

Deposit Insurance Reform Options

Article

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The Federal Deposit Insurance Corporation (FDIC) has requested comments on a Deposit Insurance Options Paper of August 2000, which outlines problems in the current system of federal deposit insurance. These issues relate to: the fact that virtually all banks now pay nothing for deposit insurance; the perception that new, large banks are able to "free ride" on past contributions by other banks to the insurance fund while paying nothing for deposit insurance; the procyclical nature of the premiums required now that the fund has reached 1.25% of total insured deposits; and the erosion of the real value of the \$100,000 per account deposit insurance guarantee for individual depositors.

The Shadow Committee applauds the FDIC for outlining these issues in a thorough, clear and comprehensive fashion. In this statement, we advance our views on several of the issues the FDIC has identified.

Recent Regulatory Reforms and Risk to the Deposit Insurance System

While the FDIC Report includes a good analysis of various means of

measuring the risks of bank failure and the resulting risk to the deposit insurance fund, the Options Paper does not sufficiently recognize the reduction in the risk to the deposit insurance system brought about by recent legislative changes. First, FDICIA significantly increased bank capital requirements. Second, and more importantly, FDICIA requires the FDIC to take prompt corrective action to prevent losses to banks from impacting the deposit insurance system and restricts the FDIC's ability to protect uninsured depositors, both of which substantially reduce the risk of loss to the deposit insurance system. Third, banks themselves are now fully responsible for losses to the deposit insurance system through an ex post settling-up process. This change realigns banks' risk-taking incentives, since they will now be responsible for making up the losses of imprudently managed banks, and should increase the likelihood that prudently managed banks will demand stronger and more effective regulation. Finally, the Committee has recently proposed that large banks be required to issue significant amounts of subordinated debt in addition to currently required capital levels, a measure which, if used appropriately by bank supervisors, should both reduce the risk of individual bank failures and the risk of loss to the deposit insurance system. The Committee believes that these reforms, if fully and effectively implemented, may be a satisfactory substitute for risk-based insurance premiums under the current deposit insurance system.

How Should Banks be Charged for Deposit Insurance?

FDICIA fundamentally changed the structure of the nation's deposit insurance system by placing the risk of loss on insured banks rather than the FDIC or the federal government. Under the system adopted in 1991—in addition to the changes in regulatory approach outlined above—FDICIA required insured banks, in proportion to their deposit liabilities, to recapitalize the Insurance Funds up to a level equal to 1.25 percent of all deposits. It also authorized the FDIC to assess insured banks for whatever additional amounts might be necessary to replenish the Insurance Funds whenever they fall below the 1.25 percent level. Since there is no limit to the

amount of assessments imposed by the FDIC, this system places all liability for deposit insurance losses on insured banks themselves. Thus, it is no longer correct to say that the federal government bears any significant risk for FDIC deposit insurance. If the federal government has any responsibility, it arises only after the capital of the banking system is exhausted.

The Committee believes that this post-assessment system of providing for deposit insurance losses need not be substantially changed in order to address the FDIC's concerns.

One logical consequence of FDICIA's reforms is that once the Insurance Funds have reached a level that equals 1.25 percent of total deposits, insured banks have no further obligation to pay deposit insurance premiums. Indeed, at this point—because there have been so few losses in recent years—very few banks are paying premiums. The FDIC has noted that this creates an inequitable situation, in which banks that are now joining the system will increase its total exposure but will not have to pay for the risks they are creating.

However, the logic of the post-assessment system adopted in FDICIA suggests that once the fund has reached the 1.25 percent level—as it has now—all further risk of loss should be borne *in the future* by the insured banks in proportion to the amount of their deposit liabilities. The existence of the fund itself is not relevant to this issue, since it performs no function except as a source of revenue. In other words, if the focus of the issue is placed where the Committee believes it belongs—on the obligations of all insured banks to pay for the Insurance Funds' losses *after* they occur—it is not inequitable to permit new banks into the system without paying any premiums; they will still be obligated to pay for the losses that occur after they have joined, in proportion to the amount of risk they add to the system through their aggregate deposit liabilities.

It is true, of course, that a substantial increase in the deposit base, either due to growth of existing banks or entry into the system by a large institution,

could cause the fund to fall below the 1.25 percent level, and that it would be inequitable to require all other banks to make up the difference as this change in the denominator occurs. However, the Committee believes that this problem can be solved by allowing the funds to fall below the 1.25 percent level.

If the problem is looked at this way, one further question arises: what to do with the existing funds which were contributed by most—but not all—of the banks currently covered by the system? The Committee's view is that this sum, approximately \$40 billion, should be retained by the FDIC for the purpose of buffering or smoothing the effect of a large assessment on the banking system as a result of a sudden substantial loss. If, for example, there is a severe downturn in the economy and the losses of the Insurance Funds are large, an effort by the FDIC to replenish the funds' losses in a single year could have an adverse pro-cyclical effect on the economy. To avert this result, the existing fund could be used to extend the necessity for replenishment over a number of succeeding years.

Accordingly, going forward, insurance assessments should be set at a level which will cover the FDIC's administrative costs (to the extent that these costs are not covered by earnings on the insurance funds) and to cover whatever additional amounts are necessary to replenish the funds' losses.

The Committee is not agreed how, in this system, losses are to be allocated among insured banks. One way, of course, would be to impose assessments strictly on the basis of deposit size. However, while this would give larger banks a strong incentive to insist on effective prudential regulation, it is not clear that this pressure would overcome the frequently demonstrated reluctance of regulators to act quickly and decisively to reduce system losses. Another way to impose assessments would be through use of the existing capital/CAMEL-rating matrix now employed by the FDIC. Under this approach, lower-rated institutions would be required to pay a higher proportion of post-loss assessment than others, thus creating an incentive

for banks to improve their CAMEL scores. However, this places great emphasis on the accuracy of the CAMEL ratings, which could significantly lag reality. Still a third way might use the risk assessments of the market, obtained through bank issuance of subordinated debt in the form the Committee has recommended; those banks which seem to be creating the most risk would have to pay the highest proportionate assessment. However, since the issuance of subordinated debt is only suitable for large banks, this solution is not universally applicable. Ultimately, it might be worthwhile to explore various ways to design and administer the assessment system, including the device of a self-regulatory organization (as employed in the securities industry) which enhances the role of the bankers that are the loss-bearers.

The Committee has also considered whether losses in institutions supervised by a particular federal agency should be assessed only against other institutions supervised by the same agency. Thus, losses due to failures of national banks would be assessed only against national banks. This arrangement gives institutions the incentive to insist upon effective regulation by their own supervisor.

Raising the \$100,000 Ceiling

The Committee agrees with Federal Reserve Chairman Greenspan and Treasury Secretary Summers that it would be an error to raise the \$100,000 insurance ceiling. The fact that inflation has eroded the real value of the current ceiling, last changed from \$40,000 in 1980 in the midst of the initial thrift crisis, is not a valid reason for adjusting the ceiling yet again. The Committee has long been concerned with the incentive/moral hazard problems associated with federal deposit insurance. We hope that most of these problems have been successfully addressed with the reforms of FDICIA, but it would be a substantial step backward to increase deposit insurance coverage. The existing \$100,000 ceiling, which allows an individual to participate in several fully-insured accounts, is more than

adequate to provide the average American with access to a sizable amount of a government-guaranteed savings vehicle.

Other FDIC Proposals

The FDIC is considering some other modifications of its insurance supervision system. One proposal would eliminate the risk-based capital requirement for small banks. It appears that such banks do have some difficulty in calculating their compliance with the risk-based requirement. The FDIC proposal is consistent with the Committee's previously-stated position that the leverage ratio is preferable form of capital constraint as compared with the risk-based requirement, because of the difficulty of measuring risk accurately.

The FDIC has also proposed to investigate the reinsurance market as an aid to pricing risk. FDICIA authorized the FDIC to transfer up to 10% of its risk exposure to market participants. In theory, the price that market participants would charge for underwriting deposit insurance risk is useful information. In practice, however, the risk of loss under the present system is heavily dependent on the decision as to when to close a troubled bank. Since the FDIC is not able to delegate that decision to a private insurer, the insurer must price the risk that the FDIC will fail to act on a timely basis. This will inevitably bias the pricing decision. The Committee questions whether the reinsurance market will provide useful information to the FDIC, but supports the FDIC's plan to do a pilot test of the market.