Testimony on Federal Deposit Insurance Reform
by
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I. Introduction

Good morning, Chairman Shelby, Senator Sarbanes, and members of the Committee. Thank you for the opportunity to discuss the federal deposit insurance reform initiatives currently under consideration by Congress. The Office of Thrift Supervision (OTS) fully supports the ongoing efforts to reform our federal deposit insurance system.

While our deposit insurance system is the envy of many countries because of the protections and stability it provides to our citizens, it can be improved. A large majority of insured depository institutions continue to be healthy and profitable, which presents us with the best opportunity to improve our deposit insurance system.

Even as the bank and thrift industries have prospered, the reserve ratio for the Bank Insurance Fund (BIF) has steadily declined the last several years. The reserve ratio for the Savings Association Insurance Fund (SAIF) has reversed its own steady decline by increasing three basis points during the second and third quarters of 2002. The decline in the BIF ratio has been fairly dramatic, dropping from 1.40 percent in June 1999 to 1.25 percent as of September 30, 2002. The rate of decline has caused BIF-insured institutions to brace for the possibility of having to pay deposit insurance premiums in the near future if the BIF reserve ratio drops below 1.25 percent.

If SAIF remains at or near its current 1.39 percent reserve ratio, which is likely based on our analysis of the current risk profile of the SAIF, this will once again create an artificial difference in the pricing of federal deposit insurance, this time in favor of the SAIF.

Federal deposit insurance is a critical component of our financial system that enhances financial stability by providing depositors with safe savings vehicles. We should not continue to tolerate aspects of our deposit insurance system that undermine this stability.

In my testimony today, I will address the issues that we believe are most important to enacting federal deposit insurance reform legislation.

II. Federal Deposit Insurance Reform Issues

A. Fund Merger

Fund merger would strengthen our deposit insurance system by diversifying risks, reducing fund exposure to the largest institutions, eliminating possible inequities arising from premium disparities, and reducing regulatory burden.

Banking and thrift industry consolidation and our experience since the BIF and SAIF were established in 1989 argue strongly in favor of merging the funds. The BIF no longer insures just commercial banks holding only BIF-insured deposits, and the SAIF no longer insures just savings associations holding only SAIF-insured deposits.[1] Today, many banks and thrifts have deposits insured by both funds. The failure of an institution holding both BIF- and SAIF-insured deposits affects both funds, regardless of the institution's fund membership. Thus, the funds are already significantly co-dependent, and any reason for maintaining separate funds based on the historical charter identity of each fund—banks in the BIF and thrifts in the SAIF—has diminished.

Maintaining the BIF and SAIF as separate funds also reduces the FDIC's capacity to deal with problems and introduces unnecessary risks to the deposit insurance system. Industry consolidation will continue to increase both funds' concentration risk, *i.e.*, the risk that one event, or one insured entity, will trigger a significant and disproportionate loss. As of September 30, 2002, the largest BIF-insured institution accounted for 9.0 percent of BIF-insured deposits; and the largest SAIF-insured institution held 9.9 percent of SAIF-insured deposits. A fund merger as of September 30, 2002, would have had the largest BIF institution accounting for only 7.7 percent of combined deposits and the largest SAIF member holding only 2.5 percent of combined deposits. Fund merger would moderate concentration risk and reduce pressure for higher premiums.

Premium disparity is another potential problem. A premium disparity between the BIF and the SAIF could develop if one of the funds is exposed to proportionally higher losses or deposit growth than the other. This could occur even though both funds provide identical deposit insurance coverage. Premium differentials could handicap institutions that happen to be insured by the fund that charges higher rates. Institutions with identical risk profiles, but holding deposits

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[1] As of September 30, 2002, commercial banks held 45 percent of SAIF-insured deposits, with 47 percent of SAIF-insured deposits held by OTS-supervised thrifts. The remaining 8 percent of SAIF-insured deposits were held by FDIC-supervised savings banks.

insured by different funds, could pay different prices for the same insurance coverage. The BIF-SAIF premium differential that existed in 1995 and 1996 demonstrated that premium differentials are destabilizing because institutions shift deposits to the less expensive fund or seek non-deposit funding sources to avoid the cost of the higher premium. Fund merger eliminates this problem.

Finally, merging the funds would 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. Merging the funds would eliminate the need for these calculations.

B. FDIC Flexibility to Set Deposit Insurance Premiums

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 the FDIC's ability to anticipate and make adjustments to address increasing fund risks, 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. Higher premiums also hamper the ability of all institutions to finance activities that would help to improve the economy. Increasing the FDIC's flexibility to set fund premiums within a target range would reduce insured institutions' exposure to overall economic conditions and to sector problems within the banking and thrift industries.

Providing the FDIC with increased flexibility in setting fund targets and premiums is critical to improving the insurance premium pricing structure. 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 problem is further exacerbated because the FDIC cannot charge any 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. The current system tends to force the FDIC to charge either too little or too much relative to the actual, long-term insurance risk exposure of a fund. Relaxing the DRR target and the restrictions on premium setting will substantially improve the existing premium pricing structure.

OTS supports FDIC flexibility in addressing current and future risks in the deposit insurance fund, including relaxing the current DRR requirement. The FDIC should have the discretion to set the designated ratio of reserves within an appropriate range determined by Congress. The range must, however, provide

sufficient flexibility to make adjustments to account for changing economic conditions.

C. FDIC Authority to Provide Assessment Credits

Granting the FDIC authority to issue assessment credits will also improve the insurance premium pricing structure. It is entirely appropriate that the FDIC be provided with sufficient flexibility to extend assessment credits to institutions when sustained favorable conditions result in lower-than-expected insurance losses. The ability to issue assessment credits will also help to reduce assessment fluctuations over time. Authorizing the FDIC to issue assessment credits is an important element of an effective pricing system and would also address existing inequities in the system attributable to “free riders” that have not contributed to the fund.

D. Deposit Insurance Coverage Levels

1. Increasing the Current Coverage Level

While I support the goal of increasing the ability of institutions—particularly small community-based depositories—to attract more deposits, I am not convinced that increasing the insurance cap will achieve this result. I do not think this approach can be supported from a cost-benefit standpoint.

Increasing the current insurance coverage level significantly would result in higher costs for insured institutions since premiums would necessarily be increased. The benefits of an increase are unclear. I have heard from many of our institutions that they see no merit to bumping up the current limit for standard accounts. In their view, projected increases in insured deposits would not lead to a substantive increase in new accounts. Moreover, individuals with amounts in excess of $100,000 already have numerous opportunities to invest their funds in one or more depository institutions and obtain full insurance coverage for their funds.

2. Indexing the Coverage Level

An issue closely related to increasing the current cap is indexing the coverage level so that it adjusts periodically for inflation. I do not see the need for indexing in light of the higher risks and costs involved. There are four factors that frame my view on indexing.

First, current rules governing federal deposit insurance coverage already provide substantial latitude to depositors interested in obtaining full insurance coverage for all of their savings. By distributing their savings among different types of accounts and at different depository institutions, the relatively few persons holding more than $100,000 in deposits can protect every dollar of savings with FDIC deposit insurance.

Second, the federal deposit insurance funds would be exposed to higher risks from increases in the coverage level from indexing. Current reserves in the federal deposit insurance funds are based on the current exposure of the funds from existing insured deposits. Increasing the amount of deposits covered by the insurance funds increases the funds' exposure because the same amount of reserves must now protect more deposits.

Third, the increase in insured deposits through indexing will eventually require higher deposit insurance premiums from insured institutions. While some argue that indexing is an important issue for smaller institutions, I have seen no convincing data supporting the notion that raising deposit coverage levels will benefit smaller institutions. Indexing also creates the possibility that larger institutions, able to draw on a much larger (existing and potential) customer base, would be able to attract new deposits, with the result that smaller institutions will bear part of that cost.

Finally, indexing would incur significant ongoing administrative costs related to disclosing the new limit to consumers and changing forms, contracts, signs, and informational materials. These costs would ultimately be borne, at least in part, by customers in the form of higher fees or lower interest rates paid on deposits. Many of the institutions I have spoken to regarding this issue have highlighted the cost aspects of indexing as a reason why institutions and their customers should view it negatively.

3. Increasing Coverage for Municipal Deposits

I have similar reservations regarding increasing the insurance cap for municipal deposits. Our understanding is that providing insurance coverage for municipal deposits would have a significant negative impact on a combined fund's reserve ratio. I cannot support the cost of this increase relative to the potential benefit derived by a small number of institutions from the increase in coverage.

III. Conclusion

The time is ripe for deposit insurance reform. Although the American deposit insurance system is the envy of countries and depositors all over the world, and has worked effectively to enhance financial stability and provide savers with confidence that their savings are secure, there are significant weaknesses that should be addressed.

I strongly urge consideration of a core deposit insurance reform bill that would (i) merge the BIF and SAIF and (ii) provide FDIC flexibility to set insurance premiums within a target range. By all accounts, fund merger is an issue whose time has come. Relaxing the fixed-target DRR and funding shortfall requirement would also eliminate pressure on the system that now exists if a fund drops below its DRR, as well as provide the FDIC the necessary flexibility to manage the fund.

Thank you for this opportunity to discuss federal deposit insurance reform. I look forward to working with you, Chairman Shelby, and the members of the Committee, and appreciate your time and attention to this issue.