Testimony on Federal Deposit Insurance Reform
by
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I. Introduction

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

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 The previous system, which split administration of insurance of bank and thrift deposits, has been replaced by a two-fund system administered exclusively by the Federal Deposit Insurance Corporation (FDIC).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

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

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

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

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

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

II. Problems With the Current System: Principles for Reform

The structure of our current deposit insurance system is the result of a development process guided at various times by changes in our insured institutions, improvements in our ability to measure and monitor risk, and by modifications to the regulatory landscape. Some characteristics are artifacts of the history of the banking and thrift industries and of a regulatory environment that has evolved considerably over time. Other features represent early steps in the development of a better system. With experience, we have also found that some elements of the system are not working as intended. Our goals in reforming deposit insurance should be to modernize areas where the system can adapt to changing times, to enhance areas where it can benefit from further development, and to modify features to improve the system's effectiveness.

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

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

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

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

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

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

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

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

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

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

III. The Elements of Reform

1. Fund Merger

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

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

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

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

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

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

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

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

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

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

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

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

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

2. Risk-based Premiums and Assessment Flexibility

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

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

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

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

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

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

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

Based on an institution’s aggregate score, it is assigned to one of four risk categories. Because premiums double when dropping from one risk category to the next, there is significant incentive for institutions to improve financial results and address deficiencies. The Canadian experience is that their system is relatively transparent and easily understood by their institutions, and provides a reasonable balance among qualitative and quantitative factors.

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

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

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

The FDIC’s request for increased flexibility in setting fund targets and premiums is critical to improving risk-based pricing. It will also reduce premium volatility and diminish the current system’s counterproductive procyclicality. The current structure requires the FDIC to charge at least 23 basis points whenever a fund is below its designated reserve ratio (DRR) and cannot reach its DRR within one year with lower premiums. The problems with this structure are further exacerbated by the fact that the FDIC cannot charge premiums to its lowest risk institutions when a fund is at or above its DRR and is expected to remain so over the next year. As a result, the current system tends to force the FDIC to charge either too little or too much relative to the actual insurance risk exposure of a fund. Relaxing the DRR target and the restrictions on premium setting will reduce these impediments to risk-based pricing.

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

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

3. Deposit Insurance Coverage Levels

A necessary precondition to raising or indexing the deposit insurance ceiling is implementation of a real risk-based pricing system. In an era when funds can move between institutions at ever-greater speeds, the negative effects of inappropriate pricing incentives are magnified as the ceiling increases. It is particularly important to find a level that stabilizes the system and provides safe savings vehicles without being too high if the ceiling is to be indexed, since indexing would lock in the level over time. It is also worth considering whether a special ceiling for "sticky" funds that build over time, such as retirement accounts, might be appropriate.

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

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

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

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

It is certainly possible to take the position that all bank supervision, federal and state, serves an insurance function. After all, the rate of failure is very small, even among institutions that get themselves into financial difficulty. And the actions of federal and state regulators, combined, of course, with effective actions by institutional management and directors, helps keep the failure rate so low. What one cannot logically argue, however, is that this is true with respect to one and only one type of bank charter—state non-member banks. Either bank supervision is an insurance function for all charters, in which case all supervisory costs—federal and state—should be paid from the insurance fund, or it is not. In the latter case, the only costs of supervision that should be paid from the insurance fund are the often considerable costs that arise when there is a higher risk of failure. And in such cases, all supervisory costs, not only those of the FDIC, should be paid from the insurance funds. For these reasons, this issue is an integral element in getting deposit insurance reform right.

V. Conclusion

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

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

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

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