

**Testimony on Federal Deposit Insurance Reform**  
**by**  
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**before the**  
**Senate Banking Committee**

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**I. Introduction**

Good morning, Chairman Sarbanes, Senator Gramm 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”) is fully supportive of 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. Insured institutions continue to enjoy favorable economic conditions, which presents us with the best opportunity to improve our deposit insurance system.

Even as the bank and thrift industries have prospered, the reserve ratios for the Bank Insurance Fund (“BIF”) and Savings Association Insurance Fund (“SAIF”) have steadily declined the last several years. In fact, the decline in the BIF ratio has been fairly dramatic, dropping from 1.40 percent in June 1999 to 1.27 percent as of December 2001. 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.

In the event the SAIF remains at or near its current 1.37 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.<sup>1</sup> Today, many banks and thrifts have deposits insured by both funds. The failure of an institution holding both BIF- and SAIF-insured deposits impacts 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 has greatly increased both funds' risk concentration, *i.e.*, the possibility that one event, or one insured entity, will trigger a significant and disproportionate loss. A merged fund would have significantly less concentration risk.

Premium disparity is another potential problem. While the funds provide an identical insurance product, 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. 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. Fund merger would eliminate the possibility of a destabilizing premium differential.

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<sup>1</sup> As of December 31, 2001, BIF-member institutions held 43 percent of SAIF-insured deposits, and OTS-supervised institutions held less than half—49 percent—of SAIF-insured deposits. The BIF insured almost one-third of all savings association deposits, including 20 percent of the deposits of OTS-regulated institutions.

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. Increasing the FDIC's flexibility to set fund premiums within a target range would reduce insured institutions' exposure to overall economic conditions and to sectoral 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. As explained below, assessment credit authority would also help address another vexing problem for the deposit insurance funds—the “free rider” problem.

#### **D. Addressing the Free Rider Problem**

Providing credits to institutions that have paid assessments into the system would address existing inequities in the system attributable to free riders that have not contributed to the fund.

The free rider problem arises from an influx of deposits into the system from new institutions that enjoy the benefits of insurance coverage without ever paying insurance premiums. This burdens the insurance funds. Some financial conglomerates have caused huge sums of funds to qualify for insurance coverage by, for instance, converting money market accounts into deposit accounts. In some cases, billions of previously uninsured dollars have been transferred to insured depositories without any contribution to the insurance fund. The result is that the amount of funds that need insurance coverage increases substantially without additional contributions into the fund to build the reserve for losses.

Perhaps more than eliminating an inequity in the federal deposit insurance system, addressing the free rider problem will eliminate a practice that clearly undermines the safety and soundness of the federal deposit insurance funds. Entities that grossly add to the amount of outstanding insured deposits without adding to the reserves required to insure such deposits exploit the shortcomings of the existing insurance premium pricing structure. This is a problem that must be addressed.

#### **E. Deposit Insurance Coverage Levels**

##### **1. Increasing the Current Coverage Level**

Both the House and Senate deposit insurance reform bills propose increasing the current \$100,000 insurance cap for standard accounts to \$130,000. While I applaud efforts to increase 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 to \$130,000 would incur significant 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, tied to the consumer price index or a similar benchmark. I question the practicality of the periodic costs that would be required of insured institutions to update their systems and advise customers of the change. Insured institutions would bear the costs of disclosing the new limit to consumers and changing their logos and signs with respect to the maximum insurance coverage every time the limit changes. In addition, the federal deposit insurance funds would be exposed to increases in the coverage level from indexing. I also believe there is ample opportunity for customer confusion related to any program that would automatically increase the level of insured deposits on a periodic basis.

## **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 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 reform bill that would (i) merge the BIF and SAIF, (ii) provide FDIC flexibility to set insurance premiums within a target range, and (iii) eliminate the free rider problem. 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. Finally, I believe it is imperative that we use this opportunity to eliminate the free rider problem that currently plagues the system.

Thank you for this opportunity to discuss federal deposit insurance reform. I look forward to working with you, Senator Johnson, on your legislation; and thank you, Mr. Chairman, and the members of the Committee for your time and attention to this issue.