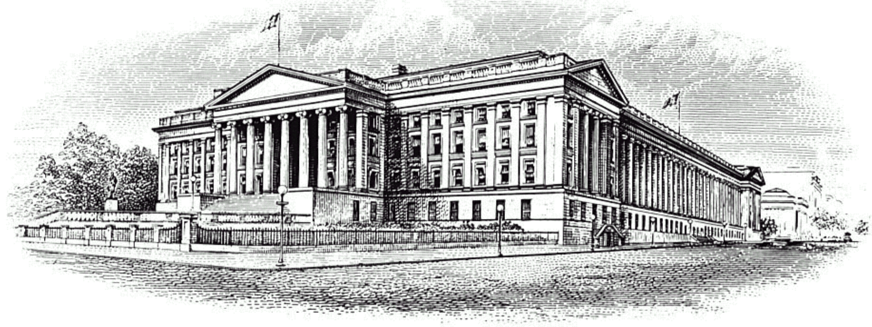

DEPARTMENT OF THE TREASURY

OFFICE OF PUBLIC AFFAIRS

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DEPOSIT INSURANCE REFORM

Testimony of Peter R. Fisher
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U.S. Department of the Treasury

Before the
Committee on Banking, Housing and Urban Affairs
United States Senate

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Mr. Chairman, Senator Sarbanes, and Members of the Committee, I appreciate the opportunity to provide the Administration's views on deposit insurance reform. I also want to commend Chairman Powell and the FDIC staff for their valuable contributions to the discussion of this important issue.

The Administration strongly supports reforms to our deposit insurance system that would, first, merge the bank and thrift insurance funds, second, allow more flexibility in the management of fund reserves while maintaining adequate reserve levels and, third, ensure that all participating institutions fairly share in the maintenance of FDIC resources in accordance with the insurance fund's loss exposure from each institution. The Administration strongly opposes any increases in deposit insurance coverage limits.

Our current deposit insurance system managed by the Federal Deposit Insurance Corporation (FDIC) serves to protect insured depositors from exposure to bank losses and, as a result, helps to promote public confidence in the U.S. banking system. I am concerned today that our deposit insurance system has structural weaknesses that, in the absence of reform, could deepen over time. I want to emphasize that there is no crisis in the FDIC; both of its funds are strong, well managed, with adequate reserves. This is the right time to act – when we do not face a crisis – and the Administration supports legislation focused on the repair of these structural weaknesses.

Increases in FDIC benefits, however, including any increases in the level of insurance coverage, are not part of the solution to these problems and should be avoided. When I testified before this Committee last April, I argued that an increase in deposit insurance coverage limits would serve no sound public policy purpose. Nothing has occurred since then to change that view. The Administration continues to oppose higher coverage limits in any form. Indeed, we feel that the entire issue of coverage limits regrettably diverts attention from the important reforms that are needed.

Merging the Bank and Thrift Insurance Funds

We support a merger of the Bank Insurance Fund (BIF) and Savings Association Insurance Fund (SAIF) as soon as practicable. A larger, combined insurance fund would be better able to diversify risks, and thus withstand losses, than would either fund separately. Merging the funds while the industry is strong and both funds are adequately capitalized would not burden either BIF or SAIF members. A merged fund would also end the possibility that similar institutions could pay significantly different premiums for the same product, as was the case in the recent past and could occur again in the near future without this change. A merger would also recognize changes in the industry. As a result of mergers and consolidations, each fund now insures deposits of both commercial banks and thrifts. Indeed, commercial banks now account for 45 percent of all SAIF-insured deposits.

Flexibility in the Management of FDIC Reserves

Current law generally requires each insurance fund to maintain reserves equal to 1.25 percent of estimated insured deposits, the "designated reserve ratio." When the reserve ratio falls below this threshold, the FDIC must charge either a premium sufficient to restore the reserve ratio to 1.25 percent within one year, or a minimum of 23 basis points if the reserve ratio would remain below 1.25 percent for a longer period. Since the latter would be expected when the banking system, and probably the economy as well, were under stress, such a sharp increase in industry assessments could have an undesirable pro-cyclical effect, further reducing liquidity precisely when liquidity is needed. Were FDIC fund contributions to come from resources that otherwise might be part of capital, every dollar paid would mean a potential reduction of 10 or 12 dollars in lending, or as much as $12 billion in reduced lending for a $1 billion FDIC replenishment.

Reserves should be allowed to grow when conditions are good. This would enable the fund to better absorb losses under adverse conditions without sharp increases in premiums. In order to achieve this objective and also to account for changing risks to the insurance fund over time, we support greater latitude for the FDIC to alter the designated reserve ratio within statutorily prescribed upper and lower bounds. Within these bounds, the FDIC should provide for public notice and comment concerning any proposed change to the designated reserve ratio. The FDIC should also have discretion in determining how quickly the fund meets the designated reserve ratio as long as the actual reserve ratio is within these bounds. If the reserve ratio were to fall below the lower bound, the FDIC should restore it to within the statutory range promptly, over a reasonable but limited timeframe. We would also support some reduction in the prescribed minimum premium rate – currently 23 basis points – that would be in effect if more than one year were required to restore the fund's reserves.

Nevertheless, as we learned from the deposit insurance experience of the 1980s, flexibility must be tempered by a clear requirement for prudent and timely fund replenishment. The statutory range for the designated reserve ratio should strike an appropriate balance between the burden of pre-funding future losses and the pro-cyclical costs of replenishing the insurance fund in a downturn. A key benefit to giving the FDIC greater flexibility in managing the reserve ratio within statutorily prescribed bounds is the ability to achieve low, stable premiums over time, adequate to meet FDIC needs in bad times, with the least burden on financial institutions and on the economy. We also believe that with this reform, the possibility of recourse to taxpayer resources is even further removed.

Full Risk-Based Shared Funding

Every day that they operate, banks and thrifts benefit from their access to federal deposit insurance. For several years, however, the FDIC has been allowed to obtain premiums for deposit insurance from only a few insured institutions. Currently, over 90 percent of banks and thrifts pay nothing to the FDIC. This is an untenable formula for the long-term stability of the FDIC.

Moreover, current law frustrates one of the most important reforms enacted in the wake of the collapse of the Federal Savings and Loan Insurance Corporation (FSLIC) and the depletion of FDIC reserves: the requirement for risk-based premiums. When 90 percent of the industry pays no premiums, there is little opportunity to do what any prudent insurer would do: adjust premiums for risk. Nearly all banks are treated the same, and lately they have been treated to free service.

For example, today a bank can rapidly increase its insured deposits without paying anything into the insurance fund. As is now well known, some large financial companies have greatly augmented their insured deposits in the past few years by sweeping uninsured funds into their affiliated depository institutions – without compensating the FDIC at all. Other major financial companies might be expected to do the same in the future. In addition, most of the over 1,100 banks and thrifts chartered after 1996 have never paid a penny in deposit insurance premiums. Yet if insured deposit growth by a relatively few institutions were to cause the reserve ratio to decline below the designated reserve ratio, all banks would be required to pay premiums to raise reserves.

To rectify this "free rider" problem and ensure that institutions appropriately compensate the FDIC commensurate with their risk, Congress should remove the current restrictions on FDIC premium-setting. In order to recognize past payments to build up current reserves, we support the proposal to apply temporary transition credits against future premiums that would be distributed based on a measure of each institution's contribution to the build-up of insurance fund reserves in the early-to-mid 1990s. In addition to transition credits, allowing the FDIC to provide assessment credits on an on-going basis would permit the FDIC to collect payments from institutions more closely in relation to their deposit growth.

We strongly oppose rebates, which would drain the insurance fund of cash. Over much of its history, the FDIC insurance fund reserve ratio remained well above the current target, only to drop into deficit conditions by the beginning of the 1990s. Therefore, it is vital that funds collected in good times, and the earnings on those collections, be available for times when they will be needed.

There are other important structural issues that need to be addressed sooner than later. It would be appropriate to evaluate whether there are changes to the National Credit Union Share Insurance Fund (NCUSIF) that would be suitable in light of the proposed reforms made to FDIC insurance so as to avoid unintended disparities between the two programs. Perhaps even more important is the need to address the long-term funding of supervision by the National Credit Union Administration, particularly in view of recent trends toward conversions from federal to state charters and growing consolidation of credit unions. Similarly, there are structural problems in the funding of the Office of the Comptroller of the Currency and the Office of Thrift Supervision, the resolution of which should not be delayed.

Deposit Insurance Coverage Limits

The improvements to the deposit insurance system that I have just outlined are vital to the system's long-term health. Other proposals, however, would not contribute to the strength of the taxpayer-backed deposit insurance system and may actually weaken it.

Increasing the general coverage limit up front or through indexation, or raising coverage limits for particular categories of deposits, is unnecessary. Savers do not need an increase in coverage limits and would receive no real financial benefit. Unlike other government benefit programs, there is no need for indexation of deposit insurance coverage because savers can now obtain all the coverage that they desire by using multiple banks and through other means.

Higher coverage limits would not predictably advantage any particular size of banks, would increase all banks' insurance premium costs, and would mean greater taxpayer exposure by adding to the contingent liabilities of the government and weakening market discipline. An increase in coverage limits would reduce – not enhance – competition among banks in general as the efficient and inefficient offer the same investment risk to depositors; in fact, perversely, investors would be drawn at no risk to the worst banks, which usually offer the highest interest rates.

Higher Coverage Limits Not Sought by Savers

First of all, the clamor for raising coverage limits does not come from savers. The evidence that current coverage limits constitute a burden to savers is scant; there has been little demand from depositors for higher maximum levels. The recent consumer finance survey data released by the Federal Reserve confirm what we found in the previous survey, namely that raising the coverage limit would do little, if anything, for most savers. Median family deposit balances are only $4,000 for transaction account deposits and $15,000 for certificates of deposit, far below the current $100,000 ceiling. The same holds true even when considering only older

Americans, a segment of the population with higher bank account usage: median transaction account balances and certificates of deposit total $8,000 and $20,000, respectively, for those households headed by individuals between the ages of 65 and 74.

Examining the Federal Reserve data for retirement accounts shows present maximum deposit insurance coverage to be more than adequate. The median balance across age groups held in IRA/Keogh accounts at insured depository institutions is only $15,000. For the 65 to 69 age group, median household IRA/Keogh deposits total $30,000.

A small group of relatively affluent savers might find greater convenience from increased maximum coverage levels. But it is a tiny group. Only 3.4 percent of households with bank accounts held any uninsured deposits, and the median income of these households was more than double the median income of all depositors in the survey.

Under current rules, these savers have plenty of options, with the market place presenting new options for unlimited deposit insurance coverage without changing federal coverage limits. At little inconvenience, savers with substantial bank deposits – including retirees and those with large bank savings for retirement – may place deposits at any number of banks to obtain as much FDIC coverage as desired. They may also establish accounts within the same bank under different legal capacities, qualifying for several multiples of current maximum coverage limits. Firms are now developing programs for exchanging depositor accounts that could offer seamless means of providing unlimited coverage for depositors without any change in current limits.

One of the fundamental rules of prudent retirement planning is to diversify investment vehicles. Many individuals, including those who are retired or planning for retirement, feel comfortable putting substantial amounts into uninsured mutual funds, money market accounts, and a variety of other investment instruments. Just 21 percent of all IRA/Keogh funds are in insured depository institutions. There is simply no widespread consumer concern about existing coverage limits that would justify extending taxpayer exposure by creating a new government-insured retirement program under the FDIC.

Coverage Limits and Bank Competition

Banks, regardless of size, continue to have little trouble attracting deposits under the existing coverage limits. Federal Reserve data have shown that smaller banks have grown more rapidly and experienced higher rates of growth in both insured and uninsured deposits than have larger banks over the past several years. After adjusting for the effects of mergers, domestic assets of the largest 1,000 commercial banks grew 5.5 percent per year on average from 1994 to 2002; all other banks grew 13.8 percent per year on average. Nor are smaller banks losing the competition for uninsured deposits. Uninsured deposits of the top 1,000 banks grew 9.9 percent annually on average over this period, while such deposits at smaller banks grew on average by 21.4 percent annually.

Higher Coverage Limits for Municipal Funds Erode Discipline

Proposals for substantially higher levels of protection of municipal deposits than of other classes of deposits would exacerbate the inherent moral hazard problems of deposit insurance. Rather than keep funds in local institutions, state and municipal treasurers would have powerful incentives to seek out not the safest institutions in which to place taxpayer funds but rather those offering the highest interest rates. Since these are usually riskier institutions, state and municipal treasurers would be drawn into funding the more troubled banks. Local, well run, healthy banks might have to pay a premium in increased deposit rates to retain municipal business. Today there are incentives for state and local government treasurers to monitor risks taken with large volumes of public sector deposits. Should the FDIC largely protect these funds, an important source of credit judgment on the lending and investment decisions of local banks would be lost.

Conclusion

In conclusion, I reaffirm the Administration's support for the three-part general framework that I have outlined to correct the structural flaws in the deposit insurance system. I encourage Congress to pursue these improvements with a steady focus on the important work that needs to be done. The Administration does not support legislation that raises deposit insurance coverage limits in any form, and we urge that Congress avoid such an unneeded and counterproductive diversion from real and necessary reform.

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