Association for
Financial Professionals

DEPOSIT INSURANCE REFORM

Statement
of the

Association for Financial Professionals

before the

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

Spencer Bachus, Chairman

Wednesday, October 17, 2001
10:00 a.m.

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SPENCER BACHUS, CHAIRMAN

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Good Morning Mr. Chairman, Congresswoman Waters and Members of the Subcommittee. I am Nolan L. North, Vice President and Assistant Treasurer of T. Rowe Price Associates, Inc. I have served as Chairman of the Board of the Association for Financial Professionals (AFP), and am currently Chairman of the Financial Markets Task Force of the Association's Government Relations Committee.

We appreciate the opportunity to comment on several important issues which have been raised in the debate on reform of the deposit insurance system. Our comments today address why deposit insurance reform is important to corporate America, and several specific issues which are at the forefront of the debate.

The AFP, formerly the Treasury Management Association, represents about 14,000 finance and treasury professionals who on behalf of over 5,000 corporations and other organizations are significant participants in the nation's payments system. Organizations represented by our members are drawn generally from the Fortune 1000 and the largest of the middle market companies and they have an active interest and a sizable stake in any proposed changes to the deposit insurance assessment system. Our members, typically, are responsible for the banking relations of their organizations and, in that role, our members negotiate, monitor and approve for payment all charges from their banks, including charges passed-through by banks for deposit insurance assessments paid to the Bank Insurance Fund (BIF).

Overview of the Deposit Insurance System:

The stake of corporate America in deposit insurance is based on the premise that deposit insurance coverage is intended for depositors, not banks. Yet the voice of bank depositors is not often heard in this debate. When the Federal Deposit Insurance Corporation (FDIC) insurance assessments are to be paid, it is generally the bank deposit customer who actually pays the assessment. In the case of depositors with large balances, those assessments are paid as a direct pass-through from the bank to the depositor, based on the total deposits of the customer. Indeed, in a study done for our Association, it was determined that 93 percent of deposit insurance premiums for business accounts are passed-through to the business customers. As such, the bank acts as an insurance agent, collecting insurance premiums and sending them on to the insurer.

Deposit insurance is best viewed as the industry mutually insuring itself. FDICIA (Federal Deposit Insurance Corporation Improvement Act of 1991) fundamentally changed the structure of the nation's deposit insurance system by placing the risk of loss on banks and effectively their depositors rather than the FDIC or the federal government. Under the system adopted in 1991, FDICIA required insured banks to recapitalize the BIF 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 which could be imposed by the FDIC, this system places all liability for deposit insurance losses on insured banks and ultimately their depositors. Federal government responsibility would arise in catastrophic situations only after bank depositors' ability to pay, and capital of the banking system, are exhausted.

The essence of a mutual insurance system is that all stakeholders fairly participate in the costs and benefits of the insurance arrangement. We therefore urge that reform include the following principles to assure fair participation by all stakeholders in the system:

- Assess only insured balances. This approach eliminates the inequity of paying premiums for uninsured balances.
- Merge the bank (BIF) and thrift (SAIF) insurance funds.
- Do not increase the deposit insurance coverage levels from $100,000.
- Remove the fixed 1.25 percent reserve ratio requirement, and provide for a range of required reserves.
- Do not charge premiums to well managed and well-capitalized banks unless required by low reserve levels.

- Do not allow premium rebates to depository institutions. They are not appropriate because they would go to an intermediary rather than to the depositor who paid the costs of the system.
- Oppose full coverage for any special category of depositors, including public sector deposits, because a "protected class" of deposits is not good public policy.
- Allow well managed and well-capitalized banks, regardless of how fast their growth rate, to be exempt from FDIC assessments when the BIF reserve is funded sufficiently.

Assessments for Uninsured Balances Constitute an Unfair Methodology:

Assessing only insured balances is fundamental to fair reform of the deposit insurance system. It is important to note that our members believe that their organizations are the dominant funders of the BIF because banks pass through the deposit insurance costs to corporate customers on the basis of balance size. Importantly, our members pay these assessments based on full balances which customarily are well in excess of the insured $100,000 limit. As a result, many businesses must both self-insure their deposits in excess of $100,000, AND pay insurance premiums for uninsured balances over $100,000. In effect large corporate depositors subsidize the BIF through premium costs for deposits which are not insured by the fund.

The rationale for assessing premiums on full deposit balances would appear to be based on a need to build reserves for a "too-big-to-fail" possibility. However, this assumption is belied by the fact that the FDICIA legislation provides for special assessments on large depository institutions in the event that federal regulators determine that systemic failure action needs to be implemented.

For these reasons, AFP urges that now is the appropriate time to redefine the deposit insurance assessment base and modernize an outdated and unfair premium methodology by assessing only insured balances.

Merging the Bank and Thrift Insurance Funds:

We support a merger of the bank (BIF) and thrift (SAIF) insurance funds. Separate funds do not reflect the current structure of the financial industry. Charters and operations of banks and thrifts have become similar. The BIF and SAIF are already hybrid funds in that each one insures the deposits of commercial banks and thrift institutions. Commercial banks now account for over forty percent of all SAIF-insured deposits through ownership of thrifts. A merger would recognize the commingling of the funds that has already taken place. We should also expect that a merger of the funds would reduce duplicative administrative expenses.

Deposit Insurance Coverage Level:

The deposit insurance coverage level should remain unchanged. An August 2000 Economic Commentary by the Federal Reserve Bank of Cleveland reported that over 98 percent of all domestic deposit accounts in commercial banks are under the $100,000 deposit insurance limit, and the average deposit in these accounts is approximately $6,000. Since we believe that the intent for the federal deposit guarantees initiated by the Banking Act of 1933 is to protect the small saver, the current deposit insurance ceiling is appropriate.

Some financial institutions feel that higher coverage limits would solve funding concerns. With competition from a broad array of non-bank and non-insured competitors for the consumer's discretionary funds, it is not clear to us that a higher coverage limit would address funding concerns at smaller institutions. But more importantly, we do not believe that the use of the deposit insurance system for the competitive purpose of trying to help some banks with their funding is an appropriate public policy position. Deposit insurance coverage is not a competitive issue—coverage is intended to benefit depositors, not banks.

A recent study by the American Bankers Association measured the impact of raising the deposit insurance level to $200,000. The study concluded that doubling coverage could result in net new deposits to the banking industry of between 4 percent and 13 percent of current domestic deposits, with the lower end of the range more likely. These hypothetical new deposits, plus the added protection that existing deposits between $100,000 and $200,000 would receive, would lower the Insurance Fund's reserve ratio below the required 1.25 percent and eliminate the $3 billion excess reserve above 1.25 percent now in the Insurance Fund. The study estimates that a 3-13 basis point assessment on all domestic deposits would be required to return the ratio to 1.25 percent.

This solution—doubling the deposit insurance coverage—translates into a costly depositor remedy to a perceived competitive problem for some banks.

We believe it is unnecessary to index the deposit insurance coverage limit to an economic measurement because the current deposit insurance ceiling is appropriate to the intent of the system—if not already too high. The intent of the system is to protect the small saver whose average deposit balance in these accounts is about $6,000.

If deemed unavoidable however, any indexing scheme should be effective on a prospective basis, triggered on a five-year cycle and rounded to the nearest thousand-dollar level.

Funding Principles and Required Reserves:

The FDIC should be allowed to mitigate the cyclical affects of deposit insurance pricing by permitting the reserve ratio to fluctuate within a manageable range, within which premiums would not be charged to well managed and highly-capitalized institutions.

The deposit insurance system should retain the risk-based variable premium approach, based on meeting a range of required reserves. We believe that it would be appropriate to eliminate the current requirement that premiums rise to a minimum of 23 cents per $100 of insured deposits when the fund is expected to fall short of the 1.25 percent designated reserve ratio for more than a year. The FDIC should be given discretion to set and adjust the range within which the reserve ratio may fluctuate in response to changes in industry risks and business conditions.

The risk-based premium system should allow for more differentiation among the risk profiles of the more than 9,000 institutions currently in the best insurance category. Risk exposure to the system by deposit mix characteristics should be reflected in the risk profile. An institution with deposit balances primarily well in excess of the coverage limit poses less risk to the system than an institution with deposit balances primarily under the coverage limit. The current methodology fails to capture differences in loss potential among banks with similar ledger balances but varied deposit bases. A more appropriate basis for FDIC assessments would entail some determination of account types held by the institution to assess actual loss potential from accounts under $100,000.

Premium Rebates to Depository Institutions:

Premium rebates to depository institutions are not appropriate because value would flow to an intermediary rather than to the depositor who paid the costs of the system. The current 1.25 percent required reserves ratio has triggered a demand by deposit institutions for rebates of "excess" reserves. Moving to a reserves ratio range system coupled with risk-based variable premiums would simply mean that the reserves would tend to move toward the higher end of the reserve ratio range. At the point of approaching surplus, variable premiums could be reduced or suspended.

We oppose rebates on the basis that an equitable rebate method cannot be constructed. The entity bearing the premium cost—the bank customer—is unlikely to receive the value of any rebate. A fair rebate solution would require payment to the bank customer of pass-through costs previously paid by the depositor, and which would be paid by the depositor under the FDIC proposal. We doubt this process would be undertaken by most banks on behalf of their customers. Since most banks would not pass on rebates, we prefer a system in which excess funds trigger adjustments to a variable risk-based premium system.

Full Deposit Insurance Coverage for Municipal and Other Public Sector Deposits:

We oppose full coverage for any special category of depositors, including public sector deposits, because a "protected class" of deposits is not good public policy. Full coverage for certain types of deposits reopens the 'moral hazard' question concerning excessive risk taken by institutions because deposits are fully protected. Also, a practical effect of this approach may be to chase away other types of depositors. It would not take long for corporations as well as consumer advocacy groups, to understand that in banks with large municipal deposits, other deposits would be subordinated to municipal deposits in the case of bank failure.

As a matter of course, corporates assume the responsibility for determining the soundness of institutions in which uninsured deposits are held. The public sector should operate on the same basis. Moreover, we understand that some states effectively provide full coverage for public sector deposits through collateral guarantees.

<u>Rapidly Growing and Previously Uninsured Deposits:</u>

We do not feel that well managed and well-capitalized banks, regardless of how fast they are growing, should be expected to pay an FDIC assessment when the BIF reserve is sufficiently funded.

The suspension of premium assessments for the best managed and capitalized banks has called attention to the inflow of deposits from newly chartered banks, and banks associated with securities firms. These are not concerns about loss exposure to the BIF. These rapidly growing deposits cause an arithmetic problem for the current system, as they tend to decrease the surplus toward the 1.25 percent fixed floor. However, giving the FDIC the flexibility to manage the BIF reserve within a range provides an appropriate solution.

<u>Conclusions:</u>

In summary, AFP believes that the following principles need to be included in reform of the deposit insurance system:

- Assess <u>only insured balances</u>.
- Merge the bank (BIF) and thrift (SAIF) insurance funds.

- Do not increase the deposit insurance coverage levels from $100,000.
- Remove the fixed 1.25 percent reserve ratio requirement, and provide for a range of required reserves.
- Allow well managed and well-capitalized banks, regardless of how fast their growth rate, to be exempt from FDIC assessments when the BIF reserve is funded sufficiently.
- Do not allow premium rebates to depository institutions because they are not appropriate.
- Oppose full coverage for any special category of depositors, including public sector deposits, because a "protected class" of deposits is not good public policy.

We appreciate the opportunity to present the views of the Association for Financial Professionals on deposit insurance reform — a matter of great interest and value to the corporate community.