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REFORMING FEDERAL DEPOSIT INSURANCE

Statement of Richard S. Carnell

**Before the Subcommittee on Financial Institutions
and Consumer Credit
Committee on Financial Services
U.S. House of Representatives**

October 17, 2001

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STATEMENT OF RICHARD S. CARNELL

Mr. Chairman, Ms. Waters, Members of the Subcommittee:

I am pleased to have this opportunity to discuss the reform of federal deposit insurance.

Real Deposit Insurance Reform

Over the years "deposit insurance reform has sometimes become a catchword for a narrow agenda. That happened in 1989-91 when many observers mindful of how a large increase in deposit insurance coverage had exacerbated the severity and cost of the thrift debacle[1] equated "deposit insurance reform with lowering the $100,000 coverage limit. Congress rightly took a broader view in the FDIC Improvement Act of 1991 ("FDICIA), which included prompt corrective action, least-cost resolution, and risk-based premiums. These reforms sought to reduce the FDIC's risk-exposure, give depository institutions and their regulators a healthier set of incentives, curtail wasteful and destructive subsidies to risky institutions, and thus protect the taxpayers and make deposit insurance more efficient.[2]

We should view "deposit insurance reform in the same broad spirit. Given the progress made in FDICIA, the reforms needed now are less sweeping than those needed a decade ago. But we should remain vigilant about the FDIC's risk-exposure and how deposit insurance affects incentives. We should also bear in mind a painful lesson of the 1980s: that seemingly small policy changes (e.g., expanded insurance coverage, creative accounting, or capital forbearance) can result in large and costly problems. To avoid such problems, we will do well to consider what a well-run private insurance company would do under analogous circumstances.

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[1] The 1980 legislation increasing deposit insurance coverage from $40,000 to $100,000 was widely viewed as a major blunder. *See, e.g.,* Stephen Pizzo, Mary Fricker & Paul Muolo, *Inside Job: The Looting of America's Savings and Loans* 11 (1989) ("Regulators later said [the increase to $100,000] may have been the single most costly mistake made in deregulating the thrift industry); Martin Mayer, *The Greatest-Ever Bank Robbery: The Collapse of the Savings and Loan Industry* 93-94 (1990) ("By raising to $100,000 insurance coverage that had originally topped out at $2,500 . . . , Congress inadvertently crossed a Rubicon).

[2] For a more detailed discussion of FDICIA's reforms and their rationale, see Carnell, *A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991*, 12 *Annual Review of Banking Law* 317-71 (1993).

Overview

In my testimony today, I will discuss deposit insurance reform, paying particular attention to key issues raised in the FDIC's report *Keeping the Promise: Recommendations for Deposit Insurance Reform* (2001). I will begin by underscoring the importance of risk-based premiums. I will then recommend:

letting risk-based premiums work, by repealing a 1996 amendment that has hobbled the risk-based premium system;

easing the current requirement that the FDIC charge even safe depository institutions high premiums if a deposit insurance fund's reserve ratio remains below the 1.25 percent target;

exploring the desirability of letting the FDIC grant risk-based assessment credits under certain circumstances;

skeptically regarding proposals to index or otherwise increase the $100,000 insurance limit;

merging the FDIC's Bank Insurance Fund (“BIF) and the Savings Association Insurance Fund (“SAIF); and

taking additional administrative and legislative steps to promote fairness, efficiency, and market discipline.

PERSPECTIVE

Federal deposit insurance has great power both to do good and to do harm. It can promote financial stability and protect people's hard-earned savings. But without proper safeguards, it can also encourage depository institutions to take excessive risks, force safe institutions to subsidize risky institutions, and saddle the taxpayers with large losses. We learned this the hard way during the late 1980s and early 1990s, when the Federal Savings and Loan Insurance Corporation (“FSLIC) failed costing the taxpayers $125 billion and the FDIC's Bank Insurance Fund depleted its reserves.

Because deposit insurance impairs market discipline, it encourages excessive risk-taking at the expense of the insurance fund unless accompanied by risk-based premiums and effective safety-and-soundness regulation[3]:

> Just as the automobile owner with theft insurance may be less careful about locking his car than he would be without insurance, so the depositor protected by deposit insurance may be less careful in his choice of bank. As a result, the insured bank may operate less conservatively than it would if its ability to attract and retain depositors depended only on its financial strength and soundness. . . .
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> The danger to the insurance system is that . . . the [insured] bank will tend to take greater risks in order to earn higher profits. The higher profits are retained by the bank's owners, while the greater risks are borne by the insurance system. . . . Without deposit insurance, the cost of attracting depositors is a restraint on risk-taking. The bank with a riskier-than-normal portfolio will find its cost of funds increasing, as risk-averse depositors opt for conservative banks.
>
> With deposit insurance, this pressure towards conservatism is missing or reduced. The banker can get away with a riskier portfolio without increasing his cost of funds, and [unless deposit insurance premiums are risk-based,] his risk-taking is subsidized by more conservative banks. . . .[4]

The system of federal deposit insurance and regulation in effect during the 1980s impaired market discipline but provided no sufficient substitute for such discipline. Safety-and-soundness regulation (e.g., capital requirements, examinations, and enforcement) did not adequately control risk-taking. Moreover, risky and safe institutions paid the same insurance premiums, which meant that safe institutions subsidized risky institutions. Deposit insurance thus encouraged depository institutions to take risks that would not otherwise have made sense.

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[3] In theory perfect risk-based pricing *or* perfect regulation could control moral hazard. But as we cannot achieve such perfection, we need to use some combination of risk-based premiums and regulation.

[4] George J. Benston, Robert A. Eisenbeis, Paul M. Horvitz, Edward J. Kane & George G. Kaufman, *Perspectives on Safe & Sound Banking: Past, Present, and Future* 85-86 (1986).

This increased risk-taking harmed the deposit insurance funds by causing insured institutions to fail and impose losses on the funds. But it also harmed safe, well-managed institutions because risky institutions drove up the cost of deposits, undermined credit standards, and saddled the insurance funds with losses that necessitated higher premiums.

Congress enacted FDICIA's reforms including risk-based premiums in response to this hard experience.

LETTING RISK-BASED PREMIUMS WORK

Despite the importance of risk-based premiums to the proper functioning of deposit insurance, a 1996 amendment (the "zero-premium amendment) has undercut the risk-based premium system. That amendment is unsound policy, has had adverse results, and should be repealed.

Logic of Risk-Based Premiums

Risk-based premiums are not only fair in themselves but help create a healthy set of incentives for insured depository institutions. If premiums accurately reflect risk, they avoid overcharging safe institutions, undercharging risky institutions, and thus subsidizing excessive risk-taking. Instead, premiums make each depository institution internalize the cost of its own risk-taking. Thus premiums give depository institutions' owners and managers incentives compatible with the interests of the insurance fund. Even a system that only roughly proportions premiums to risk represents a significant improvement over charging safe and risky institutions exactly the same rate.

1996 Zero-Premium Amendment

The 1996 zero-premium amendment undercut the risk-based premium system by limiting the FDIC's authority to charge premiums when a deposit insurance fund has more than $1.25 in reserves for each $100 of insured deposits. The FDIC can assess premiums on institutions insured by such a fund *only* if those institutions "exhibit financial, operational, or compliance weaknesses ranging from moderately severe to unsatisfactory, or are not well capitalized. 12 U.S. Code § 1817(b)(2)(A)(iii), (v). As June 30, 2001, the amendment exempted 92 percent of all FDIC-insured depository institutions from paying premiums. Moreover, over 900 recently chartered institutions have never paid premiums.

The zero-premium amendment responded to bankers' arguments (1) that the Bank Insurance Fund's reserves belong to member banks; (2) that charging healthy institutions premiums serves no legitimate purpose if the fund has adequate reserves; (3) that BIF would tend to accumulate needlessly large reserves to help mask or offset the government's fiscal deficit; and (4) that if BIF's reserves exceed the 1.25 percent target, Congress would almost inevitably misappropriate the excess. The first two arguments are demonstrably false; the last two are dubious. I will discuss these arguments in turn.

A deposit insurance fund's reserves are the government's property, and rightly so: the reserves come from premiums paid to compensate the government for the risk of insuring deposits. Just because the insurance fund meets the 1.25 percent target and its member depository institutions remain open does not entitle the institutions to a refund. Nor should it entitle the institutions to receive future insurance free of charge. For bankers to call BIF's reserves "our money is no more true than for persons insured by AIG, Chubb, or Travelers to call those companies' reserves "our money.

Charging all insured depository institutions risk-based premiums would serve several important purposes even when the insurance fund has adequate reserves. First, it would let the FDIC refine the risk-based system to take account of the significant differences in risk among institutions currently exempt from paying premiums. Such risk-differentiation would promote fairness and better align bankers' incentives with the interests of the insurance funds. Second, charging premiums would reflect the economic reality that insuring even the healthiest institutions poses a risk greater than zero. Third, charging premiums would avoid the distortions involved in giving deposit insurance away free. Deposit insurance is valuable. If you give it away free, people will abuse your generosity. The free-rider problem now confronting the FDIC arises directly from the zero-premium amendment: if all depository institutions paid premiums reflecting their riskiness, then no institution would get a free ride.

The arguments that BIF would amass needless reserves for reasons unrelated to deposit insurance and that Congress would divert those reserves to other purposes are dubious. The special treatment of deposit insurance under Congressional budget rules provides important safeguards against such maneuvers. And bankers' political clout has sufficed to kill any diversion proposal in its incipiency.

In strongly opposing the zero-premium amendment, the Treasury warned this committee in 1995:

> [The amendment] would undercut a crucial achievement of recent banking legislation basing deposit insurance premiums more closely on the risk an institution poses to the insurance fund. . . . At a time when Congress should be encouraging the FDIC to improve the pricing of risk, the bill

> would mandate under certain conditions flat-rate premiums for institutions with quite different risks . . . . In any event, charging no premium at all would fail to take into account the very substantial day-to-day value of FDIC insurance.[5]

Developments since then have amply vindicated that warning.[6]

Need to Repeal Amendment and Let Risk-Based Premiums Work

The zero-premium amendment resembles a law regulating automobile insurance companies that would (1) require every company with adequate reserves to insure safe drivers free of charge, and (2) allow any company with inadequate reserves to charge safe drivers only to the extent necessary to replenish its reserves. No private company would provide automobile insurance under such constraints. Nor should the government continue to provide deposit insurance under such constraints.

The zero-premium amendment should be repealed so that risk-based premiums can work as intended.

EASING MINIMUM-PREMIUM REQUIREMENT

Under current law, if a deposit insurance fund's reserves will remain below the 1.25 percent target for more than a year, the FDIC must set premiums high enough to raise 23 cents annually per $100 of deposits. 12 U.S. Code § 1817(b)(2)(E). The FDIC can and should charge risky institutions more than safe institutions. But for the FDIC to satisfy this requirement, even safe institutions must pay premiums at historically high rates. The requirement undercuts risk-based pricing and places additional stress on depository institutions during economic downturns, when they can least afford it.

I support easing the minimum-premium requirement: e.g., (1) by lowering the minimum from 23 cents to 9 cents; and (2) by making the requirement applicable only if the reserve ratio would remain below 1.15 percent for more than two years.

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[5] Letter from Under Secretary John D. Hawke, Jr., to Chairman James A. Leach (Oct. 27, 1995).

[6] Moreover, free-rider deposits placed by firms like Merrill Lynch need not remain FDIC-insured: when insurance premiums rise, money that flowed in for a free ride may flow out into other investments and thus avoid ever paying premiums.

RISK-BASED ASSESSMENT CREDITS

I recommend against paying rebates from the insurance funds or placing an upper limit on the funds' reserves. We have no assurance that a given reserve ratio (whether 1.25 percent or some higher figure) will prove adequate. The experience of the late 1980s and early 1990s underscores the difficulty of accurately predicting future insurance losses. It also reminds us that reserves can vanish quickly: the Bank Insurance Fund's balance fell from $18.3 billion at the end of 1986 (1.12 percent) to negative $7.0 billion at the end of 1991 (-0.36 percent). In any event, most Americans would be surprised (and perhaps rightly so) to learn that the FDIC does not even have 2 cents in reserves per dollar of insured deposits.

I would see possible merit in authorizing the FDIC to grant risk-based assessment credits if an insurance fund's reserve ratio exceeds some level such as 1.5 or 1.6 percent. A depository institution could use such credits to reduce its future premium payments. The FDIC would award such credits based on a combination of (1) the institution's past premium payments, and (2) the institution's past and present risk to the fund. Thus a safe institution that had paid premiums for many years would receive relatively large credits, and a new or risky institution would receive relatively small credits, if any.

Properly constructed, risk-based assessment credits could help solve two vexing problems: first, the free-rider problem arising when some institutions' rapid growth dilutes reserves built up through years of payments by slower-growing institutions; and second, the difficulty of prospectively pricing the risk posed by a depository institution.[7] If the risk-based premiums paid by the institution did not properly reflect the institution's relative safety or riskiness, risk-based assessment credits would facilitate a retrospective process of settling-up.

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[7] Measuring the risk posed by a depository institution is difficult. This difficulty stems in part from the institution's role as an intermediary:

> A major function of banks is to assess the risks of lending to borrowers for whom there is little information on their economic condition and prospects. Thus, banks specialize in obtaining information about the very events, credit risks, that are most likely to result in a loss to the insurer. Because of this specialized knowledge, the *ex ante* information gap between the insurer and the insured is perhaps larger than in most other insurance settings, and is one of the most important reasons for the inability to find good *ex ante* measures of risk.

Christine E. Blair & Gary S. Fissel, A Framework For Analyzing Deposit Insurance Pricing, *FDIC Banking Review*, fall 1991, at 27

$100,000 INSURANCE LIMIT

I urge Members to take a skeptical view of proposals to index or otherwise increase the $100,000 limit on deposit insurance coverage.

Proponents of increasing the coverage limit stress the effects of inflation since 1980. But the 1980 level was by no means normal; adjusted for inflation, it amounted to an all-time high. It has not subsequently been increased in part because (as I note in footnote 1) the 1980 increase from $40,000 to $100,000 came to be viewed as a major blunder.

Proponents of indexing stress the desirability of adjusting the limit incrementally and often. But consider what such indexing might mean in practice. Would depositors correctly understand a limit like $107,000? I suspect that depositors who kept more than that amount at a failed bank would say that they had understood the limit as $170,000. They would then ask Congress to rescue them, just as your predecessors helped rescue the holders of "yellow certificates in 1987.[8]

Unless the coverage limit were adjusted for inflation only very infrequently and in very round numbers, it would tend to conflict with the need to keep the limit clear, simple, and stable. Proponents of increased coverage having made the limit hard to administer would then demand that Congress resolve the problem by raising the limit to some higher round number.

More broadly, I believe that raising the coverage limit would do little to resolve community bankers' complaints about losing customers to competition from other kinds of financial institutions.

MERGING INSURANCE FUNDS

Merging the FDIC's Bank Insurance Fund and Savings Association Insurance would make good sense, as a merged fund would be stronger and better diversified.

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[8] During the early 1980s, the managers of Golden Pacific National Bank, located in New York City's Chinatown, sold customers securities known "yellow certificates. Although these certificates were not deposits and did not even appear on the bank's books, a court ordered the FDIC to protect certificate-holders up to the $100,000 insurance limit. Title XI of the Competitive Equality Banking Act of 1987 required the FDIC to pay interest on the yellow certificates.

ADDITIONAL REFORMS

By administrative action, the FDIC and other federal banking agencies can help better control the FDIC's risk-exposure, promote market discipline, and provide incentives more compatible with the interests of the insurance funds. The FDIC can make the risk-based premium system better reflect depository institutions' riskiness: e.g., by taking account of additional criteria beyond capital levels and examination ratings; by considering the risk posed when depository institutions tie up good assets as collateral and thus make those assets unavailable to the FDIC if the institutions fail; by exploring the feasibility of using the yields on subordinated debt to help set premiums for the largest banks. To achieve such improvements, the FDIC would need only a modest legislative assist: repeal of the zero-premium amendment. The FDIC otherwise already has ample authority to consider all relevant risks. 12 U.S. Code § 1817(b)(1)(C).

The FDIC has often argued that actuarially fair premiums (i.e., premiums reflecting the FDIC's expected loss) for the riskiest banks "are likely to be so high that they could cause additional failures. As a realistic measure, such premiums will have to be capped and some portion of the cost borne by less risky institutions. *Keeping the Promise*, at 8. I agree in principle. But I would urge the FDIC to consider that raising premiums for the riskiest institutions could yield benefits besides increased premium revenue: it could strengthen incentives for weak institutions to resolve their problems promptly if necessary, by seeking out capital infusions or friendly acquirers.

The four federal banking agencies have opportunities: to reconsider the tradeoffs between required capital levels and deposit insurance losses; to require the largest banks to issue subordinated debt; and to strengthen the architecture of the financial system so as to reduce the potential for systemic risk.

Congress can help in at least three ways: first, by correcting potentially destabilizing inequities in the federal banking agencies' funding; second, by reducing risk to the FDIC by treating the Federal Home Loan Banks like other similarly situated creditors and repealing an extraordinary privilege (the so-called "superlien), 12 U.S. § Code 1430(e), whose purpose has long since ceased to exist; and third, by letting the FDIC get on with the job of improving risk-based premiums, without micromanagement.

CONCLUSION

Congress can achieve important deposit insurance reform: by repealing the zero-premium amendment and letting risk-based premiums work as intended; by easing the minimum-premium requirement applicable when an insurance fund's reserve ratio falls below its target; by pursuing the idea of risk-based assessment credits; and by merging BIF and SAIF.

But I urge caution in dealing with demands for tradeoffs like increased insurance coverage. It would be better to postpone reform than to enact flawed legislation now.