Statement No. 175

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Statement of the Shadow Financial Regulatory Committee

on

Deposit Insurance Reform

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Legislation relating to the coverage, premium structure, and administration of federal deposit insurance has recently been introduced in both the Senate and House of Representatives. These bills propose a number of changes, some of which the Committee discussed in its Statement No. 165 (December 4, 2000).

Perhaps most importantly, the bills may jeopardize the long-term welfare of healthy banks and undermine the protection of taxpayers introduced by the FDIC Improvement Act (FDICIA) in 1991. The Act effectively shifted the cost of insurance fund losses to insured banks by requiring that the FDIC increase insurance premiums whenever losses reduced the FDIC's reserves-to-insured deposit ratio below 1.25%, and requires the FDIC to raise premiums on average to at least 23 basis points if the 1.25% ratio is not achieved in one year. Thus, FDIC losses cannot be carried forward indefinitely. The bills now under consideration would eliminate the 23 basis point requirement and give the FDIC more discretion on the timing necessary to regain the minimum designated reserve ratio.

This would be a major mistake. The current statutory structure provides a strong incentive for well managed banks to support the FDIC against Congressional pressure when it takes the politically unpopular step of raising premiums at a time when the economy is weak. Since well-managed banks will eventually have to pay the costs of failure by badly managed banks, it is in their interests to support higher premium rates for all banks when many bank failures are in prospect. The 23 basis point statutory minimum may prevent the regulatory forbearance that ultimately resulted in the huge insurance fund losses of the late 1980s and early 1990s.

The bills would also provide the FDIC with the ability to vary the reserve ratio between 1% and 1.5%. If a percentage requirement is to be retained, the Committee does not object to the flexibility provided by the proposed legislation to vary the ratio in this way. In effect, it provides the FDIC with some ability to smooth premiums on banks over time.

The Committee recognizes that the required prompt recapitalization of the fund may increase the burden on insured banks precisely at the time that they are suffering losses. But insurance premiums for all types of insurance increase after insurers suffers large losses; hurricane insurance premiums after hurricanes, and terrorism insurance premiums after acts of terrorism as on September 11, are only recent examples. Banks should be treated no differently.

In discussions of the proposed legislation, most attention has been devoted to the proposal to raise the current $100,000 ceiling on deposit insurance coverage. The Committee continues to believe that the existing ceiling and rules, which allow an individual to participate in a number of fully-insured accounts, in even a single institution, is more than adequate to provide the average American with access to a sizable amount of a government-guaranteed savings vehicle. The average account is well below that amount and many depositors have shown no hesitancy in using noninsured money market funds. Increases in the insurance coverage amounts will also serve to reduce market discipline, particularly on smaller banks, and increase the need for intensified government prudential regulation.

With respect to other elements of the proposed bills, the Committee supports the merger of the Bank Insurance and Savings Association Funds and premium rebates when the FDIC's reserve ratio exceeds the upper limit.