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Statement of the Shadow Financial Regulatory Committee on

The FDIC and Unintended Consequences of Dodd-Frank

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The Dodd-Frank Act required the FDIC to change how it assesses banks for deposit insurance. FDIC's final rule implementing that mandate went into effect on April 1, 2011. The FDIC now charges a risk-fee based upon an institution's net assets rather than on domestic deposits. The new fee has triggered market and institutional responses that create incentives for institutions to engage in regulatory avoidance, increase the likely cost of credit to borrowers and affects the efficacy of monetary policy.

The FDIC's rule is complex and runs to more than 200 pages. It changes the assessment base for insurance premiums from domestic deposits to net assets, which is defined as total assets less high quality capital. That base is then adjusted for the existence of secured and unsecured debt and brokered deposits. The base fee can vary according to the institution's risk and size, and it can range from 2.5 basis points to 45 basis points. This new structure potentially increases the cost of deposit insurance to those institutions with significant reliance upon non-deposit sources of funds. There are several implications of the new assessment fee.

For example, the fee schedule is structured to minimize the impacts upon banks less than $10 billion in size by attempting to make the fees collected from small banks revenue neutral to the FDIC relative to the fees collected prior to the new rule. However, seeking revenue neutrality would defeat the purpose of making fees more sensitive to the total risks posed to the insurance fund and appears intended to competitively advantage small banks by increasing the costs to large banks. This might be sold as a way to offset the inherent subsidy to large banks due to too-big-to-fail, but the intent of Dodd-Frank was to eliminate too-big-to-fail.

The new structure provides for a larger fees for institutions that rely upon brokered deposits for a significant proportion of their funding. But institutions in the two lowest risk classes are not subject to the brokered deposit add-on fee. Brokered deposits are a way for banks to obtain “hot money” financing. The recent crisis has demonstrated that reliance upon such funding, especially when they are used to support longer term assets, is extremely risky. Therefore, the Committee sees little justification for the exemption. Furthermore, the Committee finds it curious that use of brokered deposits is considered to pose added risks to the FDIC, no such similar fee is levied on institutions that rely upon Federal Home Loan Bank advances as a significant source of funds. Countrywide and Indy Mac, for example, had most of their funding in the form of such advances when they were resolved.

The Committee also notes that, while the rule applies different fee-weights to adjust for secured and unsecured debt, the weights are arbitrary and not market based. As we have seen in the past, experience with arbitrary regulatory risk weights in determining capital adequacy, suggests that they induce institutions to structure portfolios to game the fee schedule. We see no reason to doubt that this will happen again. In fact, there is already evidence that some large institutions have begun changing their organizational structures to lower the size of the fee they must pay.

Finally, and most importantly, the effect of the fee has been to shrink both the demand and supply for funds in both the federal funds and repo markets such that prevailing rates are now substantially lower. Indeed, the fee reduces demand by increasing institutions’ cost of funds for those dependent upon the federal funds market for short term financing. Ceteris paribus, this should also increase those institutions’ incentives to expand assets by funding expansion in the federal funds market and/or should increase the rates they demand for credit or on purchased securities. Similarly, the fee has also reduced the supply of funds in both the federal funds market and repo market. Prevailing rates are such that despite the fee, it is now more advantageous for institutions to keep excess reserves idle at the Federal Reserve earning 25 basis points, rather than to expand lending or to supply funds to the federal funds market. The federal funds rate has declined from 14-18 basis points to 7 to 9 basis points and repo rates have declined to near zero after the structure went into account.

In summary, the net effect has been to shrink the market for short term funds and increase rates for credit, which is an effectively a policy tightening. This is just the opposite of the intent of current monetary policy and attempts by the Federal Reserve to stimulate lending through its program of asset purchases referred to as QE2. Indeed, some commentators suggest that the fee has now largely offset the simulative effect of QE2. In short, the FDIC has now injected itself in the monetary policy setting process.