive disadvantage simply because they were insured by the higher cost fund. Some institutions reacted to the differential by shifting deposits between funds, while others sought non-deposit funding sources. Merging the funds would eliminate the possibility of premium differentials caused by factors unrelated to the risk posed by individual institutions.

Merging the funds would also eliminate regulatory burdens. Institutions with both BIF- and SAIF-insured deposits are required to make arbitrary and complex calculations to estimate the growth rates of deposits insured by each fund. These calculations are largely artificial and constitute an unnecessary burden on both insured institutions and regulators. Merging the funds would eliminate the need for these anachronistic calculations.

2. Risk-based Premiums and Assessment Flexibility

Implementing an effective risk-based premium system will entail enhancing the current risk groupings for insured institutions. Also important is eliminating existing statutory restrictions on how the FDIC sets fund targets and premiums when the funds vary from their targets. It is critical to address these issues collectively, since they all contribute to risk-based pricing.

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[2] Bank of America, First Union, Chase Manhattan, Fleet, and Wells Fargo are the top five BIF members. Washington Mutual, Bank of America, First Union, California Federal, and Charter One hold the most SAIF deposits.

[3] The five institutions with the most insured deposits in a combined fund would be Bank of America, First Union, Chase Manhattan, Washington Mutual, and Fleet.

Over 92 percent of FDIC-insured institutions are currently classified into a single risk group, "Group 1A." This is largely because the FDIC's risk classifications focus on only two measures—an institution's PCA capital category and its safety-and-soundness examination rating. As a result, the current system fails to capture substantial risk variations among institutions.

Rather surprisingly, given the current situation in which institutions in Group 1A are charged no premiums, over time the concentration of institutions in Group 1A creates a bias toward overcharging the lowest risk institutions. Under the existing strúcture, institutions will tend to be concentrated in Group 1A because they have non-deposit-insurance reasons to stay in the well capitalized PCA group and most institutions tend to be rated "1" or "2" even in difficult times for the industry. The concentration of deposits into group 1A makes the FDIC dependent on assessments from these institutions. In periods when the FDIC needs assessment income, it will have little choice but to derive it from the Group 1A institutions. This bias was particularly evident before the funds reached their target capitalization levels, when the requirement that the FDIC charge an average premium of 23 basis points basically dictated that premium level as the rate for Group 1A institutions.

The FDIC's proposed scorecard is an attractive approach for refining the existing risk groupings. This approach permits the incorporation of information beyond the PCA category and safety-and-soundness ratings into the risk classifications. This is increasingly important as nontraditional activities and funding, including asset securitization and increased use of collateralized funding sources, play a greater role in defining the relationship between deposits and the risk of loss to the funds. The positive Canadian experience with a scorecard lends support to this approach.

The Canada Deposit Insurance Corporation (CDIC) implemented a risk scoring system in 1999. Under the Canadian model, institutions are rated on a variety of quantitative and qualitative factors based on an aggregate scale of 100. The quantitative factors—capital adequacy, profitability, efficiency, asset quality and asset concentration—comprise 60 percent of the score. The qualitative factors under the Canadian model, although more subjective, allow for consideration of things such as the extent of adherence to the CDIC's risk management standards.

Based on an institution's aggregate score, it is assigned to one of four risk categories. Because premiums double when dropping from one risk category to the next, there is significant incentive for institutions to improve financial results and address deficiencies. The Canadian experience is that their system is

relatively transparent and easily understood by their institutions, and provides a reasonable balance among qualitative and quantitative factors.

While the FDIC has offered a specific example of a scorecard for most institutions, their report also notes "for large, complex financial institutions, it may be advantageous to develop a separate approach, possibly including market data such as stock or bond prices." I would suggest that the parameters of an appropriate measure of risk to the fund from the failure of a very large institution—and perhaps even certain types of non-traditional smaller institutions—should focus on the risk of sudden failure.

Regulatory experience bears out Congress' premise in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) that prompt supervisory intervention in a problem institution will mitigate insurance fund losses. In addition to the prompt corrective action (PCA) tools of FDICIA, regulators often work with an institution to explore a voluntary liquidation, merger or acquisition before failure, and/or to shrink an institution (to minimize fund exposure to insured deposits) before it fails. Sudden failure, however, presents a problem that often frustrates effective use of supervisory tools.

Sudden failure can put maximum pressure not only on the deposit insurance fund, but also on the financial system as a whole. If we can find indicia of high risk for sudden failure, and then charge higher premiums for those who present such indicia, we may be able to discourage such risks as well as shift the cost of sudden failure risks to those who take them. An initial list of factors that might be taken into consideration in such a model could include market confidence in an institution (as evidenced by major and idiosyncratic changes in stock prices or debt ratings), the concentration of its lending portfolio and ongoing operations, and its dependence on non-deposit funding sources. Other relevant factors could be an institution's business model and the risks associated with its operational model (for example, whether the institution's activities are in high risk areas with thin secondary markets), potential risks arising from management changes—particularly situations involving wholesale management changes in a well-rated traditional institution, and excessive growth.

The FDIC's request for increased flexibility in setting fund targets and premiums is critical to improving risk-based pricing. It will also reduce premium volatility and diminish the current system's counterproductive procyclicality. The current structure requires the FDIC to charge at least 23 basis points whenever a fund is below its designated reserve ratio (DRR) and cannot reach its DRR within one year with lower premiums. The problems with this structure are further exacerbated by the fact that the FDIC cannot charge premiums to its lowest risk institutions when a fund is at or above its DRR and is expected to remain so over

the next year. As a result, the current system tends to force the FDIC to charge either too little or too much relative to the actual insurance risk exposure of a fund. Relaxing the DRR target and the restrictions on premium setting will reduce these impediments to risk-based pricing.

The current funding structure also implicates the issue of fund merger, and emphasizes the need for a comprehensive approach to deposit insurance reform. No one knows better than the thrift industry the impact on both the insurance fund and individual institutions of a sudden high assessment. In 1996, OTS-regulated thrifts paid $2.1 billion into the SAIF, representing a reallocation of 31 percent of industry earnings. It was the continued drain of a 23 basis point premium on SAIF-insured institutions, coupled with the instability resulting from the substantial premium disparity between the SAIF and the BIF, that led the industry to reluctantly support a one-time 86 basis point assessment to fully capitalize the SAIF. This was a risky and calculated decision necessitated solely by the interaction between the 23 basis point premium requirement and the existence of separate deposit insurance funds. Fortunately, it successfully stabilized the SAIF without doing long-term damage to the financial stability of the institutions that paid the assessment. We cannot count on being so lucky if there is a next time, particularly since the need for a sudden increase in premiums is unlikely to coincide with a favorable economic environment.

Granting the FDIC rebate authority will also facilitate improved risk-based pricing. I do not believe that the funds are currently excessively capitalized given the changing nature of the industry (including, but not limited to, the "sweeping" of billions of previously uninsured dollars into insured depositories) and where we currently stand in the economic cycle. However, it is not hard to imagine that, under a system with effective risk-based pricing, such a situation might occur. It is therefore entirely appropriate to consider the possibility of a system in which the FDIC could rebate excess funds accumulated in past years when sustained good conditions result in lower-than-expected insurance losses. While the FDIC has suggested, for quite sensible reasons, that rebates should be based on past contributions (perhaps weighted by institutions' past risk classifications), it is important to consider the potential budgetary implications of such a system.

3. Deposit Insurance Coverage Levels

A necessary precondition to raising or indexing the deposit insurance ceiling is implementation of a real risk-based pricing system. In an era when funds can move between institutions at ever-greater speeds, the negative effects of inappropriate pricing incentives are magnified as the ceiling increases. It is particularly important to find a level that stabilizes the system and provides safe savings vehicles without being too high if the ceiling is to be indexed, since

indexing would lock in the level over time. It is also worth considering whether a special ceiling for "sticky" funds that build over time, such as retirement accounts, might be appropriate.

IV. Principles of Risk-based Pricing: Preserving Integrity in the Allocation of Supervisory Costs

A system premised on the principle of risk-based pricing should allocate costs based on a structure that preserves the integrity of the system's pricing mechanism. True risk-based pricing bases premiums on both the overall risk to the system (i.e., the appropriate reserve ratio) and the relative risk of each insured institution within the system. The integrity of a risk-based pricing system is compromised if costs unrelated to the insured risks are included in the premiums charged.

The FDIC currently does double duty, functioning as insurer of commercial banks and thrift institutions and as primary federal regulator of state nonmember banks. The FDIC's role as primary federal regulator places a burden on the insurance funds that works against the goal of risk-based pricing. As part of deposit insurance reform, we should consider ways to remove this burden from the insurance funds or to integrate the cost of supervision for all insured institutions into a risk-based pricing model.

More than 40 percent of the FDIC's current operating budget is used to pay for supervisory costs relating solely to the FDIC's role as primary federal regulator of state non-member banks. These are costs not related to administration of the insurance system or the FDIC's insurance-based role when it takes part in the supervision of troubled institutions of whatever charter. These primary regulator costs are no different than the costs of OTS or OCC supervision of savings associations and national banks. Yet, while OTS- or OCC-supervised institutions pay assessments to cover the cost of their supervision, the FDIC's costs are charged to the insurance funds. Ironically, premiums paid by OTS- and OCC-supervised institutions, and the earnings on those premiums, account for the bulk of the current balance of the insurance funds.

It is certainly possible to take the position that all bank supervision, federal and state, serves an insurance function. After all, the rate of failure is very small, even among institutions that get themselves into financial difficulty. And the actions of federal and state regulators, combined, of course, with effective actions by institutional management and directors, helps keep the failure rate so low. What one cannot logically argue, however, is that this is true with respect to one and only one type of bank charter—state non-member banks. Either bank supervision is an insurance function for all charters, in which case all supervisory

costs—federal and state—should be paid from the insurance fund, or it is not. In the latter case, the only costs of supervision that should be paid from the insurance fund are the often considerable costs that arise when there is a higher risk of failure. And in such cases, all supervisory costs, not only those of the FDIC, should be paid from the insurance funds. For these reasons, this issue is an integral element in getting deposit insurance reform right.

V. Conclusion

The American deposit insurance system is the envy of countries and depositors all over the world, and it has indeed worked effectively to enhance financial stability and provide savers with confidence that their savings are secure. There are, however, significant weaknesses in the system that should be addressed sooner, rather than later. As we have demonstrated, a comprehensive approach to implementing reforms is needed. The current favorable economic climate presents an excellent opportunity to implement reforms with minimal impact on insured institutions or the economy.

Risk-based premiums would reward sound risk-management activities by insured institutions, allocate deposit insurance costs according to insurance risks, and provide flexibility within the system to allocate supervisory costs and make other adjustments within the system, including the issuance of premium rebates when warranted. Relaxing the fixed-target designated reserve ratio and funding shortfall requirement would eliminate the pressure on the system that now exists if a fund drops below the designated reserve ratio.

Finally, we strongly urge merger of the BIF and SAIF. It is an issue whose time has come and should be pursued as part of a comprehensive reform package.

Thank you for this opportunity to testify on the subject of federal deposit reform. This may be my last opportunity to testify before this Committee and I want to thank each and every one of you for the opportunity to work with you over the last 3 1/2 years. I have enjoyed my time as OTS Director and appreciate having had the opportunity to meet with many of you to discuss some of the issues facing the thrift industry and OTS. I am certain that you will extend to my successor the same courtesy that you have shown to me. Thank you.

Office of Thrift Supervision
Department of the Treasury
Director, Congressional Affairs
1700 G Street, N.W., Washington, DC 20552 • (202) 906-6288

August 28, 2001

The Honorable Frank Mascara
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Mascara:

Please find enclosed a response to your question submitted to Director Ellen Seidman, Office of Thrift Supervision, in conjunction with her appearance before the Subcommittee on Financial Institutions and Consumer Credit on July 26, 2001. If you have any questions, please do not hesitate to contact me at (202) 906-6288.

Sincerely,

Kevin L. Petrasic (ps)

Kevin L. Petrasic

Enclosure

Question from Congressman Frank Mascara

Since the passage of Gramm-Leach-Bliley (GLB), some of the larger brokerage firms have dumped huge amounts of money into insured deposits. Is it fair to have smaller community banks, who already paid high premiums as a result of the S&L bailout a few years ago, to contribute premiums to cover this huge infusion of cash into these insured deposits?

Answer

Institutions have found it advantageous to switch uninsured funds into insured deposits because of shortcomings in the current system that the deposit insurance reform initiative seeks to address. The actions of these institutions increase insured deposits and dilute the insurance funds, which brings the system closer to the point where premiums would again be required.

The parent holding companies of these brokerages also own federally insured banks and thrifts through which the brokerages offer their customers federally insured deposits as an alternative to uninsured money market funds. Federally insured deposits are attractive to brokerage customers because they are priced competitively with uninsured funds. What makes this possible is that federal deposit insurance is free because the FDIC cannot levy premiums on these institutions since they are in the 1A premium group and the insurance funds are above their designated reserve ratios (DRRs).

The proposed reforms would address this situation by improving risk-based premiums, adding flexibility to the funds' DRRs, and basing rebates on past insurance assessments. Improved risk-based premiums would better align an institution's insurance costs with the risks it poses to the insurance funds. Institutions would have to factor risk-based premium costs into the rates offered to their brokerage customers, which would make the insured accounts less attractive than they are now with zero premiums. Adding flexibility to the DRRs would enable the FDIC to vary a fund's DRR with the risks that it faces, such as dilution from a mass conversion. Basing rebates on past assessments would deny institutions with rapidly growing deposits undue shares of FDIC rebates.

The fact that so many customers have opted for federally insured deposits in place of uninsured money market funds illustrates the value of federal deposit insurance. Problems like the one you raise are best addressed by comprehensive deposit insurance reform that looks at the system as a whole and seeks to improve its overall operation rather than narrowly focused reforms that might appear to fix a specific problem but could lead to other, unforeseen problems.

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