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COMPREHENSIVE DEPOSIT INSURANCE REFORM: RESPONSES TO THE FDIC'S RECOMMENDATIONS FOR REFORM

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

ON

THE FEDERAL DEPOSIT INSURANCE CORPORATION'S RECOMMENDATIONS FOR IMPROVING THE DEPOSIT INSURANCE SYSTEM

AUGUST 2, 2001

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THURSDAY, AUGUST 2, 2001

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS,
Washington, DC.

The Subcommittee met at 10:03 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Tim Johnson (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. I would like to call the Subcommittee to order.

Good morning. I am pleased to convene the first meeting of the Financial Institutions Subcommittee of my Chairmanship on a topic that has been of great interest to me for a great many years. Federal deposit insurance is one of the cornerstones of our banking and financial system. This insurance gives depositors the confidence they need to fully utilize America's financial institutions. Since I began service in Congress in 1987, we have seen some real ups and some real downs in the banking industry, and it is a great privilege today to Chair a hearing on a matter of such importance to our Nation's bankers, and indeed, to our country as a whole.

I would first like to recognize Ranking Member Bennett, who I am told has a hearing conflict right now and, hopefully, will be able to join us later. I am pleased that Senator Gramm is able to join us here this morning. But I do want to thank Ranking Member Bennett in particular for working with me on a great range of banking issues. He has a very distinguished business background. I value his insights. Obviously, I appreciate Chairman Sarbanes, who conducts all of his hearings in a dignified and thoughtful manner and I aspire to live up to the high standards that he has set for the Senate Banking Committee.

As everyone in the room knows, or surely will find out in short order, comprehensive deposit insurance reform is an enormously complex issue. I will resist the opportunity today to recite a history of banking reform, and steer clear of too many statistics—at least until the question and answer period. While the body of literature on deposit insurance is vast, I would note that there appears to be more consensus than there is disagreement on potential reforms.

At today's hearing, the financial services industry will respond to the FDIC's recommendations for comprehensive reform of the Fed-

eral Deposit Insurance System. The FDIC, in my view, has identified some significant weaknesses in the current system.

In particular, it is hard to argue with the FDIC's observation that the current system is procyclical. That is, in good times, when the funds are above the designated reserve ratio of 1.25 percent, 92 percent of the industry pays nothing for coverage. But in bad times, institutions could be hit with potentially crushing premiums of up to 23 basis points. I think that most industry members agree that this so-called "hard target" presents a very real threat to their businesses.

Of course, this means that any movement in the funds down toward 1.25 percent increases the anxiety level of bankers and regulators alike, whether that movement comes from fast growth of certain institutions, or from institutional failures like we saw last Friday in the case of Superior Bank of Illinois. The numbers are still preliminary, but cost estimates of the failure start at around $500 million, which would reduce the SAIF ratio by seven basis points. I say this not to be alarmist, but I would urge caution against becoming simply complacent in good times and resisting changes that make sense over the long term and have the potential to enhance the overall stability of our system.

I am particularly interested in hearing from the witnesses about their positions on premiums. I would note that there is unanimity among the Federal banking regulators that institutions should pay regular deposit insurance premiums, though not with respect to how we should determine those premiums.

Now, I understand that 92 percent of the industry is free from current premium payments, and it certainly presents an interesting psychological and political challenge to persuade folks to pay for something that they currently get for free. On the other hand, I am not the first to note that very few things in life are, in fact, free. If you are getting something of value, eventually, you have to pay for it. The question is not whether you will have to pay up; it is when and how much.

I am also interested in hearing comments about the erosion in value of deposit insurance. I think my position is well known. I believe that we need to increase, and index, coverage levels. Over the last 20 years, coverage values have decreased by more than half, and previous increases were unpredictable both in terms of amount and timing. I expect to hear a spirited debate on that topic, and I believe it should be included in any discussion of comprehensive reform.

I would urge everyone involved in this debate to take a step back and recognize that when we talk about deposit insurance, we are talking about the foundation of our financial system. I think it is simply irresponsible to take a short-term approach, or to politicize these issues. And while I am open to persuasion on just about every component of reform, I am firm in my belief that we all share the common goal of a safe and sound banking system.

As many of you know, I am committed to ensuring that our small banks and thrifts—which play such an important role in rural States such as mine, South Dakota—have the tools they need to survive. I am also well aware of the value that our larger banks, thrifts, and bank holding companies bring to this country. I believe

my strong support of financial modernization speaks for itself, and would simply add that I am committed to finding a reform package that considers the needs and interests of all members of our financial services community.

Now some might argue that it will be impossible to craft changes to our deposit insurance system that will bring all the interested parties together, but I reject that argument. First, every single bank and thrift in this country benefits from our world-class deposit insurance system, and it is in everyone's interest to find an acceptable set of changes. Second, I believe that our witnesses will tell us that the industry is, in fact, close together on many of the core reform issues. Finally, the regulators themselves have said that they are approaching consensus on a great many of these issues. I am optimistic that we will be able to develop a sound and comprehensive reform policy.

I am looking forward to hearing what my colleagues and our witnesses have to say and I will now turn to my good friend and colleague from Texas, Senator Gramm, for any opening statement that he may have.

STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. Well, Mr. Chairman, first of all, I want to thank you for this hearing. It has been my great pleasure to work with you on banking issues now for several years. I have appreciated your interest in small banks.

Let me say that, without question, I represent more small banks and bankers than any other Senator, other than my colleague, Senator Hutchison. And if there is a small banker in Texas who does not support me, I do not know him.

So, I am very concerned about the health of small banks. I am not one of these people who believes the future of America's financial system is going to be dominated by large banks. There are a lot of niches where small banks can be very successful, and I think that people are finding these niches in my State.

I do believe we need a comprehensive reform of deposit insurance, and I want to congratulate you for your interest and leadership in this area. I want to pledge to you that I am willing and eager to work with you to try to deal with the problem we have.

We need to keep in mind that we have two different insurance systems. We have two types of institutions with very different charters and powers, that for all practical purposes have the same deposit insurance. And this is something that needs to be looked at very closely. Should we merge the funds, and if we do, should we change charters so that all financial institutions within the same insurance fund have the same powers? I think these are the issues that ought to be looked at.

I would say that my experience with the S&L crisis convinces me that we should not raise the insurance limit.

I remember vividly from those terrible days of the S&L crisis where institutions were broke, and it was obvious that, at some point, they were going to be closed. But because of deposit insurance, deposits would come into a failing institution by the tens of millions of dollars and seize a higher rate of return with absolute

certainty that the taxpayer was going to pick up the bill—if and when that institution failed.

I believe that this created tremendous instability in the system. I do not want to add to that by adding to these limits.

I think I am in good company with Alan Greenspan. I have not yet talked to the new Secretary of the Treasury or the new FDIC Chairman about this issue in any great detail, and I do not remember whether the Comptroller of the Currency joined the Secretary of the Treasury and Alan Greenspan in opposing last year's proposals to raise deposit insurance limits.

There are a lot of issues here that we do have agreement on, and I think this is an important area. I want to thank our witnesses for their time today.

I have to go to a Budget Committee thing. We have some people downstairs that want to take back the tax cut and they need to be beaten into submission.

[Laughter.]

I want to thank you, Mr. Chairman, for holding this hearing, and to pledge to you that I have an open mind on these issues and I hope and believe we can work together.

Thank you.

Senator JOHNSON. Thank you, Senator Gramm.

Senator Bunning.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman, for holding this very important hearing and I would like to thank our witnesses for testifying today.

It is good to have the industry represented here on the topic of Federal deposit insurance reform. A little while back we had the regulators here and we touched upon many of the same issues that we will be talking about today. It will be very helpful to have your take on these issues.

Last April, the FDIC issued its paper, "Keeping The Promise—Recommendations for Deposit Insurance Reform." There are many ideas in that paper that I believe there were a great deal of support for. Merging the BIF and the SAIF funds is an idea that has been around a long time. In fact, it has been around since I started in the House Banking Committee in 1987.

There is a great deal of support for merging the funds. But it seems it has always been caught up in the bigger plans for overall deposit insurance reform. Because of the desire for reform, the funds have not been merged. I also believe there is a consensus to adjust the reserve ratios. The current 1.25 hard cap with 23 basis points under capitalization could very likely be imposed in a time of great concern to the banking industry when banks could least afford a readjustment.

By giving the FDIC some flexibility, we can prevent turning hard times into crisis times. I also believe there is a lot of consensus to price premiums on a risk basis. I do not believe, however, there is a consensus on raising and indexing for inflation the insurance levels. When the regulators were here on June 20, Chairman Greenspan hesitated to speak for the Fed. But in the past, he says he opposes raising the insurance levels.

The OCC has also expressed concern about raising the levels. The FDIC and the OTS have supported indexing the levels for inflation. I also have concerns about raising the deposit insurance levels. I am leery of putting the taxpayer on the hook for higher levels of coverage.

I am also skeptical that raising the levels will lead to a great deal of increased deposits for smaller banks. I believe the deposits have shrunk in the smaller banks because those deposits have been going to higher returning uninsured vehicles. I do not believe those deposits would be put into banks.

Mr. Chairman, once again, thank you for holding this hearing and I look forward to our witnesses' testimony.

Thank you.

Senator JOHNSON. Thank you, Senator Bunning.

I am pleased that our Chairman, Senator Sarbanes, could join us this morning at this initial hearing of our Subcommittee.

And on very short notice, Chairman Sarbanes, do you have any opening comments that you would like to share with us?

STATEMENT OF SENATOR PAUL S. SARBANES

Chairman SARBANES. I would just like to make a few remarks, Mr. Chairman.

First of all, I want to thank you as Chairman of the Financial Institutions Subcommittee for holding this morning's hearing on the very important subject of possible Federal Deposit Insurance System reform. Obviously, any reform effort will require thorough analysis of the issues and today's hearing is an opening contribution to that effort.

As we are all of course aware, the FDIC in April published a report on reforming the deposit insurance system, which included, among other things, merging the two funds, charging insurance premiums based on the institution's risk to the insurance fund, so-called "risk-based premiums," shifting from a fixed reserve ratio of 1.25 percent of insured deposits to a target range of reserve ratios, to avoid sharp swings in insurance premiums and to counter the cyclical economic movements.

At the moment, the way it works, it often ends up pushing the cycle along rather than countering the cycle.

Rebating premiums based on an institution's historical contributions to an insurance fund when the fund grows above a target level. And indexing deposit insurance coverage levels to the inflation rate.

Last week, the various Government agencies, in a hearing on the other side, announced their views on the FDIC's various recommendations, and they picked some and left others by the wayside. Obviously, we need to review their positions very carefully.

Let me say, I think today's hearing is particularly timely in light of last Friday's failure of a major thrift, Superior Bank of Illinois. It is the eleventh largest depository institution to fail in our history. Reports suggests that it may cost the SAIF as much as $500 million. Furthermore, customers with uninsured deposits—in other words, amounts over and above the $100,000 figure—may lose over $40 million.

I am very much concerned about this failure and have taken steps to inquire into its causes. We have asked the GAO, under the leadership of the Comptroller General, to examine the situation, not as much the specific one, as a general examination, because the specific one will be examined by the Inspector General of the Treasury Department, which has authority over the Office of Thrift Supervision, and by the Inspector General of FDIC. And we have asked both of them to submit their reports to us so that we may have an opportunity to review them.

The statute actually requires the Inspector General at Treasury to write a report when the deposit insurance fund incurs a material loss. The statute also requires that the report be made available to Congress upon request and it requires the IG's report to review the agency's supervision of the institution, including the agency's implementation of prompt corrective action, to discuss why the institution's problems resulted in a material loss to the deposit insurance fund. And it also calls for recommendations for preventing such losses in the future.

Pursuant to that statute, I have already requested of the Inspector General that the report be made available to the Congress upon its completion.

We look forward to receiving these two IG reports and the study from the GAO as we examine this situation. And in a sense, it is a timely reminder of the role of the insurance fund. It is a timely reminder of the potential exposure eventually to the taxpayer, if things really go amiss, as we experienced in the savings and loan crisis when we ended up footing a very large bill.

So, Mr. Chairman, I am pleased to join you and I am looking forward to hearing from the witnesses.

Thank you very much.

Senator JOHNSON. Thank you, Chairman Sarbanes.

I am pleased that we are able to have a very distinguished panel with us here this morning.

Mr. Robert Gulledge is here on behalf of the Independent Community Bankers of America. He is Chairman of the ICBA. Mr. Gulledge is Chairman, President, and CEO of Citizens Bank of Robertsdale, Alabama.

Mr. Jeff Plagge is here on behalf of the American Bankers Association. Mr. Plagge is President and CEO of the First National Bank of Waverly, Iowa.

Mr. Curt Hage is here on behalf of America's Community Bankers. Curt is the First Vice Chairman of the ACB. Curt is Chairman, President, and CEO of Home Federal Bank in Sioux Falls, South Dakota, and a good friend of mine. And I might note that David Bochnowski, the Chair of the ACB, graciously stepped aside and is allowing Curt to come before the Subcommittee today. I know the Subcommittee is very well served by Mr. Hage's testimony.

Welcome to the Subcommittee. Rather than using the formality of the 5 minute clock because we have a relatively small panel and just one panel, we will forego that.

I would invite panel members to summarize their statements if they so wish. Their full statements will be placed into the record.

With that, why don't we begin with Mr. Gulledge.

STATEMENT OF ROBERT I. GULLEDGE
CHAIRMAN, PRESIDENT & CHIEF EXECUTIVE OFFICER
CITIZENS BANK, INC., ROBERTSDALE, ALABAMA
CHAIRMAN OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA
ON BEHALF OF THE
INDEPENDENT COMMUNITY BANKERS OF AMERICA

Mr. GULLEDGE. Good morning, Chairman Johnson, Senator Sarbanes, and Senator Bunning. I am Bob Gulledge and I am President of Citizens Bank, an $80 million asset community bank in Robertsdale, Alabama. I am also the Chairman of the Independent Community Bankers of America, on whose behalf I appear today.

Mr. Chairman, I want to commend you for moving this important issue forward. It has been 10 years since Congress last took a systematic look at the deposit insurance program. Now is the time, during a noncrisis atmosphere, to modernize our very successful Federal Deposit Insurance System, by adopting a package of interrelated reforms.

First, deposit insurance coverage levels have been badly eroded by inflation and must be increased and indexed for inflation. Today, in real dollars, deposit insurance is worth less than half of what it was in 1980, and even less than what it was worth in 1974, when coverage was raised to $40,000.

Higher coverage levels are critical to meet today's savings and retirement needs. A recent Gallup poll showed that nearly four out of five consumers think that deposit insurance should keep pace with inflation. Higher coverage levels are critical to support the local lending of community banks as they increasingly face liquidity pressures in trying to meet loan demand for our small business and agricultural customers.

Community banks' funding sources other than deposits are scarce. Consumers and small businesses shouldn't have to spread their money around to get coverage they deserve. They should be able to support their local banks, and local economies, with their deposits.

Meanwhile, the examiners and the U.S. Treasury are warning against our growing reliance on Federal Home Loan Bank advances and other noncore funding sources such as brokered deposits.

We do not have access to the capital markets like the large banks do. In troubled times, we, unlike large banks, are many times "too small to save."

A recent Grant Thornton survey revealed that nearly four out of five community bank executives say higher coverage levels will make it easier to attract and keep core deposits.

The growing concentration of deposits and of financial assets in fewer and fewer organizations, not an increase in coverage, presents the greatest systemic risk and "moral hazard" in our financial system and to the loss exposure of FDIC.

Chairman Johnson, ICBA strongly supports your legislation, S. 128, which would substantially raise coverage levels and index them in the future. This feature of deposit insurance reform is essential for our support of legislation. The ICBA also supports full FDIC coverage for municipal deposits and higher coverage for IRA's and other retirement accounts.

Second, we must address the free-rider issue. Over the course of last year or so, Merrill Lynch and Salomon Smith Barney have moved around $100 billion into insured accounts without paying a penny in insurance premiums, thereby reducing the reserve ratio.

Further, by owning multiple banks, they offer their customers higher coverage levels than we can. This is a double-barreled inequity that we think must be addressed.

Third, a risk-based premium system must set pricing fairly. Currently, 92 percent of banks pay no premiums. The FDIC says that this is because the current system underprices risk.

The proposal to charge all banks premiums, even when the fund is fully capitalized, faces controversy in our industry. But we believe that as part of an integrated reform package, which includes a substantial increase in the deposit insurance limit, most community bankers would be willing to pay a small, steady, fairly priced premium in exchange for increased coverage levels and less volatility in the premiums. This is also one way to make sure that the "free-riders" pay their fair share, also.

Fourth, the 1.25 percent hard-target reserve ratio and the requirement of a 23 percent premium when the fund is below target should be eliminated. The U.S. Treasury and the regulatory agencies recommend using a flexible range, with surcharges as the ratio gets too low and rebates if the ratio gets too high.

We believe that the current system is dangerously procyclical with premiums the highest when banks and the economy can least afford it. Using a more flexible target would help to eliminate substantial fluctuations in premiums and avoid intensifying an economic downturn by diverting lending funds out of the banking industry.

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

Fifth, the FDIC proposes to merge the BIF and the SAIF. The ICBA supports the merger only so long as it is a part of an overall comprehensive reform package.

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

The less that deposit insurance is really worth due to inflation erosion, the less confident Americans will be about their savings in banks. Thus, the soundness of our financial system will then be diminished.

Congress must not let this happen and we urge Congress to adopt an integrated reform package as soon as possible.

I thank you for the opportunity to comment and I will be happy, Mr. Chairman, to answer questions.

Senator JOHNSON. Thank you, Mr. Gulledge.

We will turn next to Mr. Plagge.

STATEMENT OF JEFF L. PLAGGE
PRESIDENT & CHIEF EXECUTIVE OFFICER
FIRST NATIONAL BANK OF WAVERLY, IOWA
ON BEHALF OF THE
AMERICAN BANKERS ASSOCIATION

Mr. PLAGGE. I want to thank you, Mr. Chairman, for holding this hearing. We certainly appreciate your long-term support of a strong banking system and the financial system in general and your leadership on this particular issue.

Assuring that the FDIC remains strong is of utmost importance to the banking industry and the consumers nationwide.

Over the past decade, the industry has gone to great lengths to assure the insurance funds are strong. In fact, with $42 billion in combined financial resources, the FDIC is extraordinarily healthy. The outlook is also very good.

The banking industry is extremely well-capitalized, profitable, and reserved for potential losses. Thus, now is a great time to consider how we might improve an already-strong system on a comprehensive basis.

A consensus is key to any bill being enacted. To fulfill this goal, we have held extensive discussions with bankers, Members of Congress and staffs, and the FDIC. And as you noted, some differences remain between our three organizations, but in most cases, our positions are very similar.

Our three associations have agreed that it is imperative to discuss these issues together and work together with this Committee to develop legislation that would have broad support.

Just this weekend, this issue was again brought before our organization's bankers at the ABA summer meeting. This meeting brings together our board of directors, government relations council, and the leadership of all State banking associations and others. My testimony today reflects the conclusions reached during this meeting.

I must add, however, that while there is a willingness to go forward, we do have deep concerns about legislation that might increase bank costs or become a vehicle for extraneous amendments. If that were to be the case, support amongst many of our banks and bankers would quickly dissipate.

Indeed, the consensus at our summer meeting was more so than ever that the ABA will oppose any FDIC reform legislation that results in increased premiums when the insurance funds are already above the 1.25 percent ratio as they are today. Fortunately, we also believe, however, that by working together, a consensus bill could be developed that would have broad support.

In my testimony today, I would like to make several key points that are also in the written testimony that was submitted.

First, today's system is strong and effective, but some improvements could be made. The current system of deposit insurance has the confidence of depositors and banks. Strong laws and regulations buttress this financial strength. Even more important is that the bank industry has an unfailing obligation to meet the financial needs of the insurance fund.

Second, as you have noted, a comprehensive approach is required. Because insurance issues are interwoven, any changes

must consider the entire system. We are pleased that all the issues are now on the table. We recognize that any final bill might not cover all of these issues in full, but we certainly appreciate the comprehensive process that the Congress and this Committee is pursuing.

The issues that we feel should be considered include: Number one, the impact inflation has on the $100,000 insurance level and how it can be addressed in the long term; number two, the fact that very fast growing institutions can dilute the fund ratios without paying any premiums; number three, the current counterproductive and procyclical premium requirement when the fund falls below the 1.25 percent ratio; number four, the need to cap the growth of the fund at some point and provide rebates; number five, the possibility of basing rebates on the history of bank payments into the fund; number six, insurance levels on municipal deposits; and number seven, merger of the insurance funds in general.

Our summer meeting participants emphasized that caps and rebates need to be included in the deposit insurance legislation.

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

Banks have paid for their insurance and, in fact, they have prepaid and they continue to pay almost $800 million a year to cover the FICO interest payments, even though the current institutions that are paying these bills had nothing to do with the S&L crisis.

We thank you, Mr. Chairman, for this opportunity to express our views and we look forward to working with the Committee to find workable and comprehensive solutions.

Senator JOHNSON. Thank you, Mr. Plagge.

Mr. Hage.

STATEMENT OF CURTIS L. HAGE
CHAIRMAN, PRESIDENT & CHIEF EXECUTIVE OFFICER
HOME FEDERAL BANK, SIOUX FALLS, SOUTH DAKOTA
FIRST VICE CHAIRMAN, AMERICA'S COMMUNITY BANKERS
ON BEHALF OF
AMERICA'S COMMUNITY BANKERS

Mr. HAGE. Mr. Chairman and Members of the Subcommittee, I am Curt Hage, Chairman, President, and CEO of Home Federal Bank in Sioux Falls, South Dakota. I am representing America's Community Bankers today in my capacity as First Vice Chairman. We are pleased to have this opportunity to present our views on deposit insurance reform.

America's Community Bankers welcomes your interest in comprehensive reform. At the same time, we believe there are serious potential problems facing the deposit insurance system that Congress must act on immediately.

Last week's failure of Superior Bank and the failure of the First National Bank of Keystone in 1999 should remind us of the importance of strengthening the Federal Deposit Insurance System. If the list of comprehensive reform proposals is too long for Congress

to pass this year, we ask that you set priorities, enact what you can this year, and then return to the rest of the issues next year.

America's Community Bankers urges Congress to enact three major deposit insurance reform provisions this year:

First, merge the BIF and the SAIF into a single, stronger deposit insurance fund.

Second, give the FDIC flexibility in recapitalizing the deposit insurance fund if the fund falls below the 1.25 percent reserve requirement. Current statute requires the FDIC to impose a 23 basis point premium if a fund dips below the required reserve ratio level for longer than a year.

The real dollar cost of this arbitrarily set premium would be significant. For my bank alone, that premium would cost $1.4 million. For all banks in the State of South Dakota, that would be $31 million—enough capital to support over $300 million in additional lending. In a rural State like South Dakota, $300 million would make a big difference in helping our State continue to grow.

We recommend that Congress allow the FDIC to recapitalize the fund using a laser-beam approach, not a sledgehammer.

Third, allow the FDIC to impose a special premium on excessive deposit growth, if such growth would threaten the health of the deposit insurance fund.

A few companies have shifted tens of billions of dollars from outside the banking system into insured accounts at banks that they control. While legal, this has diluted the deposit insurance funds and reduced the reserve ratio of the BIF by three to four basis points. It is time to give the FDIC authority to counter this free-rider problem.

Fortunately, there is already legislation introduced in the House to address these three priority issues. H.R. 1293, the Deposit Insurance Stabilization Act, introduced by Representatives Bob Ney and Stephanie Tubbs Jones. ACB asks Congress to either pass this legislation immediately or to make it the centerpiece of comprehensive reform legislation that can be enacted this year. In any case, the provisions found in H.R. 1293 should be enacted before either the BIF or the SAIF falls below the 1.25 percent reserve ratio level.

We agree with the incoming FDIC Chairman Don Powell that Congress need not deal with all deposit insurance issues at once. But ACB's strong support for addressing the most pressing matters certainly does not rule out adding other provisions if a consensus can be quickly developed.

In the area of coverage, ACB strongly believes that Congress should focus on increasing protection for retirement savings and also urges substantially increasing coverage for retirement savings plans, such as IRA's and 401(k) accounts.

With respect to general increases in deposit insurance coverage, ACB supports indexing coverage levels from 1974, which, according to the FDIC, would bring the coverage limits to approximately $135,000. This would help maintain the role of deposit insurance in the Nation's financial system.

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

In determining the actual ceiling level, Congress should consult the FDIC. Once a ceiling has been set, reserves in the fund that exceed the ceiling should be returned to insured institutions based on their average asset base measured over a reasonable period and based on premiums paid in the past. For example, S. 2293, introduced by Senators Santorum and Edwards in the 106th Congress, provides one approach that Congress might take.

Finally, ACB strongly supports preserving the current statutory language preventing the FDIC from imposing premiums on well-capitalized and well-run institutions when reserves are above the required levels. These institutions have already paid dearly for their coverage.

Mr. Chairman, let me sum up by reiterating ACB's strong belief that Congress should address the most pressing needs of the deposit insurance system immediately—acting quickly to give the FDIC the flexibility it needs to deal with the strains imposed by the free-rider problem.

If a consensus can develop around other deposit insurance reform measures, we welcome their consideration and inclusion.

Deposit insurance is an essential part of our banking system. While a variety of opinions exist on the issues, general consensus exists that any reform should leave the FDIC stronger. It should continue and strengthen the original mission of the FDIC to protect depositors.

America's Community Bankers is committed to working with you and your Committee, and others in the industry, to help forge a bill that can move expeditiously through Congress.

Again, Mr. Chairman, thank you for this opportunity to testify on behalf of America's Community Bankers. I welcome any questions that you or any Member of the Subcommittee might have.

Senator JOHNSON. Thank you, Mr. Hage.

My able colleague and friend, Senator Bennett, is able to join us now. And what I would suggest is that Senator Bennett share with us some opening thoughts, and then with the permission of the remainder of the Subcommittee, we would move directly on to questioning at that point.

Senator Bennett.

COMMENTS OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you very much, Mr. Chairman. I appreciate your holding this hearing.

When I first joined this Committee as a very freshman Member and sat at the end of the table on the other side, I had no idea what BIF and SAIF were. I would go home filled with the excitement of a new Senate election and my appointment to the Banking Committee and have bankers sit me down and say, where are you on the issue of BIF and SAIF? And I said, well, I am in favor of SAIF. Everybody likes to be safe.

[Laughter.]

What is BIF? That sounds like a statement on a Saturday morning cartoon.

So, I now have been immersed in BIF and SAIF issues for nearly 8 years and had thought they had gone away. I thought that the problems had all been solved. But as you hold this hearing, I real-

ize that I was wrong. The problems have not all been solved. They have simply changed. We are no longer dealing with the issue of bailing out savings and loans. We are now dealing with the issue of prosperity and too much money in BIF and SAIF.

I am grateful to you, Mr. Chairman, for highlighting the issue again and bringing it back up in the next context so that we do not simply ignore it.

I think that is a salutary thing for you to be doing. I appreciate the witnesses and the information they have shared with us here today. And I hope that, maybe with your leadership, Mr. Chairman, we finally can get to the point where we can forget it and let it go on. But life being what it is around this town, I am not sure we will ever do that.

Thank you.

Senator JOHNSON. Thank you, Senator Bennett.

If it is all right with Senators Allard and Reed, we will proceed on with questioning. But certainly, your statements will be placed into the record.

In the process of trying to find how much consensus is possible on FDIC reform, we had an opportunity to seek out the opinions of a wide range of authorities, not the least of all the panel before us here today.

We also looked to the viewpoints of the FDIC itself, the Fed, the Treasury, the OCC, and the OTS. And I thought it might be useful to display a chart, which we have on the stand here, which demonstrates a great many of the key components of FDIC reform. There actually is a great deal of consensus, admittedly, a bit less consensus on the indexation issue. Certainly on the other issues, there is a great deal of general consensus among these agencies.

I would ask Mr. Plagge and Mr. Hage that, with the FDIC, the Fed, the Treasury, the OCC and OTS in unanimous position, recommending that banks and thrifts, in fact, pay annual premiums for deposit insurance coverage, it is my take on their perspective that they are suggesting that a steady premium system would not necessarily require banks and thrifts to pay more. They would pay a steady amount each year rather than 23 basis points into the hard target, and that variability in premiums would be reduced, not increased. Their attitude appears to be making an assumption that these institutions will never have to pay premiums because we will never break 1.25 percent, which may not be a realistic position to take.

I wonder if you would share again with me a bit of deliberation about why your organization is right and these institutions are wrong on the issue of premiums.

Mr. Plagge.

Mr. PLAGGE. Okay. I will start that. It is an interesting discussion. And having served on the ABA board level and then also on the Government Relations Council at the ABA, as well as at the State level, what we find with our bankers that have been brought into the discussion is they become almost more emphatic about the fact that we have prepaid into the fund.

The combined funds today are extremely strong—1.37 percent, I believe is the ratio when you look at them combined. In fact, congratulations to Congress for designing a system that has worked.

We put the fund together. We have been far above the 1.25 percent, and we continue to pay $800 million a year toward the $12 billion obligation for the FICO interest. So, we look at it as, we have paid. We want to continue to make sure that the fund is extremely strong. And at this point, it just seems to us that the system in that regard is working.

Every dollar that comes out of our institutions, and I am in a small, $140 million institution in rural Iowa, is money that we cannot loan back into the economy, cannot do the kinds of things that we are doing. And as one banker told me, we already bought this car. It is paid for. The system is working in that regard. Let's not continue to put more money into that fund.

Last, our bankers tell us, and I agree, that right now, the fund is building at approximately $1.5 billion more each year just based on the excess earnings in the fund over and above the operating cost to the FDIC. So in fact, the fund will continue to grow as it stands today over and above the FICO premiums and so forth that are being paid.

Senator JOHNSON. Mr. Hage.

Mr. HAGE. Thank you, Senator Johnson.

I think we need to put a couple of pieces into perspective to make this puzzle look like a whole picture.

I do not know of any of our members who are suggesting that we shouldn't pay any premium for deposit insurance. Historically, we have paid for those premiums and have paid for that coverage and I think it has been appropriate.

The situation we are in today is that we have overpaid or prepaid for the present insurance level required. And so, our members are concerned about the equity of getting that prepayment back where it belongs.

Normal conditions without the aberrations of huge inflows of free-rider deposits probably wouldn't raise the issue to the level it is today. But they are linked.

We have a number of beneficiaries who are not paying for any coverage, yet getting full coverage at the expense of those of us who have prepaid. And I think that is unfair and wrong. So an important ingredient of getting back to paying a correct premium is to rebalance who should pay and how much should they pay.

Second, there seems to be a growing notion, as I get reports of conversations around Capitol Hill and perhaps around the country, that somehow this is a free system that we are living off of.

It is not free at all. We have paid for this deposit premium. We have accumulated those balances. My company alone since 1991 has paid over $10.4 million in premiums. I have gotten value for that. But a lot of that is prepaid and I would like it back. And let those who are now putting uninsured money into the system pay their fair share like the rest of us have.

That is really the key ingredient, to get it rebalanced and get it fairly structured so all participants are paying appropriately for participation in the deposit insurance fund.

Senator JOHNSON. Thank you, Mr. Hage.

I am going to suggest that Members of the Subcommittee abide by the 5 minute clock, so that everybody gets a fair opportunity.

And having my time expire here, I will try and behave myself and set a good example. So, I would turn next to Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

This is for any of the panelists. Do you believe that deposits are down in smaller banks because insurance reform has not kept up with inflation or because depositors are putting their money in other uninsured vehicles that have the potential for higher returns? Anyone who would like to speak on that would be fine.

Mr. GULLEDGE. I do believe that deposits are down in the smaller banks. I think that customers are in many instances following the rates that they are getting for other nonbank products. But also, there are quite a number of people who are leaving community banks to take their funds simply because we are not in a day when $100,000 coverage is indicative of a person being rich.

Some of these people who are taking their retirement accounts, their life event funds are being taken to other banks and other products simply because we do not have the insurance coverage to give them the protection that they are seeking and that they expect from the FDIC coverage.

Mr. HAGE. Senator Bunning, I think we saw in the last 5 to 6 years, maybe longer, a huge disintermediation or shift from commercial bank deposits, thrift and community bank deposits, because of higher rates of return and a high confidence level in equity markets and mutual fund markets. I think that it had relatively little to do with the deposit insurance coverage limit itself as a stand-alone concept.

Today, with the lack of confidence given the recent market readjustment, we have seen new inflows of deposits back into community banks. Whether that will stay or not, I do not know.

I do know that people have and are accumulating higher balances on an individual basis, particularly in their retirement funds. And I think as we see the baby boomers reach retirement age, their appetite for risk is going to decrease. They are going to pay more attention to how much insurance coverage they can get to assure return of their principle rather than return on their principle.

Senator BUNNING. During the Chairman of the FDIC's testimony, she addressed the FDIC's concerns regarding the issue of rapid deposit growth and its impact on the rest of the industry. Do you see a trade-off between reform in this area versus stifling the very initiative of practices that Gramm–Leach–Bliley was intended to encourage?

Mr. HAGE. Senator Bunning, I would draw a distinction and definition of rapid deposit growth that I think is important. If we are talking about deposit growth——

Senator BUNNING. Those are her words, not mine.

Mr. HAGE. I understand. But just to clarify the issue, if we are talking about deposit growth, meaning one bank gives up its deposits by competitive forces to another bank, that is deposit growth for the bank, but it has no change on the fund itself because both sides of that transaction were insured. So bank-to-bank deposit growth has no effect, effectively, on the insurance funds.

Funds like we see today that are in money market funds that were not previously insured now moving into the deposit insurance system through banks and thrifts that have been properly char-

tered, that has an impact. It may well be a one-time impact given the environment we have come from and the environment we are into today. But it nevertheless is a very significant impact today.

Over $50 billion have moved into the insured deposit funds with no premium attached. That is significant.

Senator BUNNING. How does the ABA feel?

Mr. PLAGGE. I would echo that. In fact, from a personal example standpoint, we started a new bank in a close-by community. Literally, all the money that has come into the growth of that bank has come from other banks within the system. And so, the impact is basically a neutral impact to the FDIC.

The funds that are flowing in from the money market funds and so forth, obviously have had an impact. As my counterpart mentioned, it looks like it may be coming to an end as far as the amount of that impact. Most of that money that would flow in in the large amounts has. But it certainly can move the percentages a lot greater than anything that happens within the industry itself, the banking industry.

Senator BUNNING. In meeting with the community bankers in my area, Kentucky and most of the area that surrounds the greater Cincinnati area, I have not heard one complaint, not one, from any of them about merging the funds or charging too much or increasing the amount of insured deposits. Not one of them have ever come to me and said, this is something that we really think is strongly needed.

So unless we can really see a great improvement, it is going to take a lot of momentum to get this done. And I have a personal banker who is a community banker and they are so happy, it is unbelievable how happy they are. They are making a lot of money.

Mr. HAGE. Senator, I think that you have issued a challenge for all three of our industry trade groups to awaken the issues to your bankers.

Chairman SARBANES. Well, I am sure that you will be hearing from them now.

[Laughter.]

Senator BUNNING. All right.

[Laughter.]

Senator JOHNSON. Thank you, Senator Bunning.

Senator Sarbanes.

Chairman SARBANES. Examination of this issue actually raises a lot of, in a sense, basic questions, and I would like to ask a couple of those on the way to sort of gaining an analytical framework. What do you think the deposit coverage should be and what is the rationale for it?

And in answering that question, I would like you to abandon the rationale that simply takes an old figure and then adjusts it for inflation because that assumes that the old figure was correct, or under changing circumstances, even today, represents an appropriate base off of which to work. I do not know whether that is the case or not.

What should the figure be and what is the rationale for that figure? Should there be no limit? And if the answer to that is no, why should there be a limit? If there should be a limit, at what level? Why? What is the underlying rationale for arriving at that figure?

Mr. HAGE. Senator, I would offer that I do not know that there is a clear, single number answer to your question. The foundation of the question I think reflects the real heart of the issue here. What is it that we as a society should protect in terms of individual's wealth accumulation? What was magical about $5,000 coverage at the beginning, going to $15,000, to $20,000? I do not really know.

The related facts are that through incentives in the currently passed tax act, we have encouraged individuals to accumulate more wealth for retirement. We have a generation of baby boomers coming into retirement that will be unprecedented in the numbers of people. We know there is a strain on Social Security.

So, I think there is a connection between how much deposit insurance coverage we should provide and how much at-risk wealth accumulation we should permit.

More than getting to a very specific number I think is an active process which I think has been and can continue to be actively administered through FDIC. Giving them some more flexibility to continually look at the insurance coverage ratio limit would be a strength. Giving them some flexibility in setting the premiums that would be necessary to maintain various ratio coverages that might be determined based on the risk profile of our public depository institutions I think would be a very healthy start. But I do not know that I could give you a specific number that would be any more legitimate than the numbers we have today.

Chairman SARBANES. Should it be part of the rationale to look at what percentage of the American people may, in fact, have savings at a certain level, where we would say, well, for ordinary people, we want to provide them the safety net. But we are not going to provide a safety net without limit. And for people of greater wealth, they presumably have their own investment strategies and they are used to putting their money at risk and so forth. Therefore, we are not going to cover everything for everybody. Is that a reasonable factor to include in the evaluation?

Mr. HAGE. I would agree with that, Senator. I do not think it is important that we provide 100 percent coverage. I think there is some healthiness to having segments of wealth at risk. I think it is a balance for public policy.

As you as an elected body make policies that may put our Nation in positions of debt or not, the balance of how much risk that puts on deposit accumulation and protection I think is an integral ingredient of that.

Chairman SARBANES. Obviously, if we start examining the whole range of this, we put in the statute of the 1.25 percent figure that the FDIC is supposed to work off of. But I guess I would have to start looking at what the rationale is for that figure.

Actually, you point out, Mr. Plagge, in your statement: "As a result of failure last week, the FDIC's SAIF will reportedly lose $500 million, 5 percent of the total in the fund. A loss that size would reduce the SAIF's reserve ratio from 1.43 percent of insured deposits to 1.36 percent." Now that means that just two more failures of this magnitude would bring that deposit fund below the 1.25 percent, and would then kick in a mandated 23 basis point premium on all institutions in the fund.

People are seeking not to have that fall off the cliff, so they do not want the automatic mandatory premium when you go below 1.25 percent. And of course, one argument made for that is you may well be going below the 1.25 percent because of worsening economic circumstances.

So, you are imposing an additional burden that is countercyclical—I mean, it is procyclical. The press is on not to do that, to do—I think you say later, a laser effect. And I think there is some argument for that. But it would seem to me that would seem to carry with it the proposition that the figure would have to be higher in good times in order to build up the fund.

You, of course, have addressed the so-called free-rider, people that are sweeping in the deposits, and I think that is a reasonable issue to be looked at, and I am appreciative of that.

But again, what is the magic of the 1.25 percent? Maybe that is not an adequate figure, particularly if we are going to raise the amount of coverage.

This thing can erode very quickly. And those of us who went through the S&L's are still scarred by the experience. We ran out of the fund. It was all gone. In the end, there was, what, $160 billion? I forget the figure. The figure was so enormous, I have forgotten how much it was. What is the response on that point?

Mr. PLAGGE. I might comment on that. I think, especially in particular to the failure last week, there is a little bit of an issue of what caused the failure and is it a bigger-picture issue going on or is it more like a Keystone issue, where there was particular issues with an institution?

Chairman SARBANES. Well, we are going to look at that. And of course, they were very heavy into high-risk lending and so forth.

Mr. PLAGGE. I think the other thing is it is always important to remember that both funds have the ability to set aside another fund within the fund for reserves. And from what I understand, approximately $250 million had already been reserved in the subfund for that particular failure.

Time will tell us what the actual loss is. I think the percent I have heard in the past over historical purposes is approximately 13 percent is the average loss. Now if you get into unusual situations like this one or Keystone where there are other issues going on, obviously, that percent can change.

But the 1.25 percent, for whatever reason they came to that number, whether it was historical discussion at that time or long-term discussion, that is up for debate, obviously.

The fact remains that we are almost 1.37 percent today. So even the 1.25 percent, which was considered the right number back in previous discussions, we have exceeded that now and it appears that, based on past failures, for instance, the Keystone case, the numbers were large as a percentage as well. But, again, it was an individual situation and there hasn't been a lot of follow-up behind it. We hope that is the case in this S&L failure as well.

Chairman SARBANES. Mr. Chairman, I see my time is up. I would just close with this observation.

If you increase the amount of coverage, you obviously increase the extent to which you are placed at risk, ultimately the taxpayer. It seems to me that then raises the question of what is a proper

figure for the fund, particularly if we are going to move in the direction of not replenishing the fund quickly if it drops below whatever the established level is.

So if you do not replenish it on the downside—or replenish it more slowly, I guess—it raises a question of whether you have to boost it more to have more of a margin to absorb these losses.

Now, we have been through a pretty good period in terms of failures and so forth. And so that tends to shape your thinking. But the system is not in a sense there for the good times. The system is there for the bad times. Therefore, we have to be thinking in those terms.

Mr. Chairman, thank you and I want to thank the panel.

Senator JOHNSON. Thank you, Chairman Sarbanes.

Senator Bennett.

Senator BENNETT. Thank you very much, Mr. Chairman.

Let me do what you are not supposed to do—ask a question to which I do not know the answer.

What happens to the extra money? Are we setting up another Social Security trust fund here where the money is beyond the 1.25 percent level or whenever it gets invested and earns interest, the money that is not needed to run the FDIC? Does it just go into the Treasury Department? Does anybody know?

Mr. HAGE. It stays in the insurance fund, Senator.

Senator BENNETT. What is it invested in?

Mr. HAGE. I do not know the investment portfolio. But that, I believe, is under the administration of FDIC.

Senator BENNETT. I understand that it stays in the portfolio. But what is it invested in? Is it invested in Government bonds?

Mr. HAGE. We believe, yes.

Senator BENNETT. So from a cashflow standpoint, just like Social Security, if you have a big run on the fund and people present those bonds for payment, the Government has to come up with the cash from some place else to pay off those bonds.

Mr. HAGE. Those bonds would have to be sold in a marketplace environment. They would not be called by the FDIC against the Government.

Senator BENNETT. I understand that.

Mr. PLAGGE. I guess I might add that it actually gets kind of to the heart of some of the concerns of our bank members. It is really the question of what doesn't happen to it? Do we keep building the fund up over and above and it takes money out of my institution in Iowa, it takes money out of other banks around the country, especially in rural areas where liquidity is already tight and loan to deposit ratios are high? How much do we keep putting into a fund that appears to be, by all accounts, very safe and sound and meeting the needs of the insurance fund itself?

Senator BENNETT. If it becomes too tempting because the Government gets the revenue by selling the bonds, it becomes almost a form of taxation to fund other governmental programs. And we love that around here. But we are not sure that is the thing that ought to be.

Mr. Plagge, institutions get rated as 1–A and therefore, they do not have to pay anything into this fund. So in a very real sense, that rating is worth something financially.

Mr. PLAGGE. Yes.

Senator BENNETT. And you are at the mercy of the bank examiner as to whether you get rated or not rated. So that just raises the question of how objective is the bank examiner? Do you feel good about the process that says, okay, this bank doesn't have to pay and this bank does? Or do you have some problems with it?

Mr. PLAGGE. Well, we have concerns, as you look at some of the recommendations in the FDIC proposal of changing the assessment system and changing the rating system. We are a national bank. Both of our banks are national banks, so I strictly deal with OCC. But I have been in a State bank before where I have had FDIC and State regulators.

I like the system the way we have it. I think, again, congratulations to the designers. It has worked. It has put 92 percent of the banks in the top category. I look at that as a good thing.

The incentive has been to be in the top-rated, well-capitalized category, which is exactly where you want banks in any economic downturn. It puts more capital behind the whole system, let alone the $42 billion that is sitting in the fund. You have the $600 plus billion that is sitting behind it in bank capital. I think the more you try to break that down, when I see the assessment, the proposal where it is 1–A plus, 1–A, 1–A minus, 1–B, 1–C, and then going down the ladder into the other categories, the subjectivity of that is somewhat dazzling.

Bank regulators, and we have always had a good relationship with our bank regulators, but they do have a lot of discretion. There is a lot of subjectivity in that system, whether it is on the overall rating or the individual ratings that make that up.

I guess I have not seen anything broke with the current system that would dictate to me or suggest to me that we need to keep breaking that down even further.

So, I think it trends into areas that would put, quite honestly, a lot more pressure on the individual field examiners, let alone the systems themselves. Again, I do not see that the system has broken down in any fashion that would suggest we need to go that route.

Senator BENNETT. I see. Thank you. One final question.

You all talked about the free-riders, and nobody likes a free-rider. But at the same time, the institutions that pay no premiums, pay no premiums because they fall into the safest risk category. And you just talked about the process by which a bank gets into the safest-risk category. Should we change the category in order to pick up the free-riders? Or are you saying that there should be an entry fee to get into this business regardless of how safe you are?

Free-rider is almost a pejorative—it is a pejorative term. And it may very well be an earned pejorative term. But when you look at it from the standpoint of, well, the safest banks now do not pay anything, how do you specifically propose that these institutions coming in that are very, very safe should pay something? What should the ticket to the dance be, or how should it be structured in your view, any of you?

Mr. HAGE. Senator Bennett, I would suggest to you that free-rider, as we would define it in our terminology, means those institutions that have paid no premium in the past, yet are dumping huge sums of deposit money into the insurance fund.

Senator BENNETT. I understand that. But they come in dumping this into the fund, as you say, and they have very, very safe capitalization.

Mr. HAGE. Yes. And what I was about to say is that, going forward, I do not think any of us are proposing that there would be a category of membership or participation in the fund that would pay no premium, but that there would appropriately be categories or grades of premium paid based on the risk profile of individual institutions. That risk profile or grading would be determined by FDIC as a result of their examination process.

What is happened today in banking that is relatively new is that balance sheets can today be constructed with different risk profiles more in a broader range of business plans that have perhaps historically been true.

You asked about the impact of regulation and examination. I think regulators have grown in their sophistication of being able to understand these instruments as have managements of banks.

It is really critical that management in a bank understand the risk profile that they are taking on into a balance sheet. That risk profile is the investments and the loans that a bank makes. That is where the risks come from, not the deposit.

When we talk about deposit insurance, we have to be careful that we understand that difference. By and of itself, the amount of a deposit in a bank has meaning only as the basis for what we are insuring. But it is separated from the risk profile of the bank, which is driven by the assets it has. So it is really important that we measure the risk of the use of the deposits and have a premium that reflects that risk on an ongoing basis.

That underscores what we are talking about in terms of the need for flexibility. Over time, as, cumulatively, bank balance sheets would change, the FDIC should have some flexibility to determine whether 1.25 percent or some other number is the right minimum threshold for coverage. And if we gave that flexibility, theoretically, any way, there would be an opportunity to adjust premiums that would be less dramatic than the all-or-nothing base that we have today, all of 23 basis points or zero.

That is really the hard-core, not-working part of the premium structure today. It is the all-or-nothing idea.

But the notion of having the ability over time to adjust the appropriate level of reserve ratio to be able to accelerate that in reasonable time frames, to be able to have a mix of premium assessments based on risk profiles of institutional members makes for a much healthier, stronger system.

Senator BENNETT. Thank you.

Chairman SARBANES. The FDIC, as I understand it, at least is proposing indirectly to address this issue by providing rebates that would be based on what you had paid into the fund. So that at least if you are an institution, over time, the very point you were making earlier, as I understood it, which had paid into the fund, you would get a rebate, and if you were an institution that had not paid into the fund, you would not get a rebate.

Now that is addressing it at the other end, so to speak. But I think it did reflect some sensitivity on their part.

Mr. Chairman, can I ask one question?

Senator JOHNSON. Yes, Chairman Sarbanes.

Chairman SARBANES. I am interested in the fact that 92 percent of the institutions are well-capitalized. Now, if you heard about a teacher who was giving 92 percent of the students in her class an A, presumably, you would say, I do not know about that marking system. I am not sure exactly what standard the teacher is using.

Senator BENNETT. Pretty smart class.

Chairman SARBANES. Yes. She needs to make more differentiations. I take it that is what the FDIC is perhaps searching to do on this risk-based approach. So that you wouldn't have all but 8 percent that passed the post, so to speak, and were in the same risk category.

Mr. PLAGGE. I understand that as well. The incentive has been placed where the regulation wants banks to be, and that is in the well-capitalized area.

Breaking that down to the level that is being discussed, where I looked at one chart where the potential premium charge for, I think it was a 1–C bank, which is still in the well-capitalized area, would essentially be the same as the premium requirement for one that was in the low category. It would be the 3–A category.

It seems to me that the risk to the system is certainly much better protected when you still have that well-capitalized bank.

Again, to try to break that down and micromanage that at the kind of levels that are being discussed to me, becomes very, very subjective. And I think we should look at the positive side of that and the fact again that the system was designed in a fashion that has moved banks to be exactly where regulators hoped they would be in the well-capitalized category.

Especially as we look at times like today, especially in agriculture and so forth, in the part of the country where we live.

It is good that banks are in that category. It does give them the ability to stand the risk of a downturn and so forth, long before the insurance fund would ever be tapped.

Chairman SARBANES. Mr. Chairman, thank you again for the hearing. This has been a very thoughtful panel and we appreciate their testimony very much.

I am not sure how far the statement that the system is working gets us because you are talking about making changes in the system. Therefore, we have to consider what the consequences of those changes should be. Again, I repeat the fact that we are at the end of an extremely good economic period. We haven't gone through the stress and strain that we would experience in more difficult economic circumstances. And that is what we have to evaluate because that is why all these protections have been set up, to be able to carry us through such a period.

But thank you very much and I very much appreciate the thoughtfulness that is reflected in your statements and in your responses at the table.

Senator JOHNSON. Thank you, Mr. Chairman.

It is my ongoing effort to try to find consensus wherever we can find it. I have a couple of questions I want to ask.

Let me start by asking the entire panel, from what I understand from your testimony today, you all appear to support a significant increase in coverage for retirement accounts, which, as you note,

are likely to exceed $100,000 in fairly short order and fairly commonly. Is it fair to say, at least on this panel, that there is an industry consensus that we should consider a significant increase on retirement accounts independent of any disagreements that we might have about a general coverage increase?

Mr. Plagge.

Mr. PLAGGE. We actually haven't centered in on that. The one concern that seemed to be expressed about increasing insurance in general is the fact that it would attract hot money, and relating back to the comments that were made during the S&L crisis.

I think the reason that bankers have talked about, well, at least let's look at the retirement funding, is because it falls out of that category of hot money. It is stable funding for banks and so forth.

So as you look at the different areas where insurance could be increased, whether it is municipal deposits or just insurance in general, or IRA's and retirement funds, it seems to be the one category that kind of deals directly with the hot money, concern that resulted from the S&L crisis.

Senator JOHNSON. Mr. Hage.

Mr. HAGE. Senator Johnson, I think that when you look at the public policy directions that are articulated increasingly today where citizens of this country are asked and encouraged to be prepared to carry a larger amount of their retirement well-being, increasing deposit insurance coverage to those retirement accounts makes all the sense in the world. It supports that philosophy.

The critical thing about when you reach the age of retirement, I am told, although I am getting close, is that your tolerance for risk, because you cannot replace funds lost, goes down.

I think we need to recognize that in the nature of how we encourage people to accumulate wealth and how we allow them to protect its value. It makes a lot of sense to increase coverage specifically for retirement type of instruments to encourage people to add to that saving. That also provides a stable base of funding for community banks to continue to play the important role of providing growth through lending in our local communities.

Senator JOHNSON. Mr. Gulledge, of course, ICBA supports a generalized increase and catch-up with inflation. I would assume that, obviously, a retirement component would be something that you would support in the context of a larger comprehensive increase.

Let me ask you, Mr. Gulledge, obviously, we do have a bit less consensus on this issue than on some of the others in FDIC reform. And we have heard some observe that increasing the level from $100,000 to $200,000 would create the potential for a moral hazard of the kind last seen in the banking system during the savings and loan crisis of the 1980's.

The Fed and the Treasury, among others, have expressed to this point adamant opposition to the concept of doubling because of the risk issue. I wonder if you would share your observations on that point.

Mr. GULLEDGE. Well, we do not agree that this would have a great effect on the moral hazard issue. We feel that, for the increase and the doubling of coverage under the provisions of your bill for individual coverage, we think that consolidation is bringing

about, is creating more risk to the FDIC fund than would be on an individual raising of the coverages.

Senator JOHNSON. I appreciate your observation on that, Mr. Gulledge.

In the brief amount of time that I have left on the clock for myself, let me ask Mr. Hage, because of your experience with the Federal Home Loan Bank System, the Treasury has suggested that Federal Home Loan Bank advances and other secured capital be considered in the deposit insurance assessment base. The FDIC's report said that a bank's reliance on noncore funding, which may include these advances, should be considered risky. How would you respond to those recommendations?

Mr. HAGE. I would oppose the inclusion of the Federal Home Loan Bank advances as a part of the deposit insurance premium base. Federal Home Loan Bank advances are an alternative source of funding. They are fully collateralized by other collateral that we offer to offset that. They provide no risk to a consumer and there is no direct benefit to a consumer. To include Federal Home Loan Bank deposits would increase the cost of bank funding without any economic value whatsoever.

So, to me, there is no correlation at all to including the Federal Home Loan Bank advances with the deposit premium.

Senator JOHNSON. There is agreement from the ABA, Mr. Plagge.

Mr. PLAGGE. Yes. I can speak to a little different path on that.

As you know, in your State, and at least in Iowa, community banks are using the Federal Home Loan Bank System pretty readily. With the new advances allowed for ag and small business loans, it has become an important source of funding for us.

We just went through a regulatory exam in the last 4 or 5 months. I think the thing to keep in mind on that is the examiners already take that into account. As they look at our liquidity, as they look at our balance sheet, as they look at all the things that they look over when they do an exam, they take that into account in how we are structuring our balance sheet and how we are structuring our organization.

And so, I would hope and caution against that kind of stuff being taken to equation because I think it really would have a pretty exasperating impact on community banks.

Senator JOHNSON. Mr. Gulledge, are you in concurrence?

Mr. GULLEDGE. First of all, I would like to say that we appreciate very much the expansion of the membership in the Federal Home Loan Bank System because it has been very meaningful to the community banks in our country. It has helped in the liquidity problems that we do have. And it is also true that the regulatory agencies are warning us about over-use of advances from the Federal Home Loan Bank. And we understand some of this warning because the rates are higher. It is creating a shrinking of net interest margins.

But we feel that the cure for that and the need for using these lines is increased coverage so that we will have the liquidity that we need and we do not have to go to the Home Loan Bank for these advances.

Senator JOHNSON. Thank you. My time is expired.

Senator Reed.

COMMENTS OF SENATOR JACK REED

Senator REED. Thank you very much, Mr. Chairman.

Let me first commend you and the Ranking Member for holding this hearing and beginning the careful deliberation about deposit insurance reform. It has been an issue, as Senator Bennett said, that has been with us for a long, long time. We hope, with your leadership, that we can move forward and reach some type of satisfactory conclusion.

Let me also thank the witnesses for their excellent testimony.

I would just like to address initially a general question to all the panelists. You have had the occasion to look at the FDIC's proposals for reform. Is there any major element that they have neglected to leave out that you would suggest in terms of issues that should be considered in a comprehensive reform package by the Senate?

Mr. Hage.

Mr. HAGE. Senator Reed, as I have read that, I think it is a very well-written report and reflects a lot of good, thorough study on the part of the FDIC staff. I do not have anything excluded that I would want to be included.

On behalf of ACB's position, I would remind you that we think that the three points of our position of getting those things done urgently and quickly are important, not as an alternative of no additional reform, but simply get those done first, they are right now urgent, continue the debate and the dialogue on the rest of the proposal, and then enact it appropriately.

Senator REED. Again, without pinning you down to an hour and a day, how fast do you feel that this should be done in terms of the continued soundness and safety of the banking system? And if you say yesterday, I will understand.

[Laughter.]

Mr. HAGE. Well, since we all have a lot of money invested in terms of prepaid premiums, yesterday would be a little sooner——

Senator REED. I have been listening to this discussion and I am going to call my insurance agent because I believe I have lots of prepaid premiums, also.

[Laughter.]

I have been behaving reasonably safely for years now.

[Laughter.]

But I appreciate your point.

Mr. HAGE. Senator Reed, they are only charging you a year in advance. This is a multiyear prepayment.

Senator REED. All right.

[Laughter.]

Mr. Plagge.

Mr. PLAGGE. We agree as well. I think the FDIC has presented a very good package. Obviously, we are not in agreement on all elements of it, but we feel it is good to have all those elements on the table.

The only thing that we think maybe has been left out is giving more of an independent nature to the FDIC board going back to the three independent seats to make sure that there is continuity through transition of parties and so forth. But, otherwise, we agree

that they have done a comprehensive look at things and hopefully, we can find those areas that we can agree on.

Senator REED. Thank you very much.

Mr. Gulledge.

Mr. GULLEDGE. We too feel that the FDIC proposals were good. They were well thought-out, very thoroughly put together. They established five areas or five points for consideration. We believe that all of those are important.

Former FDIC Chairman Tanoue, I believe in her testimony previously, has stated, and the report indicates that it is not felt that there should be a separation or a segregation of any of those points. For comprehensive coverage, all of those should be taken into consideration.

Senator REED. Thank you very much. The final point—related to the size of the fund and the size of premiums is the effectiveness of regulation. If we do not have effective regulation, then we are going to need a lot of money in that fund because we would be paying lots of failed institutions.

And so I would just ask for your comments with respect to your sense of, at this juncture, the adequacy of the regulation, the resources available for regulators, because I think that is inextricably bound up in this whole discussion.

Mr. HAGE. Senator Reed, I think you are on to a very important point. Effective regulation certainly is the base upon which any system like this would ever work.

Again, observing from our personal experience, I think that the sophistication of the regulators in terms of being able to model different financial instruments, getting more savvy about management's preparedness and proactiveness in being able to model the impact of different risk profiles that they might take has improved significantly.

The system will never be 100 percent fail-safe. It is just the nature of our economy and the instruments themselves. But I think the process has gotten much better.

Senator REED. Thank you.

Mr. Plagge.

Mr. PLAGGE. I agree with that as well. Again, we are a national bank and we have gone through recent exams. In fact, I would say the safety and soundness portion of the exams have stepped up, which I consider positive. I think it is back to the basics.

The other thing that I would point out is that the regulators have so much more authority to take actions than they used to have, which I think makes the fund safer by its own nature. And so, I feel good about the exam process that we currently have.

Senator REED. Mr. Gulledge.

Mr. GULLEDGE. Well, I am examined by the FDIC and I think the FDIC is doing a very adequate job of examination. I hear no complaint of that. I have no complaint of their assessment ratings, the CAMEL ratings of the bank.

They are, however, saying that the current system is such that they have some difficulty. And this goes back I think to the question earlier on the 92 percent of the banks that pay no premiums.

I believe it was not because of the capital, it was because of the CAMEL ratings that exists. So that speaks to the strength of the industry.

As relates to the capital, however, there is a requirement under FDICIA that banks remain at certain capital levels, and I think that speaks to those levels that we have today.

Senator REED. Thank you very much.

Thank you, Mr. Chairman.

Senator JOHNSON. Thank you, Senator Reed.

Senator Miller.

COMMENTS OF SENATOR ZEL MILLER

Senator MILLER. First, I apologize for not being here at the beginning of this hearing. I was presiding in the Senate. And I also apologize if I am asking you something which you have already covered.

I am curious about how you feel about this. Mr. Powell indicated that perhaps all the FDIC-proposed reforms did not have to be all in one package. I would like to know what any of you think would be a must-have in the bill if you were making it up, and what needs to be done most immediately.

Mr. PLAGGE. If it is okay, I will start with that.

Senator MILLER. All right.

Mr. PLAGGE. Actually one of our concerns is that if it is not a comprehensive approach, maybe one or two things happen and then the rest of it is never visited again. And so, we really feel that it is the time. It is good public policy time. The fund is strong. It is a great time to look at the whole package.

Obviously, there is a lot of things in that package, in the comprehensive bill, and we understand fully that something may come out as a result of these discussions, that it probably won't include everything. But we will have to look at that at that particular time.

I guess we do caution that one or two things should not be picked out of that and run through, with the rest of them set aside for a later date, that unfortunately, may never come. We want to see the comprehensive discussion, even if it goes on longer and takes longer to reach consensus.

Senator MILLER. Do you feel the same way, Mr. Gulledge?

Mr. GULLEDGE. I surely do. I think that the FDIC comes with a very good report and our association and our membership is very supportive of all the provisions of that report.

We think it is also important to look at the whole package while this is being done at this time. Frankly, we hope that Mr. Powell will get a better view of this after he has come on board and has been at the helm of the corporation for a period of time.

Senator MILLER. Mr. Hage.

Mr. HAGE. Senator Miller, ACB agrees with Mr. Powell, they do not all have to be looked at at once. But I think, eventually, they all should be looked at.

From my opening remarks, the first importance to us is the merger of the BIF–SAIF funds. We think that ought to be done immediately. Second, give the FDIC appropriate flexibility to set the correct premium levels in balance with the coverage ratio, so that can be corrected on a smooth basis rather than a catastrophic, all-

or-nothing basis. Third, allow for the special premiums for the free-riders to rebalance and reset the appropriate funding for the deposits that have come into the system.

Senator MILLER. Thank you very much.

Senator JOHNSON. Senator Bennett, anything further?

Senator BENNETT. No, Senator.

Senator JOHNSON. Well, let me thank the panel again for what I think has been excellent testimony. We have had good participation on the part of the Subcommittee as well. I am appreciative of Senators Gramm and Sarbanes joining us for this, and obviously, Senator Bennett's good work with me on the Subcommittee.

We want to continue to move this issue forward. And as was noted in Senator Miller's last line of questioning, I acknowledge that it may be that we cannot find consensus on every single issue here. But, on the other hand, I think it is important that we begin this debate as comprehensively as possible and recognize that a balanced meal involves both the spinach and the dessert, and that some of that is part of reality.

We will see what components we can move ahead with. But I do want to see us work in conjunction with Representative Bachus on the House side, with whom I met yesterday. I would like to see what we can do to find bicameral and bipartisan consensus on these issues. I think that our panel has contributed very significantly to our progress in that regard and again, I thank you for your participation.

The Subcommittee hearing is adjourned.

[Whereupon, at 11:40 a.m., the hearing was adjourned.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR TIM JOHNSON

Good morning. I am pleased to convene the first meeting of the Financial Institutions Subcommittee of my Chairmanship on a topic that has been of great interest to me for many years. Federal deposit insurance is one of the cornerstones of our banking and financial system. This insurance helps give depositors the confidence they need to participate in America's financial institutions. Since I began service in Congress in 1987, we have seen some real ups and downs in the banking industry, and it is a great privilege today to chair a hearing on a matter of such importance to our Nation's bankers, and indeed to our Nation as a whole.

I would first like to recognize Ranking Member Bennett, and thank him for his participation at today's hearing. It is a great pleasure to work with Senator Bennett on banking issues. He has a very distinguished business background, and I value his insights. I would also like to recognize Chairman Sarbanes, who conducts all his hearings with such dignity and thought. I hope I can live up to the high standards that he sets for the Senate Banking Committee.

As everyone in this room knows, or will surely find out in short order, comprehensive deposit insurance reform is enormously complex. I will resist the opportunity to recite a history of banking reform, and steer clear of too many statistics—at least until the question and answer period. While the body of literature on deposit insurance is vast, I would note that there appears to be more consensus than disagreement on potential reforms.

At today's hearing, industry will respond to the FDIC's recommendations for comprehensive reform of the Federal Deposit Insurance System. The FDIC, in my view, has identified some significant weaknesses in the current system.

In particular, it is hard to argue with the FDIC's observation that the current system is procyclical: that is, in good times, when the funds are above the designated reserve ratio of 1.25 percent, 92 percent of the industry pays nothing for coverage; but in bad times, institutions could be hit with potentially crushing premiums of up to 23 basis points. I think most industry members agree that this so-called "hard target" presents a real threat to their businesses.

Of course, this means that any movement in the funds down toward 1.25 increases the anxiety level of bankers and regulators alike, whether that movement comes from fast growth of certain institutions, or from institutional failures like we saw last Friday in the case of Superior Bank of Illinois. The numbers are still preliminary, but cost estimates of the failure start at $500 million, which could reduce the SAIF ration by seven basis points. I say this not to be alarmist. But I would urge caution against becoming complacent in good times, and resisting changes that simply make sense over the long term and have the potential to enhance the stability of our system.

I am particularly interested in hearing from the witnesses about their positions on premiums. I would note that there is *unanimity* among the Federal banking regulators that institutions should pay regular deposit insurance premiums, though not with respect to how we should determine those premiums.

Now, I understand that 92 percent of the industry is free from current premium payments, and it certainly presents an interesting psychological and political challenge to persuade folks to pay for something they currently get for free. On the other hand, I am not the first to note that very few things in life are, in fact, free. If you are getting something of value, eventually you have to pay for it. The question is not whether you will have to pay up; it is when and how much.

I am also interested in hearing comments about the erosion in value of deposit insurance. My position is well known: I believe we need to increase, and index, coverage levels. Over the last 20 years, coverage values have decreased by more than half, and previous increases were unpredictable both in terms of amount and timing. I expect to hear a spirited debate on this topic, and believe it should be included in any discussion of comprehensive reform.

I would urge everyone involved in this debate to take a step back and recognize that when we talk about deposit insurance, we are talking about the foundation of our financial system. It is simply irresponsible to take a short-term approach, or to politicize the issues. And while I am open to persuasion on just about any component of reform, I am firm in my belief that we all share the common goal of a safe and sound banking system.

As many of you know, I am committed to ensuring that our small banks and thrifts—which play such an important role in States like South Dakota—have the tools they need to survive. I am also well aware of the value that our larger banks, thrifts and bank holding companies bring to this country. I believe my strong support of financial modernization speaks for itself, and would simply add that I am

committed to finding a reform package that considers the needs and interests of all members of our financial services community.

Now some might argue that it will be impossible to craft changes to our deposit insurance system that will bring all the interested parties together. I reject this argument. First, every single bank and thrift in this country benefits from our world-class deposit insurance system, and it is in everyone's interest to find an acceptable set of changes. Second, I believe that our witnesses will tell us that the industry is, in fact, close together on many of the core reform issues. Finally, the regulators themselves have said they are approaching consensus on many issues. I am optimistic that we will be able to develop a sound comprehensive reform policy.

I would like to hear what my colleagues and our witnesses have to say, and would invite Ranking Member Bennett to make an opening statement.

PREPARED STATEMENT OF SENATOR PAUL S. SARBANES

I thank Senator Johnson, Chairman of the Financial Institutions Subcommittee, for holding this morning's hearing on the important subject of possible Federal Deposit Insurance System reform. Any reform effort will demand a thorough analysis of the issues and today's hearing contributes to that effort.

On April 5, 2001, the FDIC published a report on reforming the deposit insurance system. The FDIC recommended:

- *Merging the Bank Insurance Fund (BIF) and Savings Association Insurance Fund (SAIF)* to reduce risk.
- *Charging insurance premiums based on an institution's risk* to its insurance fund, or "risk-based premiums."
- *Shifting from a fixed reserve ratio of 1.25 percent of insured deposits to a target range of reserve ratios* to give FDIC flexibility and to eliminate sharp swings in insurance premiums.
- *Rebating* premiums based on an institution's historical contributions to an insurance fund when the fund grows above a target level.
- *Indexing deposit insurance coverage levels by the amount of inflation.*

Last week, the Treasury Department, Federal Reserve Board, Comptroller of the Currency, and the Office of Thrift Supervision announced their views on the FDIC's recommendations. They all supported merging the funds. They also supported the concept of giving the FDIC greater flexibility to allow a range of reserve ratios. The Treasury Department, Fed, and Comptroller did not support raising the amount of Federal deposit insurance coverage.

Today's hearing is particularly timely in light of last Friday's failure of a major thrift, Superior Bank, FSB, of Illinois. The failed institution is projected to be the 11th most costly loss to the insurance fund in U.S. history. Reports suggest that the failure may cost the SAIF $500 million. In addition, customers with uninsured deposits may lose over $40 million.

I am very concerned about this failure and have taken steps to inquire into its causes. I have sent letters to the Comptroller General of the United States, Inspector General of the Treasury Department, which has authority over the Office of Thrift Supervision, and the Inspector General of the FDIC and asked them to report on the reasons for the failure with recommendations for preventing future losses. I look forward to their responses.

I look forward to hearing the testimony from representatives of the banking and the thrift industries on their views of the deposit insurance system and the FDIC's recommendations.

PREPARED STATEMENT OF SENATOR JACK REED

First of all, I want to commend Senator Johnson for holding this hearing. This is a very timely issue now, particularly with the House Financial Services Committee already holding several hearings on the subject. I am pleased that the Senate Banking Committee, within the appropriate Subcommittee, now has an opportunity to discuss the issue from our own perspective. I also understand from Senator Johnson that he intends to hold several hearings on this topic once Congress has returned from the August recess.

Second, I want to thank all of the witnesses who are appearing before us this morning. I know that this is an important issue to all of you, and for those that

you represent, so we are appreciative of your time and work in this effort, in order to better explain your positions to us at this time.

Third, I want to just briefly speak of my feelings toward deposit insurance reform, and the importance I believe it holds in the context of this Committee's attention, and possible future action.

The FDIC's Options Paper that it produced in April provides much sound advice on how Congress should proceed with reforming our deposit insurance system. Most importantly I think, it needs to be done sooner rather than later, and I certainly commend former FDIC Chairwoman Donna Tanoue for having the foresight to work on this issue and produce such a worthy product for discussion.

It has been said many times before by others, including the distinguished Chairman of the Subcommittee, that the current system is procyclical and will harm the banks it seeks to assist by charging higher premiums during more difficult economic times. Therefore, it seems to behoove us to work together to enact a system that will have the opposite effect. In other words, we should change the system now during strong and healthy economic times, by potentially charging minimal premiums to institutions, based on their risk of course, and lessening the burden in the leaner years.

Obviously, there are many complicated issues inherent in taking on a matter as complex as our deposit insurance system, and there are many different sides to the issue as well. That is why I am pleased that we are able to hear today from the major banking trade associations, and that we will hear from other interested parties in the weeks to come. I also look forward to working with Senator Johnson and others on the Committee on deposit insurance reform legislation in the near future. We have a long road and task ahead of us, but I am confident that we will produce thoughtful and comprehensive legislation at the end of the day.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

I want to thank Subcommittee Chairman Tim Johnson for holding this important hearing. I am a cosponsor of his legislation to index deposit insurance and I look forward to working on this and on the broader issue of deposit insurance reform. I think we have some excellent witnesses here today and I am looking forward to their testimony.

PREPARED STATEMENT OF ROBERT I. GULLEDGE

CHAIRMAN, PRESIDENT & CHIEF EXECUTIVE OFFICER
CITIZENS BANK, INC., ROBERTSDALE, ALABAMA
CHAIRMAN OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA
ON BEHALF OF THE
INDEPENDENT COMMUNITY BANKERS OF AMERICA

AUGUST 2, 2001

Good morning, Chairman Johnson, Ranking Member Bennett, and Members of the Subcommittee. My name is Robert I. Gulledge, and I am Chairman, President, and CEO of Citizens Bank, a community bank with $75 million in assets, located in Robertsdale, Alabama. I also serve as Chairman of the Independent Community Bankers of America (ICBA)[1] on whose behalf I appear today. Thank you for this opportunity to testify on the very important issue of deposit insurance reform.

I want to commend you, Chairman Johnson, for scheduling this hearing and giving this matter priority attention. Deposit insurance is of enormous importance to community banks and their customers—and to the safety and the soundness of our financial system.

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[1] ICBA is the primary voice for the Nation's community banks, representing 5,000 institutions at nearly 17,000 locations nationwide. Community banks are independently owned and operated and are characterized by attention to customer service, lower fees and small business, agricultural and consumer lending. ICBA's members hold more than $486 billion in insured deposits, $592 billion in assets and more than $355 billion in loans for consumers, small businesses, and farms. They employ nearly 239,000 citizens in the communities they serve. For more information, visit *www.icba.org.*

Few would dispute that Federal deposit insurance has been an enormously successful program, enhancing financial and macroeconomic stability by providing the foundation for public confidence in our banking and financial system. It has done what it was established to do—it has prevented bank runs and panics, and reduced the number of bank failures. Even at the height of the S&L crisis, there was no panic or loss of confidence in our financial system. The financial system and our economy are stronger and less volatile because of Federal deposit insurance.

But it has now been more than 10 years since the last systematic Congressional review of our deposit insurance system, and it should be modernized and strengthened. In the past two decades since deposit insurance levels were last increased, inflation has ravaged the value of this coverage. Inflation has eroded the real level of deposit insurance coverage to less than half what it was in 1980. The less deposit insurance is really worth due to inflation erosion, the less confidence Americans will have in the protection of their money, and the soundness of the financial system will be diminished. Rejecting an inflation adjustment to deposit insurance levels, as the Federal Reserve and Treasury Department did in testimony last week before a Subcommittee of the House Financial Services Committee, is a prescription for weakening a vital and successful U.S. Government program.

The deposit insurance system currently remains strong, the industry is strong and the overwhelming majority of institutions are healthy, but as the FDIC states in its report *"Keeping the Promise: Recommendations for Deposit Insurance Reform"* (FDIC Report), there are emerging problems and room for improvement.

Now while we can do it in a noncrisis atmosphere, is the time to consider comprehensive improvements to enhance the safety and the soundness of our Federal Deposit Insurance System and ensure that the effectiveness of this key element of the safety net is not undermined.

Emerging Issues

The major deposit insurance reform issues that have emerged and should be addressed in a comprehensive legislative package include:

- Preserving the value of FDIC protection and coverage for the future by substantially increasing coverage levels and indexing these new base levels for inflation.
- Establishing a pricing structure so that rapidly growing "free-riders" pay their fair share into the deposit insurance funds (these free-riders like Merrill Lynch and Salomon Smith Barney have also used multiple charters to offer coverage levels well beyond the reach of community banks).
- Smoothing out premiums to avoid wild swings caused by the hard target reserve ratio (so banks do not pay unreasonably high premiums when they and the economy can least afford it).
- Providing appropriate rebates of excess fund reserves.

These issues, plus others addressed in the FDIC Report, are discussed below.

Deposit Insurance Coverage Has Been Eroded By Inflation and Should Be Increased and Indexed for Inflation to Maintain Its Real Value

For community bankers, the issue of increased deposit insurance coverage has been front and center in the deposit insurance reform debate. More coverage would benefit their communities, and their consumer and small business customers. It would help address the funding challenges and competitive inequities faced by community banks and ensure that they have lendable funds to support credit needs and economic development in their communities. For community bankers, any reform package will fall far short if it does not include a substantial increase in coverage levels and indexation.

The ICBA strongly supports legislation introduced by Chairman Johnson and Representative Joel Hefley (R–CO) to raise Federal deposit insurance coverage levels. Both bills (S. 128 and H.R. 746) would increase FDIC coverage levels to around $200,000 and provide for automatic inflation adjustments (based on an IRS index) every 3 years rounded up to the nearest thousand dollars. Both bills have garnered substantial bipartisan support. Thirteen Senators are on the Johnson bill, 7 Democrats and 6 Republicans. Sixty-six Representatives have signed onto the Hefley bill, including 28 Democrats, 37 Republicans, and one Independent.

Coverage Levels Ravaged By Inflation

The general level of income, prices, and wealth in the United States has been steadily increasing for decades. As a consequence, inflation is severely eroding the value of FDIC protection. The current deposit insurance limit is economically inadequate and unacceptable for today's savings needs, particularly growing retirement savings needs as the baby-boomer generation reaches retirement age.

The real value of $100,000 coverage is only about half what it was in 1980 when it was last increased. *Chart 1,* which is attached, shows that simply adjusting for inflation, the $100,000 limit set in 1980 represents only $46,564 in coverage today. Worse yet, as *Table 1* shows, today's deposit insurance limit in real terms is worth $20,000 *less* than it was in 1974 when the deposit insurance limit was doubled to $40,000.

Looked at another way, in 1934, when Federal deposit insurance was established, the coverage level was 10 times per capita annual income. Today, it is only four times per capita income. During the last two decades, while deposit insurance levels remained unchanged, financial asset holdings of American households have quadrupled, from $6.6 trillion in 1980 to $30 trillion in 1999.

Deposit insurance coverage levels have been increased six times since the program was created in 1934. But the increases have been made on an ad hoc basis with no predictability either on timing or the size of the increase. We need to first adjust coverage levels not touched in 20 years and move away from ad hoc increases to a system that is predictable and grows automatically with inflation.

The ICBA strongly supports the FDIC proposal to increase coverage levels to make up for inflation's devaluing effects by automatically adjusting the levels based on the Consumer Price Index. Using 1980 as the base year would raise coverage levels to nearly $200,000 (see *Chart 2* attached); using 1974 as the base year—the year coverage levels were raised to $40,000—and would boost coverage to around $137,000 today.

Gallup Poll Shows Consumers Want Increase

A recent survey conducted by The Gallup Organization[2] on behalf of the FDIC revealed that Federal deposit insurance coverage is a "significant factor" in investment decisions, especially to more risk-averse consumers and those making decisions in older and less affluent households. Fifty-seven percent of respondents said deposit insurance is "very important" in determining where to invest.

Six in ten respondents said they would be likely to put more of their household's money into insured bank deposits if the coverage level of deposit insurance were raised. Six in ten said they would move their money into insured accounts as they neared retirement age or during a recession. The survey also showed that one in eight households keep more than $100,000 in the bank, and about one-third of all households reported having more than $100,000 in the bank at one time or another.

Importantly, the Gallup survey indicated that nearly four out of five (77 percent) respondents thought deposit insurance coverage should keep pace with inflation.

Small Business Customers Support Increase

Small businesses are key customers of the community banks, which in turn are premier providers of credit to these businesses. A recent study commissioned by the American Bankers Association (ABA)[3] found that half of small business owners think the current level of deposit insurance coverage is too low. When asked what actions they would take if coverage were doubled, 42 percent said they would consolidate accounts now held in more than one bank; 25 percent would move money to smaller banks; and 27 percent would move money from other investments into banks.

Consumers and small businesses should not be forced to spread their money around to many banks to get the coverage they deserve. As more and more institutions base pricing on the entire customer relationship, consolidating accounts enables customers to reap the benefits of pricing and convenience when holding more of their financial "wallet" at one institution. For small businesses, especially, aggregating their business with one bank can enhance their banking relationship. And equally important, customers should be able to support their local banks, and local economies, with their deposits.

Increased Deposit Insurance Will Help Support Local Lending

An adequate level of deposit insurance coverage is vital to community banks' ability to attract core deposits, the funding source for their community lending activities. Many community banks face growing liquidity problems and funding pressures.

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[2] The Gallup Organization conducted telephone interviews with a randomly selected, representative sample of 1,658 adults who identified themselves as the people most knowledgeable about household finances age 18 or older, living in households with telephone service in the continental United States. The interview period ran from November 20 to December 23, 2000. The margin of error is plus or minus 3 percent.

[3] "Increasing Deposit Insurance Coverage: Implications for the Federal Insurance Funds and for Bank Deposit Balances," Mark J. Flannery, December 2000 (study was commissioned by the ABA).

It is hard to keep up with loan demand as community banks lose deposits to mutual funds, brokerage accounts, the equities markets, and "too-big-to-fail" banks.

Deposit gathering is critical to community banks' ability to lend because alternative funding sources are scarce. Due to their small size, unlike large banks, community banks have limited access to the capital markets for alternative sources of funding. As a consequence, community banks must rely more heavily on core deposit funding than large banks. To illustrate, at year end 1998, core deposits represented 72 percent of assets for banks of less than $1 billion in size, and only 43 percent of assets for banks over $1 billion.

The Federal Reserve's recent observation that small banks have enjoyed higher rates of asset growth and uninsured deposit growth than large banks misses the point. Since 1992, deposit growth has lagged the growth in bank loans by about half—hence small banks are finding it harder to meet loan demand that supports economic growth. Average loan-to-deposit ratios are at historical highs and the ratio of core deposits to assets is declining as community banks fund a growing share of their assets with noncore liabilities such as Federal Home Loan Bank advances and other more volatile, less stable sources of funds such as brokered deposits. Federal Home Loan Bank advances are not a substitute for deposits. Bankers must pay higher rates for advances and other nontraditional funding than they do for deposits, putting pressure on net interest margins. Examiners are warning community banks against over-reliance on FHLB advances and other noncore funding sources.

Some banks have seen a surge in deposit activity during the last two reported quarters. The instability of the stock market has caused some weary investors to pull out of the equities market and return to the safety and stability of banks. But most observers believe this is an aberration that may not continue when the market turns back up. Moreover, this phenomenon provides deposits to banks in a down economy when loan demand is weakened; it does not help address the need for funding when loan demand is strong.

Large complex banking organizations (LCBO's) are acknowledged as presenting greater systemic risk to our financial system.[4] The systemic risk exception to the least cost resolution requirement in FDICIA has never been tested. It is our belief, based on the historical record that LCBO's will never be allowed to fail because of this systemic risk factor. Government policy has fostered the establishment of ever-larger financial institutions further concentrating our financial system. Uninsured depositors in such institutions benefit from too-big-to-fail.[5]

The Federal Reserve spokesmen reject the notion that any bank is too-big-to-fail. The historical record, however, is to the contrary. Notably, the Secretary of the Treasury—not the Federal Reserve—has authority under FDICIA to make systemic risk determinations (after consultation with the President).

In our judgment, the issue is not that FDICIA does not require that uninsured depositors and other creditors be made whole, as the Federal Reserve testified last week, but rather that the determination of systemic risk does *permit* all uninsured depositors to be made whole—as they have been made whole during previous banking crises.

Increasing deposit insurance coverage would help level the playing field for community banks with large banks and large securities firms offering FDIC-insured products, while protecting the funding needs of Main Street America.

According to Grant Thornton's "Eighth Annual Survey of Community Bank Executives,"[6] 77 percent of community bankers favor raising the insurance coverage from its current level of $100,000 in order to make it easier to attract and retain core deposits.

Full Coverage for Public Deposits

The ICBA also supports full deposit insurance coverage for public deposits. Most States require banks to collateralize public deposits by pledging low-risk securities to protect the portion of public deposits not insured by the FDIC. This makes it harder for community banks to compete for these deposits with larger banks. Many

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[4] In a speech before the National Bureau of Economic Research Conference on January 14, 2000, Federal Reserve Board Governor Laurence H. Meyer said, *". . . the growing scale and complexity of our largest banking organizations . . . raises as never before the potential for systemic risk from a significant disruption in, let alone failure of, one of these institutions."*

[5] Thomas M. Hoenig, President of the Federal Reserve Bank of Kansas City, noted in a speech on March 25, 1999, *"To the extent that very large banks are perceived to receive governmental protection not available to other banks, they will have an advantage in attracting depositors, other customers and investors. This advantage could threaten the viability of smaller banks and distort the allocation of credit."*

[6] "The Changing Community of Banking," 2000 Seventh Annual Survey of Community Bank Executives, published by Grant Thornton LLP, March 2001.

community banks are so loaned-up that they do not have the available securities to use as collateral. And those that do have to tie up assets in lower yielding securities which could affect their profitability and their ability to compete. In addition, collateralizing public deposits takes valuable resources away from other community development and lending activities.

As the FDIC noted in its report, "Raising the coverage level on public deposits could provide banks with more latitude to invest in other assets, including loans. Higher coverage levels might also help community banks compete for public deposits and reduce administrative costs associated with securing these deposits."

Providing 100 percent coverage for public deposits would free up the investment securities used as collateral, enable community banks to offer a more competitive rate of interest in order to attract public deposits, and enable local governmental units to keep deposits in their local banks as a valuable source of funding that can be used for community lending purposes.

ICBA strongly supports legislation, S. 227 and H.R. 1899, introduced by Senator Robert Torricelli (D–NJ) and Representative Paul Gillmor (R–OH) respectively, to provide 100 percent coverage of public deposits.

Full Coverage for IRA's and Retirement Accounts

Today's retirement savings needs require a deposit insurance limit higher than $100,000. Retirement accounts are long-term investments that over time can reach relatively large balances that exceed the FDIC coverage limit. Today, accumulating $100,000 in savings for education, retirement, or long-term care needs is not a benchmark of the wealthy. With the graying of the population, safe savings opportunities are needed more than ever and an insured savings option is becoming even more crucial now that budget surpluses are reducing the supply of Treasury securities. Thus, raising the coverage level on IRA's and other long-term savings accounts could encourage depositors to invest more of these savings in insured bank deposits.

FDICIA Reforms Minimize Taxpayer Exposure

Critics of proposals to substantially increase and index coverage levels contend that the 1980 increase to $100,000 was unjustified and increased the resolution costs of the S&L crisis. Overlooked, perhaps, is the fact that the Federal Reserve Board advocated this increase at the very time its monetary policies were driving the prime rate over 20 percent to wring inflation out of the economy and Congress passed legislation deregulating interest paid on deposits. Also overlooked is the fact that the new $100,000 coverage limit helped stem depositor panic as thousands of the thrifts holding long-term, fixed-rate loans failed from the resulting severe asset liability mismatch.

Higher coverage limits will not necessarily increase exposure to the FDIC or taxpayers as some fear. A variety of factors serve to minimize any increase in exposure to the FDIC or taxpayers from bank failure losses due to an increase in deposit insurance coverage levels.

The reforms in bank failure resolutions instituted by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)—including prompt corrective action, least cost resolution, depositor preference, and a special assessment when a systemic risk determination is made—are designed to reduce losses to the FDIC.

Prompt corrective action helps ensure that swift regulatory action when a bank becomes critically undercapitalized so that losses do not increase while the bank's condition further deteriorates. Least cost resolution requires that—except in the case where the systemic risk exception is invoked—the FDIC uses the least costly method when a bank fails to meet its obligations to pay insured depositors only. And depositor preference minimizes the FDIC's losses by requiring that assets of the failed institution are first used to pay depositors, including the FDIC standing in the shoes of insured depositors, before other unsecured creditors are paid. And when a systemic risk determination is made, the FDIC must charge all banks an emergency special assessment to repay the agency's costs for the rescue.

It is ironic indeed to hear policymakers talk about the moral hazard of increasing deposit insurance coverage to account for inflation when the trend of greater and greater deposit concentration in fewer and fewer banks that are likely too-big-to-fail because of systemic risk continues.[7] The moral hazard, if any, created by inflation-indexing coverage pales in comparison to that presented by the increased number

[7] In 1980, 14,000 banks with less than $500 million in assets accounted for about 50 percent of total core deposits, and 11 banks with more than $20 billion in assets accounted for 15 percent of core deposits. By 1999, 7,800 banks with less than $500 million in assets accounted for only 20 percent of core deposits and 46 banks with more than $20 billion in assets accounted for 50 percent of core deposits.

of LCBO's whose failure could have serious adverse effects and thus trigger the systemic risk exception of FDICIA. Systemic risk presents much greater loss exposure to the FDIC, and ultimately taxpayers, than does an increase in the coverage limit.

"Free Riders" Must Pay Their Fair Share

Currently, the FDIC is restricted from charging premiums to well-capitalized, highly rated banks so long as the reserve level remains above the 1.25 percent designated reserve ratio. As a result, 92 percent of the industry currently does not pay premiums, rapidly growing institutions do not pay their fair share for deposit insurance coverage, and the more than 900 banks that were chartered within the last 5 years have never paid premiums. According to the FDIC, this system underprices risk and does not adequately differentiate among banks according to risk.

By the end of the first quarter of 2001, Merrill Lynch and Salomon Smith Barney had moved a total of $83 billion in deposits under the FDIC–BIF umbrella through two banks that Merrill owns and six banks affiliated with Salomon Smith Barney, without paying a penny in deposit insurance premiums. This dilutes the FDIC–BIF's reserve ratio, which is already lagging behind the FDIC–SAIF's, which doesn't face a similar inflow problem. Every $100 billion of insured deposit inflows drops the reserve ratio of the FDIC–BIF—which stood at 1.32 percent on March 31, 2001 (down from 1.35 percent on December 31, 2000)—about six basis points.

Once the 1.25 percent reserve ratio is breached, FDIC is required by law to assess all banks a minimum average of 23 cents in premiums unless a lower premium would recapitalize the fund within 1 year. How long it will be before the 1.25 percent designated reserve ratio is breached and premiums are triggered for all banks is not known. But today, past assessments on banks are subsidizing the insurance coverage for Merrill Lynch and Salomon Smith Barney! This inequitable situation must be remedied.

Because Merrill Lynch and Salomon Smith Barney own multiple banks, they can offer their customers more than $100,000 in insurance coverage. Merrill with two banks can offer $200,000 in FDIC coverage, and Salomon Smith Barney is offering each of its customers $600,000 in FDIC protection. This could have a significant negative impact on the funding base of community banks. Most community banks cannot offer their customers more than $100,000 in deposit insurance coverage in this manner. Additionally, these huge institutions are too-big-to-fail, giving them another advantage over community banks in gathering deposits.

If the FDIC were able to charge premiums to all banks, even when the reserve level is above 1.25 percent, it could collect premiums from Merrill Lynch and Salomon Smith Barney as they move deposits under the insurance umbrella. As it now stands, the FDIC is prohibited from charging them anything. Furthermore, if rapidly growing banks grew at a particularly fast rate, posing a greater risk, they could be charged premiums at a higher rate.

Regular Premiums

The FDIC, Federal Reserve and Treasury have all recommended that the current statutory restriction on the agency's ability to charge risk-based premiums to all institutions be eliminated, and that the FDIC be allowed to charge premiums, even when the fund is above the 1.25 percent designated reserve ratio.

The recommendation to charge premiums to all banks, even when the fund is fully capitalized, faces controversy in the industry. *However, we believe that in a carefully constructed, integrated reform package which includes substantial increases in deposit insurance coverage levels, bankers would be willing to pay a small, steady premium in exchange for increased coverage levels and less volatility in premiums.* With a small, steady premium, bankers will be better able to budget for insurance premiums and avoid being hit with an unexpectedly high premium assessment during a downturn in the business cycle. Also the premium swings will be less volatile and more predictable. It is also one way to extract some level of premiums from the free riders and reduce the dilution of the reserve ratio.

Risk-Based Premium System Should Set Pricing Fairly

The current method of determining a bank's risk category for premiums looks at two criteria—capital levels and supervisory ratings. The FDIC argues that this risk-weighting system is inadequate since it allows 92 percent of all banks to escape paying premiums when the fund is fully capitalized. The FDIC says that it cannot price risk appropriately under this method.

The FDIC has proposed a sample "scorecard" to charge premiums based on a bank's risk profile. The FDIC is quick to point out that this example is not etched in stone, and the factors to be used to stratify banks by risk deserves more analysis and discussion. But the model can be used as a starting point.

The FDIC proposes to disaggregate the highest-rated category of banks that currently do not pay insurance premiums (92 percent) into three separate risk categories based on a scorecard using examination ratings, financial ratios and, for large banks, possibly certain market signals as inputs to assess risk.

Under this system, three premium subgroups would be created—42.7 percent of the currently highest-rated institutions would pay a 1 cent premium, 26.5 percent would pay 3 cents, while another 23 percent would pay a 6 cent premium. The 8 percent of institutions that are currently charged premiums under the current system would fall into higher-risk categories and pay premiums ranging from 12 to 40 cents, as contrasted to the 3 to 27 cents they pay now. Under this example, the FDIC would collect $1.4 billion in annual premiums for an industry average of 3.5 cents.

The Treasury Department and the OCC have cautioned against making the risk-based premium structure unduly complex at this time, both in terms of assigning banks to risk categories and in setting premium rates for the various categories.

The ICBA and community bankers generally support a risk-based premium system. However, we believe more study is needed to determine the appropriate risk factors, risk weighting, and complexity to be used in the matrix. Reaching consensus on the factors to be used to stratify banks into risk categories and the premiums to be charged in the various categories will take more thought and discussion.

We are concerned that under the FDIC proposal, nearly 50 percent of banks that do not pay insurance premiums now would be paying either a 3 or 6 cent premium (before rebates) during good times. We are also concerned about charging unduly punitive premiums against weak institutions. We are concerned as well that this system could create a reverse-moral hazard by encouraging banks to squeeze risk out of their operations and in the process reduce the amount of lending they do in their communities. Banking is not a risk-free enterprise.

We do recommend, however, that while it would be appropriate for Congress to establish parameters or guidelines for the risk-based premium structure, the details of the structure should be set by the FDIC through the rulemaking process with notice and comment from the public. The FDIC is in a better position to judge the relative health of the insurance funds and the industry and can react more quickly to make changes in the premium structure as necessary.

Assessment Base

The Treasury Department has recommended that deposit insurance reform consider whether the existing assessment base, which is domestic deposits, be modified to account for the effect of a bank's liability structure on the FDIC's expected losses. The Treasury notes that in the event of bank failure, secured liabilities including Federal Home Loan Bank advances have a higher claim than domestic deposits on bank assets, and may increase the FDIC's loss exposure.

If consideration is to be given to changing the assessment base at this time, then Congress should look beyond assessing deposits and secured liabilities, which discriminates against community banks, and consider all liabilities (excluding capital and subordinated debt). For years, community banks have paid assessments on close to 90 percent of their liabilities, since domestic deposits are their primary funding source, while the largest banks—the too-big-to-fail banks—pay on less than 40 percent of liabilities since their funding comes in large part from nondeposit liabilities. Experience has shown that all nonassessed liabilities, not just deposits and secured liabilities, have funded excess growth and troubled loans of banks that subsequently failed. If the assessment base were to be expanded, it must be done so equitably.

Premiums Should Be Smoothed Out and Volatility Reduced

The current statutory requirement of managing the funds to the hard 1.25 percent DRR can lead to volatile premiums with wide swings in assessments. As noted above, under the current system, well-capitalized and well-run banks cannot be charged premiums so long as the reserve ratio is above the DRR of 1.25 percent. However, when the reserve level falls below 1.25 percent, the law requires the FDIC to charge an average of 23 cents in premiums unless the fund can be recapitalized at a lower premium in 1 year.

This means there could be substantial fluctuations in premium assessments, depending on the extent of bank failure losses. The current system is dangerously procyclical with premiums the highest when banks and the economy can least afford it. Premiums could rise rapidly to 23 cents when economic conditions deteriorate, potentially exacerbating the economic downturn, precipitating additional bank failures and reducing credit availability by removing lendable funds from banks.

The FDIC, Federal Reserve, and Treasury Department all recommend that the 1.25 percent hard target be eliminated, and the reserve ratio be allowed to fluctuate within a given range. The FDIC argues that the deposit insurance system should work to smooth economic cycles, not exacerbate them. For example, maintaining the current DRR of 1.25 percent as a target, the reserve ratio could be allowed to fluctuate between 1.15 percent and 1.35 percent. Regular risk-based premiums would be charged so long as the ratio is within that range.

However, in years when the ratio is below 1.15 percent, the FDIC suggests a "surcharge," for example, equal to 30 percent of the difference between the reserve ratio and 1.15 percent. Alternatively, in years when the ratio is above 1.35 percent, there would be a rebate equal to 30 percent of the difference between the reserve level and 1.35 percent. This would ensure that premiums rise and fall more gradually than under the current system.

The ICBA supports eliminating the hard 1.25 percent DRR and instituting a range within which the funds can fluctuate without penalty or reward as part of a comprehensive reform package. Under the current system, banks could be faced with steep deposit insurance payments when earnings are already depressed. Such premiums would divert billions of dollars from the banking system and raise the cost of gathering deposits at a time when credit is already tight. This in turn could cause a further cutback in credit, resulting in a further slowdown of economic activity at precisely the wrong time in the business cycle. The agency says it would be preferable for the fund to absorb some losses and for premiums to adjust gradually, both up and down, around a target range.

The FDIC also makes a strong case for maintaining 1.25 percent as the mid-point of such a range. The FDIC report showed that under various loss scenarios (no loss, moderate loss, and heavy loss), the fund never drops below .80 percent and it never goes above 1.5 percent. Gradual surcharges and gradual rebates help to keep the fund within this range.

Rebates

Pricing and rebates go hand-in-hand. If premiums are charged to all institutions regardless of the fund's size, rebates represent a critical safety valve to prevent the fund from growing too large. The FDIC notes that in the best years, the rebate could result in a bank receiving a net payment from the FDIC. In an economy as relatively strong as we have today, more than 40 percent of banks would receive a net rebate.

Importantly, under the FDIC proposal, the rebates would be based on past contributions to the insurance fund, and not on the current assessment base. This would have two advantages. It would not create a moral hazard that would encourage banks to grow just to get a higher rebate. And it would not unjustly enrich companies like Merrill Lynch and Salomon Smith Barney, which have transferred large deposits under the insurance umbrella without paying any premiums.

We very strongly support this recommendation on rebates. It is only fair to those institutions that have paid into the insurance fund for years. And it would prevent free riders like Merrill Lynch and Salomon Smith Barney from earning rebates on premiums they never paid.

Merge the BIF and SAIF As Part of the Comprehensive Reform Plan

Historically, banks and thrifts have had their own insurance funds. The BIF and the SAIF offer identical products, but premiums are set separately. Since the S&L crisis, when many banks acquired thrift deposits, many institutions now hold both BIF- and SAIF-insured deposits. More than 40 percent of SAIF-insured deposits are now held by banks.

The FDIC, Federal Reserve, and Treasury Department all recommend merging the BIF and the SAIF as part of a deposit insurance reform package. They note that the lines between S&L's and banks have blurred to the point where it is difficult to tell them apart. They argue that merging the two funds would make the combined fund stronger, more diversified, and better able to withstand industry downturns than two separate reserve pools. The FDIC says costs also would go down since it would not need to track separate funds.

The ICBA supports a merger of the BIF and the SAIF so long as it is part of a comprehensive and integrated deposit insurance reform package that includes an increase in coverage levels.

Conclusion

In summary, Mr. Chairman, the ICBA believes it is critical to review the Federal Deposit Insurance System now in a noncrisis atmosphere. An ongoing strong deposit insurance system is essential for future public confidence in the banking system and to protect the safety and soundness of our financial system. The effectiveness of this

key Government agency should not be permitted to be undermined or eroded away by a failure to preserve the value of its protection.

Deposit insurance is critical to the thousands of communities across America that depend on their local community bank for their economic vitality. Without substantially increased deposit insurance coverage levels indexed for inflation, community banks will find it increasingly difficult to meet the credit needs of their communities and compete fairly for funding against the too-big-to-fail institutions and nonbank providers.

We believe that deposit insurance reform should be comprehensive. The coverage levels should be raised and indexed for inflation. The hard 1.25 percent designated reserve ratio should be scrapped in favor of a flexible range. The statutory requirement that banks pay a 23 cent premium when the fund drops below the DRR should be repealed. A pricing structure that fairly evaluates the relative risks of individual banks without undue complexity should be instituted. Full deposit insurance coverage should be accorded to public deposits. And IRA's, education savings and retirement accounts should be accorded higher coverage levels. We urge Congress to adopt such an integrated reform package.

We commend you, Mr. Chairman, for moving the debate forward. The ICBA pledges to work with you, the entire Committee, and our industry partners, to craft a comprehensive and an integrated deposit insurance reform bill that can work and can pass.

Thank you, Mr. Chairman, for the opportunity to express the views of our Nation's community bankers.

TABLE 1

Federal Deposit Insurance Limit
Adjusted for Inflation
$1980 Dollars

Year	GDP Chain Price Index 1996=100	Adjusted GDP Chain Price Index 1980=100	CPI-U 82-84=100	Adjusted CPI-U 1980=100	Nominal Dollar Deposit Insurance Limit 1974 - Present	Real Dollar Deposit Insurance Limit (GDP Chain) 1974 - Present	Real Dollar Deposit Insurance Limit (CPI-U) 1974 - Present
1974	36.61	64.2	49.3	59.9	**$40,000**	**$62,344**	**$66,820**
1975	40.03	70.2	53.8	65.3	$40,000	$57,013	$61,223
1976	42.30	74.1	56.9	69.1	$40,000	$53,957	$57,681
1977	45.02	78.9	60.6	73.6	$40,000	$50,696	$54,363
1978	48.23	84.5	65.2	79.2	$40,000	$47,319	$50,510
1979	52.24	91.6	72.6	88.1	$40,000	$43,685	$45,401
1980	57.05	100.0	82.4	100.0	**$100,000**	**$100,000**	**$100,000**
1981	62.37	109.3	90.9	110.4	$100,000	$91,478	$90,598
1982	66.28	116.1	96.5	117.2	$100,000	$85,107	$85,342
1983	68.87	120.7	99.6	120.9	$100,000	$82,838	$82,728
1984	71.44	125.2	103.9	126.2	$100,000	$79,864	$79,266
1985	73.70	129.2	107.6	130.6	$100,000	$77,417	$76,584
1986	75.32	132.0	109.7	133.1	$100,000	$75,744	$75,104
1987	77.57	136.0	113.7	138.0	$100,000	$73,547	$72,446
1988	80.22	140.6	118.4	143.7	$100,000	$71,122	$69,610
1989	83.27	146.0	124.0	150.5	$100,000	$68,515	$66,425
1990	86.53	151.7	130.8	158.7	$100,000	$65,934	$63,008
1991	89.66	157.2	136.3	165.4	$100,000	$63,630	$60,457
1992	91.85	161.0	140.4	170.4	$100,000	$62,118	$58,674
1993	94.05	164.9	144.6	175.5	$100,000	$60,660	$56,990
1994	96.01	168.3	148.3	180.0	$100,000	$59,425	$55,542
1995	98.10	172.0	152.5	185.1	$100,000	$58,156	$54,022
1996	100.00	175.3	157.0	190.5	$100,000	$57,053	$52,487
1997	101.95	178.7	160.6	195.0	$100,000	$55,963	$51,287
1998	103.23	180.9	163.1	198.0	$100,000	$55,270	$50,508
1999	104.77	183.6	166.7	202.3	$100,000	$54,454	$49,432
2000	106.99	187.5	172.3	209.1	$100,000	$53,328	$47,821
2001e	109.87	192.6	176.93	214.8	**$100,000**	**$51,926**	**$46,564**

e Estimate

Source: Department of Commerce, Bureau of Economic Analysis, GDP Chain-Type Price Index;
Bureau of Labor Statistics, Consumer Price Index CPI-U, and ICBA calculations.

Chart 1

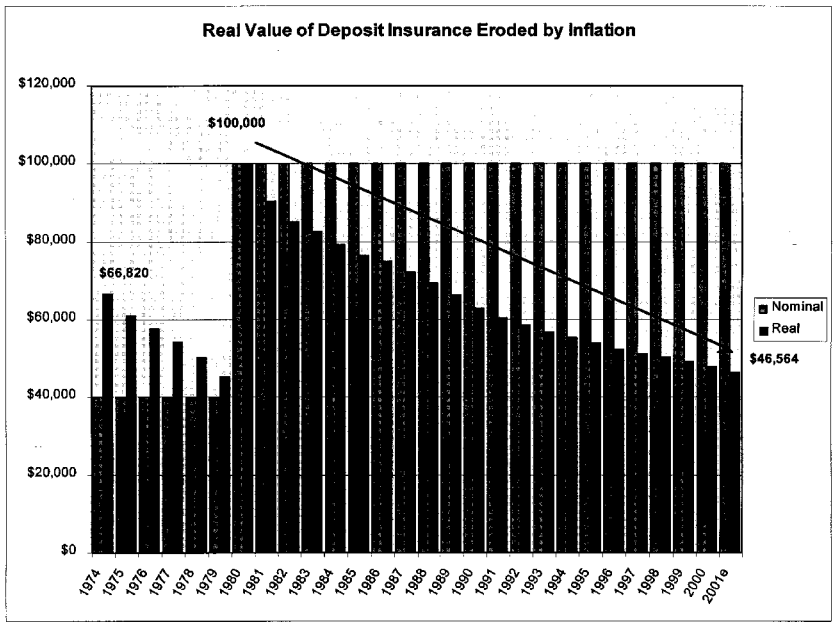
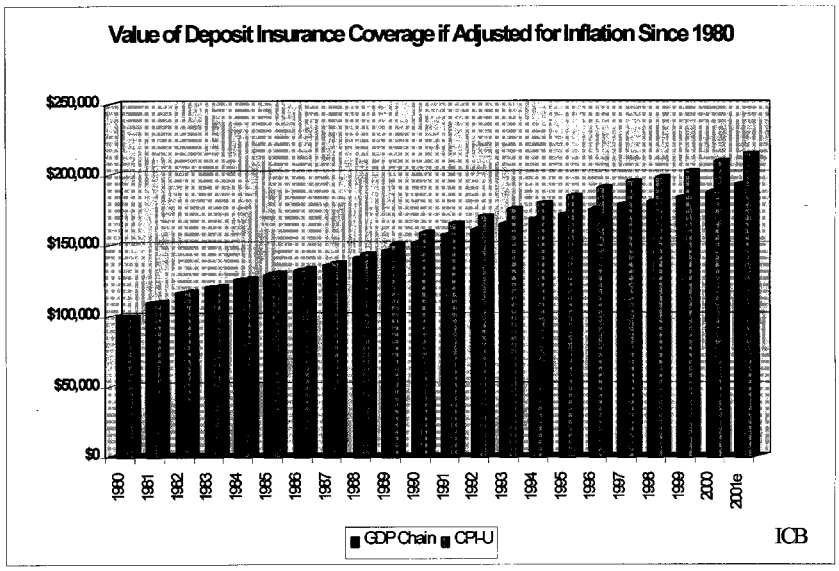


Chart 2



PREPARED STATEMENT OF JEFF L. PLAGGE

PRESIDENT & CHIEF EXECUTIVE OFFICER
FIRST NATIONAL BANK OF WAVERLY, IOWA
ON BEHALF OF THE
AMERICAN BANKERS ASSOCIATION

AUGUST 2, 2001

Mr. Chairman, I am Jeff L. Plagge, President and CEO of First National Bank of Waverly, Waverly, Iowa, and a member of the Government Relations Council of the American Bankers Association (ABA). I am pleased to be here today on behalf of the ABA. ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional, and money center banks and holding companies, as well as savings institutions, trust companies, and savings banks—makes ABA the largest banking trade association in the country.

I would like to thank you, Mr. Chairman, for holding this hearing to examine some key issues related to the Federal Deposit Insurance Corporation (FDIC). We appreciate your long-held support of a strong banking and financial system, and in particular, your concern for community banks. We also greatly appreciate your leadership and your openness to working with the banking industry to develop reforms that enhance the deposit insurance system.

Assuring that the FDIC's deposit insurance funds remain strong is of the utmost importance to the banking industry. Over the past decade, commercial banks and savings associations have gone to extraordinary lengths to rebuild the insurance funds, contributing $36.5 billion to ensure that the insurance funds are well-capitalized. With the Bank Insurance Fund (BIF) exceeding $31 billion and the Savings Association Insurance Fund (SAIF) at nearly $11 billion as of March 2001—*representing over $42 billion in financial resources*—it is safe to say that FDIC is extraordinarily healthy.

The outlook is also excellent. There have been few failures, and the interest income earned by BIF and SAIF (nearly $2.5 billion per year) is roughly three times the FDIC's cost of operation. As the current deposit growth rate moves back to the recent norm, as we expect it will, this interest income will likely continue to move the reserve ratio even further beyond the designated reserve ratio mandated by Congress. Moreover, the banking industry is extremely well-capitalized, adequately reserved for potential losses, and profitable.

With the deposit insurance funds so strong, now is an appropriate time to consider how we might improve the overall system. To this end, the ABA has held extensive discussions with commercial banks and savings institutions, as well as with Members of Congress and their staffs and the FDIC, in order to facilitate the development of an approach that would both strengthen the system and be acceptable to a broad range of parties.

Just this weekend, this issue was discussed in detail at ABA's Summer Meeting, which brings together our Board, Government Relations Council, the leadership of all the State Bankers Associations, and others. This testimony reflects the conclusions reached during that meeting.

The FDIC has done an excellent job developing an approach that addresses many of the key issues. While we do not agree with everything in the FDIC's April 2001 report—*and are particularly concerned about the possibility of increasing premiums*—we believe it provides a basis for serious discussion.

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

I would add that while there is a general belief among most bankers that we should work with Congress to strengthen the FDIC, there is also deep concern that such legislation could evolve to increase banks' costs or to become a vehicle for extraneous amendments. If that were to be the case, we have no doubt that support would quickly dissipate and turn to opposition. Indeed, our Summer Meeting discussion emphasized that the ABA will have to oppose any FDIC reform legislation that results in a increase in premiums when the insurance funds (or a merged fund) are above the 1.25 percent designated reserve ratio, as they are today. Fortunately, we also believe working together, we can see a consensus bill develop that can have broad bipartisan support.

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

- *Today's system is strong and effective, but some improvements could be made.* It is the position of the ABA that we have a workable deposit insurance system that has the confidence of depositors and banks. However, there are areas that can be improved. Any reform should strengthen and improve the deposit insurance system, enhance the safety and the soundness of the banking system, and improve economic growth.
- *A comprehensive approach is required.* Because deposit insurance issues are intrinsically interwoven, any changes must consider the overall system. We are pleased that all the issues we believe should be considered are on the table now. We recognize that any final bill may not cover in full all of the issues given political realities, but the Congress is engaging in a thoughtful comprehensive process, which we appreciate.
- *Changes should only be adopted if they do not create new costs to the industry.* The ABA will work to develop and support a consensus position, but ABA will oppose deposit insurance legislation that imposes new insurance costs or contains negative add-on amendments not related to deposit insurance reform.

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

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

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

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

A Comprehensive Approach is Required

The ABA firmly believes that any approach to reforming the FDIC should be done in a comprehensive manner. Since last year, support for a comprehensive approach has clearly grown. We are pleased that the FDIC's proposal released in April 2001 is comprehensive and basically has put most of the relevant issues on the table for discussion. In this section of my testimony, I want to give you ABA's perspective on what constitutes a comprehensive approach. Again, we recognize that any final bill may not cover in full all of the issues discussed below, but we respectfully suggest that all of them should be on the table.

MUTUAL APPROACH

The ABA believes consideration should be given to the *concept* of including the current insurance program elements of a mutual approach in which banks are provided with some type of ownership interest. Under such an approach, dividends would be paid based on the ownership interest. This approach will help address the issue of new and fast growing institutions paying no premiums, since such institutions will not have the same dividend stream. A great deal more work needs to be done to develop a specific proposal. We believe, however, that when the fund reaches a designated cap (discussed below), dividends should be paid to banks and savings institutions based on a measure of their historic payments to the FDIC. The FDIC says it can track such payments and develop such a system. A dividend system based on previous contributions is fair because it is the accumulated interest income on those very contributions that boosted the fund beyond the cap. Thus, this represents a return on the significant sacrifices that were made to more than fully capitalize the insurance funds.

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

DEPOSIT INSURANCE LIMIT

As ABA stated last year, the current $100,000 insurance limit—set in 1980—has lost over half its value when adjusted for inflation. As a consequence, it is more difficult, particularly for smaller institutions, to raise sufficient amounts of funds to meet loan demand in their communities. For many banks, a source of funding is the number one issue. Recent increases in loan-to-deposit ratios demonstrate that many community banks are searching for funds to support loan demand. In discussing this issue, three items deserve consideration: (1) indexing the insurance limit to account for inflation; (2) raising the insurance limit above the current $100,000; and (3) providing additional coverage to IRA's and other retirement accounts held at banks. Let me briefly discuss each in turn.

Indexing

There is general, although not unanimous, support within the banking industry for permanently indexing the level of deposit insurance coverage. Under an indexing system, the insurance limit would be automatically adjusted from time-to-time, based on changes in an appropriate index. These changes should be in level increments—that is, $5,000—to avoid consumer confusion. Without indexing, the insurance level constantly falls behind inflation, as Congress cannot be expected to regularly pass increases.

Base for Indexing

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

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

The study concluded—based on research conducted separately with bankers, individuals, and small business owners—that doubling coverage could result in net new deposits to the banking industry of between 4 percent and 13 percent of current domestic deposits, with the lower end of the range more likely, in Flannery's opinion. Obviously, the amount of any increase would vary among individual banks, depending on their markets and business strategies. These hypothetical new deposits, plus the added protection that existing deposits (between $100,000 and $200,000) would receive, would lower the BIF–SAIF reserve ratio below the required 1.25 percent. This would eliminate the $3.2 billion cushion that exists today and would, under current law, require a 3–13 basis point assessment on all domestic deposits to return the ratio to 1.25 percent.[2]

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

While there are differences of opinions in the industry, we believe that Congress should consider an increase in the current limit to the maximum possible that can be achieved without incurring significant costs that would outweigh the value of the increase. We appreciate your efforts, Mr. Chairman, to focus on this issue and the importance of attracting additional deposits into the banking industry to meet the credit needs of our communities. Of course, the bottom line is that we need to develop a comprehensive bill that addresses the key issues outlined in this statement that can also be enacted. We recognize that this is a controversial issue and therefore want to work with you to see what approach can be developed that can have the support necessary to be enacted.

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

Retirement Savings

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

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

We also note that some of the concern, expressed by some Members of Congress and others, about a general increase in the $100,000 limit is based on the problem of "hot money" moving to weak institutions, as occurred in the 1980's. However, this concern would not seem to apply to retirement savings, which are very clearly more stable.

CAPPING THE INSURANCE FUND AND EXPANDING THE REBATE AUTHORITY

The ABA has long advocated that the insurance fund should be capped and the rebate authority expanded. Not only are the BIF and SAIF currently fully capitalized, they are $3.2 billion over the 1.25 percent designated reserve ratio (DRR) set by Congress following the difficulties in the 1980's. Moreover, with interest income exceeding the FDIC's operating expense by $1.5 billion a year, it is highly likely that the insurance funds will continue to grow, after deposit growth rates return to their norm, as we expect. The compounding effect will mean even greater rates of growth in the future. We believe the FDIC's proposal on this point—*which for the first time acknowledges the importance of rebates as a check on excessive growth of the fund*—is a tremendous step forward. While in the past we have advocated direct rebates, a dividend approach, based on historic payments into the funds, accomplishes the same purpose and ABA supports that approach. The Federal Reserve and Treasury Department, in testimony before a House Financial Services Subcommittee last week, supported such an approach.

The funds held in excess of the DRR are not necessary to ensure the soundness of the deposit insurance system. As I mentioned above, the FDIC has the authority to adjust premium levels and has significant regulatory powers over depository institutions to ensure that the FDIC can meet any funding contingency. Importantly, the FDIC also has the authority to set aside a reserve to cover anticipated future losses. The power of this reserve was clearly demonstrated in the early 1990's when the FDIC reserved $16 billion for future losses, *$13 billion of which was never needed.* Because this reserve is subtracted out of the funds' balances, the reserve ratios were dramatically understated at that time. This extra, and often overlooked, cushion provides an important tool for managing the funds resources. Perhaps most importantly, the *banking industry is legally obligated to meet the financial needs of the insurance fund.* Simply put, limiting the size of the fund and expanding the rebate or dividend authority will not affect the FDIC's ability to meet any future obligations to insured depositors.[3]

The cost of FDIC holding excess reserves is very high. It represents a significant loss of lendable funds for banks in the communities they serve. I can tell you as a banker that I certainly can put rebates to good use in my community providing loans and services to my customers. This will have a far greater positive impact on economic conditions in Waverly, Iowa, than if that money sits in the Government's coffers in Washington.

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

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

There is a precedent for this type of system. The National Credit Union Administration has provided over $500 million over the last 5 years in dividends to credit unions. The dividend payment is designed to keep the National Credit Union Share Insurance Fund at 1.30 percent of insured deposits.

PREMIUMS FROM FAST GROWING INSTITUTIONS

Bankers believe there is an inherent unfairness in the current system that allows fast growing institutions to pay no premiums, even though their growth materially dilutes the coverage reserve ratio of the insurance funds. For many bankers this has become a top priority in FDIC reform. The problem of fast growing institutions can be addressed through a combination of a dividend/rebate system under the mutual approach and granting the authority to the FDIC to charge premiums in cases where institutions are growing by a defined percentage over average growth at banks.

MUNICIPAL DEPOSITS

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

A number of bankers advocate a 100 percent insurance on municipal deposits, or at least on local municipal deposits. They point to the huge administrative burden required to pledge bonds to collateralize these deposits, as well as the lost opportunities from holding excess bonds rather than making more loans. The ABA recognizes that 100 percent has raised economic and political concerns with some Members of Congress due to "moral hazard" questions, and there is, frankly, no consensus within the industry on this issue at this point. There is, it is worth noting, precedent under current deposit insurance practices for a differentiation between municipal and other deposits. Therefore, we believe further work needs to be done on this issue. For example, consideration could be given to providing broader coverage or perhaps granting banks the option to purchase additional insurance for municipal deposits. Any such additional insurance should be limited to some definition of local deposits, and the cost of such additional insurance should fully cover any additional risk to the insurance fund.

TOO-BIG-TO-FAIL

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

MERGER OF THE FUNDS

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

SMOOTHING OUT PREMIUMS

The FDIC is recommending that the "hard" 1.25 percent "Designated Reserve Ratio" (DRR) trigger be softened so that the industry would not be charged very high premiums all at once if the fund falls significantly below the 1.25 percent level. The ABA believes there is merit to smoothing premiums by eliminating the so-called "23-cent cliff" as long as it does not result in additional net premium payments over the long run. The current system is, in effect, a major tax increase in a recession. It is procyclical and would undermine any economic recovery.

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

INDEPENDENT FDIC BOARD

Consideration should be given to changing the FDIC Board to make sure it is truly independent, as it is designed to be. The most direct way to do that would

be to have three independent board members. Since the board was expanded to five members in FIRREA, more often than not, there have been vacancies on the board. The vacancies tend to be the "outside" seats because the seats held by the Comptroller of the Currency and the head of the Office of Thrift Supervision are always filled (either by the Comptroller or the head of OTS or acting directors of those organizations). Thus the Administration has generally had half of the Directors. Such an imbalance threatens the independence of the FDIC and could politicize decisions. Returning to a three-member independent board—which served the FDIC for well over 50 years—should be considered as part of a comprehensive approach to reform.

Changes Should Only Be Adopted If They Do Not Create New Costs To The Industry

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

There are several arguments made for charging premiums to at least some banks that now pay no premiums. First, it is argued that to charge no premiums means these banks are not paying for their insurance. We could not disagree more. Banks have paid for their insurance—*they prepaid it.* The billions of dollars in the BIF and SAIF are the result of premiums and interest on premiums. The fact that the FDIC is now *self-funded* is an extraordinary achievement.

Moreover, banks are obligated to maintain the fund at 1.25 percent of insured deposits. If the fund falls below this level, all institutions pay to recapitalize the fund. This assures adequate funding of the insurance fund. Even more important is that the banking industry has an unfailing obligation—set in law—to meet the financial needs of the insurance fund. This means that the entire capital of the industry—over $600 billion—stands behind the FDIC funds.

It is also worth noting that the commercial banks and savings banks are paying nearly *$800 million* each year to cover FICO and interest payments; despite the fact that these institutions had nothing to do with the crisis that led to the issuance of the FICO bonds. Therefore, we have fully paid up our insurance and more. We must remind Congress that the current premium system was a carefully negotiated compromise with our industry in exchange for the picking up of the FICO interest payments. We see no justification for Congresses' unilaterally reworking that "agreement" with our industry when the funds remain above the 1.25 percent reserve ratio.

A second argument is that there must be gradations of risk in the upper category of banks. We are not at all persuaded that these gradations are significant or that the FDIC or anyone else has a system that can really make that differentiation with any degree of confidence. Furthermore, we believe there is a sort of "grade on the curve" implicit in this argument. The upper category is just that. Banks have worked hard to become stronger institutions, with strong capital; these banks are in the top category because they deserve to be there, as would be clearly shown by an historical perspective. We see no justification for changing the system now by arguing that there are too many banks in that category, after they have done what it takes to be strong, well-managed and well-capitalized.

Of utmost importance, bank premiums are funds that otherwise could be lent and invested in local communities. Charging new premiums takes that money out of communities, undermining economic growth.

Another potential cost that could severely impact bank lending would be a change in the assessment base related to Federal Home Loan Bank advances and other secured liabilities. This change was suggested in testimony last week by the Treasury Department. We believe that such actions are directly counter to the intent of Gramm–Leach–Bliley, which recognized the need for additional sources of funding for community banks, and the appropriate role that the Federal Home Loan Banks could play in filling that need. To alter the assessment base to now include Federal Home Loan Bank advances and other secured liabilities will hamper the ability of banks to fund themselves and their communities.

We would also note that changing the risk-based premium system may trigger other problems and costs. For example, the scoring system suggested by the FDIC could impose additional regulatory burdens and may conflict with examination ratings of the OCC, the Federal Reserve, and State banking departments. The Federal Reserve, in testimony last week before a House Financial Institutions Subcommittee, raised questions about how this new system might work. The Treasury Depart-

ment noted in the same hearing that the approach was complicated and suggested it not be included in this legislation.

Conclusion

Mr. Chairman, we greatly appreciate the speed with which you have moved to hearings on this issue. We are prepared to work with you and the Members of this Subcommittee to find the best solution to these critical issues. We think this is an excellent time to begin that process—with the industry and the FDIC in excellent health. We sense there is a growing consensus on issues to be addressed and approaches to these issues. We look forward to working with you to see if we can develop and enact legislation to make the FDIC insurance system even stronger.

Appendix A

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

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

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

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

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

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

Additional Authorities That Protect FDIC

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

- PROMPT CORRECTIVE ACTION: This established mandatory regulatory actions as capital levels fall below the minimum requirements.
- CRITICALLY UNDERCAPITALIZED INSTITUTIONS: This requires mandatory conservatorship or receivership of institutions with capital less than 2 percent. Theoretically, if receivership takes place, the FDIC should suffer no losses on the institution at all.
- HOLDING COMPANY GUARANTEES/CROSS GUARANTEES: This requires the holding company to guarantee compliance with recapitalization plans of the bank and puts losses on sister banking institutions of a holding company in the event that one bank subsidiary fails. By expanding the obligation to cover losses, the FDIC effectively reduces its loss exposure.
- DEPOSITOR PREFERENCE: This law elevates the FDIC's claim above general creditors (standing in place of the insured depositors that it has made whole) in the receivership of any failed bank. This superior claimant position will certainly lower resolution costs to the FDIC.
- RULES RESTRICTING TOO-BIG-TO-FAIL: FDIC may not take any action, directly or indirectly, that causes a loss to the insurance fund by protecting depositors for more than the insured portion of deposits or by protecting creditors other than depositors.[4]
- EMERGENCY SPECIAL ASSESSMENT AUTHORITY: This authority requires the industry to repay any borrowing by FDIC and for any other purpose deemed necessary.
- "LEAST-COST RULE:" This requires the FDIC to resolve failures in the least costly manner of all alternatives.
- LINE OF CREDIT EXPANDED: The 1989 law increased the FDIC's line of credit to the Treasury from $5 billion to $30 billion and made it mandatory for the industry to repay any borrowing.

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

PREPARED STATEMENT OF CURTIS L. HAGE

CHAIRMAN, PRESIDENT, & CHIEF EXECUTIVE OFFICER
HOME FEDERAL BANK, SIOUX FALLS, SOUTH DAKOTA
FIRST VICE CHAIRMAN, AMERICA'S COMMUNITY BANKERS
ON BEHALF OF
AMERICA'S COMMUNITY BANKERS

AUGUST 2, 2001

Chairman and Members of the Committee, I am Curtis Hage, Chairman, President, and CEO of Home Federal Bank in Sioux Falls, South Dakota. I am here today representing America's Community Bankers (ACB)[1] as their First Vice Chairman. ACB is pleased to have this opportunity to discuss with the Committee reform of the deposit insurance system. While the system is still healthy, rapid growth of insured deposits is highlighting the problems caused by an overly rigid statute that could result in damage to the banking system and the Nation's economy.

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

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

Rapid growth is diluting the insurance funds as they stretch to cover more deposits. And inevitably, the FDIC must sometimes use those funds to protect depositors. As a result of a failure last week, the FDIC's Savings Association Insurance Fund (SAIF) will reportedly lose $500 million—5 percent of the total in the fund. A loss that size would reduce the SAIF's reserve ratio from 1.43 percent of insured deposits to 1.36 percent. The Bank Insurance Fund (BIF) had already fallen to 1.32 percent through a combination of rapid growth in insured deposits and similar losses.

Both funds are still well above the statutory minimum of 1.25 percent of insured deposits. However, under a statutory requirement imposed in 1989, if a fund falls below the 1.25 percent reserve requirement, the FDIC must impose premiums. If a fund is projected to take over a year to exceed 1.25 percent, the FDIC must impose a statutorily mandated 23 basis point premium on all institutions in that fund. For a community bank with $100 million in deposits, that equals $230,000. This premium would be like a targeted tax *increase,* threatening to drag the economy closer to recession, and inhibiting community bankers' ability to help their customers.

Fortunately, there is a ready solution to this problem. The Deposit Insurance Stabilization Act (H.R. 1293), introduced by Representatives Bob Ney and Stephanie Tubbs Jones, would eliminate the arbitrary 23 basis-point requirement. Eliminating the 23 basis-point premium would give the FDIC flexibility to recapitalize the fund under a more reasonable schedule. The bill would also do what everyone agrees should be done, merge BIF and SAIF. A merged fund is stronger and would be less affected by either rapid growth or losses from failures. The bill would also permit the FDIC to impose a special premium on excessive deposit growth.

ACB strongly recommends that Congress act on the Deposit Insurance Stabilization Act this fall, *before* either BIF or SAIF might fall below 1.25 percent. We agree with incoming FDIC Chairman Don Powell that Congress need not deal with all deposit insurance issues at once. Our position does not rule out adding additional provisions. If Congress can quickly develop a consensus on other issues, such as capping the fund, providing for rebates, and modestly indexing coverage, ACB would endorse an expanded bill.

On the coverage issue, ACB believes that Congress should focus on increasing protection for retirement savings. We strongly urge you to provide substantially more coverage for retirement savings than for other accounts, as was done before 1980. This is needed to provide adequate coverage for the variety of tax-advantaged savings accounts that have grown substantially over the years, as well as prepare for any Social Security reform, including self-directed accounts should Congress adopt that concept.

While ACB believes the FDIC should reform the risk-based premium system, we strongly oppose the agency's proposal to impose a premium on all insured institutions when the funds are over the statutory reserve ratio. Healthy institutions that are not paying a premium today paid extraordinary premiums in the 1990's—in effect prepaying for today's coverage. Despite the rhetoric being used, they are *not* getting free coverage.

Congress should not let the objective of comprehensive reform be the enemy of the necessary—stabilizing the deposit insurance system.

The Most Urgent Issue

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

As last week's failure demonstrated, this situation could worsen very quickly. A combination of rapid growth and just a few failures could trigger a 23 basis point premium. For my bank the cost of such a premium would be $1.4 million annually. For all banks in South Dakota the cost would be $31 million. That much capital can support over $300 million in lending. These premiums could come at the worst possible time—when the national economy and some local economies are shifting to

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

a different pace. Whenever they might come, they would divert resources from communities and shift them to Washington.

How large is this free-rider problem? In 2000, Merrill Lynch swept $36.5 billion from its Cash Management Accounts into insured accounts at its two affiliated banks, effectively reducing the BIF reserve ratio by 2.15 basis points. Merrill has swept an additional $11 billion into those banks this year.

Another major firm, Solomon Smith Barney has swept a total of $17 billion into its six BIF- and SAIF-insured affiliates this year, making this program especially attractive to large investors. The FDIC now estimates that all of this activity has lowered BIF's reserve ratio by at least 3 basis points.

ACB does not object to growth in insured deposits. These firms' activities are permissible under the current law, which never anticipated the current scenario. But two companies' growth plans are diluting the funds and reducing the designated reserve ratio at the possible expense of all insured banks. Without this dilution, the BIF reserve ratio would have increased, rather than fallen. And the FDIC is faced with a statutory prohibition on assessing for this growth.

Because of these high-growth programs, institutions in every State could be forced to pay premiums. These institutions collectively paid billions into the FDIC in the late 1980's and the 1990's. In the early 1990's, all FDIC-insured institutions paid approximately 23 basis points each year—again, $230,000 for each $100 million in deposits—$900,000 annually for my bank. And in 1996 SAIF-insured institutions paid an additional 66 basis points—a total of $4.5 billion. My bank's share was $2.6 million. Those substantial payments brought the FDIC back to health. Now these premiums are being used, in effect to cover new deposits at a few rapidly growing institutions.

To correct this situation, Congress should quickly pass H.R. 1293, or similar legislation. The bill does three things:

- PERMITS THE FDIC TO IMPOSE A FEE ON EXISTING INSTITUTIONS FOR EXCESSIVE DEPOSIT GROWTH SO THAT THE REQUIRED RESERVE RATIO CAN BE MAINTAINED. Currently, the FDIC may impose an excessive deposit growth fee on new institutions or new branches. By allowing the FDIC to impose fees on existing institutions, H.R. 1293 would address the current "free-rider" problem.
- MERGES THE BIF AND THE SAIF. According to the FDIC, merging the BIF and the SAIF would create a more stable, actuarially stronger deposit insurance fund. A single, larger fund would be less affected by either rapid growth or losses from failures.
- ALLOWS FOR FLEXIBLE RECAPITALIZATION OF THE DEPOSIT INSURANCE FUND. If the reserve ratio of the merged fund falls below the required level of 1.25 percent, the bill would give the FDIC flexibility in recapitalizing the fund over a reasonable period of time. By repealing the automatic assessment of 23 basis points, H.R. 1293 would give the FDIC authority to use a laser beam approach, rather than a sledgehammer, to recapitalize the insurance fund.

ACB believes that Congress should act quickly on this legislation to help ensure the continued strength of the FDIC and prevent the unnecessary diversion of billions of dollars away from community lending to homeowners, consumers, and small businesses.

How the Excess Growth Premium Would Operate

Ironically, Congress permits the FDIC to impose special assessments on *de novo* institutions.[3] Congress recognized that these institutions can be expected to grow at rates that exceed the industry average and impose other risks. However, because of their relatively small size, they cannot be expected to dilute a multibillion dollar deposit insurance fund. The same thing cannot be said about an existing institution—now effectively exempt from premiums—that embarks on a new business plan that could add tens of billions to the insured deposit base. So the law correctly recognizes that *de novo* institutions are relatively risky. However, the law forces the FDIC to ignore the risk to the institution and to the insurance fund posed by an existing institution that begins growing at a rate significantly above the industry average.

A growth premium would avoid dilution of the fund by making the fund whole with respect to any excess growth, preventing the imposition of unnecessary premium costs on other institutions. The special growth premium would apply only to those institutions whose growth imposed a material impact on the fund. It would also not apply to growth through merger or acquisition. By definition, these deposits

[3] 12 U.S.C. 1815(d)(1)(A).

are already included in the insured deposit base, so shifting them from one institution to another does not dilute the fund.

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

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

Additional Provisions

While ACB urges you to take immediate action on legislation to deal with the free-rider issue and eliminate the 23 basis point "cliff," we welcome consideration of some additional reforms to the deposit insurance system. Our positions on these issues are discussed in detail in our comprehensive report to the FDIC, which we released in January. A copy of that report was distributed to you along with this testimony. What follows is a summary of ACB's position on issues on which a prompt consensus might emerge.

Coverage

The industry has a mixed reaction to proposals to change deposit insurance coverage levels. Most ACB members are skeptical that increases in general deposit insurance coverage levels would significantly increase funding. Former FDIC Chairman Helfer is even more skeptical. Last year, she said, "There is very little evidence that doubling the coverage limits will expand the deposit base of smaller banks. Community bankers that I have talked to think that very little benefit will result from a significant increase in coverage limits."[4] Depositors with large sums may shift insured deposits from one bank to another to consolidate balances or take advantage of higher interest rates. But one bank's gain may well be another bank's loss.

A better approach would focus on increasing coverage for retirement savings, such as IRA and 401(k) accounts. Coverage should be increased to an amount substantially above the general coverage level. This is not a new concept; in 1978 Congress provided for $100,000 coverage for retirement savings accounts, two and one-half times the then-current level for regular savings. Higher retirement account coverage would provide a stable funding source for community lending and is extremely important to retirees and those nearing retirement.

Additional retirement account coverage would help implement an important national policy. Congress has just provided substantially enhanced tax incentives to encourage individuals to accumulate retirement savings. These individual savings are often replacing resources that employers previously provided through defined-benefit pension plans. This shift in retirement funding has increased the burden on individuals to manage their own assets. As individuals respond to tax incentives, their retirement assets often exceed by substantial amounts the current $100,000 coverage limit. Since planners generally recommend that individuals shift these savings into more secure and stable investments as they approach retirement, a substantial increase in deposit insurance coverage for retirement savings would be particularly helpful. These plans could be easily defined by requiring that they meet the standards of the Internal Revenue Code. The increased coverage would also be useful if Congress adopts some version of private accounts under the Social Security System.

In addition to a substantial increase in retirement coverage, to help maintain the role of deposit insurance in the Nation's financial system ACB supports indexing coverage levels. Congress should use as a base the last time it adjusted coverage primarily for inflation, which was done in 1974. At that time, it increased coverage to $40,000. According to the FDIC, if adjusted for inflation since that time, the current coverage limit would be approximately $135,000.

As long as the fund is above its statutory minimum of 1.25 percent of insured deposits, a modest increase in coverage should not require an additional minimal premium. If unacceptable premium increases are a condition for an immediate in-

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

crease in coverage, Congress should at least index coverage from the current $100,000 level.

Indexing on a going-forward basis would certainly not justify any premium increase. However, it would maintain "the same relative importance of deposit insurance in the economy over time. . . ."[5] Indexing using the current level would also end the debate over what year and level should be the basis for indexing. Depository institutions and the economy have adjusted to the current level of coverage. Indexing would effectively maintain that level without the need for more Congressional action.

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

Congress Should Set a Ceiling on the Fund

ACB recommends that Congress set a ceiling on the deposit insurance fund's designated reserve ratio (DRR), giving the FDIC the ability to adjust that ceiling using well-defined standards after following full notice and comment procedures. In deciding the actual ceiling amount, ACB recommends that Congress ask the FDIC to provide it with a firm recommendation on where it should set a statutory ceiling. The agency has already done considerable historical analysis on the level of the funds and income needed to maintain them.[6] Clearly, the agency could adapt that analysis to determine a reasonable ceiling to recommend to Congress.

ACB agrees with Former FDIC Chairman Helfer's comment:

> I believe it is possible for the FDIC to develop analytical tools that will permit it to identify a ceiling on the funding needs of the deposit insurance system at any particular time—a DRR that would change as circumstances change. . . . The purpose of establishing a ceiling DRR is so that insurance funds will not grow beyond a size that can be justified on the basis of the needs of the deposit insurance system, thereby withdrawing capital from banks who could have contributed to economic growth by leveraging those funds to meet the economic needs of their communities. Amounts accumulated in the system over and above the DRR ceiling should be rebated to banks to facilitate economic activity, which benefits every one.[7]

Before increasing the ceiling, the FDIC should be required to find that a higher level is needed to meet a substantial and identifiable risk to the fund or the financial system. In addition, Congress should require the FDIC to follow a full notice and comment process under the Administrative Procedure Act before making any change to the ceiling.

Excess Reserves Should Be Returned to Institutions That Paid Premiums

Reserves in the fund that exceed the ceiling should be returned to insured institutions based on their average assessment base measured over a reasonable period and based on premiums paid in the past. Rebatable premiums would include the 1996 SAIF special assessment, but not the high-growth special assessments.

During the 106th Congress, ACB supported legislation introduced by Senators Rick Santorum (R–PA) and John Edwards (D–NC) and Reps. Frank Lucas (R–OK) and Mel Watt (D–NC) that would have set a 1.4 percent ceiling and used the excess to pay interest on FICO bonds.[8] After the FICO bonds mature, excess funds above the ceiling would be rebated. The bill would have given the FDIC authority to change the ceiling. Reps. Lucas and Watt have reintroduced that legislation in the current Congress (H.R. 557).

ACB continues to believe that this is a constructive solution to a serious potential problem that could be caused by a substantially overcapitalized insurance fund. However, a broader approach could lead to full rebates more promptly than provided in the Lucas/Watt bill.

The FDIC should also consider risk factors when calculating any rebate. This would allow the FDIC to provide a risk-based incentive to institutions without imposing a premium on the healthy institutions. Under a broader rebate program, these incentives could come into play before the FICO obligation ends. The riskiest institutions would get no rebates, while the safest institutions would get higher than average rebates. Those in between could expect average rebates. These dif-

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[5] FDIC Options Paper, August 2000, p. 44.
[6] 60 *Fed. Reg.* 42680 (August 16, 1995).
[7] Helfer, December 4, 2000, p. 12.
[8] S. 2293 and H.R. 3278.

ferential rebates would provide the same risk-reduction incentive as variations in premiums. All institutions would know that as the fund approached the ceiling, they could expect to benefit by operating in a less risky manner.

Whatever the mechanism Congress provides, resources not needed for reasonably foreseeable deposit insurance purposes should not remain in Washington.

Risk-Based Premiums

Just as ACB urges Congress to prevent the imposition of a 23 basis point premium, we also support the current statutory language that prevents the FDIC from imposing premiums on well-capitalized and well-run institutions when reserves are above required levels. The FDIC and others have recommended that the Congress repeal this policy, contending that institutions are getting "free" deposit insurance coverage. This is like contending that a single-premium annuity policy is free.

Look at the numbers: From 1992 through 1996, BIF-insured banks paid a total of $19.9 billion, while SAIF-insured institutions paid over $8.4 billion. In 5 years, the total paid was a staggering $28.3 billion. During that period, a $100 million deposit SAIF-insured institution paid $1.8 million in premiums. A comparable BIF institution paid $810,000. Those payments would cover 36 years of premiums for a SAIF institution and 16 years for a BIF institution if they paid the average premium assessed between 1950 and 1990.

The industry stepped up to the plate to recapitalize their funds. As a result, the FDIC got the money over a 5 year period, gaining the opportunity to earn substantial interest that built up the funds. That is just the way a single premium annuity works. An insurance company charges less in nominal dollars than it expects to pay out, making up the difference and earning a profit by investing.

Conclusion

ACB appreciates this opportunity to present our views on the significant deposit insurance issues before you today. The deposit insurance system is still strong, but could be made even stronger. We urge you to move quickly to give the FDIC the flexibility that it needs to deal with the strains imposed by extraordinary growth in insured deposits at a few institutions. Prompt passage of legislation like the Ney/Tubbs Jones bill (H.R. 1293) will strengthen and stabilize the system.

In addition, Congress may wish to seek an early consensus on additional issues that could be added to this legislation. Indexing coverage, providing for increased coverage of retirement accounts, capping the size of the fund and providing for the rebates could result in comprehensive reform that would substantially improve the system.

Deposit insurance is an essential part of our banking system. While a variety of opinions exist within the industry regarding what reforms, if any, should be enacted, general consensus exists that any reform should leave the FDIC stronger. It should continue and strengthen the original mission of the FDIC to protect depositors. America's Community Bankers is committed to working with you and your Committee, and others in the industry to help forge a bill that can move expeditiously through Congress.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MILLER FROM ROBERT I. GULLEDGE

Q.1. Some of the past concern about raising the deposit insurance level above $100,000 was the moral hazard of putting the American taxpayer at risk if financial institutions fail. Give me your thoughts as to why we should raise the deposit insurance level above $100,000 and place the American taxpayer at risk.

A.1. The reasons for raising the insurance level above $100,000 are covered in detail in my written statement submitted for the hearing record, but I will summarize them below. The ICBA does not agree that raising the deposit insurance level above $100,000 will materially increase the risk to the American taxpayer. This is more fully described in my written statement, and also summarized below.

Higher deposit insurance coverage levels would benefit communities, consumers, and small businesses. It would help address the funding challenges and competitive inequities faced by community banks and ensure that they have lendable funds to support their communities.

Inflation has severely eroded the real value of FDIC coverage, which has been a bulwark of consumer confidence in our financial system, in the two decades since it was last adjusted. The current limit is inadequate for today's savings needs, particularly growing retirement savings needs.

Higher coverage would benefit consumers. A recent Gallup consumer survey conducted for the FDIC showed that: 57 percent of respondents cited Federal deposit insurance as "very important" in determining where to invest; one in eight households keep more than $100,000 in the bank; one-third of all households reported having more than $100,000 in the bank at one time or another; and nearly four out of five (77 percent) respondents thought deposit insurance coverage should keep pace with inflation.

Reports of the 816 uninsured depositors at the recently failed Superior Bank, FSB demonstrate well the need for increased coverage. Some of those who will lose substantial sums include an injured worker who deposited a $145,000 disability settlement the day before the thrift failed; and a woman who deposited $120,000 in proceeds from the sale of her deceased mother's home days before the thrift failed. Many of the uninsured had their retirement savings at the thrift, including one person with $3 million in an IRA. The ICBA supports substantially higher coverage levels for retirement savings.

These stories demonstrate that depositors with more than the coverage limit are not necessarily wealthy or capable of exercising "depositor discipline" by scrutinizing their banks. If Federal bank regulators can be surprised by the true financial condition of a bank (as in the case of both the Superior and Keystone National Bank failures), then how can we expect the ordinary depositor to exercise "depositor discipline"?

Higher coverage would benefit small businesses. A recent ABA survey of small business owners found that half think the current level of deposit insurance coverage is too low. If the coverage were doubled, 42 percent said they would consolidate accounts now held in more than one bank; 25 percent would move money to smaller

banks; and 27 percent would move money from other investments into banks.

Higher coverage would benefit our communities. Consumers and small businesses shouldn't be forced to spread their money around to many banks to get the coverage they deserve. Customers should be able to support their local banks, and local economies, with their deposits.

Higher coverage levels are needed to enable community banks to maintain sufficient core deposits to meet community lending needs as they lose deposits to mutual funds, brokerage accounts, the equities markets and too-big-to-fail banks. Since 1992, deposit growth has lagged the growth in bank loans by about half—hence small banks are finding it harder to meet loan demand that supports economic growth. And because of their small size, the community banks lack access to the capital markets for alternative sources of funding.

Community bankers in agricultural and rural markets are particularly faced with these difficulties. As the Federal Reserve Board noted in the attached July 27 letter to Representative Spencer Bachus (R–AL), who Chairs the Financial Institutions Subcommittee (House Financial Services), asset and deposit growth at small banks in agricultural and rural areas (see lines 6 and 7 of accompanying chart) between 1995 and 2000 has failed to keep pace with asset and deposit growth for small banks in metropolitan areas (see line 8).

Also, growth of uninsured deposits at agricultural banks (far right column of line 6) greatly lags growth of uninsured deposits at all other banks for this period, averaging 3.9 percent annually compared to double-digit percentage annual increases at all other institutions. And other Federal Reserve data shows deposit growth for all small banks is lagging loan growth. We believe this to be direct evidence of the difficulties many community bankers face in attracting and maintaining core deposits to meet loan demand.

FDICIA reforms minimize taxpayer exposure. Higher coverage limits will not necessarily increase exposure to the FDIC or the taxpayers. A variety of factors serve to minimize any increase in exposure to the FDIC or the taxpayers from bank failure losses due to an increase in deposit insurance coverage levels.

The reforms in bank failure resolutions instituted by the Federal Deposit Insurance Corporation Improvement Act of 1991 FDICIA—including prompt corrective action, least cost resolution, depositor preference, and a special assessment when a systemic risk determination is made—are all designed to reduce losses to the FDIC.

It is ironic to talk about the moral hazard of increasing deposit insurance coverage to account for inflation when the trend of greater and greater deposit concentration in fewer and fewer banks that are likely too-big-to-fail continues. This deposit concentration, not an increase in coverage levels, presents the greatest systemic risk and "moral hazard" in our financial system and to the loss exposure of the FDIC and the taxpayer. And even if an emergency determination of systemic risk is made by the Secretary of the Treasury, and if all depositors—and creditors—at Large Complex Banking Organizations (LCBO's) are again made whole, a special

assessment on all banks will be levied to recover all of these bailout costs.

Q.2.a. Mr. Plagge's testimony says "there is general, although not unanimous, support with the banking industry for permanently indexing the level of deposit insurance coverage." What percentage of your membership supports indexing the level of deposit insurance coverage? What percentage of your membership supports covering municipal deposits? What percentage of your membership supports covering IRA's, and other retirement accounts? What percentage of your membership would be willing to pay a small, steady premium?

A.2.a. While we have not conducted a formal, membership-wide survey of community banker support for indexing coverage, covering municipal deposits, IRA's and other retirement accounts, and paying a small, steady premium, the ICBA strongly supports all of these proposals as part of a comprehensive approach to deposit insurance reform.

On the procedural level, the ICBA formulates its public policy positions through a multifaceted input and review process involving the organization's banker-elected and banker-composed Executive Committee, Board of Directors (composed of over 100 bank and thrift executives from 48 States), 13 separate issue committees (e.g., Federal Legislation, Policy Development, Regulation Review), as well as consulting with individual community bankers and State community banking trade associations affiliated with the ICBA.

In addition to being approved and ratified by the ICBA's Policy Development Committee, Executive Committee and Board of Directors, our current policy resolutions were ratified by unanimous voice vote of the 1,300 community banker delegates to the ICBA Annual Convention held in Las Vegas, Nevada in March 2001. Our policy resolutions on "Deposit Insurance" and "Community Bank Funding and Liquidity" are attached.

Our stance in strong support for comprehensive deposit insurance reform, including provisions to both substantially increase current coverage levels and index this new base for future inflation, is the result of community-banker deliberations over the course of the last several years. This process was intensified in March 2000 following former FDIC Chairman Donna Tanoue's announcement at the ICBA Annual Convention in San Antonio, Texas that her agency would be undertaking a thorough review of and make recommendations on Federal deposit insurance reform. Chairman Tanoue's speech mentioning proposals to increase and index coverage levels for inflation since 1980 drew a standing ovation from the community banker delegates at the convention.

Throughout this process, all of the above-noted issues (and other possible reforms) have been considered, and often reconsidered, by various ICBA committees and ultimately our Executive Committee and Board of Directors. This process has provided our banker membership with extensive and repeated opportunities to weigh in on the issues under consideration and formulate the trade association's positions and advocacy strategies.

With regard to paying a small, steady premium, I would reiterate my testimony at the August 2 hearing that the ICBA believes "that in a carefully constructed, integrated reform package which in-

cludes substantial increases in deposit insurance coverage levels, bankers would be willing to pay a small, steady premium in exchange for increased coverage levels and less volatility in premiums." This will enable bankers to better budget for premiums and will help avoid unexpectedly high premiums during economic downturns. In addition, we believe premium swings would be less volatile and more predictable, and it would also result in "free riders," like Merrill Lynch and Salomon Smith Barney which have now pumped upward of $100 billion into insured deposits, paying some level of premiums and thereby reduce further dilution of the insurance fund(s) reserve ratio.

Q.2.b. Mr. Plagge's testimony also discusses a study which shows that "doubling coverage could result in net new deposits to the banking industry of between 4 percent and 13 percent of current domestic deposits, with the lower end of the range more likely." Also doing this "would lower the BIF–SAIF reserve ratio below the required 1.25 percent." Is this worth the potential cost? Is it worth the potential for premium increases that would accompany a significant increase of the insurance limit?

A.2.b. The premium costs of an increase in deposit insurance coverage must be considered in the context of comprehensive reform. The ICBA believes that community bankers are willing to pay a small, steady, fairly priced premium as part of a comprehensive package that includes a substantial coverage increase. In a comprehensive package, the hard target 1.25 percent reserve ratio would likely be replaced by a flexible range in order to reduce premium volatility. Premiums would remain steady as long as the reserve ratio stayed within the range. Thus, a dip in the reserve ratio below 1.25 percent in such a scenario would not result in increased premiums.

Q.2.c. What do you think of Mr. Hage's proposed bill to merge the BIF and the SAIF, allow for flexible recapitalization of the deposit insurance fund and permit the FDIC to impose a fee on existing institutions for excessive growth?

A.2.c. We believe Mr. Hage's proposed bill is too narrow. Instead, the ICBA supports a comprehensive approach to deposit insurance reform as more fully described in our answer below to Question 3.

Q.3.a. Mr. Powell indicated that perhaps all the FDIC proposed reforms did not have to be in one package. What would be on your "must have in the bill" list if you were making one?

A.3.a. The ICBA's preference, as noted in Answer 2 above, would be comprehensive legislation that: (1) substantially raises coverage levels and indexes the new base for future inflation; (2) increases coverage for public deposits and retirement products; (3) removes the current hard 1.25 percent designated reserve ratio in favor of a flexible range, with rebates, based on past contributions, when the fund exceeds the upper end of the range; (4) repeals the current statutory requirement that banks pay a 23 cent premium when the fund(s) drop below the DRR; and (5) institutes a pricing structure that fairly evaluates the risks of individual banks without undue complexity or cost, including the payment of a small, steady premium. Also, in the context of a comprehensive bill, the ICBA would

not oppose merger of the BIF and the SAIF into a single insurance fund.

The ICBA's bottom line on deposit insurance reform remains that we cannot support any legislative proposals that do not substantially increase current coverage levels and index the new base for future inflation.

Q.3.b. Should these reforms be done now?

A.3.b. Yes. The ICBA fully shares the view stated in the FDIC's recent report "Keeping the Promise: Recommendations for Deposit Insurance Reform" that the time for comprehensive action is now in a noncrisis atmosphere. Indeed, the recent Superior Bank, FSB failure should serve as a catalyst for action. Delay in dealing with the S&L crisis of the late 1980's not only prolonged the problem, but also greatly increased the costs of the bailout.

The ICBA is also concerned that a piecemeal approach to deposit insurance reform will not result in all the important issues being addressed adequately, or possibly at all. Should Congress move on a limited package this year, as some suggest, momentum for action on other critical topics could well be lost. That would be unfortunate, as the ICBA joins the Senate Banking Committee's Financial Institutions Subcommittee Chairman Tim Johnson (D–SD), Representative Bachus, and others who believe the best way to deal with this complex situation is to face all the issues directly in a proactive fashion. To do otherwise could be an invitation to larger obstacles down the road.

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

LAURENCE H. MEYER
MEMBER OF THE BOARD

July 27, 2001

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

Dear Mr. Chairman:

At the subcommittee's hearings on July 26 on deposit insurance reform, you asked me if the growth rates of small banks in rural areas were different from the growth rates of all small banks. We have constructed the enclosed table to address that question.

All data in the table show annual rates of growth from 1995 to 2000, and the groupings are adjusted for mergers. The same interval and adjustments were used to calculate the growth rates in my statement. "Large" banks are the largest 100; "medium" banks are the next 900; "small" are all others. The largest "small" bank had assets of $331million in 2000.

All small bank assets (line 5) grew at a 13 percent annual rate over this interval, while their insured and uninsured deposits expanded at annual rates of 9.6 and 20.5 percent, respectively. These rates of growth were considerably in excess of those for large banks (line 2).

We cannot determine a pure "rural" bank grouping, but we can come close by considering banks where agricultural loans account for 25 percent or more of total loans ("agricultural" banks) and small banks that are not located in Standard Metropolitan Statistical Areas (SMSAs). As you can see in lines 6 and 7, small banks in both of these groups did expand their assets and deposits less rapidly than other small banks (line 8).

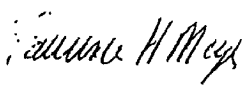
It is true that small agricultural banks (line 6) expanded their uninsured deposits less rapidly than all other groupings of banks. This slower growth rate reflects, in large part, developments in the agricultural sector that are independent of banking. The health of the agricultural economy constrained income and thus increases in the insured deposit cap probably would have had little effect on the outcome.

The Honorable Spencer Bachus
Page Two

At non-agricultural rural banks (line 7) growth rates of total assets and insured deposits exceeded those of large and medium-sized banks, and their uninsured deposit growth rates are very similar.

Please let me know if you need any additional information.

Sincerely,



Enclosure

cc: Assistant Secretary Bair
Comptroller Hawke
Director Seidman

Selected Growth Rates 1995-2000 (Percent, annual rate)			
	Total Domestic Assets	Deposits	
		Insured	Uninsured
1) All banks	7.7	3.7	12.4
2) Large banks[1]	6.1	0.4	10.9
3) Medium banks[2]	8.5	5.3	14.0
4) Small banks[3]			
5) Total	13.1	9.6	20.5
6) Agricultural[4]	5.9	5.4	3.9
7) Non-agricultural, non-SMSA[5]	8.7	7.4	10.0
8) All other[6]	19.8	15.6	21.4

Note: All data are merger adjusted.

1) Largest 100 commercial banks when ranked by total assets
2) Next 900 commercial banks
3) All other commercial banks (largest in 2000Q4 $331 million)
4) Small banks where agricultural loans account for 25% or more of loans
5) Small, non-agricultural banks located outside of standard metropolitan statistical areas (SMSA), i.e. not in urban areas
6) Small, non-agricultural banks located in standard metropolitan statistical areas (SMSA), i.e. in urban areas.

2001 ICBA POLICY RESOLUTIONS

[Excerpts]

DEPOSIT INSURANCE

A strong and well-functioning Federal Deposit Insurance System is the foundation on which consumer confidence in our banking and financial system rests. That confidence in turn plays a pivotal role in maintaining stability during difficult economic times. The Federal Deposit Insurance System has worked well for more than 65 years, but following the "financial modernization" accomplished in the Gramm–Leach–Bliley Act, it is now time to review and modernize our Federal Deposit Insurance System as well.

Increased Coverage Levels

ICBA strongly supports increasing deposit insurance levels and regularly indexing them for inflation to adequately preserve the value of its protection going forward. Deposit insurance coverage levels have not been increased in 20 years—the longest period in FDIC history without an increase. Deposit protection has been eroded in half due to inflation since 1980 and is inadequate for today's savings needs, particularly growing retirement savings needs. The less deposit insurance coverage is really worth due to inflation erosion, the less confidence Americans will have in the protection of their money, and the soundness of the financial system will be diminished.

Adequate deposit insurance levels are also critical to community banks' ability to attract core deposits to support community lending as they lose deposits to mutual funds, brokerage accounts, the equities markets, and "too-big-to-fail" banks. Increased coverage levels will help local communities by enabling depositors to keep more of their money in local banks, where it can be reinvested for community projects and local lending.

The ICBA also supports full deposit insurance coverage for in-market municipal (public) deposits—taxpayer funds that should not be put at risk. State deposit collateralization requirements make it harder for community banks to compete for these deposits with larger banks. Many loaned-up community banks do not have securities available to use for collateral. Those that do must tie up assets in lower-yielding securities affecting their profitability and ability to compete. Full deposit insurance coverage of in-market municipal deposits would free up the investment securities used as collateral, enable community banks to offer a more competitive rate of interest to attract municipal deposits, and enable local governmental units to keep deposits in their local banks and communities.

Other Deposit Insurance Reform Issues

The FDIC has undertaken a timely and a comprehensive review of the Federal Deposit Insurance System. In addition to the issue of coverage levels, the FDIC is reviewing two other key issues: Fairness in deposit insurance pricing and funding insurance losses over time. The ICBA supports this comprehensive review and—in conjunction with an increase in the coverage level—supports efforts to reform the system to:

- Adequately assess deposit growth at rapidly growing institutions—which currently pay no insurance premiums to offset the dilution in the reserve ratio caused by their deposit growth ("free rider" problem).
- Appropriately differentiate pricing for individual institutions based on risk.
- Reduce premium volatility by smoothing out premium payments to remedy the current procyclical nature of deposit insurance premiums—with premiums lowest when the industry is healthiest and highest when the industry is weakest and can least afford to pay—caused by the hard target reserve ratio.
- Provide appropriate options for rebate of excess fund reserves to the industry.
- More equitably apportion the costs of systemic risk protection, recognizing that the benefits of a stable financial system goes beyond the banking system alone.

COMMUNITY BANK FUNDING AND LIQUIDITY

[Priority]

Community banks are facing serious funding and liquidity challenges as they find it harder and harder to attract and maintain core deposits to match asset growth and support community lending. According to the FDIC, deposits increased by only 4.1 percent in 1999, the smallest annual increase since 1993, while bank lending increased 7.8 percent. Community banks continue to see disintermediation of deposits to mutual funds, brokerage accounts, the equities markets, tax-free credit unions and "too-big-to-fail" banks. Alternative sources of funds at competitive prices for community banks are scarce because community banks lack ready and efficient access to the capital markets. By contrast, large commercial banks can access the capital markets for funds and use securitization to supplement deposits. High tax rates on traditional saving instruments such as certificates of deposit further encourage investment in higher risk investments and drain community bank core deposits.

Deposit Insurance Coverage Levels

To stem the deposit flight out of local communities and enable community banks to better compete with the emerging financial conglomerates, the ICBA urges that Federal deposit insurance coverage levels be increased, and indexed for inflation going forward.

Deposit insurance coverage has been frozen at $100,000 since 1980. Inflation alone has cut the real value of deposit insurance protection in half. The ICBA strongly supports an increase in deposit insurance coverage levels in order to help community banks attract additional core deposits. Improved access to Federal Home Loan Bank advances will help (see below), but more is needed as advances are not a complete substitute for deposits. Increased coverage levels will allow depositors to keep more of their money in local banks, thus boosting the supply of lendable funds at community banks and providing funds to keep local economies prosperous.

While community banks now have more alternative funding sources, these sources cannot be relied on as a complete replacement for deposits. Community bankers recognize this and their examiners caution against too great a reliance on nontraditional funding sources. Community banks need to offer higher levels of deposit insurance to avoid overdependence on Federal Home Loan Bank advances.

Federal Home Loan Bank Access

Federal Home Loan Bank System modernization provisions included in the Gramm–Leach–Bliley Act of 1999 represented a significant step in addressing community bank funding problems by providing Community Financial Institutions (insured depository institutions with less than $500 million in assets) greatly enhanced access to the Federal Home Loan Banks for long-term fixed-rate funding.

The ICBA will continue its work to expand eligibility for direct access to longer-term funding sources as these provisions are implemented. The ICBA strongly encourages the FHLB's to move forward to implement their expanded collateral options available for Community Financial Institutions (CFI's) as rapidly as possible without jeopardizing safety and soundness. We urge the FHLB's to develop the products and programs to support their CFI members lending to agriculture and small businesses as envisioned by the legislation.

Other Sources

ICBA will continue to work to improve community bank access to other longer-term funding from sources including the Farm Credit System, Farmer Mac and the Federal Reserve banks in order to be better able to meet their local lending demand. We call upon the Federal Reserve to review the operations of its discount window as a potential new long-term funding window for community banks.

ICBA will continue to interface with banking regulators on the growing importance of community bank use of nondeposit sources of liquidity. ICBA will work to educate its members about funding alternatives and the asset/liability management challenges that arise with their use.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MILLER FROM JEFF L. PLAGGE

Q.1. Some of the past concern about raising the deposit insurance level above $100,000 was the moral hazard of putting the American taxpayer at risk if financial institutions fail. Give me your thoughts as to why we should raise the deposit insurance level above $100,000 and place the American taxpayer more at risk?

A.1. The severe effect of inflation over the last 21 years has cut the real value of the $100,000 insurance limit in half. Thus, the coverage that individuals and importantly, small businesses, have received has diminished significantly over time. The importance of deposit insurance to maintaining the confidence of our system requires very careful consideration of the real value of the protection provided.

A very important part of your question is what risk this poses to taxpayers. A critical provision, enacted in the FDIC Improvement Act of 1991, makes banks entirely responsible for any losses or other expenses of the FDIC. In effect, this means that the entire capital of the banking industry stands behind the funds. Therefore, the taxpayer risk is extremely small under our current system and an increase of the insurance limit would have no appreciable effect on this.

Some observers have commented that the increase of the insurance limit from $40,000 to $100,000 in 1980 contributed to the losses in the S&L crisis. While this increase may have made it easier for some high-flying S&L's to fund their risky activities, the failure on the part of the S&L's regulator to close insolvent institutions was the primary cause of the significant losses. This, of course, was exacerbated by poor accounting methods, insufficient capital and lack of prompt regulatory action to prevent abuses from taking place or becoming worse. With such lax regulatory oversight, those high-flying S&L's could have raised any level of funding regardless of whether the limit were $40,000 or $100,000.

Q.2.a. Mr. Plagge, your testimony says "there is general, although not unanimous, support with the banking industry for permanently indexing the level of deposit insurance coverage." What percentage of your membership supports indexing the level of deposit insurance coverage?

A.2.a. While it would be impossible to say with any precision what percentage of our membership supports indexing, it is fair to say that the vast majority believes that *indexing the fund going forward*—whether the fund is indexed from $100,000 or some higher base level—would be appropriate. As I said in my statement, support is not unanimous. There are some institutions that believe that no change—either increasing the current base of $100,000 or indexing going forward—should be undertaken. We base our response on discussions within our Government Relations Council (about 130 bankers from every State and all bank sizes), but also discussions held in numerous forums and meetings throughout the country over the last 18 months.

It is very important to remember that as the real value of the insurance limit has fallen with inflation, it becomes increasingly difficult, particularly for smaller institutions, to raise sufficient

amounts of funds to meet loan demand in their communities. For many banks, a source of funding is the number one issue. Recent increases in loan-to-deposit ratios demonstrate that many community banks are searching for funds to support loan demand. Thus, there is an important public policy issue that underlies the need to keep the insurance coverage limit revised to reflect inflation.

Q.2.b. What percentage of your membership supports covering municipal deposits?

A.2.b. It would be difficult to estimate a percentage with any precision as there are varying opinions on increasing coverage for municipal deposits, and frankly, there is not a consensus within the industry. Some of our members support full coverage on municipal deposits. They believe that there is no economic difference to the municipality whether the deposits are fully secured or fully insured by the FDIC, yet there is a big difference in the management of the collateral, which is costly and time-consuming to administer and often absorbs resources that would have otherwise been used for lending. There are also other bankers who support a system that would allow them to purchase additional insurance from the FDIC to cover these deposits, perhaps at limits to $5 million or $10 million (reflecting the level of deposits that are often associated with these deposits). As the collateral rules are dependent on State law and regulation, the opinions on the importance of coverage vary from State-to-State. There are also bankers who want no change. ABA believes that the issue should be under consideration as legislation is developed. It is worth noting that there is precedent under current deposit insurance practices for a differentiation between municipal and other deposits.

Q.2.c. What percentage of your membership supports covering the IRA's, and other retirement accounts?

A.2.c. The vast majority of bankers support a differential coverage limit on IRA's, Keoghs, and other retirement accounts. Again, there are some institutions that are opposed to any increase of any sort in the level. As noted in ABA's testimony, there is precedent for differential coverage: Between 1978 and 1980, the coverage for IRA's and Keoghs was two-and-a-half times ($100,000) the limit at that time ($40,000). The recent failure of Superior Bank has highlighted the fact that many people have retirement savings that exceed the insurance limit. This is not "hot" money and well-deserves special consideration. Moreover, the retirees are hardly the source of market-discipline that would constrain risk-taking at financial institutions.

Q.2.d. What percentage of your membership would be willing to pay a small, steady premium?

A.2.d. Increasingly bankers have become concerned about the potential costs that a revised risk-based assessment system would involve. Thus, there is very strong and near universal opposition to any reform that would entail additional costs to the industry. The ABA strongly opposes this concept when the fund is above 1.25 percent of insured deposits. The industry does recognize that there is potential for the fund to fall below the 1.25 percent level and that costs would arise at that time. Moreover, changes such as increas-

ing the insurance limit above $100,000 might move the reserve ratio closer to the 1.25 percent designated reserve level and increase the likelihood that new premium payments would have to be made. However, those potential costs are far different than the immediate increase in premiums for approximately 4,500 banks that has been suggested in examples presented by the FDIC. These banks, among the 92 percent of the industry currently in the 1A risk-category, pay no premiums. The prospect of paying higher premiums when the fund has over $3 billion in excess capital is very disturbing for the industry. In this regard, I attach a letter, recently sent by ABA President Donald Mengedoth to the House Financial Services Committee, which addresses this issue in detail.

Q.2.e. Is it worth the potential for premium increases that would accompany a significant increase of the insurance limit?

A.2.e. There were many bankers, particularly community bankers, who had expressed a willingness to pay some small premium if the insurance limit was raised to $200,000. They believe they would benefit from new deposits flowing into their banks from such a change. They recognized that the current reserve ratio would decline and thus might run the risk of paying some small premium in the future. As political opposition to doubling the insurance limit has increased and as the realities of the potential costs of greater premiums due to the reduction of the reserve ratio, the acceptability of paying any new costs has fallen dramatically. The concern over paying greater costs has also risen as the suggestions about splitting up the top-rated category has made it clear that some institutions that pay no premiums today would be required to pay something if these changes were adopted.

It is important to differentiate between the two types of additional costs. Under the current premium structure, any increase in the insurance level, even indexing, would raise the potential for additional premiums because the insurance funds would move closer to the 1.25 percent designated reserve ratio. That loss of cushion is acceptable to most, but not all, banks in this context. The second costs—asking banks not currently paying premiums to pay when the fund is above 1.25 percent—is completely unacceptable to the great majority of our members and to ABA.

Q.2.f. What do you think of Mr. Hage's proposed bill to merge the BIF and the SAIF; allow for flexible recapitalization of the deposit insurance fund and permit the FDIC to impose a fee on existing institutions for excessive deposit growth?

A.2.f. We believe it is too narrow. The provisions in Mr. Hage's bill provide a reasonable starting point for any reform. As ABA pointed out in our testimony, there are other very important considerations—including capping the funds, providing rebates and adjusting insurance levels for inflation—that should be considered as part of any comprehensive plan. We are pleased that the FDIC and the other banking regulators recognize the need for a comprehensive approach to reforming the deposit insurance system.

Q.3. Mr. Powell indicated that perhaps all the FDIC proposed reforms did not have to be in one package. (a) What would be on your

"must have in the bill" list if you were making one? (b) Should these reforms be done now?

A.3. We have serious doubts about proceeding in stages, frankly because we doubt there would be a second stage. In our written statement we have laid out the many issues that should be considered as part of any comprehensive reform of the FDIC. We believe that any narrowing of the list or prioritizing would tend to limit the possibility that a complete review of the issues be undertaken.

From our discussions at our large Summer Planning Meeting two messages were heard loud and clear: First, that industry would be opposed to any reform that would raise the cost of the system to the banking industry; and second, that any reform package should include a cap on the fund and a rebate or dividend system.

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To Members of the House Financial Services Committee

In testimony on July 26 before the House Subcommittee on Financial Institutions and Consumer Credit relating to deposit insurance, both the Treasury and the Federal Reserve testified, in essence, that many banks receive deposit insurance coverage for free. The American Bankers Association (ABA) believes this characterization ignores the history of the deposit insurance funds and the Congressional debates that led to the current system, and we would like to set the record straight for members of the Financial Services Committee.

The banking industry has paid tens of billions of dollars for the deposit insurance system we enjoy today. In fact, today the deposit insurance funds are so large that the interest income they generate more than meets the full costs of the system – in short, the insurance premiums were prepaid, the system is now self-funding, and no premiums are required of top-rated institutions. Any discussion of the current premium system should recognize the huge sacrifice that banks made to build the funds to an aggregate level that now exceeds $42 billion. Simply put, the zero premium for top-rated banks is a direct result of pre-paid premiums and should be recognized as such.

The story does not stop there. Federal Reserve Governor Laurence Meyer indicated during the hearing that he thought the current structure was an anomaly, not intended by the framers of the Deposit Insurance Funds Act of 1996. To the contrary, as Representative Bereuter pointed out during the hearing, Congress specifically set up this structure and knew exactly what it wanted. Congress recognized that excessive FDIC funding represented significant opportunity costs in the form of fewer loans made and that limits on premium assessments were an appropriate check on such costs. Congress also considered that in that legislation the SAIF members were being asked to provide a huge one-time infusion of resources to fully capitalize the SAIF and commercial banks were being asked to absorb a significant portion of the FICO bond obligations (issued to repay some of the losses from the S&L crisis in the 1980s). This FICO obligation, borne by all banks and savings institutions, totals nearly $800 million a year, and the current premium structure was directly related to the assumption of this FICO obligation. It

is most unfair for those who advocate additional premiums to ignore this huge annual payment.

Why is it important to preserve the zero-premium for top-rated institutions? There are several reasons. First, premiums paid to the FDIC necessarily mean that fewer resources are available for lending in banks' communities. In fact, the loss is more than dollar-for-dollar – given banks' level of capital, a dollar of added expense translates into $7 of lost lending opportunities. To reiterate, the current legal restriction that prevents the FDIC from charging premiums to top-rated institutions once the insurance fund is fully capitalized is an important check on excessive build-up of the fund.

Second, the proposals to charge premiums would in practice almost certainly mean a separation of CAMELS 1 and 2 rated institutions. There is typically little difference between such institutions, and it comes down to the opinion of the examiner. Subjective elements could dominate, and regulatory inconsistencies among examiners would become magnified since a financial penalty would come with a CAMELS 2 rating. Moreover, there is considerable risk that the examiners will always err on the side of downgrading institutions during poor economic conditions and, therefore, exacerbate declining credit availability. In fact, typically a CAMELS 1 rating is subject to review at higher levels within the bank regulatory agencies. What incentive would an examiner have, particularly in a weakening economy, to rate an institution a CAMELS 1 when such a decision is subject to scrutiny?

The testimonies of the FDIC, Treasury, and Federal Reserve were also noteworthy for their disagreement about how to structure such a new risk-based system. Treasury testified that "we would prefer not to extend the complexity of the risk-based structure at this stage." We applaud Treasury for recognizing the complexity involved. The ABA questions whether or not any new risk-based structure would be able to accurately gage risk differentials among the highest rated banks, and ***we are very concerned about the potential regulatory cost to banks of complex measurements under any such new system.***

Third, the incentive is always to be in the top category. So many banks are in the top category because they have worked to be there. There seems to be a "grading on the curve" mentality in some of the testimony against the current system. The great majority of banks worked hard to get in the top category, and then we are told that too many banks "got As" and something must be wrong – that we need more B and C grades. Under today's system, there is a significant cost to not being in the top-rated category. Splitting up the top-rated category will only create an incentive to be in the new highest category. How might banks accomplish this? By making loans only to the very best credit-risks. This means that low- and moderate-income communities, that may represent higher risks of loss, would have less credit available to them. Some would argue that this would make the FDIC even stronger. ABA would argue that it makes our communities weaker and their economic potential less bright.

In 1996, Congress specifically determined that when the deposit insurance funds are overcapitalized there is no need for higher premiums. Congress also recognized the heavy financial burden being placed on banks and savings institutions to pay the interest on FICO obligations. The $42 billion in the FDIC funds did not magically appear, but was a result of significant sacrifices that banks and savings institutions made. ***Perhaps most importantly, the entire capital of the banking industry stands behind the FDIC funds to assure that they will always meet their obligations.*** Banks have assumed this responsibility and should be entitled to the benefits of not paying premiums when the funds exceed the fully-capitalized level. Simply put, the current zero premium system for top-rated banks (except for those that grow at rates well-above the norm) should be preserved when the insurance funds exceed 1.25 percent of insured deposits.

Sincerely,

Donald R. Mengedoth

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MILLER FROM CURTIS L. HAGE

Q.1. Some of the past concern about raising the deposit insurance levels above $100,000 was the moral hazard of putting the American taxpayer at risk if financial institutions fail. Give me your thoughts as to why we should raise the deposit insurance level above $100,000 and place the American taxpayer more at risk?

A.1. ACB supports a modest increase in general coverage levels indexed from the $40,000 level Congress set in 1974, since that was the last time coverage was adjusted solely to account for inflation. Depending on the index used, that would result in coverage of approximately $135,000. We also support indexing coverage to account for future inflation. We do not believe such an increase in coverage would pose additional risk to the taxpayers because the "real," or inflation-adjusted level of coverage would be unchanged. Moreover, the deposit insurance funds remain strong and banking industry capital—the first line of defense against losses—remains at historically high levels.

Nevertheless, ACB would not an advocate an increase in general coverage levels if it were accompanied by unacceptable increases in costs or if debate over the issue threatened to delay action on more urgent deposit insurance reform issues.

ACB believes Congress should act quickly to deal with the rapid growth in deposits at a few "free rider" institutions. As I said in our testimony, ACB urges Congress to act this year on a bill to merge the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF), eliminate the mandatory 23-basis-point premium, and give the FDIC authority to impose premiums on excess deposit growth.

ACB does not believe that a modest increase in coverage levels or indexing would greatly increase the total amount of insured deposits. Frankly, our members believe that there would be some shuffling of deposits among insured institutions, but no major infusion of deposits from outside the system. Since there would be only a modest increase in total insured deposits, a premium increase would not be justified.

However, we agree with the FDIC that indexing coverage would be helpful to maintain the relative position of deposit insurance in the Nation's economy. Indexing would allow an individual to maintain the same relative level of coverage without opening multiple, additional accounts at different institutions.

While ACB does not advocate a substantial increase in general coverage levels, we strongly support providing a substantial increase in retirement account coverage. As I said in our testimony to the Committee, Americans are increasingly responsible for managing their own retirement funds and need a safe haven for these important assets. In the recently passed tax legislation, Congress encouraged even greater growth in these accounts. Clearly, substantially increased deposit insurance coverage would help implement this public policy.

Q.2.a. Mr. Plagge's testimony says "there is general, although not unanimous, support within the banking industry for permanently indexing the level of deposit insurance coverage." What percentage

of your membership supports indexing the level of deposit insurance coverage?

A.2.a. ACB has not surveyed our membership on this question explicitly. However, in the fall of 2000, we formed a deposit insurance team of 32 members to comprehensively examine the FDIC's deposit insurance options paper, which raised the possibility of indexing. The team's consensus was that if it was not possible to obtain modest increases in coverage in the short run, the Congress should at least index coverage going forward. That would maintain the relative role of deposit insurance in the Nation's economy without adding significant new risk to the FDIC. This conclusion (as well as the Team's other recommendations) was later endorsed unanimously by the 70 members of ACB's Government Affairs Steering Committee and Board of Directors.

Q.2.b. What percentage of your membership supports covering the municipal deposits?

A.2.b. ACB members hold differing views on increased coverage for municipal deposits. This generally reflects differences in State and local practices. For example, in Minnesota local governments have joined together to form mutual funds, effectively by-passing insured depository institutions. In other States, not all depository institutions are eligible to accept municipal deposits. On the other hand, some minority owned institutions believe they might benefit from increased coverage for these deposits. In sum, ACB believes that policymakers should avoid imposing an across-the-board premium for increased coverage that would not benefit all institutions.

Q.2.c. What percentage of your membership supports covering the IRA's and other retirement accounts?

A.2.c. As indicated in my reply to question 1, ACB strongly supports a substantial increase in coverage for retirement accounts. ACB's deposit insurance team believes that this has a solid basis in public policy and would be a major benefit to the Nation's retirees and those approaching retirement. In addition, these deposits would be a major boost to community lending by providing a stable base of long-term funding.

Q.2.d. What percentage of your membership would be willing to pay a small, steady premium?

A.2.d. ACB strongly supports maintaining the current statutory language preventing the FDIC from imposing premiums on well-capitalized and well-run institutions when FDIC reserves are above the required levels. We reject the notion that by not paying premiums currently, these institutions are getting "free" deposit insurance coverage. My bank and thousands of others have already paid for our coverage. From 1992 through 1996, insured institutions paid a total of $28.3 *billion* into the insurance funds. That is a large majority of the approximately $42 billion now available in BIF and SAIF. Much of the additional amount is the interest earned on the money we paid in.

Q.2.e. Mr. Plagge's testimony also discusses a study which shows that "doubling coverage could result in net new deposits to the

banking industry of between 4 percent and 13 percent of current domestic deposits, with the lower end of the range more likely." Also doing this "would lower the BIF–SAIF reserve ratio below the required 1.25 percent." Is this worth the potential cost?

A.2.e. ACB does not believe that doubling deposit insurance coverage—which could reduce the reserve ratio below the required 1.25 percent—would be worth the potential cost. As I indicated in response to question 1, we would expect only a very modest increase in deposits as a result of doubling coverage. ACB believes that prompt action on legislation to permit banks to pay interest on business checking accounts would do far more to improve banks' ability to attract deposits. We strongly urge the Senate to act on this proposal, which has already passed the House as H.R. 974.

Q.2.f. Is it worth the potential for premium increases that would accompany a significant increase of the insurance limit?

A.2.f. As indicated in my answers to other questions, ACB does not support a significant increase in general coverage limits in large part because they would likely be accompanied by unacceptable premiums.

Q.3.a. Mr. Powell has indicated that perhaps all of the FDIC-proposed reforms did not have to be in one package. What would be on your "must have in the bill" list if you were making one?

A.3.a. ACB's "must have in the bill" proposals are contained in H.R. 1293, the Deposit Insurance Stabilization Act, introduced by Representatives Bob Ney (R–Ohio) and Stephanie Tubbs Jones (D–Ohio). That bill fully addresses the concern that one or both of the deposit insurance funds could fall below the 1.25 percent ratio, triggering a damaging 23 basis point premium. H.R. 1293 contains three elements:

- *Permits the FDIC to impose a fee on existing institutions for deposit growth that materially dilutes the insurance funds, so that the required reserve ratio can be maintained.* Currently, the FDIC may impose an excessive deposit growth fee on new institutions or new branches. By allowing the FDIC to impose fees on existing institutions, H.R. 1293 would address the current "free-rider" problem.
- *Merges the BIF and the SAIF.* According to the FDIC, merging the BIF and the SAIF would create a more stable, actuarially stronger deposit insurance fund. A single, larger fund would be less affected by either rapid deposit growth at a few institutions or losses from failures.
- *Allows for flexible recapitalization of the deposit insurance fund.* If the reserve ratio of the merged fund falls below the required level of 1.25 percent, the bill would give the FDIC flexibility in recapitalizing the fund over a reasonable period of time. By repealing the automatic assessment of 23 basis points, H.R. 1293 would give the FDIC authority to use a laser beam approach, rather than a sledgehammer, to recapitalize the insurance fund.

ACB believes that Congress should act quickly on this legislation to help ensure the continued strength of the FDIC and prevent the

potential diversion of billions of dollars away from community lending to homeowners, consumers, and small businesses.

Q.3.b. Should these reforms be done now?

A.3.b. ACB strongly urges the Congress to act this year on the proposals contained in H.R. 1293. We would welcome action on other issues—such as providing for rebates and substantially increasing coverage for retirement accounts. However, if the list of comprehensive reform proposals is too long for the Congress to pass this year, we ask that you set priorities, enact what you can this year, and return to the rest next year.

Further large transfers from uninsured money market funds into insured deposits, accompanied by just a few costly failures, could easily trigger large premium assessments across the country. There is no way to predict those events with any accuracy. But unless Congress acts now, the matter will be outside your control. That is a risk we should not take and one we can avoid.

RESPONSE TO ORAL QUESTION OF SENATOR JOHNSON FROM CURTIS L. HAGE

I would like to take this opportunity to supplement my response to Chairman Johnson's question on this topic.

Q.1. Senator Johnson asked for responses to a Treasury Department suggestion "that Federal Home Loan Bank advances and other secured capital be considered in the deposit insurance assessment base. The FDIC's report said that a bank's reliance on noncore funding, which may include these advances, should be considered risky."

A.1. My bank has relied for years on Federal Home Loan Bank advances; they *are* a core part of my funding. Advances are a stable and reliable supplement to my core deposit base. With these options, I do not have to rely on other funding sources, such as the higher-cost brokered deposits. The FHLBank advances are overcollateralized as required by regulation and they add strength to a properly run depository institution as an alternative source of funding. My use of advances makes my institution more stable, reducing the likelihood that the FDIC would suffer any loss associated with our insured deposits.

It is true that a bank might use advances, or any other funding source, to finance risky operations. However, the risk-based premium structure is in place precisely to impose appropriate costs on more risky activities. If the FDIC finds that certain types of lending or other activities increase the risk of failure, then it should impose a premium to reflect that risk. The additional risk would stem from the activity, *not* how that activity is funded, especially when the funding source is as stable as advances from the Federal Home Loan Bank System.

While it is true that the collateral supporting advances stands ahead of the FDIC in the event of an institution failure and resolution, appropriately used advances provide necessary funding flexibility, helping ensure that depository institutions remain healthy. Adding advances as a risk factor would unnecessarily raise costs to

the detriment of consumers and businesses that ultimately benefit from the responsible use of advances.

Now that the System is more fully open to the commercial banks, advances are becoming more important to community lending throughout the country. Given the shortage of deposits in many communities, it would not make sense to artificially discourage depository institutions use of Federal Home Loan Bank advances for housing and community development.