VIEWPOINTS OF THE FDIC AND SELECT INDUSTRY EXPERTS ON DEPOSIT INSURANCE REFORM

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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VIEWPOINTS OF THE FDIC AND SELECT INDUSTRY EXPERTS ON DEPOSIT INSURANCE REFORM

WEDNESDAY, OCTOBER 17, 2001

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

The subcommittee met, pursuant to call, at 10:04 a.m., in room 2128, Rayburn House Office Building, Hon. Spencer Bachus, [chairman of the subcommittee], presiding.

Present: Chairman Bachus; Representatives Royce, Kelly, Cantor, Hart, Waters, Bentsen, Sherman, Lucas and Shows.

Chairman BACHUS. The subcommittee meets today for its third hearing this year on reforming the deposit insurance system. We're delighted to have with us today the new Chairman of the FDIC, Don Powell, who assumed his responsibilities at the Agency less than two months ago, after a distinguished career in Texas banking. Chairman Powell will provide us with the FDIC's updated recommendations on how to reform a system that has served our country well over the years but is in need of some retooling for the 21st century marketplace.

Shortly after the subcommittee's last hearing on deposit insurance reform in late July, the Office of Thrift Supervision announced the failure of Superior Bank, a Chicago-based thrift with assets of $2.3 billion and a heavy concentration of sub-prime loans. Early estimates are that Superior's failure could end up costing the Savings Association Insurance Fund upward of $500 million, which would in turn lower SAIF's ratio of reserves to insured deposits from its current level of 1.43 percent to 1.35 percent or even lower.

In and of itself, the Superior failure is hardly cause for panic. Both the SAIF and its banking industry counterpart, the Bank Insurance Fund, remain extremely well capitalized and the banking and thrift industries appear well-positioned to weather any significant downturn in the economy. Nonetheless, a precipitous drop in SAIF's reserve ratio—coinciding with recent declines in the BIF ratio—highlight the need for Congress to consider reforms before the ratios fall below levels which, under the current system, would trigger sizable premium assessments on all institutions.

As this subcommittee begins in earnest to consider legislative proposals to address deficiencies in the current deposit insurance system, I can think of no Government official better qualified to provide us with wise counsel than our first witness at today's hearing. With more than 30 years of experience in the financial services industry, including his recent tenure as president and CEO of the First National Bank of Amarillo, Chairman Powell brings to his new position a real world understanding of the industry he is now charged with overseeing, that is truly refreshing.

I had the pleasure of spending time with Chairman Powell when he visited my office last month. I found him to be exceedingly well versed on the issue of deposit insurance reform as well as extremely sensitive to the challenges faced by America's Main Street banks.

Chairman Powell pledged to work closely with the subcommittee both in the context of deposit insurance reform and in other areas to ensure that the legislative and regulatory initiatives we pursue here in Washington make sense when viewed from the perspective of a Main Street banker and his customers. In the area of deposit insurance reform, I've been particularly encouraged by Chairman Powell's endorsement of the principle of indexing coverage levels to inflation and increasing coverage for individual retirement accounts.

And I was extremely pleased to see an analogy you made in your testimony that actually that's the only way we can keep coverage at the same level because of inflation. If we don't move it up or index it, it actually diminishes in value. And I think that's probably the best argument that I've heard in ten years for an increase.

As I said, Chairman Powell has expressed a willingness to work with the subcommittee in exploring possible changes in the system, and one of the changes I've advocated is insuring municipal deposits. If we are truly serious about addressing liquidity problems facing small community banks across America, we should be doing everything possible to encourage local government agencies to keep their receipts in the community by depositing them with local banks.

Currently, many States require banks that maintain municipal deposits to pledge collateral against the portion of such deposits that exceed $100,000 and are therefore not insured by the FDIC. This not only makes it difficult for small banks to compete for those deposits with larger institutions, but it also ties up resources that could otherwise be devoted to community development and other lending activities.

This is an issue I look forward to discussing further with Chairman Powell as the deposit insurance reform debate moves forward.

Let me close again by issuing Chairman Powell a warm welcome, testifying for the first time before our subcommittee, and also welcome those who'll be testifying on our second panel.

[The prepared statement of Hon. Spencer Bachus can be found on page 26 in the appendix.]

I now recognize there are no other Members who wish to make opening statements so at this time, Chairman Powell, we look forward to your testimony.

STATEMENT OF HON. DONALD E. POWELL, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. POWELL. Thank you, Mr. Chairman.

It is a great pleasure to appear before you this morning, my first appearance before Congress as Chairman of the Federal Deposit Insurance Corporation, to discuss deposit insurance reform. The current system does not need a radical overhaul, but I agree with the FDIC's analysis that there are flaws in the current system. These flaws could actually prolong an economic downturn rather than promote the conditions necessary for recovery. The current system also is unfair in some ways and distorts initiatives in ways that make the problem of moral hazard worse. These flaws can only be corrected by legislation.

The FDIC staff has prepared an excellent report on deposit insurance reform with very important recommendations. In fact, if I might digress for a few moments, Mr. Chairman. Last night, I attended a lecture and ceremony for the presentation of the Roger W. Jones Award for Excellent Leadership sponsored by the School of Public Affairs at American University. This prestigious award is given to two career employees in the Federal Government that exemplify an enhancing commitment to the effective and efficient operations of Government.

Art Murton, the Director of the FDIC's Division of Insurance, was one of the recipients last night. He received the award, in large part, for the work he did on the deposit insurance study. I would like to take this opportunity to publicly congratulate Mr. Murton.

I have studied the report and have full confidence in the product the FDIC has produced. This morning I will add my thoughts on how the Congress can create a better system. The current system is designed to ensure that the funds' reserves are adequate and that the deposit insurance program is operated in a manner that is fiscally and economically responsible.

Any new system should retain these essential characteristics. It should also be fair, simple, and transparent. Specifically, what should we do?

First we should merge the Bank Insurance Fund and the Savings Association Insurance Fund. That is the FDIC's longstanding position and the industry has strong consensus supporting such a merger. In fact, I have heard no one inside the industry or out suggest otherwise. Many institutions currently hold both BIF and SAIF insured funds. A merged fund would be stronger and better diversified than either fund standing alone. In addition, the merged fund would eliminate the possibility of a premium disparity between the BIF and the SAIF. Finally, merging the funds would also eliminate the costs to insured institutions associated with tracking their BIF and SAIF deposits separately, as well as the complications such tracking introduces for mergers and acquisitions.

For all of these reasons, the FDIC has advocated merging the two funds for a number of years and I wholeheartedly agree.

Second, we should index deposit insurance coverage. I do not believe it is necessary to raise the coverage limit now. While I'm acutely sensitive to the funding pressures faced by many community banks, this is a complex issue and there are many factors at work. It is not clear whether a higher coverage limit would significantly ease current funding pressures for most of these institutions.

The impact of raising the coverage limit on the fund reserve ratio is also uncertain and we must be mindful of the potential for unintended consequences, such as facilitating deposit gathering by higher-risk institutions. We should, however, ensure that the present limit keeps its value in the future. For this reason, deposit insurance coverage level should be indexed to maintain its real value.

My suggestion would be to index the $100,000 limit to the Consumer Price Index and adjust it every five years. The first adjustment would be on January the 1st, 2005. We should make adjustments in round numbers—say, increments of $10,000—and the coverage limit should not decline if the price level falls. These seem like the right elements of an indexing system, but I'm willing to support any reasonable method of indexing that ensures that the public knows that the FDIC deposit insurance protection will not wither away over time. I look forward to working with the Congress to find a method of indexing that works.

There has been some opposition to the FDIC's indexing proposal on the grounds that it would increase the Federal safety net. Frankly, I'm puzzled by this. The FDIC is not recommending that the safety net be increased, it is simply recommending that the safety net not be decreased inadvertently because of inflation.

There is one class of deposits for which Congress should consider raising the insurance limit, and that is IRA and Keogh accounts. Such accounts are uniquely important and protecting them is consistent with existing Government policies that encourage long-term saving. When we think about saving for retirement in this day and age, $100,000 is not a lot of money. Middle-income families routinely save well in excess of this amount

Moreover, especially during this time of uncertainty when Americans may be concerned about the safety of their savings, I believe it is important for the United States Government to offer ample protection to facilitate savings through vehicles that will redeploy funds into the economy. In my view, we must do whatever we can to provide for the ongoing productive investments in our economy and solid, sustainable growth. Higher deposit insurance protection for long-term savings accounts could help.

There is some history for providing such accounts with special insurance treatment. In 1978, Congress raised coverage for IRAs and Keoghs to $100,000, while leaving basic coverage for other deposits at $40,000. I urge the Congress to give serious consideration to raising the insurance limits on retirement accounts.

On the issue of managing the insurance fund, right now there are two statutorily mandated methods for managing fund size. One of these methods prevents the FDIC from charging appropriately for risk during good economic times. The other can work to exacerbate an economic downturn. Together, they lead to volatile premiums.

To address this issue, we must, third, allow the FDIC to price deposit insurance according to risk, and the FDIC's Board must have the flexibility to manage the fund size in periods of stability as well as in periods of crisis.

Specifically, the FDIC should have the discretion to set the target size for the fund ratio and determine the speed of adjustment toward the target and charge appropriately for risk at all times.

What is the appropriate target for the size of the fund? This will depend upon economic and banking conditions and other factors that affect the risk exposure of the industry. The FDIC is in the best position to gather information about risks in the industry and to analyze it for these purposes, using state-of-the-art measurement methods, as well as to determine the best pace for moving toward the fund target.

Although I believe that greater discretion for the FDIC Board is essential in these areas, I am not suggesting that the current target of 1.25 is inappropriate or that there should be no guidelines for the FDIC in managing the size of the fund. On the contrary, I believe that the 1.25 percent target has served us well in recent years, and is a responsible reserve against the current risks in the banking sector. The current target is a reasonable starting point for the new system.

Moreover, I would steer clear of automatic triggers or hard targets. I would be happy to work with Congress to develop some guiding principles for the FDIC Board in managing the growth or shrinkage of the fund. I also believe that the FDIC should report regularly to the Congress on its actions to manage the fund, and we are fully prepared to do that.

How would premiums work if the FDIC could set them according to the risks in the institutions we insure? First and foremost, the FDIC would attempt to make them fair and understandable. We would strive to make the pricing mechanism simple, straightforward, and easy for bankers to understand. In my view, we can accomplish our goals on risk-based premiums with relatively minor adjustments to the FDIC's current assessment system.

Using the current system as a starting point, I believe that the FDIC should consider additional objective financial indicators based upon the kinds of financial information that banks and thrifts already report, to distinguish and price for risk more accurately within the existing least-risky 1A category. The sample "scorecard" included in the FDIC's April 2001 report represents the right kind of approach.

In short, I believe the right approach is to use the FDIC's historical experience with bank failures and with the losses caused by banks that have differing characteristics to create sound and defensible distinctions. Pricing deposit insurance risk is inherently difficult and some amount of subjectivity cannot be avoided.

We will never be perfect, but we are committed to doing the best possible job. We will use objective factors whenever possible, and we will invite the participation of the industry and the public in the FDIC's decisionmaking process through notice-and-comment-rulemaking and other outreach efforts.

Essentially, the FDIC wants to be able to fulfill the original mandate Congress gave it in 1991 to design and establish a truly risk-based system that allows the insurer to respond to emerging risks and evolving risk factors.

Finally, one goal of deposit insurance reform should be that, over time, it produces a better and fairer system without increasing the net costs of deposit insurance for the industry or increasing the risk posed to taxpayers. If the FDIC is charging risk-based premiums to all institutions, then to check the growth of the fund in good economic times, the FDIC must be able to grant banks a credit toward future assessments.

In its recommendations, the FDIC suggested giving rebates whenever their fund ratio moves above its target range. However, I am reluctant to mandate a cash payment out of the insurance fund at this time, given the uncertain economic environment. We can achieve the desired result by giving banks a credit toward future assessments. Initially, these credits should be allocated in proportion to assessments paid in the past, which would be fair to the institutions that built the insurance funds to where they stand today.

Mr. Chairman and Members of the subcommittee, the Congress has an excellent opportunity to remedy flaws in the deposit insurance system before those flaws cause actual damage either to the banking industry or our economy as a whole. Both insurance funds are strong and despite a slowing economy, the banking industry also remains very strong.

The FDIC has put forward some important recommendations for improving our deposit insurance system. While I believe we should remain flexible with regard to implementation, as a former banker and as the FDIC's new Chairman, I believe that we should work together to make these reform proposals a reality.

Thank you.

[The prepared statement of Hon. Donald E. Powell can be found on page 30 in the appendix.]

Chairman BACHUS. Thank you.

At this time, I'm going to yield to Mrs. Kelly for questions.

Mrs. KELLY. Thank you very much, Mr. Chairman, and Mr. Powell, thank you for testifying. I too want to applaud your idea of indexing coverage to inflation. I think that's a good suggestion and I think it's something we should consider. I'm glad to hear it.

Mr. Powell, I understand that some Oakar banks that bought safe deposits during the savings and loan crisis are asking the FDIC to make substantial payments from the SAIF and shift deposits from the SAIF coverage to coverage by the BIF as a result of their purchase. The theory behind this request is that some BIF insured banks that had bought SAIF insured deposits miscalculated their relative BIF and SAIF deposit bases, causing them to pay incorrect premiums. As a result, the FDIC made the banks whole that paid too much, and forgave the banks that paid too little.

Many Oakar banks calculated their SAIF obligations correctly, but several are now asking Congress to grant them cash, as if they had made a mistake when they calculated.

What impact, if any, could this have on the Deposit Insurance Fund?

Do you want me to wander through that again?

Mr. POWELL. No. That impact could be as much as $500 million.

Mrs. KELLY. I'm sorry, sir, could you repeat that?

Mr. POWELL. That impact could be as much as $500 million.

Mrs. KELLY. Five hundred million dollars, that would be the impact.

Mr. POWELL. Yes, ma'am.

Mrs. KELLY. OK, that's at least good for us to know and we perhaps need to address that. Thank you.

Another question I had was brought up by one of the people on my banking advisory committee. They were talking about municipal deposits. And the question is, do you think municipal deposits ought to get 100 percent insurance coverage, or should they get some other higher level of coverage, and if so, what level of coverage do you think is appropriate for municipal deposits?

Mr. POWELL. I'm concerned about providing complete protection for any class of depositors. We're willing to talk about this, but I would say that I'm not persuaded that there's strong public policy argument for raising the limit on municipal deposits at this time. We at the FDIC would be more than willing to listen to those arguments for raising those limits.

Mrs. KELLY. But you are willing to think about this?

Mr. POWELL. Yes, we would be willing to talk about it and think about it.

Mrs. KELLY. Perhaps you'd want to get back to the subcommittee and let us know what you're ponderings are?

Mr. POWELL. Sure, I'd be happy to do that.

Mrs. KELLY. I want to link that then to another issue that they brought up which was what level of coverage you think that the retirement accounts, like IRAs and 401Ks should receive, and should co-insurance be considered for higher coverage of mutual and retirement accounts?

Mr. POWELL. There's been some history, as I mentioned in my testimony, I think Congress chose to raise the retirement accounts, the IRAs and Keoghs to 2½ times the coverage that was in place in 1979. So with that formula, that would raise the coverage to $250,000. We have done some work at the FDIC looking at the number $500,000, and do not believe that between $250,000 to $500,000 that there would be any impact on the fund, but of course that is based upon some assumptions that we don't know, in fact, would happen.

But, 2½ times, it seems to me, would be a reasonable number.

Mrs. KELLY. Thank you, Mr. Powell. Unfortunately, I'm going to have to go up to the floor so I'm going to yield the rest of my time to Chairman Bachus.

Chairman BACHUS. Thank you. And what I'm going to do, I've got several Members that want to participate in the money laundering debate on the floor too, so I'm going to yield at this time, and then when they are through, I have a few questions.

The gentleman from Texas.

Mr. BENTSEN. Thank you, Mr. Chairman, and Mr. Powell, my fellow Texan, I'm sorry I missed the opening part of your statement and I, unfortunately, have not completed your testimony, but I was able to glean some information from it.

From reading the initial part of your testimony, you seem to at least partially endorse the report of your predecessor in the approach that she and your staff were trying to take to reform in the FDIC, I'm sorry, the deposit insurance program. I agree with you on the merger of the funds. I think that makes perfect sense.

You sort of get into some detail of more of a risk-based pricing model, which I also think makes sense, and rather than giving just a cash rebate back, you would want to, you just want to carry it forward on basically a credit against future assessments, and I think that makes some sense also.

I particularly like the idea of trying to get away from this sort of counter-cyclical pricing approach.

What I'm curious about is one of the things that I think your predecessors proposed was that even with a risk-based pricing and even with credit assessments, if I understood this correctly, that there would always be some assessment so that you could never get to zero in effect, so that there was always some cash flow coming into the fund in the event that you hit a real bump in the road.

And we have seen, not in this industry, but in other industries, the bumps in the road can come out of nowhere, as we saw in the airline industry and potentially in the insurance industry because of September 11th.

Is that your position as well, that even with the, if we were to develop a model or legislation off of your testimony and off of the FDIC's proposal, as modified by you, with the assessments, with the credit allocation, with the risk-based pricing, that there would still be at least, there would always be some premium that would be paid?

Mr. POWELL. Yes, sir. The thought behind that is that all institutions, we believe, benefit from FDIC insurance and every institution, even those that are extremely well run, offer some risk to the FDIC.

Mr. BENTSEN. Is it, and in the midst of everything going on, I realize banking policy isn't necessarily getting the full attention that this subcommittee might believe it deserves, but is this, is the reform of the deposit insurance system a top priority of the Administration, and is it something that you all will seek to push in this Congress?

Mr. POWELL. We have been in contact with the folks at Treasury and they have been informed of our position and we've had dialogue back and forth with the folks in Treasury. We at the FDIC, we believe that this is good public policy, we believe it's the right thing to do, and we will attempt to move this forward.

Mr. BENTSEN. Well, I'm glad to hear that, Mr. Powell, because I do think that it's something that we ought to do. They're not as many other issues on the agenda, having passed Gramm-Leach-Bliley, that I think are as important to the industry. We, as you know from your prior life, we have debated this issue for some time, long before I came here and hopefully not long after I leave, but we went through a number of machinations in 1995 and 1996. We came up with compromise language in 1996, but that was really left undone, and so I'm pleased with where your testimony is heading today, that you want to take the approach a step further and I encourage you to keep pushing, and at least for this Member, any assistance I can give in prodding the Administration—they don't listen to me all that often, but to the extent that we can work together, I'm eager to work with you and I yield back the balance of my time.

Mr. POWELL. Thank you.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman BACHUS. Let's see, the gentlelady from Pennsylvania doesn't have questions, is that correct?

And the gentleman from California does not have questions.

Gentleman from Kentucky, no questions.

This is a great first hearing.

Let me go over what I, I just made some notes on your testimony from reading it yesterday, and let me sort of go down this list as opposed to some questions and answers, and make sure that maybe I'm hitting the highlights.

First of all, merge the funds?

Mr. POWELL. Yes, sir.

Chairman BACHUS. No across-the-board increase in the basic coverage now?

Mr. POWELL. Yes.

Chairman BACHUS. Index the present $100,000 limit to the Consumer Price Index, and adjust that every 5 years with the first adjustment 1/1/05.

Rounding in whole numbers in $10,000 increments, and then I think I also agree with you, and retain the coverage level even if the price level falls.

Mr. POWELL. Right.

Chairman BACHUS. Because if you didn't do that, you could actually cause some unease in the market?

Mr. POWELL. Right.

Chairman BACHUS. Increase the insurance limit for IRA and Keough deposits since existing Government policies encourage long-term savings, and middle income families routinely save well in excess of that amount.

Also higher IRA and Keough deposit insurance coverage promotes productive economic investment in growth, which is something I think Chairman Greenspan and other economists have asked this Congress to figure out ways to do.

The basis, and some people question why have two different limits, but you pointed out, I think, that in 1978, when it was established the IRA/Keough coverage at $100,000, while leaving basic coverage at $40,000, so we already have that precedent.

While banks and thrifts account for just $220 billion of IRA Keoughs, the short-term impact to the reserve ratio could be dramatic, because of $2.5 trillion in IRA/Keoughs in the overall economy. And that's a concern for you. And the FDIC is going to study that before they make a final recommendation?

Mr. POWELL. Yes, sir.

Chairman BACHUS. And will that include in the amount to bring that coverage up to?

Mr. POWELL. Yes, sir.

Chairman BACHUS. Deposit insurance within the 1A category can be priced according to risk using the existing system of subjective indicators. Then you're going to add six additional objective financial indicators?

Mr. POWELL. Yes, sir.

Chairman BACHUS. And I do have, I'm going to have a follow-up question on that. Grant future assessment credits allocated in proportion to past assessment payments using 1996 as a baseline date when both funds have been capitalized. And I will have a follow-up on that too, I think, if no one else asks it, about how we compute that, if one institution's acquired another institution.

But, you're not going to provide a cash out of the fund now due and that's due to the uncertain economic environment? And obviously, I don't think anybody would argue with that. I probably shouldn't have said no one will argue with it, but I think your position is certainly reasonable.

Eliminate the 23 basis point cliff effect to ensure that new deposit growth no longer triggers premium increases. That's something that this subcommittee has also identified. I think there's some pretty broad agreement by the industry and the regulators.

I've got four more questions, and this is now getting into something that is maybe where the industry and regulators might see some disagreement.

Provide the FDIC board with the flexibility to set the fund ratio's target size, determine the speed of adjustments toward the target and charge appropriately for risk at all times. Although no target range is specified, the current 1.25 percent level is a reasonable starting point for the new system. Avoid hard targets or automatic triggers in managing the fund's growth or shrinkage.

Now in regard to that, as I see it, you're actually saying let the FDIC—basically it almost appears to be a request for total discretion. You're a Main Street banker, is the industry comfortable with that? I'm asking you as a regulator, but you've been in the business for 30 years. Is the industry comfortable with—and I'll stop, I've got one more.

Mr. POWELL. Mr. Chairman, I think you're correct, but I would add this to it, that there would be some parameters and some accountability back to Congress on an annual basis. I mean, we are willing to work with Congress about setting some parameters as relates to our discretion, but in fact, we would like to manage the fund without some hard targets associated with it.

I look at it, not unlike a loan loss reserve at a bank. We, at the FDIC, should have the ability to make sure that we understand the risks in the system. It's a commercial bank and I have my loan portfolio. I need to assess what the risk is without saying that my reserves should be 2 percent of loans or 1 percent of loans or 5 percent of loans, because the risk varies from time to time. And the risks will vary from time to time and we are simply asking that we be allowed, with these parameters in place and with reporting back to the Congress, of being accountable back to Congress, that we manage that risk, because risk is ever changing, to be fair to the system. And we have the data we think that would enable us to assess the risks.

Chairman BACHUS. I agree with you that, you know. Hard targets are not the way, and that ranges—you know, we talked about ranges, but I don't know that we've ever talked about not having a bottom of the range and a top of the range. Maybe there are extenuating circumstances, and let me tell you the reason I'm saying that.

Two reasons, two concerns. One is the bank needs to know at a certain capitalization rate the Government is not going to be asking me to put more in, and you know, at a certain level, I know that I've probably got to start paying more. And you know, I see, as that ratio goes up and down, there's some predictability that I can make in business judgment.

But another concern is, not while you're Chairman, but what is to prevent a new Chairman, unless there are some ranges, of saying we're going to raise the ratio to give—we're going to punish the—we're going to finance some of the operations with this.

Mr. POWELL. I've been on that side, Mr. Chairman, yes.

Chairman BACHUS. You see what I'm saying?

Mr. POWELL. Absolutely.

Chairman BACHUS. As a banker, I think they'd be able to raise it to 2½ percent.

Mr. POWELL. It gets back to that accountability. I think we need to be accountable, and we would again work with the Congress. It may be there should be a minimum, there should be a maximum. We would again be willing to listen to any of those views, be they your views or any other Members of Congress.

Chairman BACHUS. You know, at a certain point, and as I've said before, you've come from Amarillo, you've come from the real world, and you know that there is a ratio at which, whether it's 1.5, 1.8, where banks, even that, you know, a one-half of 1 percent or one-quarter of 1 percent makes you competitive or non-competitive in the marketplace.

Mr. POWELL. Yes sir, I think your point is very good and I want to stress that we want to be accountable. Accountability is something that we at the FDIC understand and we want to be accountable to Congress. And we would listen to any standards that Congress may want to put into that. We would just simply say that the economy moves from time to time, and a benchmark of 1.25 has served us extremely well in the past, but in the future, perhaps that should be managed in a different way. So we're willing to listen and willing to work with you.

Chairman BACHUS. Particularly, you know, the industry doesn't agree, but the regulators—and there are certain people saying there ought to be at least some premium paid, and at some level, I think we all agree that an assessment, when there's a certain capitalization rate, there's probably no need to go above that.

Mr. POWELL. Absolutely, yes, sir.

Chairman BACHUS. My first question is this. Well, let me, I had one other point, I think here, and that would maybe complete what I've sort of gone over your testimony just some high points, is the combination of risk-based premiums and assessment credits tied to past contributions would help to fix the problems related to rapid growers and new entrants. And I think that's a real concern among many people in the industry.

Mr. POWELL. Yes, sir.

Chairman BACHUS. Other than the new entrants and fast growers that aren't at all concerned about that problem, but I think that's a good recommendation. And here's my first question, it's sort of a follow-up. There's widespread industry concern that well-managed, well-capitalized institutions with ratings of 1 or 2 should not have to pay premiums. Why should premiums be reimposed on these institutions if their 1A assessment rating and high ratings accurately reflect their risk profile and financial condition? And I'll just ask the follow-up now and you can answer it all.

And how do you persuade those institutions to support a proposal to pay premiums for the first time since 1997?

Mr. POWELL. I think that question really needs to be answered in taking into consideration the credit assessments that we are recommending. But we believe that every institution, in fact, does have some risk to the Fund. The FDIC has data that supports that statement in that banks in the past that have failed, and I don't have that data before me, but clearly, banks of a rating of 1 and 2 represented some percentage of the banks that failed 2 and 3 and 5 years later.

So all banks have risk. And all banks benefit from FDIC insurance. Thus, it would seem to me that all banks should pay, again based upon the risk, and those that have paid in the past and those that are the best rated banks will receive some credit assessment, and obviously the premiums would be much lower for the best rated banks than those that present a higher risk to the system.

Chairman BACHUS. I think your response is very concise and hits two or three of the points very well, so I agree with you, and I think many on this subcommittee do.

How do you perceive the public's reaction to a modest increase in the deposit insurance coverage limit of, let's say, $10,000 or $20,000 or is there a minimum that it goes up or $30,000 or even $40,000? What is the estimated effect to the Fund and the Fund ratio from such increases?

Mr. POWELL. The FDIC has done lots of work as relates to that and, Mr. Chairman, I would tell you that under the current proposal that the impact on the Fund is not material. That has lots of assumptions, of course, based upon it as we go forward depending upon what happens in the economy, but it's not material.

Chairman BACHUS. At this time, I'm going to yield to the gentlelady from California, and invite you to make an opening statement, and I have explained to the Chairman that our money laundering bill is on the floor and that traditionally the minority Member as well as the Chairman were to be there, but the Chairman of the Full Committee is there on my behalf, and I think Ms. Waters has come from the floor.

Ms. WATERS. Thank you very much, Mr. Chairman. You're absolutely correct. Our bill is on the floor and a lot of other things are going on. But I certainly wanted to be here, Mr. Chairman, and I thank you for calling this hearing, the third in a series on Federal Deposit Insurance Reform, and I'm pleased that we'll be hearing from the new FDIC Chairman, Donald Powell, as well as Professor Rick Carnell, Mr. Nolan North, and Professor Kenneth Thomas this morning.

Deposit insurance has served America well for almost 70 years. It has maintained public confidence in our banking system throughout times of prosperity and times that weren't so good. It is important that we examine these issues closely in order to maintain and strengthen today's system for tomorrow's consumers.

Earlier this year, the FDIC released its report on deposit insurance reform which highlighted a number of major issues, including deposit insurance is currently provided by two different funds at two different prices. Deposit insurance currently cannot be priced effectively to reflect risk. Deposit insurance premiums are highest at the wrong point in the business cycle, and the value of deposit insurance does not keep pace with inflation.

In addition, 92 percent of all institutions are currently paying nothing whatsoever for their deposit insurance coverage. This zero premium system became law in 1996, the same year that Congress passed Welfare Reform. Welfare Reform legislation was designed to reduce Federal assistance to poor people, the very same year that we decided that banks need not pay anything for Federal Deposit Insurance coverage.

This does make good sense. I have a stellar driving record and my insurance company may have more than adequate cash reserves, but I still pay a premium for insurance coverage or I can't drive my car.

As we examine various proposals for deposit insurance reform, we should keep this fact in mind. Banks should pay something for their insurance coverage.

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

I thank you very much, Mr. Chairman, and I'm going to try to stay as long as I can.

Chairman BACHUS. Thank you.

We'll go back to questions. This is going to be the longest question I'm going to ask you, so you get through this one, you'll have my longest question.

What objective financial and market factors should be considered when assessing premiums based on the risk posed by large and complex institutions, and how do you ensure large and small institutions are assessed premiums fairly and consistently?

Mr. POWELL. That's our objective, obviously. The answer to the latter part of your question is we want to be consistent and fair, and that the system be transparent between large and small institutions. There are several market factors that perhaps are data we could use. I think there has been some work on that as it relates to some other capital work that's being done by the regulatory bodies.

There are numerous market factors that we could look at and we're willing to look at those and to listen to the larger banks about something that they would like to see as part of our risk-based model.

Chairman BACHUS. All right, and I'm going to ask a follow up. I think you probably, you don't have to answer this today. What I might do is submit that question and some others just for the record in writing and get a comment.

The other part of that question, what is the appropriate size cut for regulators to distinguish large and complex institutions from small and middle sized institutions for regulatory and assessment purposes? I'm not sure that's something you can answer today.

Mr. POWELL. Give us a little bit of time on that, and we'll attempt to answer that question for you, Mr. Chairman.

Chairman BACHUS. I think that's totally reasonable.

At this time, I will yield to the lady from Pennsylvania.

Ms. HART. Thank you, Mr. Chairman. I'm sorry I wasn't here for the entire discussion, Chairman Powell, but I appreciate you coming before this subcommittee.

You discussed in your statement, as I've been reviewing it, how an assessment credit would work instead of a rebate where the institutions would receive credit toward their future assessments based on their past contributions to the Deposit Insurance Fund, and how it would be based on the institution's relative deposit base at the end of 1996, which for an institution that existed in 1996 in its current form, is pretty straightforward.

How would you address a situation which is becoming more and more common where a banker/thrift has acquired one or more institutions since the end of 1996, and would the acquiring institution assessment include the credits that had accrued to the acquired institution and how would that work? And how would you make sure that that's sort of done, I guess, in a balanced and fair way?

Mr. POWELL. Yes. Would the acquiring institution get credit for the past assessments paid by the acquired institution? The answer is yes. And we would have the records and data necessary to make sure that that, in fact, happens.

Ms. HART. I'm sorry, could you repeat that?

Mr. POWELL. Yes. I'm answering your question that if an institution acquires an institution, both would be combined together as if they were one institution so that we get total credit for both of those institutions.

Ms. HART. So it would be the——

Mr. POWELL. The acquiring institution would get credit for the past assessments paid by the acquired institution.

Ms. HART. OK. So all their assessments would be added together with the assessments for the new one?

Mr. POWELL. Yes, ma'am.

Ms. HART. What about the combined——

Mr. POWELL. It would be combined.

Ms. HART. From that date forward?

Mr. POWELL. That's right.

Ms. HART. OK. And is there anything about that that you'd be concerned about as far as like an imbalance because of the, I don't know, the change in size. There's no concern that you have about that?

Mr. POWELL. No, I really don't have any concern. I think we have the data necessary to calculate it.

Ms. HART. OK, so it's just a typical additional kind of thing?

Mr. POWELL. Yes, ma'am.

Ms. HART. OK, thank you.

Thank you, Mr. Chairman.

Chairman BACHUS. Chairman Powell, if there are no other questions from Members of the panel, at this time we're going to discharge you to get back to the important work of the FDIC. We very much appreciate your testimony.

I will tell you that I did not formulate that question on municipal deposits. My staff did, knowing my concern about municipal deposits and that's why you were asked it. But I did not put anybody up to asking you that question.

I will tell you this. The public policy, I think, behind some greater level for municipal deposits is simply that when you have a small county or rural county, the people in that county, they want to be able to invest with their local institutions, their water boards, their school boards, their county government. They like those taxes to stay home if they can. At the same time, they want it federally-insured.

I am in total agreement with you that it would be foolish to have an open-ended guarantee on municipal deposits with no level or no limitations. And I think one of the problems that maybe the FDIC has with that, the problems that we've had in struggling with it, is it sounds like a good idea. There is, I think, a public policy consideration for it, but how do you draft it and how do you get to sound legislation, and we're still in search of something that protects the public and protects the Fund, and is not discriminatory. So I do appreciate your comments, and as I said, you've been in banking for 30 years, you bring a world of experience from the institutions into this job. And I'm excited about working with you.

Mr. LUCAS. Mr. Chairman? Over here.

Chairman BACHUS. Mr. Lucas.

Mr. LUCAS. Would not a county government, a city government, a sewer and water board each have their own insurance since they're not combined? Is that not true?

Chairman BACHUS. I beg your pardon?

Mr. LUCAS. Well, I mean, each entity has their own limits so it's not, they don't aggregate all those deposits together.

Chairman BACHUS. That's right. In fact, a water board could deposit $100,000, you know, and the school board. But, you know, as I think the Chairman knows, as you know, even in a small county, a water board or a gas board could have several million dollars in deposits and probably would have. So what they're having to do is that 95 and 98 percent of their money sometimes is deposited outside the county.

Mr. LUCAS. OK, thank you.

Chairman BACHUS. But that is a valid point, that you're talking about, the governments divided and they're different accounts.

Mr. Chairman, at this time, panel one is adjourned.

Mr. POWELL. Thank you, Mr. Chairman, thank you.

Chairman BACHUS. At this time, we will recognize our second panel.

Mr. Richard Carnell, Associate Professor of Law, Fordham University School of Law. I have his resume before me. He teaches courses in banking law and corporations. Also taught corporations in law school, so I understand that to be a difficult job, and a write-in lecturer on a wide range of topics. Served as Secretary of the Treasury of the Association of American Law Schools Section on Financial Institutions and Consumer Financial Service. A note of interest to this subcommittee is that you advised Secretary of the Treasury, Lloyd Bentsen and Bob Ruben, and other Clinton Administration officials on financial services issues. You led the Administration's successful efforts to secure legislation in several fields including clean-up of the savings and loan industry, authorize interstate banking and branching, resolve problems with the FDIC's SAIF Fund, and many other things. You were actually senior counsel in the U.S. Senate Committee on Banking, so you certainly understand how we function here, and on the Board of Governors of the Federal Reserve System from 1984 to 1987. And were a practicing attorney at one time in San Francisco, a graduate of Harvard Law School and Yale University. We've not heard of those institutions, but I'm sure they are credible.

Our next panelist, Nolan North, is Vice President and Assistant Treasurer of T. Rowe Price Associates. Anybody that watches CNBC knows about T. Rowe Price. Responsible for the overall management of bank relations for T. Rowe Price including credit facilities and banking services, and also responsible for the implementation of modern cash management techniques. You've got a wide range of experience in banking and treasury management. Before you joined T. Rowe Price, you were a bank relations manager, assistant treasurer of a major insurance company, a sales manager for a leading treasury management bank, and department head of a marketing research firm specializing in treasury management. Past Chairman of the Board of Directors of the Association of Financial Professionals, Member of the Government Relations Committee, you currently serve NACHA as a member of the board of directors, you're on the Next Generation ACH Task Force, and various other activities.

And the reason I'm reading these is because our panel is all quite distinguished and have tremendous experience behind them, a very esteemed panel.

Dr. Kenneth Thomas, Lecturer in Finance at the Wharton School, University of Pennsylvania since 1970. Teaches banking, monetary economics at Wharton. You received—this is quite impressive here—an Excellence in Teaching Award in May, 2001. Congratulations for that. You've been a bank consultant since 1969, working with several hundred banks and thrifts throughout the country on a CRA, also on fair lending and regulatory issues. Your first book on CRA, "Community Reinvestment Performance" was published in 1993. Many of the book's recommendations were directly implemented in the revised CRA, and you won an award of excellence for that book. Your most recent book "The CRA Handbook" contains the most comprehensive evaluation of CRA exams ever conducted, including a new technique for evaluating and quantifying CRA grade inflation. You received your BSBA degree with high honors in Finance from the University of Florida, who lost this past weekend in football to where I got my undergraduate degree, Auburn University. Put a real licking on the Florida Gators.

[Laughter.]

Chairman BACHUS. You have an MBA in finance from the University of Miami, and an MA and PhD in finance from the Wharton School. You are a regular speaker and writer in the banking and thrift industries, frequently quoted in articles on these topics. I've seen you on CNBC. It also says here you appeared on CBC, CNN, Nightly Business News, and NPR. I probably saw you on those too. But you're a biweekly commentator on the net financial news.

Finally, advised Federal bank regulators on public policy issues, testified before Congress on several occasions on various bank regulatory issues. Are you at the University of Pennsylvania or are you in Miami?

Dr. THOMAS. I live in Miami, but I commute once a week to Philadelphia to teach at Wharton as I've been doing for the last 30 years.

Chairman BACHUS. Wow, boy, you need to testify to us how you can live in Miami and work at Wharton. That's great. But, no, I understand that.

And we welcome all you gentlemen and look very much forward to your testimony. The Members, or most of them, are on the floor on a money laundering bill which is legislation. Having worked on the Hill and testified on the Hill, you know we don't sometimes set the agenda, and they actually put that bill on the floor at 10 o'clock this morning, because it's part of the Administration's and the Congress' ways to address terrorism and the events of September the 11th. Those are high priority items at this time.

Your testimony, though, will be distributed to the Members, will be read by the Members, and has already been read by this Member, so I appreciate your testimony and at this time, we will start with you, Dr. Carnell.

STATEMENT OF RICHARD S. CARNELL, Ph.D., ASSOCIATE PROFESSOR OF LAW, FORDHAM UNIVERSITY SCHOOL OF LAW

Dr. CARNELL. Mr. Chairman and Members of the subcommittee, I'm pleased to have this opportunity to discuss deposit insurance reform. Federal Deposit Insurance does many good things, but it also impairs market discipline. Without proper safeguards, deposit insurance can——

Chairman BACHUS. Let me interrupt something, and I don't know how there's a good way to do this. We've got a floor vote right now. Instead of doing part of this and then coming back, it's just one vote, and I beg your indulgence.

Dr. CARNELL. I'm glad to wait, Mr. Chairman.

Chairman BACHUS. If we could recess, I will go vote. I think it would give other Members an opportunity to hear your testimony, in fact. So we're going to recess, and Dr. Carnell, I very much apologize for not knowing that before you started. I apologize for interrupting you.

I'm going to go vote, we'll recess for 10 minutes, come back here and have your testimony. And I hope in your travel plans, is this going to prejudice any of you in making connections?

[No response.]

Chairman BACHUS. OK, great, we will be 10 minutes.

[Recess.]

Chairman BACHUS. The hearing is now called to order.

Dr. Carnell.

Dr. CARNELL. Mr. Chairman, Federal Deposit Insurance does many good things, but it also impairs market discipline. Without proper safeguards, deposit insurance can encourage banks to take excessive risks, for safe banks to subsidize risky banks, and saddle the taxpayers with large losses. To avoid such problems, we need risk-based premiums as well as effective supervision.

Risk-based premiums are fair and they help give insured banks a healthy set of incentives. Banks with less capital, banks with weak management, and banks that take big risks will pay more than safe, well-managed banks with lots of capital. This gives banks incentives compatible with the interests of the Insurance Fund.

But a 1996 Amendment has undercut risk-based premiums. I'll call this the Zero Premium Amendment. If a deposit insurance fund meets its reserve target, the FDIC can charge premiums only for banks that are not well capitalized or have other obvious and significant problems. The zero premium amendment currently covers 92 percent of all FDIC insured institutions. These institutions differ greatly in their riskiness. The amendment hinders the FDIC in refining risk-based premiums to take proper account of these differences.

The amendment has also given rise to a serious free rider problem. Note that if banks paid premiums according to their riskiness, no bank would get a free ride. The zero premium amendment is like a law regulating automobile insurance companies that would require every company with adequate reserves to insure safe drivers free of charge, and would allow any company with inadequate reserves to charge safe drivers only to the extent necessary to rebuild its reserves. No private company would provide auto insurance under such circumstances, nor should the Government continue to provide deposit insurance under such constraints.

The zero premium amendment is unsound policy, it's had adverse results, and it should be repealed so that risk-based premiums can work as intended.

I also support easing the minimum premium requirement that would now apply if a deposit insurance fund missed its reserve target for more than a year. The FDIC would have to set premiums very high even for safe institutions. That would undercut risk-based pricing and it would also put additional stress on banks at just the wrong time, during an economic downturn.

Mr. Chairman, many years ago, I lived in a house with an oven that had only two temperatures; off and 600 degrees. The current premium rules are like that oven. The zero premium amendment is off and the minimum premium requirement is 600 degrees. Reform here makes sense. I suggest lowering the minimum and narrowing the circumstances when it would apply. And I spell out the details of that in my written statement.

I recommend against paying rebates from the insurance funds or capping the fund's reserves. We don't know what reserve levels will end up being needed in the future. Bank failures are hard to predict accurately. They don't come neatly spaced out like deaths from old age; they come in clusters during hard times. So a deposit insurance fund can look fat and flush one year, and be in serious trouble just a couple of years later.

Although I oppose caps or rebates, I see possible merit in letting the FDIC grant risk-based assessment credits if an insurance fund's reserves exceed 1.5 or 1.6 percent. Banks could use these credits to reduce their future premiums. The FDIC would award such credits based on a combination of a bank's past premium payments and the bank's past and present risk to the FDIC.

Properly constructed, a system like this could help solve the free rider problem. It could also help the FDIC deal with the difficulty of measuring a bank's risk ahead of time, which is one of the greatest challenges in operating a risk-based system. But if you can do the credits after-the-fact, you can make an adjustment based on risk; then you won't have to guess. By the time you award the credits, you'll know which banks were riskier than others. So if a particular bank's premium ended up being higher or lower than it should have been, given what the FDIC later knows about capital management and other aspects of riskiness, the FDIC has the opportunity to make an appropriate adjustment when awarding credits.

I urge Members to take a skeptical view of proposals to index or otherwise limit the $100,000 insurance limit. Adjusted for inflation, it was the highest level in the FDIC's history and even if you adjust it for inflation between 1980 and now, it's still relatively high by historic standards. And also I believe that raising the $100,000 limit would do little to resolve community banker's complaints about losing deposits to other institutions.

As the FDIC works to make the risk-based system better reflect banks' riskiness, I would urge Congress to resist any temptation to micromanage the FDIC. I have a thought, incidentally, Mr. Chairman, on the issue of municipal deposits. And that is it might be possible to provide insurance beyond the $100,000 amount, but not to insure the full amount of the deposit, that is, rather to provide insurance for 90 percent of the deposit. The risk to the local government would still be small, because they'd be 90 percent insured, and then on top of that, the bank's going to have some good assets, so even if there's a loss, uninsured depositors won't lose a hundred cents on the dollar; they might lose ten cents on the dollar. So you could provide insurance up to a reasonable amount that would go above $100,000.

Mr. Chairman, Congress has opportunities to achieve important deposit insurance reform. I very much hope that it does so, but I urge caution in dealing with demands for tradeoffs, like raising the $100,000 limit across the board. It would be better to postpone reform than to enact flawed legislation now.

Thank you and I'll be pleased to respond to questions at the appropriate time.

[The prepared statement of Richard S. Carnell Ph.D., can be found on page 45 in the appendix.]

Chairman BACHUS. Mr. North. One thing we're going to do, we're not limited by the 5 minutes so, you know, if it's 7 minutes or 8 minutes, feel free to do that.

STATEMENT OF NOLAN L. NORTH, VICE PRESIDENT AND ASSISTANT TREASURER, T. ROWE PRICE ASSOCIATES, INC., ON BEHALF OF THE ASSOCIATION FOR FINANCIAL PROFESSIONALS

Mr. NORTH. Good morning, Mr. Chairman, Members of the subcommittee. I am here representing the Association for Financial Professionals, AFP, and its Government Relations Committee. Our comments today address why deposit insurance reform is important to corporate America.

AFP represents about 14,000 finance and treasury professionals who on behalf of over 5,000 corporations and other organizations, are significant participants in the Nation's payment system and have a sizable stake in any proposed changes in the deposit insurance assessment system. The stake of corporate America in deposit insurance is based on the premise that deposit insurance coverage is intended for depositors, not bankers. Yet, the voice of bank depositors is not often heard in this debate.

In your invitation to these hearings, Mr. Chairman, you asked if deposit insurance should be reformed, and we certainly agree it should. You also asked if the FDIC options paper had raised the correct issues, and we do think the right issues have been raised with one significant exception. That exception is, there has been no attempt to resolve the disparity between the balances covered by insurance and the balances on which assessments are based. We believe assessing only insured balances, instead of total balances, is fundamental to fair reform of the deposit insurance system.

Our members believe that their organizations are the dominant funders of the bank insurance fund, because banks pass through the deposit insurance costs to their corporate customers directly on the basis of total balance size, which is customarily well in excess of the $100,000. As a result, many businesses must both self-insure their deposits in excess of $100,000 and pay insurance premiums for those uninsured deposits.

In effect, large corporate depositors subsidize the BIF through premium costs for deposits which are not insured by the fund. As with any insurance arrangement, the premiums should be based on what is insured.

As to the issues raised in the options paper, we do support the merger of BIF and SAIF. Regarding the coverage level, the deposit insurance coverage level should remain unchanged at $100,000. Some financial institutions feel that higher coverage limits would solve funding problems. However, deposition insurance coverage is not a competitive issue. Coverage is intended to cover depositors and benefit depositors, not benefit bankers.

The FDIC should be given discretion to set and adjust a range within which the reserve ratio may fluctuate in response to changes in industry risks and business conditions. Within that range, premiums should not be charged to well-managed and highly capitalized banks, because it would be our members who would end up paying that charge, even though they have decided to deal with well-capitalized and well-managed banks.

In other words, the deposit insurance system should retain the risk-based variable premium approach, based on meeting a range of required reserves. This is perhaps the most important reform being proposed. It would, among other benefits, allow the FDIC to mitigate the cyclical effects of deposit insurance pricing by not being tied to the 1.25 percent floor.

We oppose rebates on the basis that an equitable rebate method cannot be constructed. The entity bearing the premium cost, the bank customer, is unlikely to receive the value of any rebate. Among the benefits of moving to a reserves ratio system is that instead of rebating what are now seen as excess reserves, these reserves would just tend to move overall reserves toward the higher end of the reserve ratio range.

Chairman Powell has suggested a method of providing assessment credits instead of rebates. This proposal is certainly better than rebates, and it deserves more review, because it could reduce the amount of assessments that are being passed through by a bank to its customers.

We absolutely oppose full coverage for any special category of depositors, municipal deposits or IRA accounts. Having any protected class of depositors is not good public policy. Full coverage of certain types of deposits reopens the moral hazard issue. Also a practical effect of this approach would be to chase away other types of depositors. It would not take long for corporations, as well as consumer advocacy groups, to understand that in banks with large municipal or IRA or other special interest deposits, their deposits would be subordinated in the case of bank failure.

Regarding de novo and rapidly growing banks, we do not feel that any well-managed and well-capitalized banks, regardless of how fast they are growing, should be expected to pay FDIC assessments when the BIF reserve is sufficiently funded.

Our written statement covers these issues in greater detail and we appreciate the opportunity to exchange these views.

[The prepared statement of Nolan L. North can be found on page 55 in the appendix.]

Chairman BACHUS. I thank the gentleman.

Dr. Thomas.

STATEMENT OF KENNETH H. THOMAS, Ph.D., LECTURER IN FINANCE, THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA

Dr. THOMAS. Thank you, Mr. Chairman.

In past hearings, you've heard the views of the regulators and the industry on deposit insurance reform, specifically the April 2001 FDIC Report titled "Keeping the Promise . . .".

This morning, I bring to your consideration the views of a third party, the bank depositor. The 20 principles underlying the view of bank depositors are found in my testimony. The depositors' view is the most important view. Why? Because the FDIC established in 1934—and this is one of my collectibles, a hard copy of the original 1934 annual report, the very first one—states on the very front that depositor insurance was for the depositors. The FDIC was to protect depositors, not to insure banks, but to insure depositors. And that's where the focus must be.

In other words, the only promise to be kept in "Keeping the Promise" is that to the depositor to insure deposits and maintain confidence in the system. I will also argue that the first two of the FDIC's five recommendations do exactly that; keep the promise to the depositors. But their last three recommendations do not, and in my opinion benefit the industry at the expense of the taxpaying depositor.

I should mention that I have nothing but the greatest respect for the FDIC, the former Chairman, and the current Chairman Powell and their excellent staff. In fact, back in the early 1970s, I was recruited by them and almost went to work for the FDIC; so I think it's a great organization, they've got top people there.

Now in terms of their five recommendations, their first recommendation on the merger of the funds. Everyone agrees that's a no-brainer, and from the perspective of a depositor, this eliminates any unnecessary confusion. For example, if I deposit money in Washington Mutual, primarily insured by SAIF, is it going to be stronger than money I might deposit at Bank of America primarily insured by BIF, because, in fact, SAIF has a stronger DRR ratio than BIF? That confusion should not exist; there should be just one fund.

The second recommendation with the FDIC, which I agree with, is that every bank and thrift should pay deposit insurance based on their risk profile. Depositors want a strong fund where there are no free riders, especially the high flying Wall Street types like Merrill Lynch and Salomon Smith Barney. The two of them alone were responsible for a $20 billion increase in insured deposits in the first quarter of this year.

Now for the three FDIC recommendations that I feel are counter to depositors' perspectives. The third recommendation on ceilings: There should be no ceiling for the fund; it should be a capless fund. Like all funds, it should continue to grow without a cap for a rainy day, which may be sooner than we think with the current recession. If anything, the minimum 1.25 percent DRR, designated reserve ratio, should be increased to 1.5 percent. These ratios ensure discipline and accountability at the FDIC.

And again, from the depositors' perspective, they want a strong fund, run in a common sense manner, like any private insurance company would be run. And that gets to the fourth recommendation. There should be no rebates or no credits. I believe this is an unnecessary accommodation to the industry, apparently to win their support for deposit insurance reform. I lived through Hurricane Andrew, and I can tell you from the perspective of a major disaster like that, companies like Prudential, State Farm, Allstate, they do not give rebates if there was no accident or illness. Certainly they may give a better risk adjusted premium if you're a better driver or a better risk, but they do not give rebates.

And can you imagine going years, as the banks have been doing, without being charged for premiums, as has been the case for 92 percent of the industry. It doesn't happen in the private sector and it shouldn't happen in the public sector. With today's volatile and uncertain stock market, and in my opinion, certain recession, depositors want to know that the fund behind their deposits is growing as much as possible with no cap, with no rebates, and with no credits.

Finally, on the recommendation of increasing the amount of deposit insurance: depositors do not want, do not need, and have not asked for any increase in deposit insurance coverage, whether it be doubled or just increased by inflation. Depositors don't want to be potentially confused with different coverage levels for different types of deposits.

According to the Federal Reserve, less than 2 percent of all depositors would benefit from a doubling of the insurance from $100,000 to $200,000, and now they have adequate alternatives. In fact, one Fed analyst has argued that we should be talking about reducing the coverage instead of increasing it or adding in some inflation adjustment.

In fact, on the issue of inflation, it's important to realize that the current level is actually in excess of the level from 1934 to 1969.

It's only the artificially high level in 1980 of $100,000 that caused the problem.

Finally, Mr. Chairman, the Federal safety net is unfortunately getting bigger day by day. Much of this of course is in response to the September 11th terrorist attacks. First we had the $15 billion bailout, the $5 billion pure bailout and the $10 billion guarantee. Now we've got the insurance companies, and who knows who will come next to the Federal Government for a bailout? This is just not the time we should be thinking about increasing the Federal safety net, whether it be by doubling insurance coverage or adjusting for inflation.

The FDIC only had five recommendations in their report. The depositors' view of bank reform also makes some additional recommendations not made by the FDIC. These are covered in my testimony.

For example, I would recommend a special assessment for the 25 largest banks those deemed too-big-to-fail, because of the additional risk they pose to the system. Also I would argue for expanded market discipline by regulators starting with the public disclosure of a safety and soundness rating and a portion of that exam.

I would merge the OTS into the OCC and consider even further consolidation among the regulators. And finally there should be better disclosure of non-FDIC insured products so depositors are not confused, especially many of our seniors, who cannot see some of the very small print in the advertisements.

In conclusion, two of the five of the FDIC's deposit insurance reforms keep the promise from the depositor insurance perspective. But, the other three are apparent accommodations to the industry for which the FDIC's only promise should be to be a fair regulator and supervisor in the public interest.

Thank you very much for the opportunity to present this depositor perspective.

[Written statement of Dr. Kenneth H. Thomas can be found on page 67 in the appendix.]

Chairman BACHUS. Thank you. We've got about 4 minutes left on a vote. I am going, what I would like you all to do is your testimony you've given here today, if you have that in writing, you know, your written testimony, I would like to also have a copy of that, have an opportunity to maybe call you on some these aspects.

I'm going to adjourn the hearing now and let you be available for some of the reporters, the press, and not ask questions because I'm told it'll be 25 minutes before we are able to come back.

But I appreciate your testimony. I thought it was all easy to understand, easy to follow, had some differences of opinion, but it's been very helpful.

At this time, the hearing is adjourned.

[Whereupon, at 11:56 a.m., the hearing was adjourned.]

A P P E N D I X

October 17, 2001

OPENING STATEMENT OF CHAIRMAN SPENCER BACHUS ON DEPOSIT INSURANCE REFORM OCTOBER 17, 2001

The Subcommittee meets today for its third hearing this year on reforming the deposit insurance system. We are delighted to have with us today the new Chairman of the FDIC, Don Powell, who assumed his responsibilities at the agency less than two months ago after a distinguished career in the banking industry in Texas. Chairman Powell will provide us with the FDIC's updated recommendations on how to reform a system that has served our country well over the years, but is in need of some retooling for the 21st century marketplace.

Shortly after the Subcommittee's last hearing on deposit insurance reform in late July, the Office of Thrift Supervision announced the failure of Superior Bank, a Chicago-based thrift with assets of $2.3 billion and a heavy concentration of subprime loans. Early estimates are that Superior's failure could end up costing the Savings Association Insurance Fund (SAIF) upwards of $500 million, which would in turn lower the SAIF's ratio of reserves to insured deposits from its current level of 1.43% to 1.35% or even lower.

In and of itself, the Superior failure is hardly cause for panic. Both the SAIF and its banking industry counterpart, the Bank Insurance Fund (BIF), remain extremely well-capitalized, and the banking and thrift industries appear well-positioned to weather any significant downturn in the economy. Nevertheless, such a precipitous drop in the SAIF's reserve ratio – coinciding with recent declines in the BIF ratio – highlights the need for Congress to consider reforms before the ratios fall below levels which, under the current system, would trigger sizable premium assessments on all institutions.

As this Committee begins in earnest to consider legislative proposals to address deficiencies in the current deposit insurance system, I can think of no government official better qualified to provide us with wise counsel than our first witness at today's hearing. With more than 30 years of experience in the financial services industry, including his recent tenure as the President and CEO of The First National Bank of Amarillo, Chairman Powell brings to his new position a "real world" understanding of the industry he is now charged with overseeing that is truly refreshing.

I had the pleasure of spending time with Chairman Powell when he visited my office last month, and I found him to be exceedingly well-versed on the issue of deposit insurance reform, as well as extremely sensitive to the challenges faced by America's small community banks. Chairman Powell pledged to work closely with the Committee – both in the context of deposit insurance reform and in other areas – to ensure that the legislative and regulatory initiatives we pursue here in Washington make sense when viewed from the perspective of a small-town banker and his customers.

In the area of deposit insurance reform, I have been particularly encouraged by Chairman Powell's endorsement of the principle of indexing coverage levels to inflation, and increasing coverage for individual retirement accounts. In my discussions with him, Chairman Powell has also expressed a willingness to work with the Committee in exploring possible changes in the system for insuring municipal deposits. If we are truly serious about addressing the liquidity problems facing small community banks across America, we should be doing everything possible to encourage local government agencies to keep their receipts in the community by depositing them at local banks.

Currently, many States require banks that maintain municipal deposits to pledge collateral against the portion of such deposits that exceed $100,000 and are therefore not insured by the FDIC. This not only makes it difficult for small banks to compete for those deposits with larger institutions, but it also ties up resources that could otherwise be devoted to community development and other lending activities. This is an issue I look forward to discussing further with Chairman Powell as the deposit insurance reform debate moves forward.

Let me close by again extending a warm welcome to Chairman Powell – who is testifying for the first time before our Committee – and to our distinguished witnesses on the second panel.

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

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Financial Institutions and Consumer Credit
October 17, 2001

Viewpoints of FDIC Chairman Don Powell and Select Industry experts on Deposit Insurance Reform

Thank You Chairman Bachus.

This hearing will continue our discussion on the need to reform the nation's federal deposit insurance system. This hearing could not have occurred at a more appropriate time in the financial and economic cycle. While the deposit insurance system is the strongest it has ever been, it may be tested as the nation is confronted with an uncertain economic climate. Also, the events of September 11th have contributed to large increases of deposits at insured depository institutions.

Even so, I say with confidence that both the industry and the deposit insurance system are sound and the economic recovery, when it occurs, will be in large part determined by the ability of the financial services sector to remain vibrant and strong. A sound and responsive deposit insurance system is at the core of such vibrancy and strength.

I should also point out that the FDIC has successfully weathered several industry financial storms since its inception, and I am confident that under Chairman Powell's leadership the agency will continue that tradition. I welcome Chairman Powell to this important position and I compliment him on his efforts thus far. He comes to this new job with excellent credentials: a diverse professional background, and the talent, skills, and vision needed to shape the FDIC into a 21st century agency.

The FDIC faces critical challenges, chief of which is the need to reform the deposit insurance system in a way that ensures it understands and properly responds to new and emerging risks. FDIC must continue to adapt to address the challenges and risks posed by the post Gramm-Leach-Bliley environment, the integration of global financial service markets, and the interconnectedness of these events with our communities. This is a tall order that will require the help of the Congress to provide the necessary legislative tools and the agency to make the necessary structural and program changes. This hearing will explore these issues and any insights Chairman Powell may share for ensuring the system remains worthy of the public's confidence and appropriately and fairly treats all stakeholders and beneficiaries with respect to deposit insurance coverage and premium assessments.

I look forward to hearing Chairman Powell's views on reforming the deposit insurance system. I say with much conviction that the Committee continues to have faith in our financial services industry and in the ability of the FDIC to implement comprehensive, meaningful, and equitable reform.

Chairman Powell, thank you for your commitment to public service and to the FDIC at this most challenging of times. The Committee will pursue any changes to the deposit insurance scheme with deliberation, thoughtfulness, and a complete understanding of the attendant implications and benefits. The changes we are considering will affect the savings and investment decisions of millions of individuals and companies. The Committee will not undertake this responsibility lightly. The focus of today's hearing will be on a report prepared by your predecessor entitled *Keeping the Promise: Recommendations for Deposit Insurance Reform,* any changes you have considered for it, and any related views you may have about the overall need for deposit insurance reform.

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

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STATEMENT OF

DONALD E. POWELL

CHAIRMAN

FEDERAL DEPOSIT INSURANCE CORPORATION

on

DEPOSIT INSURANCE REFORM

before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

October 17, 2001
Room 2128, Rayburn House Office Building

Chairman Bachus, Representative Waters, and members of the Subcommittee, it is a great pleasure to appear before you this morning, my first appearance before Congress as Chairman of the Federal Deposit Insurance Corporation, to discuss deposit insurance reform.

Deposit insurance has served this country well for nearly 70 years and helped us through a difficult crisis just over a decade ago. The FDIC has played a key role in maintaining public confidence in our financial sector through good times and bad. The system is not in need of a radical overhaul.

Yet, I agree with the FDIC's analysis that there are flaws in the current system that could actually prolong an economic downturn, rather than promote the conditions necessary for recovery. The current system also is unfair in some ways and it distorts incentives in ways that exacerbate the moral hazard problem. These flaws can be corrected only by legislation. I appreciate the interest this Subcommittee has already shown in considering these issues and the interest you have shown in deposit insurance reform.

In the seven weeks I have been at the FDIC, I have been impressed by the dedication and caliber of the FDIC staff. The staff has prepared an excellent report on deposit insurance reform with very important recommendations. I have studied the report and have full confidence in the product the FDIC has produced. The recommendations, and the way the agency went about coming up with them, are a model for how agencies should create public policy proposals. Staff did its homework and kept all of the players—Congress, the banking industry, scholars and experts, and the public—involved every step of the way. I am proud of our team and what they have put together.

This morning I will take what the FDIC has already recommended and give you my thoughts, as well, on how the Congress can create a better system. First let me discuss the principles that I used in evaluating the FDIC's proposals and the principles that I am bringing to this debate. The new system should be fair, simple, and transparent. Bankers and other interested parties should participate in the process of developing and implementing any reforms to ensure that policy trade-offs are weighed appropriately and the resulting reforms will be reasonable, workable and effective. As I noted earlier, the existing deposit insurance system has served us well, and we must be mindful of this in contemplating changes. The current system is designed to ensure that the deposit insurance funds' reserves are adequate, and that the deposit insurance program is operated in a manner that is fiscally and economically responsible. Any new system should retain these essential characteristics. There are good reasons for most of the features built into our current system, and we must not lose sight of this as we attempt to make improvements.

I believe what the FDIC has recommended is true to these principles, but let me add my thoughts on each of the recommendations.

Merge the BIF and the SAIF

First, we should merge the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). There is a strong consensus on this point within the industry. In fact, I have heard no one, inside the industry or out, suggest otherwise.

Originally, the two funds were intended to insure bank and savings association deposits separately. But today, both funds insure deposits at both types of institutions. Moreover, many institutions currently hold both BIF- and SAIF-insured deposits. More than 40 percent of SAIF-insured deposits now are held by commercial banks. The concept of separate bank and thrift funds is an anachronism.

A merged fund would be stronger and better diversified than either fund standing alone. In addition, a merged fund would eliminate the possibility of a premium disparity between the BIF and the SAIF. As long as there are two deposit insurance funds, the assessment rates of which are determined independently, the prospect of a premium differential exists. A merged fund would have a single assessment rate schedule. Those rates would be set on the basis of the risks that institutions pose to the single fund. The prospect of different prices for identical deposit insurance coverage would be eliminated.

Finally, merging the funds would also eliminate the costs to insured institutions associated with tracking their BIF and SAIF deposits separately, as well as the complications such tracking introduces for mergers and acquisitions.

For all of these reasons, the FDIC has advocated merging the BIF and the SAIF for a number of years, and I wholeheartedly agree. Any reform plan should include fund merger.

Deposit Insurance Coverage

Another issue that has drawn attention is the question of coverage. The task for us is to balance the public's needs for protection, the funding needs of small banks, and the effect of coverage increases on our deposit insurance fund and on the market-distorting moral hazard problem.

I am acutely sensitive to the funding pressures faced by many community banks. This is a complex issue, and there are many factors at work. It is not clear whether a higher coverage limit would significantly ease current funding pressures for most of these institutions.

We must also acknowledge that the impact of raising the coverage limit on the fund reserve ratio is uncertain. The FDIC and others have provided estimates, but it is hard to anticipate the public's reaction to higher coverage limits, and this reaction will determine the ultimate inflow of new deposits into the system. There is also a chance that higher coverage limits could make it easier for riskier institutions to gather deposits, and we must consider the potential for unintended consequences.

I do not believe it necessary to have an across-the-board increase in the basic coverage limit now. We should, however, ensure the present limit keeps its value in the future. For this reason, the deposit insurance coverage level should be indexed to maintain its real value. As a life-long banker, I can tell you that deposit insurance is important not only to individuals and families, but also to many small businesses, community banks, charities, and some local governments. Protecting such an important program from the effects of inflation strikes me as plain common sense.

My suggestion would be to index the $100,000 limit to the Consumer Price Index, and adjust it every five years. The first adjustment would be on January 1, 2005. We should make adjustments in round numbers – say, increments of $10,000 or so – and the coverage limit should not decline if the price level falls. These seem like the right elements of an indexing system, but I am willing to support any reasonable method of indexation that ensures the public understands that the FDIC's deposit insurance protection will not wither away over time. I look forward to working with the Congress to find a method of indexing that works.

There has been some opposition to the FDIC's indexing proposal on the grounds that it would increase the federal safety net. Frankly, I am puzzled by this. The FDIC is not recommending that the safety net be increased. It is simply recommending that the safety net not be scaled back inadvertently because of inflation.

There is one class of deposits for which Congress should consider raising the insurance limit, and that is IRA and Keogh accounts. Such accounts are uniquely important and protecting them is consistent with existing government policies that encourage long-term saving. When we think about saving for retirement in this day and age, $100,000 is not a lot of money. Middle-income families routinely save well in excess of this amount.

Moreover, especially during this time of uncertainty when Americans may be concerned about the safety of their savings, I believe it is important for the United States government to offer ample protection to facilitate saving through vehicles that will redeploy funds into the economy. In my view, we must do whatever we can to provide for ongoing productive investment in our economy and solid, sustainable growth. Higher deposit insurance protection for long-term savings accounts could help.

There is some precedent for providing such accounts with special insurance treatment. In 1978, Congress raised coverage for IRAs and Keoghs to $100,000, while leaving basic coverage for other deposits at $40,000.

The $220 billion of IRA and Keogh deposits currently at banks and thrifts is not large compared to the volume of overall deposits. Thus, if the coverage limit were raised for IRA and Keogh deposits, the initial impact on the fund reserve ratio would not be dramatic. However, the total volume of IRAs and Keoghs in the economy, more than $2.5 trillion, is enormous, and estimating the influx of retirement account deposits as a result of higher coverage is subject to some of the same uncertainties that apply to deposits in general. The FDIC is prepared to investigate the implications of higher coverage for these accounts and provide this information to the Congress and the public. We would also note that a phasing–in of higher coverage limits for retirement account deposits could allow for some measure of control over the impact on the fund reserve ratio. I urge the Congress to give serious consideration to raising the insurance limit on retirement accounts.

Fund Management

When it comes to managing the fund over time, I believe several principles are important. We should be fair and equitable to the industry and to taxpayers. The FDIC should be transparent in its decision making. Deposit insurance should be priced based on risk. Finally, the FDIC Board of Directors must have the flexibility to manage the fund size in periods of stability as well as periods of crisis.

Specifically, the FDIC should have the discretion to set the target size for the fund ratio, determine the speed of adjustment toward the target and charge appropriately for risk at all times. Right now, there are two statutorily mandated methods for managing fund size. One of these methods prevents the FDIC from charging appropriately for risk during good economic times. The other can put undue pressure on the industry during an economic downturn. Together, they lead to volatile premiums.

Under current law, when a fund's reserve ratio is at or above the 1.25 percent designated reserve ratio (DRR), the FDIC is prohibited from charging premiums to institutions that are both well-capitalized, as defined by regulation, and well-rated (generally defined as those with the two best examination ratings). Under this statutory provision, there can be long periods during which the risk-based system is less than fully effective and new deposits enter without paying.

On the other hand, when a deposit insurance fund's reserve ratio falls below the DRR, the FDIC must raise premiums by an amount sufficient to bring the reserve ratio back to the DRR within one year, or charge at least 23 basis points until the reserve ratio meets the DRR. Thus, if a fund's reserve ratio falls slightly below the DRR, premiums need not necessarily increase much. On the other hand, if a fund's reserve ratio falls sufficiently below the DRR, premiums will increase to 23 basis points, at a minimum. The potential for a 23-basis point "cliff effect" is problematic because, during a period of heightened insurance losses, both the economy and depository institutions in general are more likely to be distressed. A 23-basis point premium at such a point in the business cycle would be a significant drain on the net income of depository institutions, thereby impeding credit availability and economic recovery.

These problems can be solved by eliminating the existing inflexible statutory requirements and by giving the FDIC Board of Directors the discretion to set appropriate targets for the fund ratio, determine the speed of adjustment toward the target using surcharges or assessment credits as necessary, and charge premiums based on risk throughout the cycle.

What is the appropriate target for the size of the fund? This will depend upon economic and banking conditions and the other factors that affect the risk exposure of the industry. The target should reflect the best risk analysis based on the most current information, and no one is better equipped to provide this than the FDIC. We are in the best position to gather information about risks in the industry and to analyze it for these purposes using state-of-the-art risk measurement methods.

Likewise, the appropriate speed of adjustment to the target – the proper level of surcharges or assessment credits – will vary with economic conditions and the other factors that influence the industry's condition and outlook.

Although I believe that greater discretion for the FDIC Board of Directors is essential in these areas, I am not suggesting that the current target of 1.25 percent is inappropriate or that there should be no guidelines for the FDIC in managing the size of the fund. On the contrary, I believe the 1.25 percent target has served us well in recent years and is a responsible reserve against the current risks in the banking sector. The current target is a reasonable starting point for the new system.

Moreover, while I would steer clear of automatic triggers or hard targets, I would be happy to work with the Congress to develop some guiding principles for the FDIC Board of Directors in managing the growth or shrinkage of the fund. For example, current law requires the FDIC to publish a schedule for recapitalizing the fund whenever the ratio falls significantly below target; this seems like a reasonable feature to retain in the new system. Finally, in asking for greater FDIC discretion, I recognize the need for accountability. I believe that the FDIC should report to the Congress regularly on its actions to manage the fund, and we are fully prepared to do that.

Pricing Deposit Insurance

How would premiums work if the FDIC could set them according to the risks in the institutions we insure? First, and foremost, the FDIC would attempt to make them fair and understandable. We would strive to make the pricing mechanism simple, straightforward and easy for banks to understand. In my view, we can accomplish our goals on risk-based premiums with relatively minor adjustments to the FDIC's current assessment system.

Insurers—like bankers—generally price their product to reflect their risk of loss. It is important to note that there are significant and identifiable differences in risk exposure among the 92 percent of insured institutions in the FDIC's best-rated premium category. To take just one example, since the mid 1980s, institutions rated CAMELS 2 have failed at more than two-and-one-half times the rate of those rated CAMELS 1. And no institution represents zero risk. An FDIC study of the last banking crisis found that, of the 1,617 bank failures between 1980 and 1994, 565, or 34 percent, were rated CAMELS 1 or 2 two years before failure. Of the 30 bank and thrift failures since 1995, 10, or 33 percent, were rated CAMELS 1 or 2 two years prior to failure. It is clear that all institutions pose some risk to the deposit insurance funds and, therefore, all should pay some risk-based premium.

I am aware of the concern about using subjective indicators to determine bank premiums. We will be sensitive to that issue. Using the current system as a starting point, I believe that the FDIC should consider additional objective financial indicators, based upon the kinds of information that banks and thrifts already report, to distinguish and price for risk more accurately within the existing least-risky (1A) category. The sample "scorecard" included in the FDIC's April 2001 report represents the right kind of approach. In this example, banks currently in the best-rated category were divided into three groups using six financial ratios in addition to capital and CAMELS ratings (net income, nonperforming loans, other real estate owned, non-core funding, liquid assets, and growth). Actuarial analysis showed that premiums for these three groups, based on the FDIC's loss experience since 1984, should be on the order of 1, 3 and 6 basis points, respectively; however, we are willing to listen to the industry and Congress regarding alternative pricing schedules that also may be analytically sound. The report also indicated that for the largest banks and thrifts, it might be possible to augment such financial ratios with other information, including market-based data, so long as the final result is fair and does not discriminate in favor of or against banks merely because they happen to be large or small.

In short, I believe the right approach is to use the FDIC's historical experience with bank failures and with the losses caused by banks that have differing characteristics to create sound and defensible distinctions. We will not follow the results of our statistical analysis blindly—we recognize the need for sound judgment in designing the premium system. For example, the FDIC will not set premiums for the most risky banks and thrifts so high that the premiums themselves will cause failures. Any system we adopt will be transparent and open. The industry and the public at large will have the opportunity to weigh in on any changes we propose through the notice-and-comment rulemaking process.

Essentially, the FDIC wants to be able to fulfill the original mandate Congress gave it in 1991 to design and establish a truly risk-based system that allows the insurer to respond to emerging risks and evolving risk factors.

Assessment Credits

One goal of deposit insurance reform should be that, over time, it produces a better and fairer system without increasing the net costs of deposit insurance for the industry or increasing the risk posed to taxpayers. If the FDIC is charging risk-based premiums to all institutions, then, to check the growth of the fund in good economic times, the FDIC must be able to grant assessment credits.

In its recommendations, the FDIC suggested giving rebates when the fund exceeds a target level or range. I am reluctant to mandate a cash payment out of the fund at this time, given the uncertain economic environment. But we can achieve the desired result by giving banks a credit toward future assessments. Initially, these credits should be allocated in proportion to assessments paid in the past.

Assessment credits based upon past contributions would avoid the moral hazard problems created by tying credits to the current assessment base. Also, assessment credits based upon past contributions would be fair to the institutions that built the insurance funds to where they stand today.

I think a reasonable way to allocate the initial assessment credit would be according to a snapshot of institutions' relative deposit bases at the end of 1996, when both funds had been capitalized. Each institution would get a share of the total amount to be rebated to the industry based on its share of the assessment base at yearend 1996. For example, an institution that held one percent of the industry assessment base in 1996 would get one percent of the industry's total assessment credit. Relative shares of the 1996 assessment base represent a reasonable proxy for relative contributions to fund capitalization, while avoiding the considerable complications that can be introduced by reconstructing the individual payment histories of all institutions.

Assuming that current conditions persist, the initial assessment credit should be sufficient to ensure that the typical bank currently in the best-rated (1A) category could offset its premiums for the next several years.

One of the side effects of the FDIC's current inability to price risk appropriately is that the deposit insurance system today is almost entirely financed by institutions that paid premiums prior to 1997. There are currently more than 900 newly chartered institutions, with more than $60 billion in insured deposits, that have never paid premiums for the deposit insurance they receive. In addition, deposit insurance that is under-priced allows institutions to grow rapidly without paying more for deposit insurance.

Since they are not paying premiums, new institutions and fast-growing institutions are benefiting at the expense of their older and slower-growing competitors. Under the present system, rapid deposit growth lowers a fund's reserve ratio and increases the probability that additional failures will push a fund's reserve ratio below the DRR, resulting in an immediate increase in premiums for all institutions. The FDIC's recommendation to eliminate the 23-basis point "cliff effect" would mean that new deposit growth among a minority of institutions would no longer trigger large premium increases for all others.

The combination of risk-based premiums and assessment credits tied to past contributions to the fund would help us fix the remaining problems related to rapid growers and new entrants. Regular risk-based premiums for all institutions would mean that fast-growing institutions would pay increasingly larger premiums as they gather deposits. Fast growth, if it posed greater risk, also could result in additional premiums through the operation of the FDIC's expanded discretion to price risk. The assessment credits granted to newer institutions and fast growers would be proportionally smaller than those granted to past contributors, and institutions that never paid premiums would initially receive no assessment credits at all.

I understand the industry's concern that the fund—even under the scenarios I have outlined—could grow unnecessarily large. I do not want to unnecessarily accumulate money at the FDIC when it could be put to better use in the economy.

As I mentioned earlier, I believe the FDIC's Board of Directors should be given the flexibility to manage the insurance fund, whether the fund has grown too large or too small. In a crisis, the Board must levy surcharges to ensure solvency. If the fund is too large, the Board must likewise provide more aggressive assessment credits or, at some point, fair and equitable cash dividends. Such credits or dividends would be based on the contributions of each insured institution under the new system.

I take very seriously the responsibility of prudently managing the fund and maintaining adequate reserves—it is extremely important to the industry and to the financial stability of our country. We have only to look back at the bank and thrift crises of the 1980s and 1990s to understand this. While I am Chairman, I will do all I can to ensure that the FDIC manages the insurance fund responsibly and is properly accountable to the Congress, the public and the industry.

CONCLUSION

The Congress has an excellent opportunity to remedy flaws in the deposit insurance system before those flaws cause actual damage either to the banking industry or our economy as a whole. Both insurance funds are strong and, despite a slowing economy, the banking industry also remains very strong. The FDIC has put forward some important recommendations for improving our deposit insurance system. While I believe we should remain flexible with regard to implementation, as a former banker and, as the FDIC's new Chairman, I believe that we should work together to make these reform proposals a reality.

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REFORMING FEDERAL DEPOSIT INSURANCE

Statement of Richard S. Carnell

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

October 17, 2001

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The views expressed here are my own, and not necessarily those of Fordham University or Fordham University School of Law

STATEMENT OF RICHARD S. CARNELL

Mr. Chairman, Ms. Waters, Members of the Subcommittee:

I am pleased to have this opportunity to discuss the reform of federal deposit insurance.

Real Deposit Insurance Reform

Over the years "deposit insurance reform has sometimes become a catchword for a narrow agenda. That happened in 1989-91 when many observers mindful of how a large increase in deposit insurance coverage had exacerbated the severity and cost of the thrift debacle[1] equated "deposit insurance reform with lowering the $100,000 coverage limit. Congress rightly took a broader view in the FDIC Improvement Act of 1991 ("FDICIA), which included prompt corrective action, least-cost resolution, and risk-based premiums. These reforms sought to reduce the FDIC's risk-exposure, give depository institutions and their regulators a healthier set of incentives, curtail wasteful and destructive subsidies to risky institutions, and thus protect the taxpayers and make deposit insurance more efficient.[2]

We should view "deposit insurance reform in the same broad spirit. Given the progress made in FDICIA, the reforms needed now are less sweeping than those needed a decade ago. But we should remain vigilant about the FDIC's risk-exposure and how deposit insurance affects incentives. We should also bear in mind a painful lesson of the 1980s: that seemingly small policy changes (e.g., expanded insurance coverage, creative accounting, or capital forbearance) can result in large and costly problems. To avoid such problems, we will do well to consider what a well-run private insurance company would do under analogous circumstances.

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[1] The 1980 legislation increasing deposit insurance coverage from $40,000 to $100,000 was widely viewed as a major blunder. *See, e.g.,* Stephen Pizzo, Mary Fricker & Paul Muolo, *Inside Job: The Looting of America's Savings and Loans* 11 (1989) ("Regulators later said [the increase to $100,000] may have been the single most costly mistake made in deregulating the thrift industry); Martin Mayer, *The Greatest-Ever Bank Robbery: The Collapse of the Savings and Loan Industry* 93-94 (1990) ("By raising to $100,000 insurance coverage that had originally topped out at $2,500 . . . , Congress inadvertently crossed a Rubicon).

[2] For a more detailed discussion of FDICIA's reforms and their rationale, see Carnell, *A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991*, 12 *Annual Review of Banking Law* 317-71 (1993).

Overview

In my testimony today, I will discuss deposit insurance reform, paying particular attention to key issues raised in the FDIC's report *Keeping the Promise: Recommendations for Deposit Insurance Reform* (2001). I will begin by underscoring the importance of risk-based premiums. I will then recommend:

letting risk-based premiums work, by repealing a 1996 amendment that has hobbled the risk-based premium system;

easing the current requirement that the FDIC charge even safe depository institutions high premiums if a deposit insurance fund's reserve ratio remains below the 1.25 percent target;

exploring the desirability of letting the FDIC grant risk-based assessment credits under certain circumstances;

skeptically regarding proposals to index or otherwise increase the $100,000 insurance limit;

merging the FDIC's Bank Insurance Fund ("BIF) and the Savings Association Insurance Fund ("SAIF); and

taking additional administrative and legislative steps to promote fairness, efficiency, and market discipline.

PERSPECTIVE

Federal deposit insurance has great power both to do good and to do harm. It can promote financial stability and protect people's hard-earned savings. But without proper safeguards, it can also encourage depository institutions to take excessive risks, force safe institutions to subsidize risky institutions, and saddle the taxpayers with large losses. We learned this the hard way during the late 1980s and early 1990s, when the Federal Savings and Loan Insurance Corporation ("FSLIC) failed costing the taxpayers $125 billion and the FDIC's Bank Insurance Fund depleted its reserves.

Because deposit insurance impairs market discipline, it encourages excessive risk-taking at the expense of the insurance fund unless accompanied by risk-based premiums and effective safety-and-soundness regulation[3]:

> Just as the automobile owner with theft insurance may be less careful about locking his car than he would be without insurance, so the depositor protected by deposit insurance may be less careful in his choice of bank. As a result, the insured bank may operate less conservatively than it would if its ability to attract and retain depositors depended only on its financial strength and soundness. . . .
>
> The danger to the insurance system is that . . . the [insured] bank will tend to take greater risks in order to earn higher profits. The higher profits are retained by the bank's owners, while the greater risks are borne by the insurance system. . . . Without deposit insurance, the cost of attracting depositors is a restraint on risk-taking. The bank with a riskier-than-normal portfolio will find its cost of funds increasing, as risk-averse depositors opt for conservative banks.
>
> With deposit insurance, this pressure towards conservatism is missing or reduced. The banker can get away with a riskier portfolio without increasing his cost of funds, and [unless deposit insurance premiums are risk-based,] his risk-taking is subsidized by more conservative banks. . . .[4]

The system of federal deposit insurance and regulation in effect during the 1980s impaired market discipline but provided no sufficient substitute for such discipline. Safety-and-soundness regulation (e.g., capital requirements, examinations, and enforcement) did not adequately control risk-taking. Moreover, risky and safe institutions paid the same insurance premiums, which meant that safe institutions subsidized risky institutions. Deposit insurance thus encouraged depository institutions to take risks that would not otherwise have made sense.

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[3] In theory perfect risk-based pricing *or* perfect regulation could control moral hazard. But as we cannot achieve such perfection, we need to use some combination of risk-based premiums and regulation.

[4] George J. Benston, Robert A. Eisenbeis, Paul M. Horvitz, Edward J. Kane & George G. Kaufman, *Perspectives on Safe & Sound Banking: Past, Present, and Future* 85-86 (1986).

This increased risk-taking harmed the deposit insurance funds by causing insured institutions to fail and impose losses on the funds. But it also harmed safe, well-managed institutions because risky institutions drove up the cost of deposits, undermined credit standards, and saddled the insurance funds with losses that necessitated higher premiums.

Congress enacted FDICIA's reforms including risk-based premiums in response to this hard experience.

LETTING RISK-BASED PREMIUMS WORK

Despite the importance of risk-based premiums to the proper functioning of deposit insurance, a 1996 amendment (the "zero-premium amendment) has undercut the risk-based premium system. That amendment is unsound policy, has had adverse results, and should be repealed.

Logic of Risk-Based Premiums

Risk-based premiums are not only fair in themselves but help create a healthy set of incentives for insured depository institutions. If premiums accurately reflect risk, they avoid overcharging safe institutions, undercharging risky institutions, and thus subsidizing excessive risk-taking. Instead, premiums make each depository institution internalize the cost of its own risk-taking. Thus premiums give depository institutions' owners and managers incentives compatible with the interests of the insurance fund. Even a system that only roughly proportions premiums to risk represents a significant improvement over charging safe and risky institutions exactly the same rate.

1996 Zero-Premium Amendment

The 1996 zero-premium amendment undercut the risk-based premium system by limiting the FDIC's authority to charge premiums when a deposit insurance fund has more than $1.25 in reserves for each $100 of insured deposits. The FDIC can assess premiums on institutions insured by such a fund *only* if those institutions "exhibit financial, operational, or compliance weaknesses ranging from moderately severe to unsatisfactory, or are not well capitalized. 12 U.S. Code § 1817(b)(2)(A)(iii), (v). As June 30, 2001, the amendment exempted 92 percent of all FDIC-insured depository institutions from paying premiums. Moreover, over 900 recently chartered institutions have never paid premiums.

The zero-premium amendment responded to bankers' arguments (1) that the Bank Insurance Fund's reserves belong to member banks; (2) that charging healthy institutions premiums serves no legitimate purpose if the fund has adequate reserves; (3) that BIF would tend to accumulate needlessly large reserves to help mask or offset the government's fiscal deficit; and (4) that if BIF's reserves exceed the 1.25 percent target, Congress would almost inevitably misappropriate the excess. The first two arguments are demonstrably false; the last two are dubious. I will discuss these arguments in turn.

A deposit insurance fund's reserves are the government's property, and rightly so: the reserves come from premiums paid to compensate the government for the risk of insuring deposits. Just because the insurance fund meets the 1.25 percent target and its member depository institutions remain open does not entitle the institutions to a refund. Nor should it entitle the institutions to receive future insurance free of charge. For bankers to call BIF's reserves "our money is no more true than for persons insured by AIG, Chubb, or Travelers to call those companies' reserves "our money.

Charging all insured depository institutions risk-based premiums would serve several important purposes even when the insurance fund has adequate reserves. First, it would let the FDIC refine the risk-based system to take account of the significant differences in risk among institutions currently exempt from paying premiums. Such risk-differentiation would promote fairness and better align bankers' incentives with the interests of the insurance funds. Second, charging premiums would reflect the economic reality that insuring even the healthiest institutions poses a risk greater than zero. Third, charging premiums would avoid the distortions involved in giving deposit insurance away free. Deposit insurance is valuable. If you give it away free, people will abuse your generosity. The free-rider problem now confronting the FDIC arises directly from the zero-premium amendment: if all depository institutions paid premiums reflecting their riskiness, then no institution would get a free ride.

The arguments that BIF would amass needless reserves for reasons unrelated to deposit insurance and that Congress would divert those reserves to other purposes are dubious. The special treatment of deposit insurance under Congressional budget rules provides important safeguards against such maneuvers. And bankers' political clout has sufficed to kill any diversion proposal in its incipiency.

In strongly opposing the zero-premium amendment, the Treasury warned this committee in 1995:

> [The amendment] would undercut a crucial achievement of recent banking legislation basing deposit insurance premiums more closely on the risk an institution poses to the insurance fund. . . . At a time when Congress should be encouraging the FDIC to improve the pricing of risk, the bill

> would mandate under certain conditions flat-rate premiums for institutions with quite different risks . . . . In any event, charging no premium at all would fail to take into account the very substantial day-to-day value of FDIC insurance.[5]

Developments since then have amply vindicated that warning.[6]

Need to Repeal Amendment and Let Risk-Based Premiums Work

The zero-premium amendment resembles a law regulating automobile insurance companies that would (1) require every company with adequate reserves to insure safe drivers free of charge, and (2) allow any company with inadequate reserves to charge safe drivers only to the extent necessary to replenish its reserves. No private company would provide automobile insurance under such constraints. Nor should the government continue to provide deposit insurance under such constraints.

The zero-premium amendment should be repealed so that risk-based premiums can work as intended.

EASING MINIMUM-PREMIUM REQUIREMENT

Under current law, if a deposit insurance fund's reserves will remain below the 1.25 percent target for more than a year, the FDIC must set premiums high enough to raise 23 cents annually per $100 of deposits. 12 U.S. Code § 1817(b)(2)(E). The FDIC can and should charge risky institutions more than safe institutions. But for the FDIC to satisfy this requirement, even safe institutions must pay premiums at historically high rates. The requirement undercuts risk-based pricing and places additional stress on depository institutions during economic downturns, when they can least afford it.

I support easing the minimum-premium requirement: e.g., (1) by lowering the minimum from 23 cents to 9 cents; and (2) by making the requirement applicable only if the reserve ratio would remain below 1.15 percent for more than two years.

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[5] Letter from Under Secretary John D. Hawke, Jr., to Chairman James A. Leach (Oct. 27, 1995).

[6] Moreover, free-rider deposits placed by firms like Merrill Lynch need not remain FDIC-insured: when insurance premiums rise, money that flowed in for a free ride may flow out into other investments and thus avoid ever paying premiums.

RISK-BASED ASSESSMENT CREDITS

I recommend against paying rebates from the insurance funds or placing an upper limit on the funds' reserves. We have no assurance that a given reserve ratio (whether 1.25 percent or some higher figure) will prove adequate. The experience of the late 1980s and early 1990s underscores the difficulty of accurately predicting future insurance losses. It also reminds us that reserves can vanish quickly: the Bank Insurance Fund's balance fell from $18.3 billion at the end of 1986 (1.12 percent) to negative $7.0 billion at the end of 1991 (-0.36 percent). In any event, most Americans would be surprised (and perhaps rightly so) to learn that the FDIC does not even have 2 cents in reserves per dollar of insured deposits.

I would see possible merit in authorizing the FDIC to grant risk-based assessment credits if an insurance fund's reserve ratio exceeds some level such as 1.5 or 1.6 percent. A depository institution could use such credits to reduce its future premium payments. The FDIC would award such credits based on a combination of (1) the institution's past premium payments, and (2) the institution's past and present risk to the fund. Thus a safe institution that had paid premiums for many years would receive relatively large credits, and a new or risky institution would receive relatively small credits, if any.

Properly constructed, risk-based assessment credits could help solve two vexing problems: first, the free-rider problem arising when some institutions' rapid growth dilutes reserves built up through years of payments by slower-growing institutions; and second, the difficulty of prospectively pricing the risk posed by a depository institution.[7] If the risk-based premiums paid by the institution did not properly reflect the institution's relative safety or riskiness, risk-based assessment credits would facilitate a retrospective process of settling-up.

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[7] Measuring the risk posed by a depository institution is difficult. This difficulty stems in part from the institution's role as an intermediary:

> A major function of banks is to assess the risks of lending to borrowers for whom there is little information on their economic condition and prospects. Thus, banks specialize in obtaining information about the very events, credit risks, that are most likely to result in a loss to the insurer. Because of this specialized knowledge, the *ex ante* information gap between the insurer and the insured is perhaps larger than in most other insurance settings, and is one of the most important reasons for the inability to find good *ex ante* measures of risk.

Christine E. Blair & Gary S. Fissel, A Framework For Analyzing Deposit Insurance Pricing, *FDIC Banking Review*, fall 1991, at 27

$100,000 INSURANCE LIMIT

I urge Members to take a skeptical view of proposals to index or otherwise increase the $100,000 limit on deposit insurance coverage.

Proponents of increasing the coverage limit stress the effects of inflation since 1980. But the 1980 level was by no means normal; adjusted for inflation, it amounted to an all-time high. It has not subsequently been increased in part because (as I note in footnote 1) the 1980 increase from $40,000 to $100,000 came to be viewed as a major blunder.

Proponents of indexing stress the desirability of adjusting the limit incrementally and often. But consider what such indexing might mean in practice. Would depositors correctly understand a limit like $107,000? I suspect that depositors who kept more than that amount at a failed bank would say that they had understood the limit as $170,000. They would then ask Congress to rescue them, just as your predecessors helped rescue the holders of "yellow certificates in 1987.[8]

Unless the coverage limit were adjusted for inflation only very infrequently and in very round numbers, it would tend to conflict with the need to keep the limit clear, simple, and stable. Proponents of increased coverage having made the limit hard to administer would then demand that Congress resolve the problem by raising the limit to some higher round number.

More broadly, I believe that raising the coverage limit would do little to resolve community bankers' complaints about losing customers to competition from other kinds of financial institutions.

MERGING INSURANCE FUNDS

Merging the FDIC's Bank Insurance Fund and Savings Association Insurance would make good sense, as a merged fund would be stronger and better diversified.

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[8] During the early 1980s, the managers of Golden Pacific National Bank, located in New York City's Chinatown, sold customers securities known "yellow certificates. Although these certificates were not deposits and did not even appear on the bank's books, a court ordered the FDIC to protect certificate-holders up to the $100,000 insurance limit. Title XI of the Competitive Equality Banking Act of 1987 required the FDIC to pay interest on the yellow certificates.

Association for
Financial Professionals

DEPOSIT INSURANCE REFORM

Statement
of the

Association for Financial Professionals

before the

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

Spencer Bachus, Chairman

Wednesday, October 17, 2001
10:00 a.m.

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DEPOSIT INSURANCE REFORM
STATEMENT OF THE ASSOCIATION FOR FINANCIAL PROFESSIONALS
BEFORE THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

SPENCER BACHUS, CHAIRMAN

October 17, 2001

Good Morning Mr. Chairman, Congresswoman Waters and Members of the Subcommittee. I am Nolan L. North, Vice President and Assistant Treasurer of T. Rowe Price Associates, Inc. I have served as Chairman of the Board of the Association for Financial Professionals (AFP), and am currently Chairman of the Financial Markets Task Force of the Association's Government Relations Committee.

We appreciate the opportunity to comment on several important issues which have been raised in the debate on reform of the deposit insurance system. Our comments today address why deposit insurance reform is important to corporate America, and several specific issues which are at the forefront of the debate.

The AFP, formerly the Treasury Management Association, represents about 14,000 finance and treasury professionals who on behalf of over 5,000 corporations and other organizations are significant participants in the nation's payments system. Organizations represented by our members are drawn generally from the Fortune 1000 and the largest of the middle market companies and they have an active interest and a sizable stake in any proposed changes to the deposit insurance assessment system. Our members, typically, are responsible for the banking relations of their organizations and, in that role, our members negotiate, monitor and approve for payment all charges from their banks, including charges passed-through by banks for deposit insurance assessments paid to the Bank Insurance Fund (BIF).

Overview of the Deposit Insurance System:

The stake of corporate America in deposit insurance is based on the premise that deposit insurance coverage is intended for depositors, not banks. Yet the voice of bank depositors is not often heard in this debate. When the Federal Deposit Insurance Corporation (FDIC) insurance assessments are to be paid, it is generally the bank deposit customer who actually pays the assessment. In the case of depositors with large balances, those assessments are paid as a direct pass-through from the bank to the depositor, based on the total deposits of the customer. Indeed, in a study done for our Association, it was determined that 93 percent of deposit insurance premiums for business accounts are passed-through to the business customers. As such, the bank acts as an insurance agent, collecting insurance premiums and sending them on to the insurer.

Deposit insurance is best viewed as the industry mutually insuring itself. FDICIA (Federal Deposit Insurance Corporation Improvement Act of 1991) fundamentally changed the structure of the nation's deposit insurance system by placing the risk of loss on banks and effectively their depositors rather than the FDIC or the federal government. Under the system adopted in 1991, FDICIA required insured banks to recapitalize the BIF up to a level equal to 1.25 percent of all deposits. It also authorized the FDIC to assess insured banks for whatever additional amounts might be necessary to replenish the Insurance Funds whenever they fall below the 1.25 percent level. Since there is no limit to the amount of assessments which could be imposed by the FDIC, this system places all liability for deposit insurance losses on insured banks and ultimately their depositors. Federal government responsibility would arise in catastrophic situations only after bank depositors' ability to pay, and capital of the banking system, are exhausted.

The essence of a mutual insurance system is that all stakeholders fairly participate in the costs and benefits of the insurance arrangement. We therefore urge that reform include the following principles to assure fair participation by all stakeholders in the system:

- Assess only insured balances. This approach eliminates the inequity of paying premiums for uninsured balances.
- Merge the bank (BIF) and thrift (SAIF) insurance funds.
- Do not increase the deposit insurance coverage levels from $100,000.
- Remove the fixed 1.25 percent reserve ratio requirement, and provide for a range of required reserves.
- Do not charge premiums to well managed and well-capitalized banks unless required by low reserve levels.

- Do not allow premium rebates to depository institutions. They are not appropriate because they would go to an intermediary rather than to the depositor who paid the costs of the system.
- Oppose full coverage for any special category of depositors, including public sector deposits, because a "protected class" of deposits is not good public policy.
- Allow well managed and well-capitalized banks, regardless of how fast their growth rate, to be exempt from FDIC assessments when the BIF reserve is funded sufficiently.

Assessments for Uninsured Balances Constitute an Unfair Methodology:

Assessing only insured balances is fundamental to fair reform of the deposit insurance system. It is important to note that our members believe that their organizations are the dominant funders of the BIF because banks pass through the deposit insurance costs to corporate customers on the basis of balance size. Importantly, our members pay these assessments based on full balances which customarily are well in excess of the insured $100,000 limit. As a result, many businesses must both self-insure their deposits in excess of $100,000, AND pay insurance premiums for uninsured balances over $100,000. In effect large corporate depositors subsidize the BIF through premium costs for deposits which are not insured by the fund.

The rationale for assessing premiums on full deposit balances would appear to be based on a need to build reserves for a "too-big-to-fail" possibility. However, this assumption is belied by the fact that the FDICIA legislation provides for special assessments on large depository institutions in the event that federal regulators determine that systemic failure action needs to be implemented.

For these reasons, AFP urges that now is the appropriate time to redefine the deposit insurance assessment base and modernize an outdated and unfair premium methodology by assessing only insured balances.

Merging the Bank and Thrift Insurance Funds:

We support a merger of the bank (BIF) and thrift (SAIF) insurance funds. Separate funds do not reflect the current structure of the financial industry. Charters and operations of banks and thrifts have become similar. The BIF and SAIF are already hybrid funds in that each one insures the deposits of commercial banks and thrift institutions. Commercial banks now account for over forty percent of all SAIF-insured deposits through ownership of thrifts. A merger would recognize the commingling of the funds that has already taken place. We should also expect that a merger of the funds would reduce duplicative administrative expenses.

Deposit Insurance Coverage Level:

The deposit insurance coverage level should remain unchanged. An August 2000 Economic Commentary by the Federal Reserve Bank of Cleveland reported that over 98 percent of all domestic deposit accounts in commercial banks are under the $100,000 deposit insurance limit, and the average deposit in these accounts is approximately $6,000. Since we believe that the intent for the federal deposit guarantees initiated by the Banking Act of 1933 is to protect the small saver, the current deposit insurance ceiling is appropriate.

Some financial institutions feel that higher coverage limits would solve funding concerns. With competition from a broad array of non-bank and non-insured competitors for the consumer's discretionary funds, it is not clear to us that a higher coverage limit would address funding concerns at smaller institutions. But more importantly, we do not believe that the use of the deposit insurance system for the competitive purpose of trying to help some banks with their funding is an appropriate public policy position. Deposit insurance coverage is not a competitive issue—coverage is intended to benefit depositors, not banks.

A recent study by the American Bankers Association measured the impact of raising the deposit insurance level to $200,000. The study concluded 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. These hypothetical new deposits, plus the added protection that existing deposits between $100,000 and $200,000 would receive, would lowe the Insurance Fund's reserve ratio below the required 1.25 percent and eliminate the $3 billion excess reserve above 1.25 percent now in the Insurance Fund. The study estimates that a 3-13 basis point assessment on all domestic deposits would be required to return the ratio to 1.25 percen

This solution—doubling the deposit insurance coverage—translates into a costly depositor remedy to a perceived competitive problem for some banks.

We believe it is unnecessary to index the deposit insurance coverage limit to an economic measurement because the current deposit insurance ceiling is appropriate to the intent of the system—if not already too high. The intent of the system is to protect the small saver whose average deposit balance in these accounts is about $6,000.

If deemed unavoidable however, any indexing scheme should be effective on a prospective basis, triggered on a five-year cycle and rounded to the nearest thousand-dollar level.

Funding Principles and Required Reserves:

The FDIC should be allowed to mitigate the cyclical affects of deposit insurance pricing by permitting the reserve ratio to fluctuate within a manageable range, within which premiums would not be charged to well managed and highly-capitalized institutions.

The deposit insurance system should retain the risk-based variable premium approach, based on meeting a range of required reserves. We believe that it would be appropriate to eliminate the current requirement that premiums rise to a minimum of 23 cents per $100 of insured deposits when the fund is expected to fall short of the 1.25 percent designated reserve ratio for more than a year. The FDIC should be given discretion to set and adjust the range within which the reserve ratio may fluctuate in response to changes in industry risks and business conditions.

The risk-based premium system should allow for more differentiation among the risk profiles of the more than 9,000 institutions currently in the best insurance category. Risk exposure to the system by deposit mix characteristics should be reflected in the risk profile. An institution with deposit balances primarily well in excess of the coverage limit poses less risk to the system than an institution with deposit balances primarily under the coverage limit. The current methodology fails to capture differences in loss potential among banks with similar ledger balances but varied deposit bases. A more appropriate basis for FDIC assessments would entail some determination of account types held by the institution to assess actual loss potential from accounts under $100,000.

Premium Rebates to Depository Institutions:

Premium rebates to depository institutions are not appropriate because value would flow to an intermediary rather than to the depositor who paid the costs of the system. The current 1.25 percent required reserves ratio has triggered a demand by deposit institutions for rebates of "excess" reserves. Moving to a reserves ratio range system coupled with risk-based variable premiums would simply mean that the reserves would tend to move toward the higher end of the reserve ratio range. At the point of approaching surplus, variable premiums could be reduced or suspended.

We oppose rebates on the basis that an equitable rebate method cannot be constructed. The entity bearing the premium cost—the bank customer—is unlikely to receive the value of any rebate. A fair rebate solution would require payment to the bank customer of pass-through costs previously paid by the depositor, and which would be paid by the depositor under the FDIC proposal. We doubt this process would be undertaken by most banks on behalf of their customers. Since most banks would not pass on rebates, we prefer a system in which excess funds trigger adjustments to a variable risk-based premium system.

Full Deposit Insurance Coverage for Municipal and Other Public Sector Deposits:

We oppose full coverage for any special category of depositors, including public sector deposits, because a "protected class" of deposits is not good public policy. Full coverage for certain types of deposits reopens the 'moral hazard' question concerning excessive risk taken by institutions because deposits are fully protected. Also, a practical effect of this approach may be to chase away other types of depositors. It would not take long for corporations as well as consumer advocacy groups, to understand that in banks with large municipal deposits, other deposits would be subordinated to municipal deposits in the case of bank failure.

As a matter of course, corporates assume the responsibility for determining the soundness of institutions in which uninsured deposits are held. The public sector should operate on the same basis. Moreover, we understand that some states effectively provide full coverage for public sector deposits through collateral guarantees.

Rapidly Growing and Previously Uninsured Deposits:

We do not feel that well managed and well-capitalized banks, regardless of how fast they are growing, should be expected to pay an FDIC assessment when the BIF reserve is sufficiently funded.

The suspension of premium assessments for the best managed and capitalized banks has called attention to the inflow of deposits from newly chartered banks, and banks associated with securities firms. These are not concerns about loss exposure to the BIF. These rapidly growing deposits cause an arithmetic problem for the current system, as they tend to decrease the surplus toward the 1.25 percent fixed floor. However, giving the FDIC the flexibility to manage the BIF reserve within a range provides an appropriate solution.

Conclusions:

In summary, AFP believes that the following principles need to be included in reform of the deposit insurance system:

- Assess only insured balances.
- Merge the bank (BIF) and thrift (SAIF) insurance funds.

- Do not increase the deposit insurance coverage levels from $100,000.
- Remove the fixed 1.25 percent reserve ratio requirement, and provide for a range of required reserves.
- Allow well managed and well-capitalized banks, regardless of how fast their growth rate, to be exempt from FDIC assessments when the BIF reserve is funded sufficiently.
- Do not allow premium rebates to depository institutions because they are not appropriate.
- Oppose full coverage for any special category of depositors, including public sector deposits, because a "protected class" of deposits is not good public policy.

We appreciate the opportunity to present the views of the Association for Financial Professionals on deposit insurance reform — a matter of great interest and value to the corporate community.

TESTIMONY OF

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on

BANK DEPOSITORS' RECOMMENDATIONS FOR DEPOSIT INSURANCE REFORM

before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

of the

COMMITTEE ON FINANCIAL SERVICES

of the

U. S. HOUSE OF REPRESENTATIVES

Wednesday, October 17, 2001
Room 2128
Rayburn House Office Building

Mr. Chairman and Members of the Subcommittee, I appreciate and welcome this opportunity to testify before you today on the bank depositors' view of deposit insurance reform.

I was similarly privileged to testify on this same topic before this same esteemed body in this same room on March 24, 1995 and more recently on February 16, 2000. I was also honored to testify on the same topic before the FDIC's Board of Directors on March 17, 1995 and their April 25, 2000 Roundtable.

Since then I have communicated with the FDIC regarding their deposit insurance reform efforts, including reviewing their April 2001 report entitled *Keeping the Promise: Recommendations for Deposit Insurance Reform* as well as their August 2000 *Deposit Insurance Options Paper* and related studies by outside firms.

I have studied the FDIC for the last 35 years and have met with and testified before their Board of Directors in the past on issues related to the insurance funds. In fact, while a Wharton Ph.D. candidate, I was recruited by the FDIC for an economist position in the early seventies and have nothing but the greatest respect for that agency.

I have taught banking and economics as a Lecturer in Finance at The Wharton School every year since 1970, but I do not come here as an ivory tower academic. I have worked as a consultant to hundreds of banks and thrifts of all sizes throughout the nation since 1969, including involvement at the board level, but I do not represent the views of those industries.

Those views, as well as those of the regulators, have been well articulated at previous hearings. My goal is to attempt to represent the views of a third party yet to be heard from, that of a taxpaying bank depositor.

This is in stark contrast to the industry view where it is felt that deposit insurance reform should be based on their needs, since it is "their" fund accumulated from many years of deposit insurance premiums. This view unfortunately fails to recognize that it is the taxpayers and the government's "full faith and credit" guarantee rather than the banks that ultimately stand behind our federal deposit insurance system.

The industry is not shy about proclaiming that it, rather than depositors, should have the final say in deposit reform. For example, we heard in the ABA's May 16, 2001 testimony here that "The ABA has stated for the past year that a bill to strengthen the FDIC is likely to be enacted only if an industry consensus in support of such legislation can be developed."

The referenced "industry consensus" is the ABA, America's Community Bankers, and the Independent Community Bankers of America. The ABA went on to warn that if any deposit insurance reform legislation increased banks' costs or contained extraneous amendments, "we have no doubt that support would quickly dissipate."

I would respectfully submit that there can be no legitimate deposit insurance reform without the considered input of taxpaying bank depositors, the forgotten and arguably the most important voice in this debate.

As a lifelong student of the FDIC, I have collected virtually every one of their publications. In fact, the FDIC staff has contacted me on several occasions to lend them FDIC material from my library that they no longer had! The prized possession of my FDIC collection is a hardbound version of their first Annual Report in 1934.

Whenever I am conducting research on the FDIC and have a question as to what this agency is really about, I refer back to this 1934 document. It states very clearly (p. 7) in the introduction that the FDIC was "created to insure depositors against loss resulting from bank failures." Not to insure individual banks but depositors, so that they maintain confidence in the system. The focus should always be on bank depositors, and this is the perspective I am taking today.

It is my opinion that the FDIC's new report on deposit insurance reform should be about "Keeping the Promise" to bank depositors NOT banks.

My goal is therefore to present the bank depositors' view of deposit insurance reform that will result in good public policy. In the case of the FDIC this means maintaining public confidence in banks through protecting depositors' accounts; promoting sound banking practices; reducing the disruptions caused by bank failures; and, responding to a changing economy and banking system.

These bank depositors' recommendations for deposit insurance reform are organized into four broad categories utilized by the FDIC, namely deposit insurance pricing, maintaining the funds, deposit insurance coverage, and bank regulation and supervision. These 14 recommendations (see Executive Summary) are based on 20 principles underlying the bank depositors' view. Following the description of these principles is the detailed analysis documenting the need for these recommendations.

EXECUTIVE SUMMARY OF BANK DEPOSITORS' RECOMMENDATIONS

I. REALISTIC RISK–BASED PRICING OF DEPOSIT INSURANCE

1. *A true risk–based system of pricing deposit insurance where all banks pay some type of premium at all times so there are no "free riders."*

2. *Revision of the current risk–based assessment structure to better differentiate among risk profiles.*

3. *"Special risk assessments" for de novo institutions, very rapidly growing ones, and others that pose special risks to the deposit insurance funds.*

4. *Explicit recognition of the "Too Big To Fail" (TBTF) policy in the form of a special assessment for TBTF banks.*

II. MAINTAINING THE FUNDS

1. *Merging of the BIF and SAIF insurance funds ASAP.*

2. *Increasing the 1.25% statutory designated reserve ratio (DRR) to 1.50%.*

3. *NO cap on the size of the merged fund.*

4. *NO rebates should be paid.*

III. DEPOSIT INSURANCE COVERAGE

1. *NO increase in the $100,000 deposit insurance limit.*

2. *Significantly improved disclosure of non–FDIC insured bank products.*

IV. IMPROVED BANK REGULATION AND SUPERVISION

1. *Significantly expanded market discipline, beginning with the public disclosure of some essential safety and soundness information on banks and thrifts such as CAMELS ratings and a portion of the safety and soundness exam.*

2. *Significantly improved bank regulatory and supervisory discipline so there are better risk management procedures, earlier identification of problem banks, and a reduction in the cost of failed ones.*

3. *Merging of the OTS into the OCC.*

4. *Additional consolidation and streamlining of federal financial institution regulators.*

Most of the above recommendations on deposit insurance reform were made in my 1995 and 2000 testimony here and at the FDIC. I should parenthetically point out that virtually none of the above recommendations were met with enthusiasm by the banking industry, but many members of this Subcommittee were quite open–minded. My 1.50% DRR proposal, for example, was endorsed by Representative LaFalce, despite the banking industry being "outraged" over it according to the front page of the March 27, 1995 *American Banker*. History will show that he demonstrated tremendous leadership and courage in this regard.

PRINCIPLES UNDERLYING THE BANK DEPOSITORS' VIEW

1. *The protection of bank depositors and the maintenance of confidence in the banking system is more important than ever now with today's volatile market.*

2. *The FDIC funds must NEVER be allowed to become insolvent again, even if by a GAO reserving "technicality," as was the case in 1991 and 1992. While not nearly as bad, the funds should strive to avoid losing money, as was the case with the BIF fund in 1999.*

3. *Taxpayers and the government's "full faith and credit" guarantee not financial institutions ultimately stand behind the federal deposit insurance system, but the banking industry will always take the opposite view that they financed their "own" insurance fund.*

4. *Deposit insurance is but one of many subsidies enjoyed by banks, but the banking industry (and even some regulators) will never concede this point. Two small Oklahoma thrifts found out how valuable the deposit insurance subsidy was after they gave up their FDIC insurance and each lost about one-third of their retail deposit base.*

5. *The federal safety net, of which deposit insurance is just one component, should be minimized rather than being expanded, as is the case with the significant increase of powers (and risk exposure) allowable under Gramm–Leach–Bliley (GLB).*

6. *The federal deposit insurance system is not "broken," and any improvements to it should be within the general framework of the existing system, relatively simple, easily understood by the public, and consistent with sound business practices. In this latter regard, the FDIC should adopt a more private rather than public attitude toward the critical issues of pricing, maintaining the funds, coverage, and regulation/supervision by always asking "What would a private insurance company do in this case?"*

7. *Market discipline is always preferred to regulatory discipline, although a balance between the two must be struck.*
8. *Increased public disclosure of the financial condition of banks and thrifts is the most effective means of market discipline.*

9. *While improved regulatory discipline is desired, banks should not be subject to an undue regulatory burden that would impact their profitability and ability to compete and be responsive to customer needs.*

10. *A healthy, profitable, and competitive bank and thrift industry is in everyone's best interest.*

11. *"Competition in laxity" by bank regulators undermines public confidence in the integrity of the bank regulatory and supervisory process.*

12. *Small and large banks and thrifts, including those that are still mutual operations, should be treated equitably to the greatest extent possible.*

13. Government expenses in the regulation and supervision of banks should be scrutinized for unnecessary duplication and waste of taxpayer monies.

14. The best time to strengthen the deposit insurance fund is during good times, because a "pay as you go" scheme to recapitalize the insurance fund during bad times may be insufficient.

15. Business cycles have not been repealed, and it is only a matter of time until the next recession begins. Any deposit insurance reforms should ameliorate not exacerbate the problems of banks during such a downturn.

16. All forms of "moral hazard" by banks or their trade associations (e.g., asking them if the $100,000 limit should be increased) regarding deposit insurance must be recognized and minimized.

17. The TBTF unwritten policy will always exist, regardless of banking industry or regulatory comments to the contrary; a corollary here is that firewalls do not exist during periods of crisis.

18. Banks, like their customers, should get what they pay for and pay for what they get (including TBTF coverage).

19. There is considerable downside risk for an undercapitalized insurance fund but little for an overcapitalized one, as the money is "still in the bank." The FDIC's concern that the fund may become "too large" is misplaced for many reasons, including the fact that there is no guarantee that rebated fund balances will be lent in the community.

20. Banks and thrifts must very carefully and clearly disclose to all customers, but especially seniors, which of their increasing array of products are NOT federally insured.

BANK DEPOSITORS' RECOMMENDATIONS FOR DEPOSIT INSURANCE REFORM

I. REALISTIC RISK–BASED PRICING OF DEPOSIT INSURANCE

1. A true risk–based system of pricing deposit insurance where all banks pay some type of premium at all times so there are no "free riders."

A. The concept of risk–based deposit insurance assessments, like risk–based capital, is based on both common and economic sense. It appears, however, that regulators may never get either of these "right," as the regulators always seem to be one step behind those nontraditional bankers who are both aggressive and creative risk takers. It often seems that regulators basically react to a new problem (e.g., fraudulent subprime lending), as compared to proactively identifying the potential problem so that its consequences and cost to the FDIC are minimized. Even if the regulators miss just *one* of our big but not even giant problem banks, the consequences can be severe as we saw with Keystone National Bank in 1999 and Superior Bank, FSB this past summer.

B. All banks, even the most conservatively–run ones, pose some type of risk to the insurance system. Thus, a realistic risk–based deposit insurance pricing scheme would result in all banks paying some premiums at all times. The least–risky banks would pay the lowest premiums, just as the least–risky drivers pay the lowest car insurance rates. Importantly, a true risk–based system would have no "free riders."

C. Since all banks would always be paying some premiums, there would be considerably less volatility in this regard compared to the present system where most banks pay nothing and then suddenly might be required to pay something during difficult times.

D. Treasury Assistant Secretary Sheila Bair, in her July 26, 2001 testimony here, stated that "Banks and thrifts benefit every day from deposit insurance, and they should compensate the FDIC for that benefit, preferably through relatively small, steady premiums." Thus, every institution would be charged a relatively stable premium on current deposits.

2. Revision of the current risk–based assessment structure to better differentiate among risk profiles.

A. The risk–based insurance premium system of the early 1990s was a significant improvement over the previous fixed rate assessments. However, as regulators failed to keep up with the increased willingness and ability of a large portion of the industry to add new types and levels of risks, the system became less effective. What other explanation can be given to a system where its primary fund lost money in 1999 and had a declining reserve ratio for the last two years, yet allows nine of ten institutions to continue paying zero premiums?

B. George Hanc, Associate Director in the FDIC's Division of Research and Statistics, accurately summarized our current system: "Many observers doubt that existing differences in premiums accurately reflect differences in bank risk or provide a sufficient incentive to reduce moral hazard significantly" ("Deposit Insurance Reform: State of the Debate," *FDIC Banking Review*, 1999, Vol. 12, No. 3).

C. The most logical improvement to the present system would appear to be the establishment of higher capital group *and/or* supervisory subgroup standards so that 89–93% of all thrifts and banks do not fall in just one of nine possible risk assessment buckets. George Hanc's above–cited article is clear in emphasizing that "...higher capital requirements are perhaps the strongest restraint on moral hazard because they force stockholders to put more of their own money at risk (or suffer earnings dilution from sales of shares to new stockholders) and provide a larger deductible for the insurer." The establishment of higher standards for "well" and "adequately" capitalized institutions not only makes the most sense from this perspective but also would probably be the easiest risk differentiation assessment technique to implement.

3. **"Special risk assessments" for de novo institutions, very rapidly growing ones, and other that pose special risks to the deposit insurance funds.**

A. "Special risk assessments" represent a third dimension to the present risk–based assessment scheme. Under this proposal the FDIC imposes special annual assessment premiums, which could be in the 3–10 basis points (bp) range, depending upon how a bank matches up to a "special risk" profile. This "real time" profile would be constantly changing based upon examiner input from the field *and* market signals. Recently released public information that is material to bank analysts and suggestive of increased risk exposure such as considerable shuffling of top management; accounting problems; adverse changes in business operations; serious customer service problems; etc. would likewise be included in the special risk profile. The more such factors, the higher the risk and special assessment, which could be increased or decreased during the year depending upon risk behavior.

B. Everything that a private insurer would look at in pricing a Directors and Officers policy as well as those items that an objective analyst would evaluate in rating a bank, such as debt and equity information, would be considered in this special risk profile. FDIC examiners would spend as much time surfing the Web for market signal data on a targeted bank as they would spend inside it reviewing loan files, board minutes, and other records. Importantly, these proposed special risk assessments would be published monthly, much like formal enforcement actions (which are not that dissimilar in their overall purpose).

C. A special risk profile that might be appropriate today would include any bank with *rapid growth* in any key financial indicator such as deposits, assets, or off balance sheet items; such a bank might have a 3 bp annual special assessment under this proposed scheme. This would include the rapidly growing brokerage banks (e.g., Merrill Lynch and Salomon Smith Barney).

D. A significant concentration in a "targeted" risk profile activity (e.g., subprime lending) would also be the basis for a special assessment, which might be another 3 bp for the very rapidly growing bank in our example.

E. ALL de novo banks and thrifts would be subject to a special risk assessment (e.g., 3 bp) for their first several years of operations, so there are no "free riders." Thus, a very rapidly growing, de novo bank specializing in subprime lending might have a 9 bp special risk assessment, which could change during the year based on risk behavior. Even though management might consider their operation to be the "best bank" around, the additional public and regulatory scrutiny of their special assessment might reduce the FDIC's loss exposure in the event of a failure.

F. Another example of an item that would be included in the special risk profile would be the rapid growth of secured liabilities, because secured creditors have priority over the FDIC at a failed bank. Former Treasury Assistant Secretary Greg Baer, in his February 16, 2000 House Banking Subcommittee hearing stated that "...premium rates or the premium assessment base should be changed to reflect more accurately the FDIC's risk position by accounting for secured borrowings." He cited an example where a bank could, without any change in it deposit insurance premiums, increase the FDIC's risk exposure by replacing unsecured borrowing with FHLB advances or repurchase agreements. Current Treasury Assistant Secretary Sheila Bair recently reiterated this concern in her July 26, 2001 testimony.

4. Explicit recognition of the "Too Big To Fail" (TBTF) policy in the form of a special assessment for TBTF banks.

There can be no true deposit insurance reform without addressing the TBTF issue. More information on this proposed TBTF insurance premium is found in my Viewpoint titled "Fed's 'Too Big to Fail' Stance Curious in the Megabank Era" in the July 27, 2001 *American Banker* (page 9). The major points in support of a special TBTF assessment are as follows:

A. There are at least four TBTF facts of life. *First,* TBTF has existed since 1984. *Second,* TBTF cannot be eliminated. *Third,* TBTF is an extremely valuable competitive advantage and benefit to the 25 or so banks in this exclusive club. *Fourth,* TBTF banks pay nothing for this privilege.

B. Realizing that nothing can be done about the first three facts, this recommendation would require a special risk assessment on the total assets (not deposits) of TBTF banks. The assessment, which might be in the 3-8 bp range, would itself be risk based so that a more traditional TBTF bank like Washington Mutual would pay much less than Citibank.

C. The assessment would be on assets rather than deposits, because the potential risk exposure of the insurance fund arguably is with the entire company not just its insured deposits. (This is consistent with Alan Greenspan's view that, in the final analysis, there are no firewalls.)

D. The Comptroller of the Currency suggested that the 11 largest banks in 1984, with roughly $40 billion or more in assets in current dollars, were TBTF. There are approximately 25 bank and thrift companies with such an asset (not deposit) base. The 20 largest bank and thrift companies, each with at least $50 billion in assets, represent approximately 50% of the industry's total assets.

E. Bank regulators recognize that megabanks must be regulated and supervised differently. The Fed has defined about 30 such companies as Large Complex Banking Organizations (LCBOs) and regularly discusses special risk management and other examination activities for them. The Comptroller of the Currency recently reorganized its entire examination staff by announcing the creation of a separate group of 350 examiners for the 30 largest national banks under a senior staff member. Since megabanks are regulated and supervised differently, it follows that they should be treated differently in terms of their potential risk and premium contributions to the insurance system.

F. As the FDIC's George Hanc mentioned in his discussion of TBTF banks in the aforementioned article in the *FDIC Banking Review*, "… the failure of only one of several currently existing megabanks could deplete or seriously weaken the deposit insurance fund, with potentially adverse consequences for the stability of financial markets."

G. With an explicit TBTF policy as recommended here, there would be the equivalent of an FDIC sticker on the lobby door, but this one would read "TBTF." And, for that privilege (and the additional risk they generate for the fund), these 25 or so banks will be paying a nominal annual special assessment that will benefit the entire insurance fund. These banks are already getting this TBTF benefit, but under this proposal they will be paying for it.

II. MAINTAINING THE FUNDS

1. Merging of the BIF and SAIF insurance funds ASAP.

While many if not all of the other recommendations presented here will generate debate, and most likely opposition from the bank and thrift industries, it is hard to imagine any basis for opposition to the merger of the BIF and SAIF funds. The arguments and broad support for this proposal are overwhelming:

A. A merged fund would eliminate any potential confusion among bank depositors as to "which fund is stronger," especially during periods when such a distinction may be made between banks and thrifts. On a more practical basis it would eliminate the problem of an unjustified premium disparity.

B. There is less and less differentiation between banks and thrifts as the strong thrifts have become banks and the weak thrifts have become history. In fact, according to the OTS, as of year–end 2000, 41% of SAIF–insured deposits were in BIF–member banks, and only 52% of SAIF–insured deposits were in OTS–supervised thrifts. Conversely, as of that same date almost one–third of savings association deposits were BIF–insured, including nearly one–fifth of the deposits of OTS–regulated thrifts according to the OTS. It makes sense that an increasingly merged industry would be covered by a merged insurance fund.

C. From an actuarial perspective, a larger more diversified fund would be much stronger in terms of protecting depositors, as the potential risk exposure from the largest insured would be reduced. This is demonstrated by the fact that Bank of America's 8.1% share of BIF–insured deposits as of year–end 2000 would drop to 7.1% for a merged fund, while Washington Mutual's 7.3% share of SAIF–insured deposits would fall to just 1.8% according to the OTS.

D. A larger and more diversified merged fund would also be stronger in terms of the potential risk exposure from troubled banks and thrifts. According to *The*

FDIC Quarterly Profile (First Quarter 2001), the 78 problem banks as of March 31, 2001 had $17 billion in assets (comparable insured deposit data are not available) representing 54% of BIF's $31.4 billion in balances at that time. The 17 problem thrifts as of that same date with $6 billion of assets likewise accounted for 54% of SAIF's $11.0 billion of balances. Even though data unavailability precludes a more relevant apples–to–apples calculation of insured deposits of problem banks and thrifts to BIF/SAIF balances, the failure of any one of the 95 problem banks or thrifts would represent a smaller proportion of the merged fund's $42.4 billion in balances compared to those in the respective fund.

E. Unlike 1995 when the BIF fund was roughly three times as well capitalized as the SAIF fund, they are approximately equal with the SAIF reserve ratio of 1.43% actually exceeding the BIF reserve ratio of 1.32% as of March 31, 2001. This approximate parity of reserve ratios as of that date eliminates any of the controversial issues that existed in 1995 regarding thrifts' payment of a special assessment to enter a merged fund or banks' increased exposure with a merged fund assuming FICO obligations.

F. Key regulators, Congressional leaders, and even most industry trade associations have expressed support for this concept, although the industry groups generally require other concessions as part of a "package deal". Importantly, academics and economists who have studied this issue generally support a merged fund. The most relevant studies have been done at the regulatory agencies themselves. Robert Oshinsky, Financial Economist at the FDIC, concluded in a fairly recent study ("Merging the BIF and the SAIF: Would a Merger Improve the Funds' Viability?") that "...a merger of the funds would substantially decrease the probability of a failure of at least one deposit insurance fund. In addition, it would provide benefits to both the BIF and SAIF." An OCC working paper ("Two Deposit Insurance Funds: In the Public Interest?") jointly prepared in February 1997 by an OCC economist and an FDIC economist likewise concluded that "Combining the deposit insurance funds may result in a lower probability of fund insolvency from unanticipated economic shocks than keeping the funds separate."

2. Increasing the 1.25% statutory designated reserve ratio (DRR) to 1.50%.

There is probably not one bank or thrift executive who would be expected to agree with this recommendation (or the subsequent ones), as higher reserve ratios and premiums would cost them money. Any regulator adopting this 1.50% DRR recommendation would immediately incur the wrath of the industry. The FDIC, for example, would have to argue that there's a "significant risk of substantial future losses" to justify a 1.50% DRR instead of the inadequate 1.25% one.

My March 17, 1995 testimony before the FDIC's Board of Directors and my March 24, 1995 Congressional testimony presented a strong case for an increase in the DRR to 1.50%. Changes in bank competition and regulatory structure, among other things, have significantly increased the insurance fund risk exposure since that time, thereby making the case for a 1.50% DRR stronger than ever:

A. Megamergers during the last decade have significantly increased the insurance fund risk exposure. Robert Oshinsky, Financial Economist at the FDIC, recently completed a working paper titled "Effects of Bank Consolidation on the Bank Insurance Fund." He found that "...based on historical loss and failure rates, the consolidation that took place between 1990 and 1997 increased the risk of BIF insolvency by approximately 50%, and that megamergers that took place or were announced during the 18 months between year–end 1997 and midyear 1999 increased the risk of insolvency further." If a 1.50% DRR made sense in 1995, it certainly makes even more sense now.

B. In addition to general megamerger trends, the increased concentration of assets in the hands of a small number of giant banks has further increased the insurance fund risk exposure. According to that same FDIC study, "... the health of the BIF has become more and more dependent on the health of the top 25 banking organizations, and future insolvency may be deeper, and harder to emerge from, than in the past." An *American Banker* story ("FDIC: Big Mergers Change Fund's Risk Calculation," September 8, 1999) about that FDIC study noted that 54.5% of industry assets at midyear 1999 were held by the 25 largest bank holding companies, compared to just 31.8% as of yearend 1990. Again, a 1.50% DRR would provide more protection to bank depositors than the current 1.25% under this environment.

C. "The little [bank failures] are never going to break you," said Roger Watson, FDIC research director. "It's the low-probability, large-institution failures" that pose the greatest risks to the insurance fund and the taxpayer according to the above–cited *American Banker* story. He also noted that there is a 12.5% or one in eight chance that BIF would be rendered insolvent if one of the top 10 banks fail. FED Chairman Greenspan stated that megabanks "create the potential for unusually large systemic risks in the national and international economy should they fail" *(New York* Times, October 12, 1999).

D. According to the FDIC, just six banks (Bank of America, BankOne, First Union, Wells Fargo, Chase and Fleet/BankBoston) and Washington Mutual comprise over 25% of domestic deposits. Another FDIC report shows that just 20 banking organizations comprise the top 50% of the industry's total assets. Such tremendous concentration of resources suggests the prudence of increasing the DRR to 1.50%.

E. The TBTF implicit guarantee now covers more banking companies than ever before, again suggesting the advisability of an increased DRR. The combined funds had $42.4 billion in balances and a combined reserve ratio of 1.35% as of March 31, 2001. There are, however, about 25 bank and thrift companies with deposits at or above the approximately $40 billion level. Also, there are over 80 banks and thrifts with assets in excess of $10 billion.

F. Expanded investment, insurance, and other powers under GLB for companies with insured bank deposits will increase the risk exposure of the insurance funds even more than was the case in 1995. Instead of just commercial banking risks, we must now consider risks in the investment banking and insurance fields. Regardless of claimed firewalls and other precautions, a solvency problem at a nonbank affiliate may find its way to the insured bank, thus increasing the funds' risk exposure. Any such increased risk exposure will be better managed with an increased DRR such as the recommended 1.50% one.

G. Recent bank failures have been blamed on new types of financial risks that were not common in 1995, thus suggesting an even stronger case now for a 1.50% DRR than was the case then. For example, we learned from a Committee hearing on February 8, 2000 that participation in subprime lending, asset securitizations, and fraud has been a factor in a disproportionate number of recent bank failures. (These would represent components of the previously recommended special risk profile.)

H. The recent and projected growth in insured deposits at existing and new types of financial depositories (e.g., Internet banks) likewise argue for an increase in the DRR. For example, there has been considerable concern about the adverse impact on the BIF reserve ratio of recent very rapid deposit growth at the insured bank affiliates of Merrill Lynch ($50 billion in nine months according to the February 15, 2001 *American Banker*) and Salomon Smith Barney (ironically affiliated with the TBTF–poster boy Citibank). According to the June 28, 2001 *American Banker*, these two firms added $7 and $13 billion, respectively, of insured deposits during the first quarter of this year alone. These and other likely Wall Street innovations further support the need for a 1.50% DRR <u>and</u> a merged fund ASAP. As will be noted in a subsequent historical discussion, Wall Street's continued interest in profiting from FDIC coverage dates back to the deposit brokers (including Merrill Lynch) that were put in business by the 1980 increase in the FDIC insurance limit to $100,000.

I. The 1.25% DRR is inadequate as demonstrated by the fact that the FDIC fund was at a 1.24% level in 1981, prior to its dwindling to a negative number in 1991 and 1992. Had the DRR been 1.50% in 1981 (see final argument below why it *could* have been), it is likely that the FDIC would NOT have had to publicly announce the insolvency of its fund during that period. Besides the obvious embarrassment to the FDIC, such an announcement reduced confidence in the banking system at the worst possible time.

J. There is another "125" number ironically related to the magic 1.25% ratio. This was appropriately recalled by former Treasury Assistant Secretary Greg Baer in his February 16, 2000 testimony citing the inadequacy of the 1.25% DRR: "...It is worth remembering that the thrift crisis – and in particular, the inability of deposit insurance reserves to cover losses from thrift failures – cost the taxpayers of this country over $125 billion." Actually, the more commonly accepted figure is $150 billion, possibly an omen that the magic 1.25% ratio should be 1.50%!

K. An increased DRR such as 1.50% provides bank depositors with greater confidence during periods of financial stress and turmoil. We had the S&L, junk bond, and BCCI scandals in the 80s and the Orange County, Mexico, Barings PLC, and Long Term Capital Management collapses in the 90s. There will likely be more financial disasters this decade, and it would be more reassuring to depositors seeking a safe haven that their insurance fund had a higher DRR.

L. Financial problems and costly bank failures can occur even in non–recessionary times as we saw with the First National Bank of Keystone in 1999 and Superior Bank, FSB this summer. The combination of insurance losses from that 1999 failure and the rapid growth of deposits from Wall Street and other sources caused the BIF insurance ratio to decrease for the last *two consecutive years*, the first such declines since the beginning of the last decade. The BIF ratio, which stagnated at 1.38% as of year–ends 1997 and 1998, fell to 1.36% as of year–end 1999 and 1.35% as of year–end 2000. With this type of environment it makes infinitely more sense to talk about *increasing* the DRR than giving rebates to free–riding banks. Had the DRR been at the recommended 1.50% level in 1995, the FDIC, with the additional investment income from a larger fund, would not have experienced back–to–back declines in the BIF ratio.

M. Assets of *failed* banks and thrifts have not exceeded $1 billion since 1994. This streak ended in 1999 with Keystone National Bank and reappeared again this year with Superior Bank, FSB. Considering the proven insufficiency of the 1.25% DRR regarding the $106.4 million BIF loss in 1999, the first such loss since 1991, it would be prudent to increase the DRR to 1.50% so this embarrassment is not repeated. This is especially the case in light of relatively recent legislative cost containment changes such as prompt corrective action, conservatorship at 2% capital, least–cost resolution, and national depositor preference.

N. A 1998 FDIC working paper ("Capitalization of the Bank Insurance Fund") by Financial Economist Kevin Sheehan used a two–state Markov–switching model to predict the impact of different required reserve ratios, ranging upward to 1.50%, on BIF solvency and fund balances. He concluded that "...increasing the required reserve ratio while maintaining the current assessment rate would substantially reduce the likelihood of small fund balances." Using data from 1972–1996, he estimated that with current assessment rates of 23 basis points, the probability that BIF would become insolvent would be only 0.9% with a 1.50% required reserve ratio compared to 3.2% for a 1.25% one. Thus, the probability of the FDIC facing the ultimate embarrassment of an insolvent fund (as was the case in 1991 and 1992) is reduced by more than three and one half times with a 1.50% rather than

1.25% required reserve ratio. This added cushion of 25 basis points in the DRR leverages itself to a substantial amount of added depositor protection and confidence in the system.

O. A better capitalized fund with a DRR of 1.50% rather than 1.25%, representing more rather than less bank equity, should promote sounder banking practices, because it is the banks' money that will be tapped first before the taxpayers are asked to support the fund.

P. A 1.50% DRR is not an unrealistic number for many reasons. *First*, it is just 15 basis point above the 1.35% level of the combined funds as of March 31, 2001, even though that ratio actually declined in recent years. *Second*, the FDIC fund ended December 31, 1934, the first full year of the FDIC's existence at a 1.61% reserve ratio, a fact that should not be ignored in terms of the original intent of the FDIC. *Third*, the FDIC's reserve ratio was at or above 1.50% for 10 year–end periods since 1934, the highest being 1.96% in 1941 and the most recent being 1.50% in 1963 (near the beginning of our previous post–war record expansion).

Q. According to cited FDIC methodology and data, the origin of the 1.25% DRR cannot be verified. The "correct" DRR apparently should have been at least 1.30% and as much as 1.45% (or perhaps even 1.5%) after rounding:

1. Confidence for the Future: An FDIC Symposium (FDIC, January 29, 1998, p. 103), notes that the 1.25% target, first referenced in the Depository Institution Deregulation and Monetary Control Act of 1980 (DIDMCA), "was selected because 1.25 represented the approximate historical average reserve ratio for the FDIC fund prior to 1980." (There was some historic precedent for this methodology, as the FDIC used the average loss experience of banks over the 1865–1934 period to establish its initial premiums.)

2. The DIDMCA referenced a broad 1.10–1.40% range for FDIC adjustments of the reserve ratio about the 1.25% midpoint. The 1.25% DRR, with a 1.50% ceiling, was specifically referenced in the 1989 Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA).

3. Using year–end FDIC reserve ratios over the 1934–79 period, I calculated that the *average* was NOT 1.25% but 1.425%. Also, the *median* reserve ratio, a more relevant statistical measure of central tendency, for that period was precisely the same 1.425%. Thus, if the FDIC's description of how this bedrock 1.25% ratio was calculated is correct, it appears from these revised calculations that someone may have ignored the "4" and read 1.425% as 1.25%. If this bizarre account of FDIC history is in fact true, the "correct" 1.425% DRR would have been rounded up to 1.45% or perhaps even 1.5%, and there would be no need for this current debate!

4. The only way to get anything close to 1.25% for this 46–year period is to calculate a "weighted" average, which disproportionately weights the

inflationary 70s. This results in a 1.29% weighted average over the 1934–79 period, which should have been rounded up to 1.30% (the weighted average for the 36 years preceding the 70s was 1.42%). Regardless of how the math is done, the 1.25% "magic" ratio cannot be verified, and the only numbers that can be verified are in the 1.3–1.5% range.

3. NO cap on the size of the merged fund.

The previous recommendation documented why a 1.50% DRR should be the floor rather than the ceiling for the deposit fund. In fact, an equally important recommendation, which follows from the above–listed principles underlying the bank depositors' view, is that there should be NO cap on the size of the merged fund. Chief among the reasons for this recommendation are the following:

A. Any private sector insuring organization would stockpile reserves collected during the good times in anticipation of the bad ones. The insurance fund should be no different and allow its reserve balances to continually grow without any designated cap. Depositors would obviously have much more confidence in an insurance fund with such a conservative policy.

B. The idea of a "capless" insurance fund is not that dissimilar from a proposal advanced in 1998 by Ron Feldman, a senior financial analyst at the Minneapolis Fed. He proposed that "Banks should have to pay for deposit insurance no matter how large reserves held by the government," according to the *American Banker* ("Minneapolis Fed Researcher: Abolish Bank Insurance Fund," October 22. 1998). He would actually abolish the insurance fund and forward mandatory insurance premiums to the Treasury. The FDIC would tap a Treasury line of credit for any needed funds, and there would be no concern over whether or not the DRR was appropriate as there would be no fund. This approach, while clearly an unconventional one, properly identifies the Treasury and the taxpayer as the ultimate insurer of last resort for the banking system. Importantly, there would be no cap under this proposal, as all banks would pay deposit insurance premiums.

C. A "capless" insurance fund allows the reserve balances to grow to much more significant levels, thus reducing the likelihood that the DRR will be breached. Once that happens, the banking system effectively transforms to a "pay as you go" procedure, with collected (and usually increasing) assessments being used to replenish the fund. However, with depressed earnings in a slowed economy, assessments may not be sufficient for recapitalization. For example, 1987 bank earnings of $2.8 billion just exceeded failure losses of $2 billion but were well below 1988 losses of $6.7 billion. A capless fund with a much larger cushion protecting the DRR would lead to increased confidence in the system by insured depositors.

D. Perhaps the most important view in this respect is that of the Treasury, which ultimately backstops the insurance funds. According to former Treasury Assistant Secretary Greg Baer, in his February 16, 2000 House Banking

Subcommittee hearing, "We oppose a structure that caps the insurance fund and mandates rebates of any "excess" reserves above that cap" (see below).

4. NO rebates should be paid.

The recommended deposit insurance system with a 1.50% DRR and no cap on the size to which the fund could grow would NOT allow rebates for the following reasons:

A. A capless system without rebates would obviously result in a larger and stronger fund, thereby instilling even greater depositor confidence. Former Treasury Assistant Secretary Greg Baer, in his February 16, 2000 House Banking Subcommittee hearing, expressed one of many reasons why rebates should NOT be paid: "Thus, we believe that allowing the insurance funds to continue building up reserves through interest income during good economic times is good policy."

B. Insurance can generally be defined as the substitution of a small certain loss in the form of a premium for a large uncertain loss. As long as banks and thrifts benefit from the large uncertain loss of depositor insurance, they should pay for this privilege with continued assessments and no rebates. According to the above–cited former Treasury Assistant Secretary, "Under its current authority, therefore, the FDIC pays no refunds since healthy institutions pay no premiums." He went on to state one of the reasons why Treasury opposes any cap or rebates: "First, we do not find sufficient evidence for concluding that any insurance fund net worth above 1.5 percent represents 'excess' capital that should be returned to insured institutions rather than retained by the insurer."

C. Rebates, which would only exacerbate the current "free ride" deposit insurance assessment situation for 92% of the industry, would be a form of *negative* premiums where a bank effectively is being paid by the FDIC to take risks! This is not only contrary to the most basic insurance principles, but it is just not the way anyone would or should run a private or public organization.

D. The idea that insurance premiums should be inventoried as reserves for future losses rather than being returned to banks in the form of rebates is consistent with the logic of many conservative bankers. For example, many such bankers retain their earnings to strengthen capital (i.e., reserves) rather than paying earnings out to stockholders in the form of dividends. Many conservative bankers with good dividend payout ratios have substantial capital cushions. It may be apples to oranges to compare the minimum required capital ratio at an individual bank to the required reserve ratio for the entire system. Nonetheless, it is of interest to note that a capital ratio of 2% results in conservatorship, but a DRR of well below that amount is considered satisfactory.

E. Rebates would make a bad "moral hazard" problem even worse. With 92% of the industry and all new institutions paying no insurance premiums, the *marginal* cost of adding an extra dollar of insured deposits is zero. The only thing worse than this would be to make this cost negative through authorizing rebates. As the above–cited former Treasury Assistant Secretary stated: "...rebates would exacerbate what is already a poor set of incentives around deposit insurance."

F. Government officials, such as those at the FDIC or elsewhere who support some sort of industry rebate, are operating under the assumption that rebated dollars from the insurance funds primarily would be lent in local communities. There is no basis in fact for this assumption, as bankers benefiting from the windfall of rebated funds may use them for other purposes besides lending such as investing them in securities or ultimately retaining or paying out the resultant profits. This is similar to the current assumption by many government officials that the current tax rebates primarily will be spent by consumers to help jumpstart the slowing economy.

III. DEPOSIT INSURANCE COVERAGE

1. NO increase in the $100,000 deposit insurance limit.

Many people, especially those in the media, limit their discussion of deposit insurance reform to the proposed doubling of the current $100,000 limit. The major arguments against this proposal are found in my Viewpoint titled "Doubling Deposit Insurance Would Compound S&L Error" in the September 1, 2000 *American Banker* (page 13). While there are many, many reasons why this proposal is not a good idea, the main ones are summarized below:

A. Considering the present environment's increased level of risk exposure for the deposit insurance funds, good public policy dictates consideration of proposals that *reduce not increase* risk exposure. *Any* increase in the deposits covered by the FDIC will increase risk exposure to the funds. For example, the proposal to provide full insurance coverage on all municipal deposits (over $42 billion at commercial banks alone as of September 30, 1999 according to the ICBA) should be rejected, as it will unnecessarily increase the risk exposure of the funds. This is also true for the proposed doubling of the $100,000 insurance limit on other types of accounts, including retirement savings.

B. The previously cited 1999 FDIC article by George Hanc summarizes four general categories of deposit insurance proposals, the first being to "increase depositors' risk exposure." One such proposal is to *reduce* insurance limits. Other such proposals include coinsurance for insured depositors; mandatory loss for insured depositors; and restriction of coverage to particular types of depositors. There is no mention in this article of any proposal to *increase* deposit insurance limits, because the purpose of those and other reform proposals is to "induce depositors to increase their monitoring of bank risk and, by means of their deposit and withdrawal activity, discipline and restrain risky banks." The proposal to double the current $100,000 limit would encourage the opposite type behavior. It would, therefore, not be good public policy.

C. The proposed doubling of the $100,000 limit will be condemning us to repeat a mistake we made 20 years ago and vowed never to make again. Shortly after the former FDIC Chairman Helfer was confirmed, she directed her staff to complete a comprehensive study of the banking crises of the eighties and early nineties. The result was titled *History of the Eighties: Lessons for the Future*, which was completed in December 1997. According to the Foreword by then Chairman Hove, "At the very least, the history of the turbulent time in banking should teach us that we cannot afford to be complacent, and the FDIC hopes this study that glances backward will be helpful as we look forward." The following are excerpts from Volume I, *An Examination of the Banking Crises of the 1980s and Early 1990s* (p. 93) about the increase in the insurance limit from $40,000 to $100,000 as part of the 1980 DIDMCA:

1. "In the Senate, the first proposal was to increase the limit to $50,000, as an adjustment for inflation." (Had that been done in 1980, it would be equivalent to less than $100,000 today after adjusting for inflation, and there would be no need to discuss raising the current limit.)

2. "But, there was clear sentiment in Congress for a greater increase that would help draw deposits into the thrifts. It has been argued that the S&Ls were the driving force behind the increase in insurance, and after the provision passed, the U.S. League of Savings Associations did state that it was 'particularly helpful.'"

3. "The lower [$50,000 proposed Senate] figure remained in the bill, however, until it was replaced by the $100,000 limit at a late–night House–Senate conference. The decision, scarcely remarked at the time, would come to be viewed by many as having weighty consequences" relative to the S&L crisis and the brokered deposits issue.

4. "The Federal Reserve supported the proposed increase to $50,000, but was 'inclined to favor an increase to $100,000.'"

5. Then FDIC Chairman Sprague "noted in testimony before Congress that an accurate adjustment for inflation would mean an insurance level of approximately $60,000, but he said nothing about a higher increase."

6. "Testifying before Congress four years later, [then FDIC] Chairman Isaac noted that he believed Congress had passed the $100,000 limit over the objections of the FDIC."

7. Then House Banking Committee Chairman St. Germain replied to Chairman Isaac "that he had agreed with the FDIC at the time but that 'it

was one of the things we had to compromise on...I thought it was a mistake.'"

D. The FDIC examination of the S&L crisis clearly notes that one of the "Lessons for the Future" is that an unjustified increase in the insurance limit can be a mistake with tremendous consequences. Actually, that official FDIC description of how the unwarranted and unwanted (by the FDIC) increase to $100,000 in 1980 was pulled off by the S&L lobby was most restrained compared to other accounts. These and other accounts suggest that the proposed doubling of the insurance limit to $200,000 would be a repeat of a past mistake.

E. Former FDIC and RTC Chairman Seidman, in his book titled Full Faith and Credit: The Great S&L Debacle and Other Washington Sagas (Random House, New York, 1993), wrote the following (pp. 178–79) about the 1980 increase in the insurance limit to $100,000:

1. "This in effect made the government a full partner in a nationwide casino, first speculating mainly in real estate, later in extremely volatile mortgage securities, junk bonds, futures and options, and similar Wall Street exotica."

2. "It gave the S&Ls practically unlimited access to funds through a $100,000 'credit card' issued by Uncle Sam."

3. "This was the exact opposite of the original intent of deposit insurance, which was to protect small savers."

4. "The thanks for this unfortunate piece of legislation goes principally, but not entirely, to [Banking Committee Chairmen Reuss and Proxmire] at the behest, it is said, of Senator Cranston and the S&L industry's lobbyists ... at a late–night conference committee meeting."

F. The most descriptive account of the 1980 increase in the insurance limit to $100,000 was reported (pp. 24–25) in Inside Job: The Looting of America's Savings & Loans (McGraw–Hill, New York, 1989) by Pizzo, Fricker and Muolo:

1. "Regulators later said this may have been the most costly mistake made in deregulating the thrift industry."

2. "While legislators were hammering out the details of the [DIDMCA] in a late–night session on Capitol Hill, Glen Troop, chief Washington lobbyist for the powerful U.S. League of Savings Institutions, and an associate convinced members of Congress to make the increase."

3. "'It was almost an afterthought,' a House staffer later told a reporter."

4. "Thrift lobbyists were said to have more influence over their regulators than any other regulated industry, and the U.S. League had traditionally participated in regulatory and legislative decisions, even going so far as to write some of the regulations. Bankers complained that they did not get treated as generously by Congress as did savings and loans because their lobbyists were not as powerful."

G. Let us assume that $100,000 coverage in 1980 approximates $200,000 in current dollars. The argument that the current deposit insurance limit should be doubled for this reason does not follow. This is because it assumes that the $100,000 number was the "correct" one in 1980. The above historical description has shown us that the 1980 DIDMCA increase was a primarily an accomodation to the powerful thrift lobby. History also teaches us that the 1980 increase in deposit insurance coverage allowed thrifts to grow much more quickly than would otherwise have been the case, thus adding a significant cost to taxpayers for the S&L bailout. Like the 1982 law permitting S&Ls to buy junk bonds, the 150% increase in the FDIC coverage limit in 1980 was one of many and perhaps the worst deregulation mistake. To adjust a 1980 number for inflation when, in fact, it was the "wrong" number to begin with, merely rubs salt in a still open S&L bailout wound. Had there been no such deregulation change in the limit in 1980 or perhaps even an increase to the then "correct" level of $50,000 (or even $60,000), the current value would be about $100,000, where we are today. Thus, there is no need for any change in the current limit.

H. This latter argument is very compelling and bears repeating. Important evidence that the increase to $100,000 in 1980 was a "mistake" is provided by the previously cited 1999 FDIC article by George Hanc. He notes that "Before passage of the 1980 legislation that provided for a $100,000 limit, the FDIC testified that an accurate adjustment for inflation would raise the limit to only approximately $60,000." This is a reference to former FDIC Chairman Sprague. Had that number been adopted in 1980, it would be equivalent to about $100,000 today according to this same source. This is precisely where we are and where we should remain. Period.

I. The aforementioned deposit insurance reform proposals (see Hanc) of *reducing* deposit insurance coverage were seriously considered (but not acted upon) in the early 1990s. With the S&L bailout bills beginning to mount, everyone began to realize the extent of the problems associated with the deregulation limit increase in 1980, especially with brokered deposits. There was even a proposal for a $100,000 maximum coverage *per social security number.* Considering the previously cited significant increases in risk exposure to the FDIC from megamergers, expanded business lines, increased sources of risk at recently failed banks, etc., a case could be made now that we should be debating a *decrease* not an increase in coverage. A credible case cannot be made for any increase in coverage.

J. An article titled "Raising the Deposit–Insurance Limit: A Bad Idea Whose Time Has Come?" by James Thomson in the April 15, 2000 *Economic*

Commentary of the Federal Reserve Bank of Cleveland determined that: "From the standpoint of the average depositor there appears to be no need to increase the deposit–insurance ceiling." He goes on to say that "At current limits, depositors have nearly twice the coverage in real dollars than they had when federal deposit insurance was implemented." The FED economist concluded that "There is no compelling reason to increase the insured–deposit limit at this time; in fact, it may be time to reconsider proposals for reducing it."

K. Most of the 68 countries with explicit deposit insurance systems identified by the IMF have insurance limits below $100,000 based on 1998 exchange rates, according to the previously cited 1999 FDIC article by George Hanc. Depositors in those countries would certainly welcome any deposit insurance limit increase here, especially considering the significant recent growth in deposits at foreign offices of our banks. Even though these deposits are technically uninsured, most foreign depositors are well aware of the implicit TBTF guarantee at giant American banks.

L. As former FDIC and RTC Chairman Seidman documents, the original intent of deposit insurance, which began with a $2,500 insurance limit, was to protect "small savers." The primary beneficiaries of the 1980 increase to $100,000 were Wall Street firms and deposit brokers. The currently proposed increase to $200,000 has nothing to do with small or even mid–sized savers. Besides Wall Street and other money brokers, the only beneficiaries would be very wealthy and high net worth depositors, a far cry from the small savers originally envisioned by the FDIC. In fact, the FED's 1998 Survey of Consumer Finance (*Federal Reserve Bulletin*, January 2000) reports that the median transaction account balance for all families then was $3,100 and as high as $19,000 for the richest families with income of $100,000 or more. The comparable numbers for CDs were $15,000 and $22,000, respectively. The median transaction and CD account balances for seniors aged 75 years or more (regardless of income) were $6,100 and $30,000, respectively. Thus, the current $100,000 limit is more than adequate for most Americans.

M. The first FDIC *temporary* deposit ceiling was raised from $2,500 to $5,000 in 1934 according to that year's *Annual Report.* Hanc's previously cited article calculates that the 1998 value of that $5,000 ceiling was only $59,000. (The FDIC's first *permanent* ceiling of $10,000 has a current value of approximately twice that amount.)

N. Deposit insurance was created in the aftermath of the Great Depression and a total loss of confidence our banking system. The unprecedented jump in the insurance limit to $100,000 in 1980 occurred at a time of increasing concern in our system, with the onset of the S&L and serious economic problems. Today, there are no such comparable concerns over our financial institutions, "full faith and credit" guarantee, and our economy. There simply is no compelling reason now for any increase in deposit insurance limits.

O. There is absolutely no public outcry over or even widespread interest in the proposal to double the FDIC insurance limit. Most people know or should know from their banks that any couple can get multiple account coverage, and singles need only open another account at a competing bank via a personal visit, a telephone call or even the Internet. There is no shortage of $100,000 insured deposit investment opportunities. Some seniors may have a preference to keep their jumbo CDs spread out among several banks in $100,000 or less amounts, *even if they have the opportunity to keep $200,000 at one bank.* One senior, for example, specifically stated to me her preference for rolling over her two $100,000, six–month CDs every other quarter (i.e., the first begins in January and the second begins in March), so she always has the opportunity to get her money every three months; this type of liquidity would not be there if she tied up all $200,000 for six months.

P. The FED testified on July 26, 2001 in opposition to any increase in the current $100,000 ceiling. Governor Meyer noted that the FED frequently receives letters from banks requesting a higher ceiling, "But we virtually never receive similar letters from depositors, who are not shy about sharing their many other concerns." He went on to state that "This experience may reflect the fact that, as our surveys of consumer finances suggest, depositors are adept at achieving the level of deposit insurance coverage they desire by opening multiple accounts."

Q. It is not clear that there would be any significant net new deposit benefits to the banking industry with the proposed doubling of the insurance limit. In fact, this was the conclusion of an ABA–funded study by Professor Mark Flannery of the University of Florida to forecast the costs and benefits of this proposal. He found that it would result in net new deposits to the banking industry of just 4–13%, with the lower end of the range more likely. Thus, just a 5% or so increase in net new deposits from a 100% increase in the deposit insurance limit (i.e., from $100,000 to $200,000).

R. More importantly, this ABA–funded study also found that these hypothetical new deposits from this proposal would lower the BIF–SAIF reserve ratio below the required 1.25%. Not only would this eliminate the present $3 billion cushion but it would also require a 3–13 basis point assessment on all domestic deposits to return the ratio to 1.25%. Thus, it would appear that the (increased premium) costs of this proposal would outweigh its (net new deposit) benefits for many if not most banks.

S. With 92% of banks and thrifts getting deposit insurance without paying premiums, the idea of doubling coverage without any cost is reminiscent of ATM fee "double dipping." In addition to asking for a capped fund with rebates and taking advantage of effectively free insurance coverage, there is now this interest in doubling up on it.

T. Obviously there will be considerable support for this proposal from within the industry, so it is up to the FDIC, Congress, and, of course, the Treasury to reject this proposal, which unjustifiably increases the risk exposure for the insurance funds. No one stood up to the powerful thrift lobby in 1980 when the $40,000 limit was unjustifiably increased to $100,000; we are still paying the consequences for that mistake in this new millenium. Former Treasury Assistant Secretary Baer soberly reminded Congress in his February 16, 2000 testimony: "Although the banking industry is justifiably unhappy at the $793 million per year in FICO interest payments that it and the thrift industry make to refinance the S&L cleanup, taxpayers currently make $2.3 billion in annual interest payments on REFCorp bonds and billions more on Treasury bonds issued for the same purpose."

U. Current Treasury Assistant Secretary Sheila Bair was very clear in her July 26, 2001 testimony that "the deposit insurance coverage level should remain unchanged." Among the reasons she cited were:

1. There is "no evidence that the current limit on deposit insurance coverage is burdensome to consumers."

2. "Nor do we see evidence that increasing coverage across the board would enhance competition."

3. "Increasing the deposit insurance limit would do little for the typical saver, given that the median deposit balance is far below the current ceiling" and "only 2 percent of households with deposit accounts held any uninsured deposits" (based on FED data).

4. "Ample opportunities already exist for savers with substantial deposits to obtain FDIC coverage equal to several multiples of $100,000."

5. "In addition, many consumers feel completely comfortable putting substantial amounts into uninsured but relatively safe money market mutual funds."

6. "It is not surprising, therefore, that we have found no evidence of consumers expressing concern about the existing deposit insurance limits."

7. "...We are deeply skeptical that an increase in the coverage level would promote competition and have a meaningful impact on the ability of community banks to obtain funds."

8. "...The resultant financial safety net expansion would reduce incentives for market discipline and potentially increase financial system risk."

2. Significantly improved disclosure of non–FDIC insured bank products.

A. GLB should mean a more competitive array of banking, securities and insurance products more conveniently available to a broader segment of our economy. Besides the potential increase in risk exposure to the deposit insurance fund from the nonbank activities, there is also the possibility that some of the public may be confused by them in terms of their FDIC coverage, especially when such products are sold by banks. This may result in even greater potential risk exposure to the insurance funds if bank customers buy non-FDIC insured bank products under the assumption that they were insured. Such non–FDIC covered products must be clearly and boldly differentiated.

B. An FDIC–sponsored April 2001 Gallup survey of the awareness of FDIC deposit insurance found that households lacked specific knowledge about whether certain transactions were FDIC insured. Specifically, only a slight majority (57%) of the public surveyed was aware that the FDIC does NOT insure all bank transactions; the remainder either incorrectly believed that all bank transactions are covered (27%) or did not know enough to say (16%). This same study found that over half the public incorrectly believed that the following investments were insured by the FDIC OR simply did not know: insurance annuities (63%); mutual funds (56%); stocks and bonds (50%); and Treasury bills (75%).

C. With the rapidly increasing proportion of senior citizens in states like Florida, special care should be taken to fully disclose the FDIC disclaimer on non–FDIC insured products at least in the same typeface as the word "bank," which implies FDIC–insured to most seniors. Otherwise, this may result in greater potential risk exposure to the deposit insurance funds, as duped seniors may legitimately think they are buying FDIC insured products.

IV. IMPROVED BANK REGULATION AND SUPERVISION

1. Significantly expanded market discipline, beginning with the public disclosure of some essential safety and soundness information on banks and thrifts such as CAMELS ratings and a portion of the safety and soundness exam.

While regulatory and supervisory discipline is extremely important (see below), bank management reacts more quickly and strongly to market discipline in the form of increased public disclosure of timely and relevant information.

A. One of the most popular market discipline proposals is the required periodic issuance of subordinated debt to ascertain the "market's" perception of the risk profile of an individual banking company. This approach assumes, however, that there exists adequate and timely *public* information about banks to enable the market to make an informed decision on the pricing of the debt.

B. Professor Edward Kane of Boston College evaluated various deposit insurance reforms proposals. He concluded that private-sector reforms cannot replace regulatory activities "until institutions are required to disclose more financial information to the public and regulators are forced to reveal problem institutions to the public sooner" *(American Banker,* May 27, 1997).

C. There are numerous bank rating companies such as IDC, Sheshunoff, Veribanc, and Bauer. Some of these rating services provide limited data at no charge over the Internet, and others charge steep fees for their services. All of these services use the most recent published quarterly call report data as their primary source of information. Rather than requiring depositors, customers, investors, creditors, and other interested parties to seek out and possibly pay for what may be inconsistent and inaccurate ratings from these different sources, there is a better approach. The preferred approach would be for the regulators to publicly disclose a bank's most recent safety and soundness (CAMELS) rating and a limited public portion of the bank's exam.

D. This recommendation would be similar to the approach the federal regulators adopted for CRA starting in January 1, 1990 when a rating and a public performance evaluation (PE) was made available for every examined bank. Despite opposition from bankers (and regulators), the disclosure of CRA ratings and PEs has been an unqualified success in terms of CRA performance; reduced regulatory burden (under the 1995 revised CRA); and, more consistent and well–trained examiners. The latter, whose work product and ratings are constantly under the scrutiny of the public, usually benefit from this experience. These disclosures should have a similarly beneficial impact in the safety and soundness arena.

E. Because these exam ratings can be up to a year and one-half old, an alternate and perhaps complementary approach would be the public disclosure by the FDIC of the capital group rating (3 possibilities) and supervisory subgroup rating (3 possibilities) for each bank and thrift. The FDIC three–by–three, assessment base distribution matrix has nine possible cells for deposit insurance assessment purposes. According to March 31, 2001 FDIC data, 92.4% of BIF banks and 88.6% of SAIF thrifts were in the well–capitalized, top (A) supervisory risk subgroup paying a zero premium. This recommended disclosure would represent perhaps the most powerful form of market discipline on the 8–11% of impacted banks and thrifts. I learned firsthand from various Freedom of Information Act requests and appeals, that the FDIC will not release the names of these banks and thrifts.

F. It can be argued, however, that the disclosure of the FDIC's problem bank and thrift list would be too "stampedish" and possibly harm those institutions. The disclosure of the above-suggested ratings data, however, would be the next best option, as these data do not include conclusionary statements by the regulators on the problem status or likely solvency of a given bank or thrift.

G. The recommended increased ratings disclosure will allow for more accurate and timely valuations of banks and thrifts by interested parties and a more efficient allocation of banking resources. Other relevant internal data that could reasonably be disclosed, especially for TBTF and other large banks, would include information on the top 10 credit exposures, investments, and off–balance–sheet items; internal credit ratings; loan securitizations; problem and nonperforming loans; and, daily trading activities. The public disclosure of some or all of these data could be argued to be "material" for investors that should be released anyway.

2. **Significantly improved bank regulatory and supervisory discipline so there are better risk management procedures, earlier identification of problem banks, and a reduction in the cost of failed ones.**

While market discipline can be significantly enhanced with increased public disclosure of bank data by the regulators, the quality of bank regulatory and supervisory discipline can only be improved through changes by the regulators themselves. The potential benefits to the deposit insurance system of an improved bank regulatory and supervisory function are tremendous in terms of improved risk management procedures, the earlier identification of problem banks, and a reduction in the cost of failed ones.

A. Recent hearings at this Committee on large bank and thrift failures indicated that regulators may not have properly regulated and/or supervised several of the failed banks, especially the two largest, namely Keystone National Bank and Superior Bank, FSB. Bank supervisory lapses have also been cited in recent cases where a bank did not fail but suffered internal problems.

B. FED Chairman Greenspan has recently stated that a new regulatory approach is required with megabanks and their complicated and expanding business lines. The demands on regulators in this regard will only increase with the broadening of powers resulting from GLB.

C. The federal bank regulators are constantly trying to improve their work product, but there are still four different federal agencies, the most for any federally regulated industry. The most important improvements in the bank regulatory arena would come from consolidated regulatory operations, such as the proposed OTS and OCC merger (see below), which should result in a more efficient and effective work force. The problem, however, is that even if the OTS and OCC are able to execute a smooth merger, there are still three remaining regulators with the FDIC and the FED.

D. The inconsistencies and differences in procedures in examining the largest banks were made clear in the January 2000 GAO study titled "Risk-Focused Bank Examinations". Upon reviewing the risk-focused bank exam procedures at three FED and four OCC banks, the GAO concluded that there were numerous differences in key areas such as the decentralized vs. centralized nature of the procedure, the use of resident examiners, etc.

E. I completed a similar study over a two-year period as part of a team who carefully reviewed the public portion and examiner CRA ratings on about 1,500 exams. This was the largest evaluation of bank exams ever undertaken (see The CRA Handbook, McGraw–Hill, New York, 1998). Although the exams involved bank CRA compliance (not safety and soundness) matters, there was tremendous disparity in the quality of bank examiners and published work product. For example, examiners at some of the 31 regions of the four banking regulators were nearly ten times "tougher" compared to examiners in other regions. I learned that some regulators more than others were more likely to use tougher public enforcement actions such as C&D orders compared to informal and nonpublic actions. It was clear that the power of public disclosure in such enforcement actions was considerably more effective than traditional means of regulatory discipline.

F. Assuming the experience gained from these two regulatory studies is representative of other safety and soundness examiners throughout the country, there is a pressing need for greater education and training of the bank examination forces to result in a more consistent and effective work product.

3. Merging of the OTS into the OCC.

It is reasonable to assume that a merged industry with a (hopefully) merged insurance fund would likewise have a merged regulator. This recommended merging of the OTS into the OCC, which could begin with the OTS operating as an OCC division, makes sense for numerous reasons:

A. There should be a transitional approach where the OTS initially operates as an OCC division, before an outright merger of the two agencies.

B. Both mutual and state-chartered thrifts should have the ability to continue their operations in an equitable manner. Mutual institutions should not be required to convert to stock organizations at any time under this proposal.

C. The overall quality of the examining force at both the OCC and OTS will increase as a result of such a merger due to the synergistic impact of specialized professionals benefiting from working together. These advantages are most often seen in private sector megamergers, but such economies can also benefit governmental bodies, especially those that have very similar functions.

D. Both the OTS and OCC are agencies of the Department of the Treasury (DOT), so there is already a common culture (and employer).

E. There would be substantial cost savings to taxpayers from eliminating duplication and consolidating operations, conservatively estimated by DOT in August 1993 to be at $12 million annually. Had that merger occurred then, there would have been nearly $100 million in taxpayer savings by now.

F. The OTS' five regional offices in Jersey City, Atlanta, Chicago, Dallas and San Francisco are virtually identical to the OCC's six regional offices in New York City, Atlanta, Chicago, Dallas, San Francisco and Kansas City. Thus, there would be considerable opportunity for office consolidation without the attendant employee relocation costs and family disruptions.

4. Additional consolidation and streamlining of federal financial institution regulators.

The merging of the OTS into the OCC can be viewed as a first step in a long-awaited consolidation of federal bank regulators:

A. I have long proposed (see Community Reinvestment Performance, Probus Publishing, Chicago, 1993) that a logical first step in this regard would be a common compliance function among the four federal regulators; this could be organized through the existing FFIEC working group set up for a similar purpose. This shared function would result in more consistent and efficient examinations and ultimately less regulatory burden and taxpayer costs.

B. The concept of one umbrella regulator at the federal level has been proposed for decades now by various presidential and other banking commissions. This proposal only would make sense, however, if the federal banking agency was totally independent of the Administration (unlike the OCC and OTS). If the FED can be an independent agency for monetary policy, such a consolidated federal banking agency can be one for regulation and supervision.

C. In addition to the reduced governmental expenses and possibly regulatory burden associated with one federal bank regulator, there is the added advantage that regulatory "competition in laxity" would cease to exist.

D. The most extreme step in the bank regulatory consolidation process beyond the umbrella federal bank regulator would be for the elimination of the dual banking system which has existed since the formation of the OCC in 1863. Although this proposal receives little serious consideration at the present time, it was discussed somewhat during the S&L crisis because of the federal deposit insurance costs resulting from poor state chartering and supervisory decisions. For example, since a disproportionate share of all S&L losses were due to state-chartered thrifts in California, Florida and Texas, was it fair that taxpayers in the remaining 47 states paid an equal share of the federal bailout? This is contrary to the basic management precept that **A = R** (or Authority = Responsibility). If the federal government has ultimate responsibility for bailouts, why shouldn't it likewise have the ultimate authority over all banks? State deposit insurance systems are a thing of the past, and all that is really left is the federal deposit insurance system.

E. The closest any recent deposit insurance reform proposal has come to this A=R recommendation is the concept of the FDIC issuing capital notes to the public as described in the previously cited survey article. As George Hanc states, under such a proposal, "It would also be appropriate to give the FDIC increased supervisory authority over national and state member banks so that it could better control its risk exposure and could avoid principal/agent problems with other federal regulators."

F. Federal financial institution regulators should have adequate consumer representation on their Board of Directors. The FDIC Board, for example, should have at least one independent consumer member representing the views of the individual bank depositor. This would be consistent with the FDIC's original mission of protecting and insuring depositors not banks.