S. Hrg. 107–963

THE FEDERAL DEPOSIT INSURANCE SYSTEM AND RECOMMENDATIONS FOR REFORM

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

ON

THE FEDERAL DEPOSIT INSURANCE SYSTEM AND RECOMMENDATIONS FOR REFORM, FOCUSING ON MERGING THE BANK INSURANCE FUND WITH THE SAVINGS ASSOCIATION INSURANCE FUND, STATUTORY RESTRICTIONS ON PREMIUMS, AND DESIGNATED RESERVE RATIOS

APRIL 23, 2002

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE

88–088 PDF WASHINGTON : 2003

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

C O N T E N T S

TUESDAY, APRIL 23, 2002

THE FEDERAL DEPOSIT INSURANCE SYSTEM AND RECOMMENDATIONS FOR REFORM

TUESDAY, APRIL 23, 2002

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:05 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN PAUL S. SARBANES

Chairman SARBANES. The hearing will come to order.

We are very pleased this morning to welcome a distinguished panel of witnesses for our hearing on the Federal Deposit Insurance System: Don Powell, the Chairman of the FDIC; Alan Greenspan, the Chairman of the Federal Reserve Board; Peter Fisher, Under Secretary of the Treasury; Jerry Hawke, the Comptroller of the Currency; and James Gilleran, the Director of the Office of Thrift Supervision.

Let me acknowledge the fine work that has been done by Senator Tim Johnson, who chairs the Subcommittee on Financial Institutions, and who has held a number of Subcommittee hearings on the issue of deposit insurance reform.

The objective of this morning's hearing is to review the broad public purposes behind our system of Federal deposit insurance and to consider recommendations that have been made for changes to the system.

The Federal deposit insurance system was created by Congress in 1934 for the generally acknowledged purpose of establishing greater stability and public confidence in our banking system, and providing small depositors a secure place to keep their savings.

I think the system, by and large, has served this purpose well over the years. But proposals for changes merit careful examination and review.

The current discussion was really started or precipitated by the release last April of a report by the FDIC which made a number of recommendations for deposit insurance reform.

In addition, since the release of the report, a number of other proposals for changes in the system have gained attention, and we expect to review all of these issues here this morning.

There is a vote, I should note, currently scheduled for 11:30 a.m., which will of course intrude into the proceedings of the Committee. But I hope we can move ahead with dispatch and get as much of the hearing in as we can before the vote and then, presumably, we will return afterwards.

I will defer the balance of my statement in an effort to accomplish that objective, and I yield to Senator Gramm.

STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. Mr. Chairman, thank you very much. I want to thank you for these hearings. I want to thank our distinguished panel today for coming.

I am going to have to go very shortly to a Republican conference at 11:30 having to do with the energy bill. And so, I just want to make a short opening statement. Then I am going to come back and at least get an opportunity to ask some questions.

I would like to say that I am opposed to raising deposit insurance limits. No one who sat on this Committee during the S&L crisis can be unconcerned about the solvency of insurance funds and about the impact of deposit insurance on behavior.

I can remember brokered accounts flowing by the hundreds of millions into S&L's that were insolvent, that had no hope of ever achieving solvency. And yet, those brokered accounts moved by the hundreds of millions of dollars in $100,000 increments.

I am increasingly concerned about debt of banks to the Federal Home Loan Bank system, and the prior claim that system has to assets over the FDIC.

I am not really sure that we have properly taken into account the subordinated position that we are now in in our insurance fund as the level of borrowing from the Federal Home Loan Bank has expanded.

Finally, let me say the House bill provision which gives a credit on FDIC insurance for providing subsidies to targeted constituencies is among the worst ideas that I have ever seen.

If we ever get into the position where we are setting insurance premiums based on political correctness rather than risk, then we are in great danger. And I am adamantly opposed to that provision in the House bill.

So this is a very important hearing. To this point, we have heard from many different groups, and I am not being critical. We have had as good hearings as any chairman could set with a diversity of opinion. But primarily, we have heard from the advocates of this change.

Today, Mr. Chairman, we are hearing from those who have the responsibility for regulation, the public interest, and the protection of the depositor. So, I think this is critically important testimony.

Thank you.

Chairman SARBANES. Thank you.

Senator Johnson.

STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. Mr. Chairman, thank you for holding today's hearing on the Federal deposit insurance system and recommendations for reform.

I would like to welcome our distinguished panel of witnesses and thank them for the considerable time that they have put into preparing their testimony and for appearing with us today.

I want to thank you, Mr. Chairman, for taking the issue up at the Full Committee level. The timing of this hearing is auspicious. The FDIC now projects the BIF ratio at 1.26 percent of insured deposits, perilously close to the level that would trigger mandatory premiums for BIF-insured institutions.

I believe Congress should act swiftly to enact fundamental comprehensive deposit insurance reform to avoid the disruptions that could result from these mandatory premiums.

I would note there is a significant interest among Committee Members in enacting reform. In February, Senators Hagel, Reed, Enzi, and I introduced S. 1945, the Safety Act, which implements the FDIC's thoughtful and comprehensive recommendations for reform. And since that time, Senators Bayh, Allard, and Stabenow on the Committee have joined us in cosponsoring that important legislation.

I believe that the absolutely bipartisan support for the Safety Act shows the importance of this issue to our country. And I believe that working together across the aisle, we can accomplish something that will mean a great deal to hard-working Americans who rely on local banks and thrifts for their banking needs.

Just last week, the House Financial Services Committee passed a deposit insurance reform bill, substantially similar to the Safety Act, by a vote of 52 to 2, with the explicit support of both the Chairman and the Ranking Member. That bill won the support of Members from all ideological walks and is likely to win widespread support on the floor of the House of Representatives.

In fact, as I read through the written testimony of today's witnesses, I was struck by the broad agreement on most key elements of deposit insurance reform. Setting aside the issues of coverage and indexing, I would note that the agreement appears to extend to all other elements of reform. In particular, it appears that the witnesses agree on two fundamental principles.

First, that the FDIC has identified critical weaknesses in the current deposit insurance system that should be addressed immediately. And second, that the FDIC has set forth recommendations that indeed address those weaknesses.

I have to stress this broad agreement because discussions about comprehensive deposit insurance reform tend to send a misleading signal of divisiveness. This is because the discussions often focus on the one area that lacks consensus; namely, whether coverage should be increased or, at the very least, indexed, to keep pace with inflation.

In no way do I mean to minimize the importance of coverage or indexing to successful comprehensive reform. In fact, I do not believe a package is possible unless it includes elements of the coverage and indexing measures contained in the Safety Act. But, I do think a critical point tends to get lost in the shuffle and that is that the Federal Deposit Insurance System needs to be fixed and the time to fix it is now. Before I close here, I want to make one final point with respect to indexing.

I believe it is critical to emphasize what it means when someone opposes indexing deposit insurance coverage to inflation. Setting all rhetoric aside, opposition to indexation is, in fact, support for reducing deposit insurance coverage to some other level. And I would like those witnesses who do not support indexing to explain to this Committee what alternative level of coverage they believe would indeed be appropriate.

And with that, Mr. Chairman, I once again want to thank you for holding today's hearing and I thank the witnesses for being with us here today.

Chairman SARBANES. Thank you, Senator Johnson, for the effort that you have put in on this issue.

Senator Shelby.

COMMENTS OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

As this debate moves forward, I think we have to be mindful of two critical issues. The first is the role that deposit insurance plays in our banking system. By protecting savings, insurance promotes confidence in the banking system. This faith, in turn, ensures the financial stability necessary for economic growth. Therefore, I think our focus should be on those changes which boost stability and confidence and enhance the strength of the banking system.

Second, the deposit insurance is the nexus that links the banking system directly to the pocketbook of the American taxpayer and we should keep that in mind.

As someone who participated on this Committee in the cleanup of the thrift debacle, I know firsthand that the taxpayer—yes, the taxpayer—is ultimately on the hook for the losses of insured institutions, no matter what the rhetoric is. Therefore, I believe that we must proceed only after thorough consideration of the implications reform may have for new or additional taxpayer exposure.

Yes, taxpayer exposure. Are we going to visit the taxpayer again? I hope not. We need to be careful in what we are crafting.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you, Senator Shelby.

Senator Bayh.

COMMENTS OF SENATOR EVAN BAYH

Senator BAYH. Mr. Chairman, I have no opening statement, other than to thank our witnesses and to compliment Senator Johnson for his leadership on this issue. He has done a very able job.

Thank you, Mr. Chairman.

Chairman SARBANES. Good. Thank you.

Senator Enzi.

COMMENTS OF SENATOR MICHAEL B. ENZI

Senator ENZI. Mr. Chairman, I would ask that my full statement be allowed to be a part of the record. I want to thank the Chairman for holding this hearing, the witnesses for being here.

I want to thank Senator Johnson for allowing me to work with him on this legislation. I believe that what he and Senators Reed, Hagel, and myself put together provides the Committee with an excellent starting point to examine the changes to the current deposit insurance system.

I am pleased because I think a number of issues can be agreed upon by nearly everyone, and I would hope that the few remaining issues do not prevent us from making needed changes as soon as possible.

This legislation is too important for banks not only in Wyoming, but across the country, to get stalled.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you, Senator Enzi.

Senator Crapo.

COMMENTS OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you, Mr. Chairman. I agree that it is very critical that we move from the common ground we have on these issues to resolve the remaining issues, and to see this important legislation move forward.

I thank Chairman Sarbanes for the attention he is bringing to this important issue.

Chairman SARBANES. Good. Thank you.

Well, gentlemen, we are ready to hear from the panel. Chairman Powell, since you are the point person for the Federal Deposit Insurance Corporation, we will hear from you first.

STATEMENT OF DONALD E. POWELL

CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Chairman POWELL. Thank you, Chairman Sarbanes, and Members of the Committee. I am delighted to be here. And I appreciate your willingness to hold this hearing.

As a former banker, I came to Washington not knowing a great deal about the Federal Deposit Insurance Corporation, other than they had three lines of business—supervision, resolutions, and insurance. And I perhaps knew more about the supervision area and the resolution area than I did about the insurance.

So after I came to Washington, I sat down with the staff at the FDIC and became informed and briefed as it relates to the reform proposal that was introduced by my predecessor last year.

It became apparent to me after sitting down with these people, while I may have had some question about the outcome of the recommendation, that the process was one that was very thorough. They reached out not only to industry, to trade associations, to Members of Congress, to the American public, but also to insurance consultants, and I came to the conclusion that the process was very sound.

When I look at our fiduciary role as it relates to insurance, two areas come to my mind foremost. One, as Senator Shelby indicated, is my hope and desire that the taxpayer will never, never pay for any failed institutions.

Second, industry premiums should be fair and based upon risk.

The point of reform is neither to increase assessment revenue from the industry, nor to relieve the industry of its obligation to fund the deposit insurance system. Rather, it is to distribute the assessment burden more evenly over time and more fairly across the insured institutions. It should not be a burden for the taxpayer.

My remarks will be in three areas. One is merging the funds. Two is managing the funds. And three, maintaining the value of insurance.

I think there is general agreement about merging the funds. The funds merged would be more diverse, would be stronger. Today, 40 percent of the SAIF funds are held by banks. There is the potential for premium disparity. Finally, there would be administrative efficiency in a merged fund. I think there is common ground and not much debate as it relates to merging the two funds.

Managing the funds is something I feel strongly about. As we look at the results of the past legislation as it relates to specific areas within managing the funds, it becomes apparent to me and important to me that the FDIC Board should have some discretion and judgment in managing the funds, with some parameters and with accountability to the Congress, to the American people, and to the industry. I hope that in some way we would eliminate the procyclical bias in the system and charge steady premiums over time.

It is my view that all institutions represent some risk to the system. Therefore, all should pay. I recognize this because, as a former banker, there were years that I paid—1 year that I paid more in premiums than I earned. So, I understand the burden of paying deposit insurance premiums.

I also understand that every institution provides some risk. And today, those institutions that are defined as well-managed and well-capitalized, in excess of 90 percent of the institutions, do not pay any insurance premium at all.

I do not know of a product, an insurance product, where you do not have to pay. I think that needs to be reformed also, and I would hope that this reform legislation would allow the FDIC Board to develop a risk model with today's environment, looking at the risk of every institution and those that possess more risk to the fund would have to pay higher premiums.

Being well-managed and well-capitalized are two components of risk. Risk is a change in environment that should be looked at from time to time. I would hope that we would look at earnings, growth, funding sources, including the funding sources of secured liabilities. Senator Gramm mentioned this a moment ago. I think it is of some concern to insured institutions.

The risk is dynamic. It is fluid and it changes. The risks of yesterday are not the risks of today. So it is important that we at the FDIC be allowed to design a risk profile that would charge higher premiums to those that pose more risk to the fund. It is very important.

Also, it is important that we understand the overall risk of the industry. Senator Johnson mentioned a moment ago that the Bank Insurance Fund is now standing at approximately 1.26 percent.

It is my view that the health of our industry, the overall banking industry, is solid. We are coming off of record earnings, strong capital, and lots of diversification.

Under the present law, we do not have a choice. If the BIF drops below 1.25 percent, we will assess the industry and, in my view, that is a burden to the industry that is not necessary.

So, I think it is important that the FDIC Board be allowed, again, with accountability, with parameters, to manage the Fund as it relates to the overall risk within the industry and specifically with risk within each individual institution.

Also, there is a current flaw that we would hope to correct—the imbalance of those institutions that are not paying premiums now.

I chartered a bank 4 years ago. We did not pay any premiums for FDIC insurance. That is wrong. We did not break the law and I do not want to penalize innovators. Innovators are people that do not break the law, but I think that imbalance is wrong and that all should pay.

As it relates to that, those institutions that paid into the Fund prior to 1996, our proposal calls for assessment credits. I think that too is very important as we go forward, to recognize those that have paid into the Fund. And we have allowed for credit toward those assessments that those institutions would pay, again, based upon the risk profile. If the risk profile of the institutions changes, their ability to earn and use assessment credits also changes.

It would not bother me if, in fact, assessment credits offset premiums 3, 4, 5, 6, 7, 8 years, again, depending upon the risk profile of the industry and that individual institution. I would be especially sympathetic in the years ahead to those institutions that have paid into the fund in the past.

So, basically, eliminating the procyclical bias, steady premiums over time, reserve for overall industry risk, the risk-based premiums, and correct the imbalance of free insurance that is now within the system.

The third issue is maintaining the value of the coverage.

The FDIC is not proposing to increase coverage in real terms. But doing nothing, coverage will erode. I do not believe that the value of deposit insurance should be allowed to erode over time. And I also think that there should be special consideration to those savers who place their money in retirement accounts.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you very much, Chairman Powell. You came in well under the time, and we appreciate that.

We are allocating 10 minutes. We said 5 to 10 minutes and we will go with the 10. But if you can come in under that, we would appreciate that.

Chairman Greenspan, we would be happy to hear from you.

STATEMENT OF ALAN GREENSPAN CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Chairman GREENSPAN. Thank you, Mr. Chairman.

Deposit insurance, as you just pointed out, was adopted in this country as part of the legislative framework of the Great Depression. My reading of the debate surrounding the issue in 1933 has led me to conclude that deposit insurance in this country was designed mainly to protect the unsophisticated depositor with limited financial assets from the loss of their modest savings.

As discussed more fully in my statement, which, incidentally, I ask be included in the record——

Chairman SARBANES. It will be included in full.

Chairman GREENSPAN. —there was only one time Congress used an increase in deposit insurance ceilings for a purpose other than to protect unsophisticated depositors. That was the increase in 1980 to the current $100,000 level, so that thrifts could issue an insured deposit not subject to then prevailing Regulation Q deposit rate ceilings which apply to deposits, as you remember, below $100,000.

The very large issuance of insured, market-rate, $100,000 deposits significantly exacerbated the losses to the taxpayers from a bankrupt thrift insurance fund that was caused at bottom by the flawed structure of the thrift industry.

As recognized from the beginning, deposit insurance has involved a tradeoff. On the one hand, there are benefits from the protection of small depositors and the contribution of deposit insurance to overall, short-term, financial stability by eliminating deposit runs. On the other hand, deposit insurance imposes costs from the inducement to higher risk-taking by depository institutions whose depositors become indifferent to the risk taken by the institution whose liability the Government has guaranteed. The resultant long-term financial imbalances increase the need for Government supervision to protect the taxpayers' interest. The crafting of reforms of the deposit insurance system must struggle to balance these tradeoffs.

The Federal Reserve Board believes that deposit insurance reforms should be designed to preserve the benefits of heightened financial stability and the protection of small depositors without at the same time a further reduction in the market discipline and the inducement it creates for additional risktaking by the depository institutions.

The Board also believes that there are several steps that the Congress should take to improve the strength and efficiency of the existing deposit insurance structure and limit the risk of future disruptions to the insurance funds, the banking system, and the economy. These are spelled out in some detail in my statement, but let me summarize them here.

The Board supports the merger of the BIF and SAIF and the elimination of statutory provisions that require the Government to give away to banks the valuable subsidy of deposit insurance whenever the deposit insurance fund reaches a predetermined ratio to insure deposits.

We also support more flexibility for the FDIC to impose risk-based premiums. The Board also believes it is desirable to permit a wider range of fund/reserve ratios so that the insurance fund can be built up in good times and be drawn down as needed without necessarily imposing sharp changes in the deposit insurance premiums that could be destabilizing to the banking system and the economy.

Finally, we support the use of rebates when the fund ratios are strong, targeted to the strongest banks that have paid in premiums for an extended period of time as a reasonable way to reduce, if not eliminate, the free rider problem.

The Board does not support an increase in, or an indexing of the current $100,000 deposit insurance ceiling. We understand that this posture would result in the erosion of the real purchasing power of the current ceiling. But in the Board's judgment, it is unlikely that increased coverage today would add measurably to the stability of the banking system. Macroeconomic policy and other elements of the safety net, combined with the current, still significant level of deposit insurance, continue to be an important bulwark against bank runs. Thus, the problem that increased coverage is designed to solve must be related to either the individual depositor, the party originally intended to be protected by deposit insurance, or to the individual bank or thrift.

As our surveys of consumer finances indicate, most depositors have balances well below the current insurance limit of $100,000, and those that do have larger balances have apparently been adept at achieving a level of deposit insurance coverage they desire by opening multiple insured accounts. Such spreading of asset holdings is perfectly consistent with the counsel always given to investors to diversify their assets—whether stocks, bonds, or mutual funds—across different issuers.

If the problem that raising the ceilings is seeking to address is at depository institutions, it would seem disproportionately a small bank issue, since insured deposits are a much larger proportion of total funding than at large banks. But smaller banks appear to be doing well. Since the mid-1990's, adjusted for the effects of mergers, the smaller banks' assets and uninsured deposits have expanded at twice the pace of the largest banks. Clearly, small banks have a demonstrated skill and ability to compete for uninsured deposits. To be sure, uninsured deposits are more expensive than insured deposits and bank costs would decline and profits rise if their currently uninsured liabilities received a Government guarantee. But that is the issue of whether subsidizing bank profits through deposit insurance serves a national purpose. And I might add that throughout the 1990's, small banks' return on equity was well maintained.

In our judgment, neither financial stability, nor depositors, nor depositories have been disadvantaged by the erosion of the real value of the current ceiling, other than by the reduction in profits that accrue to banks from the deposit insurance subsidy. Raising the ceiling now would extend the safety net, increase the Government subsidy to banking, expand moral hazard, and reduce the incentive for market discipline without providing any real evident public benefits.

With no clear public benefit to increasing deposit insurance, the Federal Reserve Board sees no reason to increase the scope of the safety net. Indeed, the Board believes that as our financial system has become ever more complex and exceptionally responsive to the vagaries of economic change, structural distortions induced by Government guarantees have risen. We have no way of ascertaining at exactly what point subsidies provoke systemic risk. Nonetheless, prudence suggests that we be exceptionally deliberate when expanding Government financial guarantees.

Thank you very much, Mr. Chairman.

Chairman SARBANES. Thank you, Chairman Greenspan.

Now, we will hear from Treasury Under Secretary Peter Fisher.

STATEMENT OF PETER R. FISHER
UNDER SECRETARY FOR DOMESTIC FINANCE
U.S. DEPARTMENT OF THE TREASURY

Mr. FISHER. Thank you, Mr. Chairman, and Members of the Committee. I am grateful to you for this opportunity to present the

Administration's views on reform of the deposit insurance system. I want to thank Chairman Powell and the FDIC staff for keeping this important topic before us. And I would like to add that I am honored to be sitting in the middle of this panel of four men with so many years of experience in both Government and in banking.

Our current deposit insurance system is intended to balance the interests of savers and taxpayers by aiming to protect them both from exposure to bank losses and, thereby, to promote public confidence in the U.S. banking system. Consistent with this objective, the Administration believes that some improvements could be made in the system's operation and fairness. Specifically, the Administration favors reforms that would: Reduce the system's procyclical bias by allowing the insurance fund reserve ratio to vary within a range and eliminating triggers that could cause sharp changes in premiums; Improve the system's risk diversification by merging the bank and thrift insurance funds and; Ensure that institutions appropriately compensate the FDIC for insured deposit growth while also taking into account the past contributions of many institutions to build the fund reserves.

We share the concern mentioned by Senator Gramm and FDIC Chairman Powell that some banks' growing use of secured liabilities increases risk to the insurance funds. We are also increasingly sympathetic to the FDIC's request for more flexibility to vary premiums according to the risks that individual institutions pose. However, the Administration cannot support an increase in deposit insurance coverage limits, whether directly or by indexation. While my written testimony, which I hope can be included in the record, elaborates on our support for the reforms we think worth pursuing, my remarks this morning will focus on the reasons the Administration is opposed to an increase in coverage limits.

There is financial benefit to savers to be derived from increased coverage limits because individuals can today hold insured deposits up to the limit at any number of banks, and even through multiple accounts at a single bank under different legal capacities. The only credible benefit to savers is that of greater convenience. But this is of potential use to only that small fraction of the population that has sufficient savings, and which they choose to hold in the form of deposits, to have any possible need for coverage in excess of $100,000.

The best available data indicate that only about 3 percent of households with deposit accounts hold any uninsured deposits, and the median income of these households was approximately double the median income of households with deposits under $100,000.

Ample opportunities already exist for those fortunate few with substantial deposits, including retirees and those saving for retirement, to obtain FDIC coverage equal to several times the $100,000 limit. So unlike all other Government programs where benefits have been indexed, our deposit insurance system gives individual savers the ability to choose to receive the benefit of deposit insurance in excess of the fixed nominal limit if they wish. An increase in coverage limits would reduce, not enhance, competition among banks in general, but would not predictably benefit any particular class or category of banks.

Proponents of higher coverage limits have claimed that they are necessary for community banks to remain competitive in attracting funds. However, as Chairman Greenspan has just alluded to, the Federal Reserve has data that shows there is no evidence that community banks have trouble attracting deposits under the existing coverage limits.

Furthermore, because higher coverage limits would apply to all depository institutions, including those that are part of large, multibank holding companies, it is hard to see how higher limits could improve community banks' ability to compete with larger banks for deposits.

Indeed, I believe that one reason the issue of coverage limits has surfaced is precisely because the decline in the real value of the coverage limit over the last two decades has served to promote a healthy competitive dynamic among banks in vying for the attention of customers. Continuing the current fixed ceiling on deposit insurance coverage, while permitting individuals to hold insured accounts at more than one institution, provides consumers with the potential benefits of greater total insured deposits if they need them and fosters a competitive discipline on bankers to provide quality services to their customers. Indexation of deposit insurance coverage limits would remove this discipline and only serve to reduce competition from what it otherwise would be.

Increased coverage limits would not provide any benefit to the overwhelming majority of Americans, but as taxpayers, it would expose them to additional risk. Given the lack of potential financial benefits for consumers or of any potential improvement in banking system competition, we cannot justify the increase in the Government's off balance sheet contingent liabilities that would result from higher deposit coverage limits. Thus, weighing the ephemeral benefits of increased coverage against the significant costs of added risk and the erosion of market discipline, the Administration cannot support an increase in coverage limits.

Finally, we think it is important for Congress to address the uneven distribution of supervision costs which we think is a real problem. All the Federal and State bank supervisory agencies should continue to have resources necessary to promote safety and soundness. I know that Comptroller Hawke will discuss this issue in a moment. We look forward to working with Congress and the FDIC Board to devise a solution to this problem.

Let me conclude by reaffirming the Administration's support for the FDIC's proposed reforms that would reduce the system's procyclical bias, merge the funds, take account of deposit growth and past contribution, and enhance the FDIC's flexibility to vary premiums according to risk.

Thank you for the opportunity to appear before the Committee.

Chairman SARBANES. Thank you very much, Secretary Fisher.

Next we'll hear from Jerry Hawke, Comptroller of the Currency.

Mr. Hawke.

STATEMENT OF JOHN D. HAWKE, JR.
COMPTROLLER OF THE CURRENCY
U.S. DEPARTMENT OF THE TREASURY

Mr. HAWKE. Thank you, Mr. Chairman, and Members of the Committee. I appreciate the opportunity to be here today.

Our position on the major issues in deposit insurance reform is essentially the same as those expressed by Chairman Greenspan and Secretary Fisher, and I will not burden the Committee with repetition on those points. My written statement elaborates on those issues, and I would ask that it be included in the record.

Chairman SARBANES. It will be included in the record.

Mr. HAWKE. I would like to use my time to focus on an issue that is of major consequence to the OCC—the need to reform the way that bank supervision is funded. This issue is of direct relevance to deposit insurance reform, we believe, for a number of reasons.

First, it relates to the way that deposit insurance funds are now being used to absorb the costs of supervising insured State banks that are not members of the Federal Reserve System. The question of deposit insurance reform necessarily involves consideration of how large the funds should be, and that question compels consideration of how the funds are being used and might be used in the future.

Second, some of the proposals for deposit insurance reform have held out the prospect that there might be rebates made from the fund when it exceeds a certain size, or credits against future premium liabilities given under some circumstances for banks that have paid into the funds in times past. We believe that any consideration of rebates or credits must take into account the long-standing inequity that national banks have suffered by reason of the present use of the funds to finance the costs of State bank supervision by the FDIC.

Third, we believe that a good solution to the problem of disparate funding involves the insurance funds, and I will come to that in a few moments.

While all insured banks, both State and national, have in years past paid premiums into the funds and are obligated to pay premiums in the future sufficient to maintain the insurance funds at the designated reserve ratio, State banks receive a special benefit from the funds that is not afforded to national banks. Each year, the funds, which are now about $42 billion, are tapped to pay the FDIC's costs of supervising State banks that are not members of the Federal Reserve System. I should add that State banks that are Fed members receive supervision from the Federal Reserve, and the Fed's costs of providing such supervision are charged against the System's earnings, which just last year were approximately $32 billion.

In 2001, the FDIC and the Fed together spent nearly $1 billion, by our estimate, on State bank supervision. Yet, none of these costs were passed on to the banks that they supervise. To be sure, State banks do pay modest direct assessments to their State supervisors, but the supervision provided by the States is a relatively small component of the overall supervision of State banks. Thus, in 2001, we estimate that State banks in the aggregate paid only $237 million in State assessments, or about 22 percent of the total cost of their supervision, both Federal and State.

In stark contrast, national banks pay 100 percent of the cost of their supervision in direct assessments that must be levied by the OCC. In 2001, those payments totaled more than $400 million.

As a result of the fact that the Fed and the FDIC absorb their costs of supervising State banks, there is a continuing incentive for national banks to convert to State charters to realize the lower costs that are thus made available. Indeed, State supervisors aggressively proselytize for such conversions, heavily exploiting fee disparity as a major part of their sales pitch to national banks.

The unfairness of this disparity is underscored by two facts. First, the supervisory functions performed by the Fed and the FDIC for State banks are exactly the same as those performed by the OCC for national banks. There is virtually no function we perform for national banks that is not replicated for State banks at our sister agencies. Second, because national banks account for about 55 percent of the amount presently in the Bank Insurance Fund, they are in practical effect picking up more than half of the FDIC's costs of supervising State banks.

Ending this anomaly is not just a matter of fairness to national banks. It is a very necessary component of allocating the costs and benefits of deposit insurance in an equitable and efficient manner among insured banks. We respectfully submit that this issue should be considered in the context of any legislation that would bear on the determination of how large the fund should be and how rebates and credits are calculated.

One approach to the resolution of this problem that we have formulated is to use the earnings on the FDIC's insurance funds to cover the costs of both State and national bank supervision. Today, with combined reserves of the BIF and SAIF at about $42 billion, the interest income earned by the funds of about $2½ billion per year exceeds by a large margin the combined supervisory costs of the FDIC, OCC, OTS, and all 50 State supervisory agencies. And the $525 million that the FDIC spends on State bank supervision is already a charge against the funds.

Under our proposal, which is spelled out in more detail in an OCC white paper, a nondiscretionary formula would be devised that would operate automatically to provide the various supervisory agencies, both Federal and State, with a baseline amount reflecting their current levels of expenditures on supervision. The allocations would be adjusted each year under the formula to reflect changes in the composition and risk profile of the banks. In the event the earnings on the funds were insufficient to cover the allocations called for by the formula, the various agencies would have to resort to their assessment authority to make up any shortfall. But, we calculate it would take a very significant reduction in the size of the funds to reach this point.

Such an arrangement would not only remedy the inequity to national banks that exists today, but also it would add new vitality to the dual banking system by creating a regulatory environment in which banks choose their charters on the basis of the quality of supervision and the suitability of the charter for their business objectives, rather than on the basis of a disparity in supervisory assessments attributable solely to the fact that the preponderance of the costs of supervising State banks are absorbed by the Federal agencies responsible for the major portion of that supervision.

Thank you very much, Mr. Chairman.

Chairman SARBANES. Thank you, Comptroller Hawke.

Our final panelist this morning is James Gilleran, the Director of the Office of Thrift Supervision.

Mr. Gilleran, we are happy to have you here.

STATEMENT OF JAMES E. GILLERAN
DIRECTOR, OFFICE OF THRIFT SUPERVISION
U.S. DEPARTMENT OF THE TREASURY

Mr. GILLERAN. Thank you, Mr. Chairman. I am very pleased to be here.

I support the Committee focusing on a core bill. And a core bill would contain a merger of the funds, because I believe that the funds are probably at their prime time to merge. Both BIF and SAIF group institutions are about equally sound. So this would be an ideal time to do it.

I support giving the FDIC Board greater flexibility in setting premiums. And I support the elimination of the free rider problem.

If you recall, Senator Sarbanes, during my confirmation hearing, you asked a question about where I was in connection with increasing deposit insurance coverage. At that time, I said that I had not concluded on the issue because I had not seen enough studies or talked to enough people to get views on it, but that I looked forward to participating in the discussion that you are having today.

I ask that my comments be admitted into the record, also.

Chairman SARBANES. It will be included in the record.

Mr. GILLERAN. Since that time, I have talked to an awful lot of people, read whatever is available on the subject and, even though coming out of the community banking system I had a natural interest in supporting the increase of deposit insurance or indexation, over the last at least 4 or 5 months, I have concluded that it is not of a net benefit to the system, not of a net benefit to most banks, and will result in higher costs, which will reduce earnings and reduce ability to be able to lend. So, therefore, I do not support either increasing the amount of coverage or indexation.

In answer to Senator Johnson's question about addressing specifically the indexation piece of it, that, initially, that sounded to me like a very logical thing to do, a mild thing to do, something that the system and the industry could adapt to, and the fund could adapt to over time.

However, interestingly enough, in talking to enough community bankers, and I had 50 thrifts in my office a couple of weeks ago and they were medium-size, and some large and small and I asked them, who supported increasing deposit insurance coverage, or indexation? And not one of them did, which really surprised me.

The reasons given as to why they did not support it was because: One, they did not see that they would be getting any large inflow of deposits because of it. Two, they could not see how it could possibly be done without increasing the cost of the assessment from the FDIC, which I think is absolutely correct. And three, on indexation, they felt that any periodic increases of coverage would only mean that they would have to have more communication with their customers on their subject, changing signage and other problems in connection with it.

So that the net effect of all of those cost increases, plus the FDIC increased assessment, would put them into a position where they do not see any benefit.

I think that, just looking at the deposit insurance on an aggregate basis, if you say to yourself that the $100,000 is reduced in value, in fact, by moving the money around to many banks, you can insure any amount of money in the system. So the inflationary effects are not depreciating the ability of an individual to protect his money by the system.

In addition, initially, I felt that the coverage of retirement accounts appeared to be a reasonable thing to do, to provide a retiree with a greater ability to feel comfortable about his retirement nest egg.

But, then, again, I have concluded that, by singling out one group in our society to protect in a greater way, surfaces questions about whether or not other groups in our society should be singled out to be protected in other ways by the fund. And I have concluded that that is not a good idea.

So, I am in a position where I am no longer supporting any of those ideas, even though they looked attractive to me at the start.

Senator Sarbanes, I go back to the fact that I completely support a basic bill that would include the merger of the fund, greater flexibility to the FDIC Board, and elimination of the free rider problem.

Thank you, sir.

Chairman SARBANES. Thank you very much. It has been a very interesting panel.

We have been joined by three of our colleagues and I will defer to them just briefly before we turn to questions, if they have any opening statement.

Senator Reed.

COMMENT OF SENATOR JACK REED

Senator REED. I ask that my statement be placed in the record, Mr. Chairman.

Chairman SARBANES. Senator Bennett.

COMMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. I have no opening statement, Mr. Chairman.

Chairman SARBANES. Senator Stabenow.

COMMENT OF SENATOR DEBBIE STABENOW

Senator STABENOW. Mr. Chairman, I would just ask to be able to put my statement in the record.

Chairman SARBANES. Good.

Senator STABENOW. Thank you.

Chairman SARBANES. Thank you very much.

First, I want to follow up on Comptroller Hawke's testimony and ask Chairman Powell and Chairman Greenspan their reaction to the notion that the charges for auditing the national banks should be paid out of the proceeds on the deposit insurance premiums.

Chairman POWELL. Chairman Sarbanes, as I mentioned earlier in my testimony, I chartered a bank 4 years ago, and had been in the banking business more than 30 years prior to that. I converted from a State bank charter to a national charter, understanding and knowing that I would be assessed fees for the examination.

Chairman SARBANES. I think Jerry Hawke was the Comptroller at the time. Did that influence your decision?

[Laughter.]

Chairman POWELL. Somewhat. But what did influence my decision was the value of a national charter.

I believe that the value of a national charter, in my particular market area, had more value than a State charter. I fully recognized that I would have to pay fees to the Comptroller of the Currency for examination and that, had I remained a State charter, I would have some benefit of not paying those fees.

So there is value in the national charter, as Comptroller Hawke has said many times. I made the conscious decision, knowing full well that I would have to do that.

Furthermore, I am convinced that the Comptroller and the good people at the OCC are very resourceful and will be able to manage this within their own budget without dipping into the FDIC.

Chairman SARBANES. Chairman Greenspan.

Chairman GREENSPAN. I think the issue that Comptroller Hawke raises is obviously an issue which has to be addressed for many of the reasons that he stipulates.

Nonetheless, I also agree with Chairman Powell that the value of a national charter is quite significantly superior to that of a State charter and that the differential fees paid by banks with the differing charters, in my judgment, probably grossly reflects the relative value expectations because we do not see a great deal of drift between different charters. The shift of an institution from State to a national charter occurs, but it is not very prevalent.

The problem, however, that I see with the issue is that when you get involved with the insurance funds and the issue of the Federal Government supporting the State banks' examinations, you run into issues of the dual banking system. And I think that if you were to have a State bank supervisor representative here, they would have serious questions with it.

My own judgment is that the solution to the OCC's problem, and there is a problem here, is appropriated funds, in the sense of eliminating the tie between the cost of supervision and the solvency of the supervisor. It is a national purpose that is involved here and appropriated funds, in my judgment, would be the ideal solution to his problem.

Chairman SARBANES. Well, that is a good theoretical solution, but I do not know in practice whether it always works on the appropriated funds side. But that is our problem, primarily, and I recognize that.

The national banks pay the deposit insurance premiums. Is that correct?

Mr. HAWKE. That is correct, Mr. Chairman.

Chairman SARBANES. The State banks pay them. Right?

Mr. HAWKE. That is correct.

Chairman SARBANES. Now out of those premiums that the State banks pay, the examination by the FDIC is funded. Is that correct?

Mr. HAWKE. State banks get the benefit of FDIC supervision and the cost of that supervision is charged against the fund, whereas the national banks have to pay the full cost of their supervision themselves.

Chairman SARBANES. Pay themselves. So, in a sense, there is not a level playing field on the cost of the examination. Is that essentially your argument?

Mr. HAWKE. Not only is there not a level playing field, but since national banks account for more than half of the funds that have been paid into the insurance fund, essentially, national banks are bearing 55 cents of the cost of every dollar that the FDIC spends on State bank supervision.

Chairman SARBANES. What are the factors that would determine what the level of deposit insurance should be?

Now, presumably, if it runs along unchanged, you continue to have inflation. You continue to erode the real coverage that is provided to a depositor. You all agree that there should be deposit insurance, as I understand it. I do not think there is anyone at the table who suggests to the contrary.

So what are the factors that would determine what the level should be because, obviously, if the system played itself out, you could reach a point where if you just stayed where you were, the real coverage would be pretty small. I do not know that we are there yet, or how close we are to it. But, in your mind, what are the factors that go into setting what the deposit insurance coverage should be?

Who wants to take that on?

[No response.]

Well, just to be fair, why don't we start with Chairman Powell and go across the panel?

[Laughter.]

And then I see my time has run out and I will yield to my colleagues for questions.

Chairman POWELL. Perhaps there are several factors, Chairman Sarbanes. From the consumer standpoint, I think I would refer to a recent Gallup poll that was conducted year that reflects that, almost 50 percent of the consumers believe that deposit insurance should be increased from the current level. And 77 percent of the consumers believe that deposit insurance should be indexed.

Chairman SARBANES. Should be what?

Chairman POWELL. Indexed. That is a Gallup poll.

We recently received a letter from the AARP strongly supporting the increase in coverage. And again, I would remind you that the FDIC's position is that it be indexed.

So from the consumer standpoint, I think the consumers have spoken as it relates to the Gallup poll and for sure, an important segment of our society, the senior citizens, have spoken.

For the bankers, I think it would be debatable concerning what level the insurance coverage should be, and primarily from the funding source. But I think bankers will all agree that coverage is extremely important. At what level depends upon which cycle we may be in. Normally, we do not talk about the importance of FDIC insurance when times are good. As I mentioned, I have been a banker for over 35 years. And I will confess to you that deposit insurance was not foremost in my mind 27 of those years. Three of those years, it was a matter of life and death. It was critically important to the liquidity and to the solvency of our institution.

Again, depending upon the cycle, what the level should be I think is debatable among bankers. So if the consumer clearly sees value, understands that there is value there, the bankers in general will support.

My concern as it relates to coverage is that coverage is debated during down times and we react perhaps with unintended consequences by increasing coverage. Thus, again, our position is that it should be indexed.

When we talk about coverage, I am concerned about those that oppose indexing. Essentially, they are saying that they support a reduction in the real level of deposit insurance coverage. The scary part to me is that they do not say how low they want to reduce the real value of the coverage. How low does it have to go before it no longer serves the purposes that it was created for?

Chairman SARBANES. Chairman Greenspan.

Chairman GREENSPAN. Well, I am somewhat surprised by the Gallup poll, which I read as 50 percent are not in favor of increasing the coverage and 23 percent are not in favor of indexing.

Usually, the responses to such polls when there is no cost on the other side is 100 percent in favor. And so, I find the poll surprising in a different sense from the way one would ordinarily look at it. I think the question really gets down to the notion of what problem is deposit insurance supposed to solve?

We do, through our survey on consumer finances, have fairly extensive data on what deposits are held at what levels, by income groups, by education groups, and so on. And the data I think fairly conclusively indicate that there is very little stringency at these levels and, if anything, the levels are significantly above where the basic purpose of protecting the individual savers from the type of problems that the originators of the FDIC in the 1930's contemplated.

We do not know where that number is, but it is significantly below where it is today. And you are quite right—we do support a reduction in the real value of the coverage, basically because we think that it is too high to do what it is supposed to do, so that there is an excess in there which we think can be used for better purposes for public policy.

I do suggest that there will come a point, if indeed the $100,000 is not changed, is not indexed, and prices continue to rise, when you will get a significant set of questions as to whether, indeed, the coverage level in real terms is adequate. I do not think we are close to that in any respect and would, therefore, not find a particular useful purpose in indexing.

Chairman SARBANES. Mr. Fisher.

Mr. FISHER. First, I would provide both a historical perspective and then an analytic framework.

Chairman Greenspan's written testimony suggests that taking inflation index from the 1930's, the initial $5,000 amount today, that in current dollar terms would be about $60,000.

Chairman SARBANES. I am not sure which index that would be.

Chairman GREENSPAN. That is the personal consumption expenditures index.

Chairman SARBANES. Which, as I understand it, is the most conservative of the indices.

Chairman GREENSPAN. It is not a question of conservative. It is a question of being, in our judgment, the most accurate.

Chairman SARBANES. Fine.

Chairman GREENSPAN. Therefore, we tend to use that rather than the CPI for reasons I have discussed previously.

Chairman SARBANES. Excuse me for interrupting, but if we were to use the CPI, what would the figure be?

Chairman GREENSPAN. The number is higher. I do not know specifically what it is.

I will be glad to submit that for the record, Mr. Chairman.

The amount that $5,000 in 1934—the deposit insurance ceiling at that time—is worth today depends upon the index used to measure inflation. If the chain-type personal consumption expenditure (PCE) deflator is used, then $5,000 in 1934 is worth $58,206 in 2001. But, if indexation to the consumer price index (CPI) had been in place since 1934 for deposit insurance coverage, then such coverage would be at $66,082 in 2001.

Chairman SARBANES. Thank you. Sorry, go ahead.

Mr. FISHER. That is all right. But given the recent performance, using the PCE inflator, it would be another 20 years just on a back-of-an-envelope basis, before we would be up in the $100,000 range indexing from here.

As an analytic framework, I would suggest looking at median household income, which, if memory serves, is in the $32,000 to $35,000 range today, and seeing what level of transaction balances, not the totality of their savings, but the median-income family, what do they need in terms of deposit insurance to serve their needs in providing deposit insurance on transaction balances.

Then perhaps looking at the bottom 10 or 20 percent of the income distribution and trying to find a coverage level that would provide them with coverage for their savings.

The data underlying, if memory serves, is that today there are roughly 90 million deposit-taking households in America. Only 5 million of those have deposits in excess of $100,000. And of that 5 million, roughly half choose to be fully insured, to go through the process of dividing up their accounts, and the other half choose to have some uninsured deposits.

That seems to me to be a statement of a nonproblem, that it is a relatively small section of the population, a small fraction, and it is one where they divide about in half, whether they choose to go through the inconvenience of getting multiple accounts, whether they choose to have some uninsured.

Mr. HAWKE. Mr. Chairman, I think the answer to your question lies in the original purposes of deposit insurance. It was originally conceived of as a way to provide households with a safe repository for their short-term liquidity, and to do so without imposing on households and on unsophisticated people the need to make investment decisions.

Deposit insurance has become much more than that. It has become an investment vehicle. And, I think we should resist efforts to make deposit insurance more of an investment vehicle than a repository for household liquidity.

Today, anybody can get virtually unlimited deposit insurance coverage, which means that even under today's system, it has become something vastly more extensive than the original concept of deposit insurance.

Chairman SARBANES. Mr. Gilleran.

Mr. GILLERAN. I think it is at an amount that covers the vast majority of savers. So if it covers 95 percent, that sounds pretty good to me. In addition, because you can get unlimited coverage by moving your money into other institutions, it would seem it would completely cover those who want a larger coverage.

So, I think that the $100,000 limit is okay as it is.

Chairman SARBANES. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman Greenspan, to pick up on some of your statements, what does insurance solve? In other words, what is the problem that it solves? If the thrust of it is to protect the most vulnerable of our depositors in the population. As Secretary Fisher said, and correct me if I am wrong, was it fewer than 2 percent, less than 2 percent of the population of the United States, about 5 million people, that have accounts of about $100,000?

Mr. FISHER. I think it is 5 million households.

Senator SHELBY. Households.

Mr. FISHER. Have deposits in excess of $100,000.

Senator SHELBY. So about 5 percent of the people. What is the average bank deposit in a CD or whatever, in the United States, roughly, today? It is not $100,000. I know that.

Mr. FISHER. Much smaller.

Senator SHELBY. What is the average savings account in the banks of the United States?

Chairman POWELL. I think it is approximately $10,000 to $12,000.

Senator SHELBY. Okay, $10,000 to $12,000. Not $100,000. Let's go back to risk. Risk has to be an important component here. Let's talk about that just for a minute, what is the size of the BIF fund today, roughly?

Mr. Powell.

Chairman POWELL. The combined funds are approximately $42 billion.

Senator SHELBY. How much?

Chairman POWELL. About $42 billion.

Senator SHELBY. That's $42 billion?

Chairman POWELL. Yes, combined.

Senator SHELBY. And what about the SAIF? What is that?

Chairman POWELL. That is the combined funds.

Senator SHELBY. Well, break them down.

Chairman POWELL. The BIF is $30 billion and the SAIF is the difference.

Senator SHELBY. What is the real risk in the country before you would have to have a financial crisis to eat the fund up, which it has before, before it visits the taxpayers. Right?

Chairman POWELL. Right.

Senator SHELBY. Do you believe that $42 billion is enough money in the fund, considering all the exposure that our banks have in America?

Chairman POWELL. I believe it is today, Senator.

Senator SHELBY. You do?

Chairman POWELL. Yes, sir.

Senator SHELBY. Today.

Chairman POWELL. Yes, sir.

Senator SHELBY. But you do not know about tomorrow.

Chairman POWELL. Yes, sir. Right.

Senator SHELBY. So, as you said, it is a fluid situation.

Chairman POWELL. That is right.

Senator SHELBY. It is a moving target.

Chairman POWELL. Right.

Senator SHELBY. Who pays and who doesn't pay the insurance, FDIC insurance, in America? Just go over it. Who pays and who doesn't pay?

Chairman POWELL. Currently, under the current law?

Senator SHELBY. It is the law of the land passed by Congress.

Chairman POWELL. That is right. Institutions that are well-managed and well-capitalized do not pay any premium.

Senator SHELBY. They get the benefit of the insurance, don't they?

Chairman POWELL. Yes, sir.

Senator SHELBY. So, they are getting a free ride, basically. Right?

Chairman POWELL. Well——

Senator SHELBY. They are or they are not.

Chairman POWELL. Those institutions would say that they paid into the fund——

Senator SHELBY. I understand that.

Chairman POWELL. That is true. They are not paying current assessments.

Senator SHELBY. And how many of the banks in the United States, or what percentage of banks, are not paying into the fund?

Chairman POWELL. That number is 92 percent.

Senator SHELBY. Was that 92 percent?

Chairman POWELL. Yes, sir.

Senator SHELBY. Say that again. So, 92 percent of the banks in the United States do not pay into FDIC fund. Only 8 percent are paying in. Yet, the fund insures them all. Is that correct?

Chairman POWELL. Yes, sir.

Senator SHELBY. Up to $100,000.

Chairman POWELL. Yes, sir.

Senator SHELBY. Does that make sense?

Chairman POWELL. No, sir. That is the reason our reform is before this Committee.

Senator SHELBY. And that brings to light that if there is a crisis and we eat the funds up fast, or you did, by bail-outs and so forth, the Comptroller and everybody else would be right here before this Committee for more money from the taxpayer, just like the thrift debacle. Is that correct? That is true, is not it?

Chairman POWELL. That is true.

Senator SHELBY. Who pays and who doesn't? I think that is very important.

What is the average, Chairman Greenspan, if you recall, and I am sure you would, in Europe, what kind of insurance fund do they have with their banks in Europe? Does it vary from country to country, or is it more uniform?

Chairman GREENSPAN. It varies from country to country. And, for example, in Japan, they for a while had insured all deposits.

Senator SHELBY. Blanket insurance.

Chairman GREENSPAN. Blanket insurance. Then, as of March 31, they came back down to a more moderate level.

It varies from country to country. The principle, however, is generally the same throughout the world.

Senator SHELBY. Mr. Fisher.

Mr. FISHER. No.

Senator SHELBY. Thank you.

Risk, I think is what it is all about.

Thank you, Mr. Chairman.

Chairman SARBANES. First, I would say to my colleagues, I understand the vote that was scheduled for 11:30 a.m. has now been scheduled for after lunch. So, we will be able to continue uninterrupted.

Before I yield to Senator Johnson, Chairman Powell, I just want to clarify one thing. You said 92 percent of the banks were not now paying into the insurance fund. Correct?

Chairman POWELL. Yes, sir.

Chairman SARBANES. But a very significant percentage of those banks had previously paid into the insurance fund in order to build their levels up to a point where no assessments would be required. Is that not correct?

Chairman POWELL. That is correct.

Chairman SARBANES. Because I wanted to make clear that we focus on this free rider problem, because there are financial institutions that are getting the benefit of the deposit insurance who previously had paid into the fund to build it up to the level where the assessments would stop. But there are other financial institutions, as I understand it, who have never paid into the deposit insurance fund and are receiving the coverage.

So when we talk about the so-called free rider problem, as I always understood it, it refers to that latter group and not the former group. Is that correct?

Chairman POWELL. Yes, sir.

Chairman SARBANES. Do you know, roughly, of the 92 percent, how it breaks down between those who have previously paid in and helped to build up the fund and those who have never paid into it?

Chairman POWELL. Say that one more time. Do I know those of the 92 percent that do not pay?

Chairman SARBANES. Yes. Some of those have previously paid in and helped to build up the fund. Some have never paid.

Chairman POWELL. About 10 percent have never paid into it.

Chairman SARBANES. Have never paid into the fund.

Chairman POWELL. Right.

Chairman SARBANES. Okay. Thank you.

Senator Johnson.

Senator JOHNSON. Thank you, Mr. Chairman.

Chairman Powell, I would like to touch base a little bit on the urgency of FDIC reform this year.

You indicated in your testimony that the current BIF reserve ratio has fallen to 1.26 percent. Given the requirement that the FDIC begin charging premiums and the ratio falls below 1.25, do you think that BIF-insured institutions will be paying premiums within the year if nothing is done? And also, do you see competitive implications for the prospect of BIF institutions paying assessments while SAIF institutions pay none?

Chairman POWELL. Senator, under the current economic environment and the current condition of the industry, I do not believe that we should assess the industry, as you mentioned. However, if, in fact, the fund drops below the 1.25, we have no choice. One or four institutions, together with deposit growth, could cause the fund to go below the 1.25.

Senator JOHNSON. So, we are not talking failures here. We are just talking deposit growth.

Chairman POWELL. We are talking both. We could be talking about failures, one or two large institutions, and perhaps deposit growth could both contribute to the fund dropping below the 1.25.

Again, emphasizing, we would hope that the law would change, allowing the FDIC Board to manage the fund.

Senator JOHNSON. What risks do you see for the industry and the economy if you had no choice but to impose assessments now?

Chairman POWELL. Well, I think it would be unfair, number one.

Also, it would take monies out of financial institutions that they could be using to serve their communities with credit extensions.

Senator JOHNSON. For Chairman Greenspan and Mr. Fisher, you both indicated support for the FDIC's recommendation that it have the authority to manage the reserve ratio within a range. And you have noted that it is logical to provide for reserve growth above 1.25 when conditions are good, and for reserves to decline below that level when conditions are unfavorable.

And Mr. Greenspan, you observed that FDIC's suggested target reserve range be widened in order to reduce the need to change premiums abruptly. I wonder if you would elaborate a bit on what you believe an appropriate range would be, and how you might go about determining that range?

Chairman GREENSPAN. Our view, Senator, is that the FDIC should have as much discretion as the Congress feels comfortable giving them in this regard.

[Laughter.]

Senator JOHNSON. I think it is back in our lap, Mr. Chairman.

[Laughter.]

Chairman GREENSPAN. The reason I say that is the greater the range in discretion they have, the more flexible the system will be.

Having rigid trigger points is not helpful. I agree with the Chairman about the issue of fairness, certainly. But it also has problems of disrupting the economy or particular industries such as banking, which is not very helpful. That is, it creates an unnecessary instability, and if you allow the insurance premium rates to move in a manner which are continuous and not abrupt, I believe you can manage the risk system far more efficiently.

Senator JOHNSON. Mr. Fisher, do you concur, basically? Or do you have any elaboration?

Mr. FISHER. I concur.

Senator JOHNSON. Several of you have endorsed a concept of awarding assessment credits to institutions based on contributions to the funds prior to 1997.

Chairman Greenspan notes that the current system in which both the entrants and the fast growers are awarded insurance coverage virtually cost-free is both inequitable and contributes to moral hazard.

I would be interested to hear from those of you who would care to comment, and particularly Chairman Greenspan, on whether an assessment credit of the type contained in S. 1945, the Safety Act, successfully addresses the weaknesses that the FDIC has identified in this regard?

Mr. Greenspan, and then Mr. Powell, perhaps.

Chairman GREENSPAN. Well, I think that the FDIC's evaluation of this is something that makes a good deal of sense to us.

Senator JOHNSON. Mr. Powell.

Chairman POWELL. I concur.

[Laughter.]

Senator JOHNSON. That is what we like to hear.

To Mr. Gilleran, we are covering a little bit of past area here, but, in light of your change of view or at least modification or correction of view, that you now oppose both an increase in coverage and indexation.

We have had the current level of $100,000 for over 20 years. Is there a point, and if so, at what point is that, that adjusting for this eroding loss of coverage makes sense?

Mr. GILLERAN. Senator, I do not think I changed my opinion.

Senator JOHNSON. A clarification, for our purposes.

Mr. GILLERAN. And I solidified a view.

I think there is always probably a *de minimis* coverage level that makes sense. I think that where the $100,000 is right now should not be reduced. And even though over time inflation reduces the value of that in real dollars, that through utilizing more than one account, the customers are still protected—they can get 100 percent protection of all of their funds by spreading it around—it would certainly come down to a point as to whether or not $100,000 was equal to a peppercorn, as they say, in the law, and therefore, of no real value to any individual institution.

But certainly, in my view, the coverage is not there at this point.

Senator JOHNSON. I see my time has expired here. I will ask one very quick question again for Mr. Gilleran.

You observed that your objections to a special level of coverage for retirement accounts was based on the notion that we should not be singling out one particular type of savings for public policy reasons. But the very reason we have 401(k)'s and IRA's in the first place is because we have made public policy choices that we want to encourage savings for retirement and that there is a larger public reason for doing that. Doesn't it follow, then, that it is not illogical that we have an extra concern for retirement savings and the coverage that would go for that?

Mr. GILLERAN. I completely support 401(k) plans and retirement funds. However, my view as a regulator and as a member of the FDIC Board is on the safety, the soundness, and the protection of the fund. And I believe that by extending the coverage to specific parts of our society is, in a way, defusing the safety and soundness of the fund. Therefore, I would not want to see it going to other areas and I am very cautious on supporting this at this time.

Senator JOHNSON. Thank you.

Chairman SARBANES. Thank you, Senator Johnson.

Senator Bunning.

COMMENTS OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman.

First of all, I want to apologize to the panel for being late. And second, I would like to include my opening statement into the record, if that is okay with the Chairman.

Chairman SARBANES. Certainly. It will be included in the record.

Senator BUNNING. I have a question for Mr. Powell.

Many of my bankers in Kentucky are very concerned about the cost of some of these proposals. Can you tell me what you think the cost of indexing, raising coverage to $130,000, doubling retirement account coverage, including municipal deposits would be to a first- or second-tier bank that has assets under $100 million?

I realize you probably do not have that off the top of your head, or maybe you do. And maybe you have to get back to me on it, but do you have any kind of a ballpark figure?

Chairman POWELL. It was just handed to me, Senator.

Senator BUNNING. That is great.

Chairman POWELL. One hundred thirty thousand dollars general coverage, just increasing to $130,000, is about 8 basis points.

Senator BUNNING. Eight basis points.

Chairman POWELL. Right. One hundred thirty thousand dollars, general, in our IRA coverage at $250,000, is 9.5 basis points. Just the IRA increase to $250,000 is 2 basis points.

Now the cost to the institution would depend upon that institution's risk profile and the risk to the industry.

Just because, in fact, if this does happen, and again, reminding everyone that we are not supporting increasing the limit. We are supporting indexing—is that allowing the FDIC Board to manage the fund does not necessarily mean that we would pass that increased cost to the institutions.

Senator BUNNING. Who would you pass them to?

Chairman POWELL. The fund itself may be okay.

Senator BUNNING. Yes. But what happens if you had some kind of a crisis?

Chairman POWELL. Well, if that would happen, then we would assess the industry regardless of what happened here.

Senator BUNNING. I will follow up with the same question because it has something to do with the first one. This is for you and for Chairman Greenspan and for any others who want to answer.

You have offered certain testimony, and all the others have offered contradicting testimony, more or less. And I want to congratulate Chairman Greenspan because I think it is one of the very few times that you and I agree on this, and I am very happy to agree with you.

[Laughter.]

On raising coverage, I am particularly interested in hearing both of you expand on the S&L crisis and why raising coverage would not have an effect in a similar situation.

For Chairman Greenspan, why it would have an effect. In other words, you are saying it is not going to have an effect. And in testimony that the Chairman and all others gave, it would not have an effect.

Chairman POWELL. On the cost to the institutions?

Senator BUNNING. Yes.

Chairman POWELL. First, I think it is important that we focus, to some extent, on what we all agree on. We agree, I would say, on every element of deposit insurance reform except the coverage issue.

Senator BUNNING. Which is a big one. What do we have it for?

Chairman POWELL. Well, let me just say that managing the fund is very important to me and risk-based premiums is extremely important to me.

Senator BUNNING. But to the average citizen and banker out there, the amount of coverage and the safety of their money is more important. Granted, your assessment is correct. But to the average person depositing $50,000 in the bank and having an FDIC-insured deposit, it is the most important thing.

Chairman POWELL. Well, to the average banker, also, costs associated with that and being able to pay assessments based upon risk profile I think is important. In addition, allowing the FDIC Board to manage the Fund.

I am not sure you were in the room when I mentioned a moment ago about the Gallup poll and the average consumer.

Senator BUNNING. I was not.

Chairman POWELL. That the average consumer, in the results of a recent Gallup poll, indicated that approximately 50 percent of those believed that coverage should be increased.

Senator BUNNING. The average Gallup poll also said that 75 percent of the people believed that we should drill in ANWAR. So much for the Gallup polls.

Chairman POWELL. Seventy-seven percent of those people in the Gallup poll believed that it should be indexed. We also received a letter from the AARP supporting increased coverage. Again, we do not support that. We support indexing. So the consumer in various ways has spoken also.

Senator BUNNING. Mr. Chairman, would you like to comment on the difference between the S&L crisis that we went through and this current thing that we are considering?

Chairman GREENSPAN. Yes. Senator. The S&L crisis was fundamentally caused by the fact that we constructed a thrift industry which essentially had long-term assets funded by short-term liabilities, which is an intermediary which can exist only in a noninflationary environment where short-term rates are generally low and stay low so that you do not get an interest rate mismatch.

When that industry ran into the huge inflationary pressures, the interest receipts from their asset side, the long-term mortgages, went up far less than the rollover costs that were funded with rapidly rising short-term interest rates, and they began to lose money very dramatically and they came close to default pretty much across the board with respect to their capital.

While raising the deposit insurance ceiling was not the cause of the S&L crisis, it exacerbated it because, as was pointed out previously, the availability of $100,000 chunks at market interest rates that were Federally insured, induced a very significant degree of distorted investments which, at the end of the day, cost the American taxpayer very substantial amounts of money. It did not have to happen that way and, clearly, we would have had a problem without the rise in coverage.

But I think we have to be very careful about increasing coverage because first of all, it reduces the oversight which all forms of noninsured depositors tend to have on banks. And I have heard lots of arguments that they are all very unsophisticated and they cannot tell, but the people who hold uninsured deposits, from the surveys that we have had, are well-educated, knowledgeable, and they do have, and indeed, have had, a restraint on inappropriate lending practices on the part of institutions.

So our judgment is that deposit insurance should be there for the purpose of the $50,000 depositor or, on average much less, being sure that their deposits are secured. Those are truly unsophisticated people who are depositing funds at those amounts. And we conclude that it is necessary to have a degree of coverage to make certain that that is the case.

The current level, we perceive, as I indicated earlier, Senator does far more than is remotely necessary to maintain the basic purposes of deposit insurance. We have argued that while the holding of the $100,000 rate ceiling will eventually erode in real terms, we think that is good, not bad, for a while.

At some point, it will create problems and we think at that point, we would address the issue. But as Secretary Fisher said, that by any relevant measure is a long way away.

Senator BUNNING. Thank you, Mr. Chairman.

Chairman SARBANES. Thank you.

Senator Reed.

Senator REED. Thank you very much, Mr. Chairman.

Chairman Greenspan, to follow on Senator Bunning's question, you point out the structural mismatch of the 1980's between long-term interest rates on assets and short-term interest rates in borrowing which was exacerbated, in your words, by increasing deposit insurance. Is there anything of that character today structurally in the banking industry which would argue against increasing the rates?

Chairman GREENSPAN. No, Senator. I think that the lessons of the 1980's hopefully were substantially absorbed. That does not mean that we have a full maturity match on the asset side and on the liability side of both thrifts and banks. We do not. We still have something of a problem there.

And indeed, a good deal of people believe banking should be lend long where interest rates tend to be higher, fund short and hope. That is not an effectively useful strategy as far as I can judge.

There is some of that, but it is nowhere near the order of magnitude that existed amongst the thrifts in the 1970's.

Senator REED. I do not know if there is any coincidence, but the motto of my State is "Hope."

[Laughter.]

Let me just try to probe one other aspect of this issue, and that is the one of risk.

There seems to be implicit in your comments, Chairman Greenspan and Mr. Fisher, this notion about raising deposit coverage will somehow exacerbate risk. And I know it will increase the amount of coverage outstanding. But it seems to me that the principal way we try to manage risk in the banking industry is by very vigorous oversight and regulation. I do not assume that you would say that we would minimize that or somehow that would be put aside if we increased the coverage.

You are not inferring that, are you, Mr. Fisher?

Mr. FISHER. I am certainly saying that if we increase coverage, we reduce the amount of discipline that comes out of depositors for uninsured deposits. That is certainly an element of what we look to. We do not rely exclusively on the regulators to provide a discipline on management.

Senator REED. Well, my perception is most of the major problems are caused not by wild-eyed depositors, but by imprudent managers who are not actively supervised. And so, I think the presumption that raising coverage is going to create this undiscipline in the banking system I think is a little bit too much.

Mr. FISHER. I guess we may differ, then, Senator.

Senator REED. I guess we do.

Chairman GREENSPAN. Senator, may I respond to that?

Senator REED. Mr. Chairman.

Chairman GREENSPAN. The issue is not the depositors. It is the issue of subsidized funds available to banks which would induce the type of investments we are concerned will tend to be more risky. Indeed, that is exactly what did happen in the 1980's. So the principle is still there. It is just that the order of magnitude is quite different.

Senator REED. But the principle still argues for very vigorous supervision by regulators, by risk assessments. And I do not see anyone at this table suggesting that you are going to stop doing that, or perhaps I am missing something.

Chairman GREENSPAN. No, Senator, we will not. And if I had full confidence that we regulators were capable of doing anything close to what discipline in the marketplace can do, I would agree with you. I have been around too long to make that statement.

Senator REED. Let me ask a question of Mr. Powell and Mr. Gilleran because you, in fact, through your agencies, do clean up after the failure of banking institutions. There is a presumption also in the testimony that most people consciously make these choices to have uninsured accounts. They do it deliberately. It is a convenience matter. Is that your sense from the experience at FDIC and OTS, Mr. Powell?

You know, they are very sophisticated. They go ahead and they say, I want to put $100,000 insured, but I do not want to go across the street to the other banks. So, I will put $50 uninsured. Is that the case?

Chairman POWELL. I am not sure I can make that assumption, Senator. Since coming to the FDIC, I have experienced several bank closures and I have looked at the uninsured depositors. There were a lot of retirees, a lot of unsophisticated people who lost money in the Superior failure, Keystone failure, and the most recent smaller institutions that failed. I have received lots of letters.

Senator REED. Mr. Gilleran.

Mr. GILLERAN. I was the Superintendent of Banks in California from 1989 to 1994, and I had the unfortunate job of closing 25 banks. In general, I would say that those who lost money on an uninsured basis were businesses where, on the books of the business, they had a zero balance in the bank account, but they had a lot of outstanding checks that were out there that had not cleared yet. So, in fact, the balance on the bank's books was in excess of $100,000. And therefore, when the checks all cleared, some of them were not covered because the $100,000 level was exceeded.

There are always those individuals who do forget and that they do have amounts in a bank because they have a long-standing relationship with a bank and therefore, feel like they are very comfortable. I would say that those are very small in number and that anybody who has a fiduciary responsibility in connection with funds, which is a big source of deposits to banks, that those individuals are very much on top of the $100,000 limit situation. So, therefore, I think it is well monitored.

Senator REED. Thank you.

Chairman POWELL. I also remember the Bank of New England. I think also we must remember that sometimes those sophisticated depositors, in fact, do take their money out prior to the failure. But there are still others that suffer uninsured losses.

Senator REED. Well, I think in this whole discussion, that certainly, we have to concentrate on the overall effects of the banking system. But we also have to think about when these banks fail, real people lose their money. If we are providing some protection, we might consider providing more protection.

Chairman POWELL. It has been something like 27,000 people over the past 10 years that have lost money as a result of uninsured deposits, totalling roughly $700 million.

Senator REED. Thank you, Mr. Powell.

Thank you, Mr. Chairman.

Chairman SARBANES. Senator Corzine.

STATEMENT OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman. And I apologize to the panel for being late. I was at the Federal Reserve dealing with a financial literacy issue which I know is near and dear to people on this panel.

I also think it is appropriate in the context of the discussion that we are having here since the testing of high school students has been on a deterioration with respect to financial literacy capacity of our students.

One wonders whether the general public has the sophistication to allow them to provide all that discipline that the marketplace would say they have. I think that is the essence of why there is a debate about some of these limits. I congratulate Senator Johnson and the others for their work in this area.

I have not heard, and maybe you spoke about it before I joined the other Senators, about retirement accounts and municipal deposit accounts. And it is kissing cousins to debates that have gone on in the House with regard to rebates, bad actors, or lifeline banking accounts.

I wonder if one wants to comment on the idea that certain kinds of activities may legitimately draw different kind of coverage than just general deposits, IRA's for one. Promoting retirement is something that we may think is a public good. Municipal deposits where reinvesting monies in the communities where the banks or financial institutions are located, may be a positive ingredient and justify a different kind of limit than you might have otherwise.

I guess this bad actor issue is a matter of rebates to people who do not fulfill other obligations that we might say of public goods by flying banking accounts as to promote savings by people who are low and moderate income.

Is there a basis for having these carve-outs that are different than general insurance that we talked about with regard to deposits? And how do you all feel about it and how do you feel about the specific elements in the bill that is being proposed?

Let's start with Mr. Powell.

Chairman POWELL. I am always first.

[Laughter.]

Senator, first of all, as to your opening comments, the FDIC supports this whole notion of education and financial literacy among all people. In fact, we have a program known as Money Smart that we believe is a great product that we are attempting to get into the marketplace.

Also, I think that it is important that you understand one of our charges. And that is that the FDIC is to make sure that we educate the public in relation to the FDIC insurance. We take that, too, very seriously. We have a website and pamphlets to make sure that the public-at-large understands what FDIC insurance is and, in fact, how they are covered.

We do not support additional coverage for municipal deposits. And we are committed to studying ways in which there may be a vehicle through additional premiums that municipal deposits may be, in fact, increased. But today, we do not support increasing coverage for municipal deposits.

Chairman GREENSPAN. I agree with Chairman Powell's view.

Senator CORZINE. I would like, though, to know whether you all just believe that there should be only general deposit insurance and there should be no carve-outs for retirement accounts or municipal or any kind of fundamental usage of insurance as the basis of public policy.

Mr. FISHER. Yes, Senator. While, obviously, improving America's savings rate is an overriding and important objective, particularly to try to promote investment in the future and pay for our collective retirements, we think that the deposit insurance program has a particular purpose. It is about confidence in the banking system. That is its overarching purpose.

It serves the purpose for small depositors at the bottom end of the income spectrum, to provide a complete safety net for them. But it cannot be all things to all people. And we are not in favor, we do not support any of the carve-outs that you just described.

Senator CORZINE. We are going to hear the same thing, I suspect.

Mr. HAWKE. I would concur. Senator Johnson made a point a minute ago about 401(k)'s and IRA's, which are, of course, creatures of the tax code. I am not sure we want to see deposit insurance become a vehicle for the realization of a variety of different social policies the way we use the tax code today. Keeping deposit insurance faithful to its original concept seems to me to make a lot of sense. And, when you start departing from the original purposes of deposit insurance and start using it for other purposes, it is hard to see where you stop.

Mr. GILLERAN. I feel open to the subject of securing better retirement funds. However, I am really dissuaded from supporting it because of the fact that it opens up so many other discussions of what else should be included. It is almost like, once you start down that road, there is no stopping it.

But I completely agree that the primary purpose of the deposit insurance program is the safety and soundness of the banking industry. And carving out various segments of our society for greater protection I think would put in jeopardy the safety and soundness factor.

Senator CORZINE. Thank you.

Chairman SARBANES. I want to ask another basic question. I asked before what should be the level of deposit insurance just to try to find out what the factors are. I want to ask the question, why is 1.25 percent the figure that should govern the ratio and what is in the fund?

I ask that question because, as I understand it, and this goes to the argument that some banks are too big to fail. At the moment, if you assume a loss of assets of 25 percent, which is a fairly high figure because the FDIC tells us that, traditionally, the loss of assets has been somewhere between 5 and 10 percent on a failed bank, once they do all their recoveries and everything. But in recent times, the five largest failures since 1999, losses have ranged between 10 and 15 percent of total assets.

So just for the sake of illustration, there are eight BIF-insured institutions now that are so large that if they had 25 percent of assets lost, they would more than use up the fund. Just the failure of one of those eight institutions would exhaust the fund. Then, if you change the ratio, the figures change. But that raises the question, it seems to me, whether 1.25 is adequate.

Now all the talk is in terms of a range of discretion around 1.25. But why is the 1.25 the right figure, particularly in light of this observation about large banks and what their failure would do and how the fund could cover them?

We could not even take the hit of one of the largest financial institutions failing. At least there is a big question mark as I now see the situation. So that leads one to say, well, what is the rationale that determines what the ratio should be?

Chairman Greenspan.

Chairman GREENSPAN. I am in the unusually useful position to answer that question.

[Laughter.]

Chairman SARBANES. Actually, you usually are in that position on any question.

[Laughter.]

Chairman GREENSPAN. Well, no, because somebody at a meeting on deposit insurance a number of years ago was trying to decide what would be the appropriate ratio, and I unhelpfully just threw out, just looking at this chart, the average looks like 1.25. I was just making a historical statement. I am not absolutely certain that that is where it came from, but I wouldn't want to bet against it.

[Laughter.]

The reason is, as you point out, Mr. Chairman, this is not an insurance fund in the typical sense of the word. An insurance fund is one which sets premiums and creates a level of assets which effectively will insure against the realistic probabilities of the types of defaults and losses which you point out.

We do not have private insurers and the reason we do not is that, unlike insurance on life or auto/casualty, where you have a reasonably good distribution of what the losses are and you can set premiums fairly closely to achieve an optimum insurance system, we do not know what the probabilities are of these very large losses and the potential contagion that exists within the banking industry which creates that.

There is no contagion generally in true insurance. Most losses are independent of each other. That is not true of banking. The result of that is that you need a very large premium if you are going to act in a manner which will protect an insurance fund from going below zero.

The only way you can get deposit insurance is through the lender of last resort, who does not have to create very large premiums to insure the tail-end of the probability distribution which creates these very huge losses.

As a result, private insurance insurers, which you may remember 15, 20 years ago, including in Maryland, had great difficulty when they were pressed. They had inadequate reserves. As a consequence of that, we have, of necessity, a subsidized insurance system because you could not charge the premiums which would truly act as insurance against the types of real risks that are out there.

What we have done instead is to create the current system, which for most purposes, is working. It means that commercial banks and thrifts are paying for the losses. But the broad contagion, low-probability, large-cost event can only be insured by a lender of last resort.

So that is the way the system evolved. The 1.25, I can assure you, is merely a notion of what numbers, in fact, looked like over the history. They are not a scientifically constructed number.

Chairman SARBANES. Yes. Well, I appreciate that answer. It does leave still open the question whether the growth of these large institutions, the failure of only one of them—in other words, not a systemic failure in the banking system, but a breakdown in the one institution—whether they should require us to reexamine whether the levels are adequate. If you did not have the large institutions in the picture, you would have a different question.

In other words, you would say, well, the fund is large enough that it could handle the failure of any financial institution if there were a breakdown of its management. The growth of the large institutions now precludes us from making that statement. At least there are reasonable probabilities that that is the case. And I do not know. Should that require us to reexamine the levels at which the fund is maintained?

Chairman POWELL. Senator, I think you bring up something that we have discussed at the FDIC. How would we deal with a large institution that would fail, not only from the fund, but also the complexity of disposing of assets and selling assets into the marketplace and paying off depositors.

Hopefully, as supervisors, we would be able to determine and make the necessary regulatory decisions to prohibit a large institution from failing.

I think the marketplace would recognize very quickly that a large institution was in trouble. And I think that depositors, uninsured depositors, also, sophisticated uninsured depositors, would recognize that that, in fact, is the case. I am not sure what would happen. Probably, in larger institutions, there are more sophisticated depositors than in smaller institutions.

But it is an issue. And I do not have a good solution for it, other than, as regulators, we should be on top of that. As you know, we now have certain powers, including prompt corrective action, including some other powers that we can put in play that hopefully would prohibit a large institution from failing.

Chairman SARBANES. Clearly, if it did and the fund was inadequate, you would come to the Congress. The Congress would then have to vote the money, just as we did in the S&L times, in order to deliver on the guarantee.

Chairman POWELL. Right.

Chairman SARBANES. Senator Johnson.

Senator JOHNSON. Thank you, Mr. Chairman.

Just let me direct this to Mr. Greenspan, in particular. I want to clarify a little bit in my mind. We talked about the resistance to higher levels of coverage or indexation.

Chairman GREENSPAN. We are talking about premiums at this stage. No, the issue that is involved here is a premium question, as to whether, in fact, premiums are being set appropriately.

It is a very tricky question because we support risk-based premiums because it moves in the right direction, but we do not claim that it creates a system which is a true insurance system.

Senator JOHNSON. Right.

Yes, Mr. Powell.

Chairman POWELL. I think it is important that, before we go to the taxpayers, Senator, we would go back to the industry to replenish the fund. Again, that would depend upon how large the hole would be.

Chairman SARBANES. Well, all right. Then we have the countercyclical arguments that we get into.

Chairman POWELL. Right. Exactly.

Chairman SARBANES. Or the procyclical arguments.

Chairman POWELL. Right.

Chairman SARBANES. The impact that that has on the industry in what may be a time of difficulty or even distress.

Senator JOHNSON. There may be a disconnect. I am moving on to a separate issue, and that is back again to the whole question of whether there should be indexation or any increase of any kind in terms of FDIC coverage. The objection has been that it creates additional moral hazard.

And so that I understand this a little better, it would seem to me that the point of risk-based pricing is to mitigate the additional coverage risks, that along with more recent reforms such as prompt corrective action, PCA, and that those are designed to minimize any additional hazard that might come from higher levels of coverage or indexation. Is that not reading this correctly, or are these not adequate tools to cover that additional risk?

Chairman GREENSPAN. No, on the contrary, I think you correctly identify it, Senator.

The issue is that at any given level of coverage, the existence of these various other elements which mitigate the moral hazard are valuable. But the problem is, we do not have the capacity to increase the degree of oversight supervision, the prompt corrective action, that offsets the rise in the ceilings.

But you are certainly correct that the purpose of risk-based premiums, amongst other things, is to make whatever the level of coverage is less subject to moral hazard.

Senator JOHNSON. It is certainly true that those who support some indexation are not suggesting that there be some free benefit out there, that, in fact, additional coverage be offset by the additional premium, which is based on any additional risk incurred.

Chairman GREENSPAN. The issue of the amount of premiums involved would be determined independently of that. The problem that you have is that, if, for example, you raise coverage and you are at a level where the increased requirements of the fund necessitate an increase in premiums, then, clearly, to be sure, coverage goes up, but so do premiums.

Senator JOHNSON. Okay. Mr. Chairman, I will pass. My time has expired.

Chairman SARBANES. Thank you.

Senator Corzine.

Senator CORZINE. I am fine.

Chairman SARBANES. No questions?

Senator CORZINE. No questions.

Chairman SARBANES. Well, this has been an extremely interesting panel, and we very much appreciate both your testimony and your responses here today and the obvious care that went into the preparation of the full statements that have been included in the record. We very much thank you for your contributions.

The hearing is adjourned.

[Whereupon, at 12:05 p.m., the hearing was adjourned.]

[Prepared statements and response to written questions supplied for the record follow:]

PREPARED STATEMENT OF SENATOR MICHAEL B. ENZI

Thank you, Mr. Chairman. First, I want to thank you for holding this hearing. I believe it is important that we continually evaluate the status of the deposit insurance system. It is crucial to the stability of our banking system to not watch over it as closely as possible.

I also want to thank our distinguished witnesses who are with us today. Your knowledge and background in dealing with these issues will help us immensely as we continue to work on this issue.

As everyone knows, the House Financial Services Committee passed its version of deposit insurance reform last week, and I think it is important that this Committee keep pace on this critical issue. I want to thank Senator Johnson for allowing me to work with him on his legislation. I believe that what he, Senators Reed, Hagel, and myself have crafted provides the Committee with an excellent starting point to examining changes to the current deposit insurance system.

I am extremely pleased because I think a number of issues can be agreed upon by nearly everyone, and I would hope that the few remaining issues do not prevent us from making needed changes as soon as possible. This legislation is too important for banks, not only in Wyoming, but also across the country to let it get stalled.

S. 1945 addresses a number of problems with the current system. It merges the BIF and SAIF account, which I believe is widely supported. The legislation also requires mandatory risk-based premiums, because all institutions, no matter how well managed, offer some risk to the funds, they should all pay some amount into it. The legislation also allows the FDIC to have more flexibility when assessing premiums. The bill eliminates the hard target of 1.25 percent, in favor of letting the FDIC manage the funds within a range of 1 to 1.5 percent. This clarifies that in good economic times, it would be appropriate for the FDIC to increase reserves, so that in recessionary times, FDIC could relieve pressure on banks by allowing the ratio to float down until it is more comfortable for banks to replenish the fund. The bill also specifies that wide swings in assessment rates should be avoided.

Again, I believe this issues is of critical importance. I thank you, Mr. Chairman, for holding this hearing, and I look forward to working with you and other Members of the Committee as we continue working on this issue.

PREPARED STATEMENT OF SENATOR JACK REED

Thank you, Mr. Chairman, and I appreciate your convening this very timely hearing, especially in light of last week's passage of deposit insurance reform legislation by the House Financial Services Committee.

As an original cosponsor of the Safe and Fair Deposit Insurance Act of 2002 (the "Safety Act"), I strongly support the efforts prompted by the FDIC's Options Paper of April 2001 to look closely at the system we have in place now, and begin the work we need to do to improve and strengthen it for years to come. I want to commend Senator Johnson for his work on the "Safety Act," and for moving the Committee into a position where we can begin to consider these important issues.

Our banking system has been the envy of the world because of its safety, strength, and transparency. Our work on deposit insurance reform through the "Safety Act" will only build on that record.

In recent years, we have seen some troubling bank failures, the largest of which occurred last summer at Superior Bank of Illinois, costing the Savings Association Insurance Fund almost $500 million. Others have followed since then, dropping the funds to a precipitous level. By instituting some of the reforms outlined in the FDIC's Options Paper, as well as in the "Safety Act," such as merging the two insurance funds, and removing the "hard target" of those funds, we can ensure a much more stable and viable system for the future.

Obviously, there are several other issues suggested by the FDIC and the legislation where there are serious disagreements, such as on raising the coverage limits of deposit insurance for individual accounts, as well as for retirement accounts, and indexing that coverage going forward. However, I am confident that through the upcoming Committee and floor process, we will able to reach a good compromise on the issues that will benefit the industry and all Americans who continue to depend upon it.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF SENATOR DEBBIE STABENOW

Thank you, Mr. Chairman. I am glad that we are focusing our attention today on the issue of deposit insurance reform.

Let me begin my remarks by commending the leadership of Senators Johnson and Hagel. They have done excellent work, putting together a reform proposal. Their bill, the Safe and Fair Deposit Insurance Act, is a solid and reasoned approach.

I am proud to be a cosponsor of this bill. In all, there are already 7 Members of this Committee on the bill. I know of few other proposals before our Committee that have garnered such strong bipartisan cosponsorship. That, I believe, is a true testament to the strength of the Johnson-Hagel initiative and a reflection of their collaborative efforts.

It was just about a year ago that then-FDIC Chairwoman Donna Tanoue argued to Congress that the time to address flaws in the system is now—while the industry is strong and the overwhelming majority of institutions remain healthy. I agree with her and I hope that we can move a bill forward.

While there are several issues about which there is disagreement, the need for reform, as outlined in the FDIC's April 2001 report, is clear. I hope we will work together to resolve the outstanding differences people have regarding reform. Questions about the $100,000 coverage level, indexation, municipal coverage, accounting for loan loss reserves, and so-called free riders are just a few of the issues to which the answers are not simple. And, indeed, we, as policymakers, may disagree about what is the best solution to some of the questions reform of the deposit insurance system raises. At the end of the process, however, I believe that we can pass a solid bill that is an improvement over the status quo.

We all know that last week the House Financial Services Committee overwhelmingly reported out a bill very similar to the Johnson-Hagel bill. Indeed, the vote was 52 to 2. With such broad support in Committees of jurisdiction in both Houses, I believe momentum is growing.

I thank the Chairman for calling today's hearing. I welcome our witnesses before us. And I look forward to working closely with my colleagues to move a reform bill.

Thank you.

PREPARED STATEMENT OF SENATOR JIM BUNNING

I would like to thank you, Mr. Chairman, for holding this very important hearing and I would like to thank all of our witnesses for testifying today.

We have been struggling with this issue for a number of years. My own experience with FDIC reform started when I was a Member of the House Banking Committee during the S&L bailout. That was not a fun time for anyone involved and I know most of you were involved in one way or another.

Because of that wonderful experience, I enter into any discussion of deposit reform with a certain amount of trepidation. Obviously, none of us want to live through that mess again. However, that does not mean that the current system cannot and should not be improved. There are a lot of good things in both the Senate bill offered by my colleague, Tim Johnson, and the House bill. A lot of which I agree with. The FDIC should have flexibility. We should merge the funds. We should eliminate the cliff. All of these are ideas that should have become law a long time ago and I am glad they are before this Committee now.

But I am a little nervous about one thing, how much is this going to cost the small- to mid-sized banks in my State. My bankers want a lot of the things in these bills. They like the items I previously mentioned, and they like increased coverage, in the abstract. They are, however, very much afraid of how much this is going to cost their banks.

I think, when you add up all of these proposals, that is a very legitimate fear. It is also my biggest fear. I do not want us to forget when we are trying to do all of these wonderful things, how much it is going to affect our small banks, who are so important to our economy. I do not want to force them to buy steak when what they really want is a hamburger. I can only speak for the bankers in my State, but they are telling me that although they like steak, they want a hamburger. They are afraid these proposals are getting a little too expensive.

I look forward to hearing from all of you about the cost issue, especially on how it affects smaller banks. I also look forward to hearing your other testimony as well.

I thank all of you for testifying today, I look forward to hearing from you.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF SENATOR JON S. CORZINE

Mr. Chairman, thank you for holding this important and timely hearing.

Deposit insurance reform has been the center of a great deal of Congressional consideration and discussion as of late. Among the many key issues in this debate are whether general deposit coverage limits should be increased—and if so, by how much—or whether they should simply be indexed.

The questions surround the adequacy of the current coverage limit and whether the value of that coverage has eroded since 1980, the last time it was raised. In my mind the most important element of this debate will be whether increasing the coverage will provide a net benefit that provides an incentive for people to save more. My guess is few, if any, consumers are aware that this debate is ongoing, and unless pressed for an answer, fewer would have an actual opinion on the matter. Little information exists that can provide us with an accurate portrayal of consumer sentiment on this subject.

There are other items of importance to this debate aside from the question of increasing the coverage limits. Whether we should increase coverage for individual retirement accounts and municipal deposits; whether we should merge the BIF and the SAIF; how much flexibility the FDIC should have in setting the merged fund's designated reserve ratio; and whether the FDIC should be allowed to assess premiums on all institutions are all important considerations for us to undertake. There seems to be a growing consensus to act on most of these points.

For those of us still undecided on the merits of various facets of this debate, this hearing will give us a unique opportunity to have an open, frank discussion of these important issues. Mr. Chairman, you have afforded us that opportunity by convening a hearing with a most distinguished panel.

I welcome all of our witnesses and look forward to their testimony and to an engaging discussion.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF SENATOR DANIEL K. AKAKA

Thank you, Mr. Chairman. Last April, the Federal Deposit Insurance Corporation issued recommendations for deposit insurance reform. These recommendations included merging the two deposit insurance funds, the elimination of sharp premium swings, and indexing coverage levels to account for inflation. These recommendations initiated a national dialogue on how the Federal Deposit Insurance Corporation can operate more efficiently, provide greater economic stabilization, and protect savings. I thank Senator Johnson, Chairman of the Subcommittee on Financial Institutions, and his Subcommittee staff for all of their work in continuing the national dialogue.

One area worthy of discussion is the merger of the two insurance funds. The current administration of two deposit insurance funds, the Bank Insurance Fund and the Savings Association Insurance Fund, has created a system where identical coverage is provided but assessments are determined separately. Banks and thrifts with similar risk levels could potentially be paying different amounts for coverage. This occurred in 1995 and 1996, when the highest rated Savings Association Insurance Fund institutions were paying premiums while the highest rated institutions of the other fund were not. In addition, many financial institutions have both types of insured deposits. Merging the fund would simplify reporting and accounting requirements for financial institutions and the FDIC.

Another area to examine is the elimination of sharp premium swings. Significant increases in deposit insurance premiums can occur when the designated reserve ratio falls below 1.25 percent of insured deposits. I am concerned because this would most likely happen during difficult financial times when banks would have difficulty paying sudden increases in their premiums. Access to credit could be restricted and an economic downturn could be prolonged. There is a need to provide the FDIC with greater flexibility in determining the appropriate reserve ratio in an attempt to level out the economic cycles.

Finally, the issue of indexing or increasing coverage limits needs to be thoroughly evaluated to determine the possible impact such action would have on the Nation's banking system.

I thank you for appearing today, and I look forward to your recommendations as we explore the issue of Federal deposit insurance reform.

Again, Mr. Chairman, thank you for conducting this hearing.

PREPARED STATEMENT OF SENATOR CHUCK HAGEL

Thank you, Mr. Chairman, for holding this hearing today. It is an important and timely issue that deserves our full attention. I appreciate Senator Johnson's leadership on this issue and the work of Senators Enzi and Reed in crafting the Safe and Fair Deposit Insurance Act of 2002.

Deposit insurance has been the bedrock for our banking system. It is especially significant to our Nation's community banks as the guarantee on deposits gives people confidence that their money will be safe. Last year, the Federal Deposit Insurance Corporation (FDIC) proposed several reforms to the deposit insurance system to address critical weaknesses such as the procyclical nature of the current system, the advent of "free-riders," and the pricing mechanisms. These are reforms on which we can all generally agree.

We must also support our community banks and the liquidity deficiencies they face today. We can do this by increasing coverage levels for general accounts, for retirement accounts, and for municipal deposit accounts. Increasing coverage will increase lending capacity for community banks, and is a necessary component to compete with the "too big to fail" advantage big banks enjoy.

Raising coverage levels to $130,000 will help community banks raise core deposits and allow them to lend more back into farms, small businesses, and into their communities. This rotation of each dollar invested back into the community insures the stability of their way of life. The viability of community banks is dependent on deposit insurance and in order to continue to serve their customers, we must consider raising the coverage levels.

These bankers know, better than any of us here in Washington, the needs of their customers and the needs of their banks. Studies have reinforced this viewpoint as well. A Gallup survey conducted on behalf of the FDIC found that deposit insurance is a factor in investment decisions and is especially important to more risk-averse consumers and those in older and less affluent households.

I have heard from our witnesses here before us today of their opposition to increasing coverage levels. One reason stated is that you haven't heard from anyone on how this would benefit banks. Let me share one example with you:

A $27 million bank located in Dalton, Nebraska, is the only bank in town. They have 1,500 customers and 3 percent of them hold 48 percent of the bank's deposits. These customers are well aware of the $100,000 limit and will not hold accounts above that level and have often left the bank for competitor banks. This may be a viable option in Washington or Baltimore, where banks are present at grocery stores and on every other corner. But in Nebraska's small towns, there is not the option of going to a Fleet or a CitiBank. Customers are not only disserviced by having to drive to the next town, but that bank is also losing deposits. Raising the coverage level even a small amount, will allow them to keep more deposits in their banks and expand their lending capacity.

Finally, I disagree with the theory that banks will become more reckless with increased coverage levels. I find it hard to believe that a community bank that has been in operation for decades will suddenly become irresponsible with its lending practices. This "moral hazard" argument is purely theoretical. Bad lending decisions and bank failures will be made regardless of a slight increase in coverage levels, not because of it.

The proposals we will discuss today for deposit insurance reform are addressed in the Safe and Fair Deposit Insurance Act. I welcome the thoughts from our witnesses and hope we can act on this legislation soon.

Thank you.

PREPARED STATEMENT OF DONALD E. POWELL

CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

APRIL 23, 2002

Chairman Sarbanes, Senator Gramm, and Members of the Committee, it is a great pleasure to appear before you this morning to discuss deposit insurance reform. This is one of the key priorities of the Federal Deposit Insurance Corporation and I appreciate this Committee's interest in promoting the discussion.

Deposit insurance has been a significant element of financial stability in this country for nearly 70 years and helped us through two major banking crises. During the crisis of the 1980's and early 1990's, the FDIC and the Resolution Trust Corporation resolved 2,362 failures of insured institutions involving more than $700 billion in assets. The last time we saw a banking crisis of that magnitude was during the early 1930's. Yet, the outcomes were very different. I believe this is due in large part to the presence of the FDIC and its stabilizing presence in the marketplace. Deposit insurance played a significant role in ending the banking crisis of the Great Depression by reestablishing financial stability. During the more recent crisis, there were no bank panics, no disruptions to financial markets, and no debilitating effect on overall economic activity.

We sometimes fail to appreciate the truly remarkable value and accomplishments of Federal deposit insurance, and we tend to undervalue or disregard its importance when times are good. The FDIC has played a key role in maintaining public confidence in our financial sector through good times and bad, and we are proud of this record.

The deposit insurance system protects depositors and helps the economy by preventing bank panics and stabilizing the financial system. It should accomplish this without causing other problems. Specifically, it should not increase banks' incentive to engage in riskier behavior than would be possible in the absence of insurance—the moral hazard problem. And, most of all, deposit insurance should never again cost the taxpayers a dime.

Many of the rules put in place by Congress in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) are designed to ensure that the deposit insurance funds are adequate, that the deposit insurance program is operated in a manner that is fiscally and economically responsible, and that banks and thrifts—rather than the taxpayers—fund the system. We understand that many features of the current system exist for good reason, and we have not lost sight of this in developing our proposals.

I have been at the FDIC about 8 months now. I arrived with a banker's natural skepticism about the need for deposit insurance reform, but I quickly became convinced. While the current system is not in need of a radical overhaul, flaws in the system could actually prolong an economic downturn, rather than promote the conditions necessary for recovery. The current system also distorts incentives in ways that exacerbate the moral hazard problem. These flaws can be corrected only by legislation, and I appreciate this Committee's attention to this issue.

The work that the FDIC staff did in coming up with its recommendations for reform a year ago is a model for how Government agencies should create public policy proposals. The staff did its homework and kept all of the players—Congress, the banking industry, scholars and experts, and the public—involved every step of the way. They prepared an excellent report on deposit insurance reform with very important recommendations and I have full confidence in that product.

Since I came to the FDIC, I have had a chance to add my own thoughts to the FDIC's recommendations and together we have had a chance to refine the proposals. This morning, I would like to give you our view on the best course for reform.

Specifically, I will address several areas: merging the funds, deposit insurance fund management and pricing of deposit insurance premiums, a one-time assessment credit, and deposit insurance coverage.

While I understand that much of the debate has centered on coverage, I want to first emphasize what we regard as even more critical—merging the funds, and improving the FDIC's ability to manage the fund and price premiums properly to reflect risk. These changes are needed to provide the right incentives to insured institutions and to improve upon the insurance system's role as a stabilizing economic factor, while also preserving the obligation of banks and thrifts to fund the system. I will discuss each of the issues in turn.

Merging the BIF and the SAIF

We should merge the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). There is a strong consensus on this point within the industry, among regulators, and within the Congress.

Originally, the two funds were intended to insure bank and savings association deposits separately. From the point of view of the insured depositor, there is virtually no difference between banks and thrifts. Moreover, many institutions currently hold both the BIF- and SAIF-insured deposits. More than 40 percent of SAIF-insured deposits now are held by commercial banks.

A merged fund would be stronger and better diversified than either fund standing alone. In addition, a merged fund would eliminate the possibility of a premium disparity between the BIF and the SAIF. As long as there are two deposit insurance funds, with independently determined assessment rates, the prospect of a premium differential exists. When such a price disparity exists, banks and thrifts naturally gravitate to the lower price, wasting time and money trying to circumvent restrictions that prohibit them from purchasing deposit insurance at the lowest price—an undesirable result. A merged fund would have a single assessment rate schedule and the prospect of different prices for identical deposit insurance coverage would be eliminated.

The potential for differing rates is not merely theoretical. The BIF reserve ratio at the end of 2001 stood at 1.26 percent ($1.26 in reserves for every $100 of insured deposits), barely above the Designated Reserve Ratio (DRR) of 1.25 percent, while the SAIF reserve ratio stood at 1.37 percent. The FDIC Board will decide within the next few weeks whether BIF rates must be raised for the second half of 2002 to maintain the reserve ratio at the DRR.

For all of these reasons, the FDIC has advocated merging the BIF and the SAIF for a number of years, and I wholeheartedly agree. Any reform plan must include merging the funds.

Fund Management and Premium Pricing

Two statutory mandates currently govern the FDIC's management of the deposit insurance funds. One of these mandates can put undue pressure on the industry during an economic downturn. The other prevents the FDIC from charging appropriately for risk during good economic times. Together, they lead to volatile premiums.

When a deposit insurance fund's reserve ratio falls below the 1.25 percent DRR, the FDIC is required by law to raise premiums by an amount sufficient to bring the reserve ratio back to the DRR within 1 year, or charge at least 23 basis points until the reserve ratio meets the DRR. Thus, if a fund's reserve ratio falls slightly below the DRR, premiums need not necessarily increase much. On the other hand, if a fund's reserve ratio falls sufficiently below the DRR, average premiums will increase to 23 basis points, at a minimum.

The potential for 23 basis point rates is problematic because, during a period of heightened insurance losses, both the economy in general and depository institutions in particular are more likely to be distressed. A 23 basis point premium at such a point in the business cycle would be procyclical and result in a significant drain on the net income of depository institutions, thereby impeding credit availability and economic recovery.

When a fund's reserve ratio is at or above the 1.25 percent DRR (and is expected to remain above 1.25 percent), current law prohibits the FDIC from charging premiums to institutions that are both well-capitalized, as defined by regulation, and well-managed (generally defined as those with the two best CAMELS examination ratings).[1] Right now, 92 percent of banks and thrifts are well-capitalized and well-managed and pay the same rate for deposit insurance—zero. Significant and identifiable differences in risk exposure exist among these 92 percent of insured institutions. To take just one example, since the mid-1980's, institutions rated CAMELS 2 have failed at more than 2½ times the rate of those rated CAMELS 1.

This provision of law produces results that are contrary to the principle of risk-based premiums, a principle that applies to all insurance. Because the current system does not charge appropriately for risk, this increases the potential for moral hazard. This also means that safer banks unnecessarily subsidize riskier banks. Both as an actuarial matter and as a matter of fairness, riskier banks should shoulder more of the industry's deposit insurance assessment burden.

In addition, the current statute also permits banks and thrifts to bring new deposits into the system without paying any premiums. Essentially, the banks that were in existence before 1997 endowed the funds, and newcomers are not required to contribute to the ongoing costs of the deposit insurance system. Since 1996, more than 900 new banks and thrifts have joined the system and never paid for the insurance. I know this firsthand because I chartered a bank in Texas in the late 1990's and we never paid a dime in deposit insurance premiums. Other institutions have grown significantly without paying additional premiums.

These problems can be solved by eliminating the existing inflexible statutory requirements and by giving the FDIC Board of Directors the discretion and flexibility to set appropriate targets for the fund ratio, determine the speed of adjustment toward the target using surcharges or assessment credits as necessary, and charge premiums based on risk at all times, regardless of the reserve ratio.

Fund Management

The FDIC recognizes that accumulating money in the insurance fund to protect depositors and taxpayers means less money in the banking system for providing

[1] CAMELS is an acronym for component ratings assigned in a bank examination: Capital, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. The best rating is 1; the lowest is 5. A composite CAMELS rating combines these component ratings, again with 1 being the best rating.

credit. The current system strikes a balance by establishing a reserve ratio target of 1.25 percent. The existing target appears to be a reasonable starting point for the new system—with a modification to allow the reserve ratio to move within a range to ensure that banks are charged steadier premiums. *The point of the reforms is neither to increase assessment revenue from the industry nor to relieve the industry of its obligation to fund the deposit insurance system; but rather, it is to distribute the assessment burden more evenly over time and more fairly across insured institutions.*

In my view, the reserve ratio target should remain relatively steady over the longer run and move only in response to fundamental changes that are expected to alter the risk exposure of the fund for the foreseeable future. The target should not be viewed as a short-run instrument that should rise and fall continuously with the business cycle. The key to fund management would be to bring the fund ratio back toward the target in an appropriate timeframe when it moves away in either direction. Presumably, the farther the movement away from the target, the larger would be the expected credits, rebates, or surcharges, other things equal, in order to slow the momentum and pull the ratio back toward the target. However, the greater the range over which the FDIC has discretion to manage the fund, the more flexibility we will have to eliminate the system's current procyclical bias.

The FDIC would prefer to steer clear of hard triggers, caps, and mandatory credits or rebates. Automatic triggers that "hard-wire" or mandate specific Board actions are likely to produce unintended adverse effects, not unlike the triggers in the current law. They would add unnecessary rigidity to the system and could prevent the FDIC from responding effectively to unforeseen circumstances. For a new deposit insurance fund management plan to work effectively, the Board must have the flexibility to respond appropriately to differing economic and industry conditions. For example, a given reserve ratio may warrant a credit rather than a rebate, and a smaller rather than a larger credit, depending upon economic conditions, industry performance, possible failures, and other circumstances. The legislation could contain an expectation of a rebate in certain circumstances with a requirement that the Board justify any alternative decision.

While I believe that the FDIC Board needs greater discretion to manage the fund, I am not suggesting that we need unfettered discretion and I recognize the need for accountability. The FDIC will work with the Congress to develop guidelines on an appropriate range for the fund ratio around the target—as well as some direction for the FDIC Board's management of the fund ratio levels—and to develop reporting requirements for the FDIC's actions to manage the funds. For example, the Board could be expected to adopt rules that operate to pull the reserve ratio back, at an appropriate speed, whenever it moves away from the target in either direction and to publish a schedule for recapitalizing the fund whenever the ratio falls significantly below the target, as current law requires.

Charging Premiums Based Upon Risk

How would premiums work if the FDIC could set them according to the risks in the institutions we insure? First, and foremost, the FDIC would attempt to make them fair and understandable. We would strive to make the pricing mechanism simple and straightforward. I believe that we can accomplish our goals on risk-based premiums with relatively minor adjustments to the FDIC's current assessment system.

I am aware of the concern about using subjective indicators to determine bank premiums. We will be sensitive to that issue and work to ensure that we use objective indicators to the extent possible to measure risk in institutions. Any system we adopt will be transparent and open. The industry and the public at large will have the opportunity to weigh in on any changes we propose through the notice-and-comment rulemaking process.

Using the current system as a starting point, the FDIC should consider additional objective financial indicators, based upon the kinds of information that banks and thrifts already report, to distinguish and price for risk more accurately within the existing least-risky (1A) category. The sample "scorecard" included in the FDIC's April 2001 report represents one approach. In this example, banks currently in the best-rated category were divided into three groups using six financial ratios in addition to capital and CAMELS ratings (net income, nonperforming loans, other real estate owned, noncore funding, liquid assets, and growth). Actuarial analysis showed that different premiums would be warranted for these three groups, based on the FDIC's loss experience since 1984.

We have since had many discussions with bankers and trade-group representatives regarding this sample scorecard, and we are making adjustments. We are willing to listen to the industry and Congress regarding alternative pricing schedules that also may be analytically sound.

The FDIC's report also indicated that for the largest banks and thrifts, it might be possible to augment such financial ratios with other information, including market-based data, so long as the final result is fair and does not discriminate in favor of or against banks merely because they happen to be large or small.

In short, I believe the right approach is to use the FDIC's historical experience with bank failures and with the losses caused by banks that have differing characteristics to create sound and defensible distinctions. However, we will not follow the results of our statistical analysis blindly—we recognize the need for sound judgment in designing the premium system.

Assessment Credits for Past Contributions

One result of the FDIC's current inability to price risk appropriately is that the deposit insurance system today is almost entirely financed by institutions that paid premiums prior to 1997. More than 900 newly chartered institutions, with more than $70 billion in insured deposits, have never paid premiums for the deposit insurance they receive. Many institutions have greatly increased their deposits since 1996, yet paid nothing more in deposit insurance premiums.

Since they are not paying premiums, new institutions and fast-growing institutions have benefited at the expense of their older and slower-growing competitors. Under the present system, rapid deposit growth lowers a fund's reserve ratio and increases the probability that additional failures will push a fund's reserve ratio below the DRR, resulting in an immediate increase in premiums for all institutions.

An assessment credit could be used as a mechanism to address the fairness issue that has arisen. I am reluctant to mandate a cash payment out of the fund at this time, given the recent fall in reserve ratios. But we can achieve the desired result by giving the banks and thrifts that built up the funds a credit toward their future assessments.

A reasonable way to allocate the initial assessment credit would be according to a snapshot of institutions' relative assessment bases at the end of 1996, the first year that both funds were fully capitalized. Each institution would get a share of the total amount to be credited to the industry based on its share of the combined assessment base at yearend 1996. For example, an institution that held 1 percent of the industry assessment base in 1996 would get 1 percent of the industry's total assessment credit. Relative shares of the 1996 assessment base represent a reasonable proxy for relative contributions to fund capitalization, while avoiding the considerable complications that can be introduced by attempting to reconstruct the individual payment histories of all institutions.

Institutions that had low levels of deposits on December 31, 1996, but subsequently experienced significant deposit growth would receive relatively small assessment credits to be applied against future premiums. Institutions that never paid premiums would receive no assessment credit. Institutions that made significant contributions into the deposit insurance funds would pay a lower net premium than institutions that paid little or nothing into the fund. Such an assessment credit would provide a transition period whereby banks that contributed in the past could defer any payment of net premiums.

The combination of risk-based premiums and assessment credits tied to past contributions to the fund would help us fix the remaining problems related to rapid growers and new entrants. Regular risk-based premiums for all institutions would mean that fast-growing institutions would pay increasingly larger premiums as they gather deposits. Fast growth, if it posed greater risk, also could result in additional premiums through the operation of the FDIC's expanded discretion to price risk.

Deposit Insurance Coverage

As a life-long banker, I can tell you that deposit insurance is important not only to individuals and families, but also to many small businesses, community banks, charities, and some local governments. In fact, as an agent of financial stability, deposit insurance is important to the entire economy. If you believe as I do that deposit insurance is important, the declining value of coverage should be a subject of concern.

Our recommendation is simple: the coverage limit should be indexed from the present level of $100,000 to ensure that the value of deposit insurance in the economy does not wither away over time. In real terms, this does not expand coverage. It simply holds it steady over time. I challenge those who oppose indexation to either provide a number better than $100,000 or defend the principle of eroding deposit insurance. Over the 22 years since Congress last increased the coverage limit, the real value of the $100,000 coverage limit has declined to $47,000 in 1980 dollars. I also believe that indexing the limit on a set basis will prevent any unintended consequences that may result from making large adjustments on an irregular basis, which would seem to address the argument that sudden sharp increases resulted in economic disruptions in the past.

My suggestion would be to index the $100,000 limit to a widely accepted index, such as the Consumer Price Index or the Personal Consumption Expenditures Chain-Type Index, and adjust it every 5 years. The first adjustment would take place on January 1, 2005. We should make adjustments in round numbers—say, increments of $10,000—and the coverage limit should not decline if the price level falls. These seem like the right elements of an indexing system, but I am willing to support any reasonable method of indexing that ensures the public understands that the FDIC's deposit insurance protection will retain its value. I look forward to working with the Congress to find a method of indexing that works.

There has been some opposition to the FDIC's indexing proposal on the grounds that it would increase the Federal safety net. Frankly, I am puzzled by this. I am not recommending the safety net be increased. I am just recommending the safety net not be scaled back inadvertently because of inflation.

Some argue against indexing by contending that the current limit already is too high, and they point to the problems of the 1980's in support of their concern. With respect to the problems of the 1980's, Congress undertook a comprehensive review of the deposit insurance system with FDICIA. Significant changes were made to many features of the system. Congress adopted prompt corrective action, the least-cost test and risk-based premiums as means to address moral hazard, but did not lower coverage. Moreover, as noted earlier, the real value of coverage today is far lower than it was even when the limit was increased to $40,000 in 1974, roughly a decade before the problems appeared.

I do believe, however, there is one class of deposits for which Congress should consider raising the insurance limit, and that is retirement accounts. These accounts are uniquely important and protecting them is consistent with existing Government policies that encourage long-term saving. When we think about saving for retirement in this day and age, $100,000 is not a lot of money. Middle-income families routinely save well in excess of this amount. The shift from defined benefit plans to defined contribution plans has resulted in significant wealth being accumulated outside traditional pension funds.

Protecting retirement accounts is consistent with Government policies encouraging savings and responsible retirement planning. Congress recently raised the annual maximum IRA contributions to $3,000 this year and larger amounts in future years and allowed those over 50 to make catch-up contributions. Some precedent exists for providing retirement accounts with special insurance treatment. In 1978, Congress raised coverage for IRA and Keogh deposit accounts to $100,000, while leaving basic coverage for other deposits at $40,000.

The $220 billion of IRA and Keogh deposits currently at banks and thrifts is not large compared to the volume of overall deposits. Thus, if the coverage limit were raised for IRA and Keogh deposits, the initial effect on the fund reserve ratio would not be dramatic. However, the total volume of IRA's and Keoghs in the economy is more than $2.5 trillion and estimating the influx of retirement account deposits as a result of higher coverage is subject to uncertainty. We would also note that a phasing-in of higher coverage limits for retirement account deposits could allow for some measure of control over the effect on the fund reserve ratio. I urge Congress to give serious consideration to raising the insurance limit on retirement accounts.

Conclusion

Deposit insurance has been a bulwark of the Nation's economy since its creation. It is no less important today. We must ensure that it can continue to stabilize the economy and protect depositors in the future.

Deposit insurance reform is not about increasing assessment revenue from the industry or relieving the industry of its obligation to fund the deposit insurance system. Rather, it is to distribute the assessment burden more evenly over time and more fairly across insured institutions. This is good for the industry, good for depositors, and good for the overall economy.

I take very seriously the responsibility of prudently managing the fund and maintaining adequate reserves—it is extremely important to the industry and to the financial stability of our country. We have only to look back at the bank and thrift crises of the 1980's and 1990's to understand this. The existing deposit insurance system has served us well, and we must be mindful of this in contemplating changes.

The recommendations we have made would retain the essential characteristics of the present system and improve upon them. While I am Chairman, I will do all I can to ensure that the FDIC manages the insurance fund responsibly and is properly accountable to the Congress, the public, and the industry. Our recommendations will ensure that future Chairmen can do so as well.

The Congress has an excellent opportunity to remedy flaws in the deposit insurance system before those flaws cause actual damage either to the banking industry or our economy as a whole. The banking industry remains strong despite the recent downturn. The FDIC has put forward some important recommendations for improving our deposit insurance system. While I believe we should remain flexible with regard to implementation, as a former banker and, as the FDIC's new Chairman, I believe that we should work together to make these reform proposals a reality, and I commend this Committee for providing us the opportunity to discuss this important issue.

PREPARED STATEMENT OF ALAN GREENSPAN

CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

APRIL 23, 2002

Chairman Sarbanes, Senator Gramm, it is a pleasure to appear before this Committee to present the views of the Board of Governors of the Federal Reserve System on deposit insurance reform. I will be addressing general reform issues, as proposed by the Federal Deposit Insurance Corporation (FDIC) in the spring of 2001, rather than any specific bill. Consequently, I will be expressing the broad views of the Federal Reserve Board on the issues associated with modifications of deposit insurance.

At the outset, I should note that last year's FDIC report highlighted the significant issues and developed an integrated framework for addressing them. In broad terms, while the Board opposes any increase in coverage, we support the framework for other reform issues that the FDIC report constructed.

Benefits and Costs of Deposit Insurance

Deposit insurance was adopted in this country as part of the legislative framework for limiting the impact of the Great Depression on the public. In the environment of the record number of bank failures of the time, deposit insurance in this country was designed mainly to protect the unsophisticated depositor with limited financial assets from the loss of their modest savings. References were made to the "rent money" and the initial 1934 limit placed on deposit insurance was $2,500, promptly doubled to $5,000, a level maintained for the next 16 years. I should note that the $5,000 of insurance coverage in 1934, consistent with the original intent of Congress, is equal to less than $60,000 today, based on the Personal Consumption Deflator in the GDP accounts.

Despite its initial quite limited intent, the Congress over the intervening decades has raised the maximum amount of coverage five times to its current $100,000 level. The latest increase, in 1980, was a more than doubling of the cap level and was clearly designed to let depository institutions, particularly thrifts, offer an insured deposit free of the then prevailing interest rate ceilings on such instruments, which applied only to deposits *below* $100,000. Insured deposits of *exactly* $100,000 thus became fully insured instruments in 1980, but were not subject to an interest rate ceiling. The efforts of thrifts to use $100,000 CD's to stem their liquidity outflows resulting from public withdrawals of smaller below-market-rate insured deposits led first to an earnings squeeze and an associated loss of capital and then to a high-risk investment strategy that led to failure after failure. Depositors acquiring the new larger denomination insured deposits were aware of the plight of the thrifts but unconcerned about the risk because the principal amount of their $100,000 deposits was fully insured by the United States Government. In this way, the 1980 increase in the deposit insurance cap to $100,000 exacerbated the fundamental thrift problem associated with concentration on long-term assets in a high and rising interest rate environment. Indeed, it significantly increased the taxpayer cost of the bail out of the bankrupt thrift deposit insurance fund.

Not withstanding this problematic episode, it is clear that deposit insurance has played a key—at times even critical—role in achieving the stability in banking and financial markets that has characterized the past almost 70 years. Deposit insurance, combined with other components of our banking safety net (the Federal Reserve's discount window and payment system guarantees) has meant that periods of financial stress are no longer characterized by depositor runs on banks and thrifts. Quite the opposite: Asset holders now seek out deposits—insured and uninsured—as safe havens when they have strong doubts about other financial assets.

Looking beyond the contribution of deposit insurance to overall financial stability, we should not minimize the security it has brought to millions of households and small businesses. Deposit insurance has provided a safe and secure place for those households and small businesses with relatively modest amounts of financial assets to hold their transaction and other balances.

These benefits of deposit insurance, as significant as they are, have not come without cost. The very same process that has ended deposit runs has made insured depositors—as in the 1980's with insolvent, risky thrifts—largely indifferent to the risks taken by their depository institutions because their funds are not at risk if their institution is unable to meet its obligations. As a result, the market discipline to control risks that insured depositors would otherwise have imposed on banks and thrifts has been weakened. Relieved of that discipline, banks and thrifts naturally feel less inhibited from taking on more risk than they would otherwise assume. No other type of private financial institution is able to attract funds from the public without regard to the risk it takes with its creditors' resources. This incentive to take excessive risks is the so-called moral hazard problem of deposit insurance, the inducement to take risk at the expense of the insurer.

Thus, two offsetting implications of deposit insurance must be kept in mind. On the one hand, it appears fairly unambiguous that deposit insurance has contributed to the prevention of bank runs that could have destabilized the financial structure in the short-run. On the other, there are growing concerns that even the current levels of deposit insurance have created such underwriting imbalances at insured depository institutions that future large systemic risks have arguably risen.

Indeed, the reduced market discipline and increased moral hazard, have intensified the need for Government supervision to protect the interests of taxpayers and, in essence, substitute for the reduced market discipline. Deposit insurance and other components of the safety net also enable banks and thrifts to attract more resources, at lower costs, than would otherwise be the case. In short, insured banks and thrifts receive a subsidy in the form of a Government guarantee that allows them both to attract deposits at lower interest rates than would be necessary without deposit insurance, and to take more risk without the fear of losing their deposit funding. Put another way, deposit insurance misallocates resources by breaking the link between risks and rewards for a select set of market competitors.

From the very beginning, deposit insurance has involved a tradeoff. On the one hand, deposit insurance contributes to overall short-term financial stability and the protection of small depositors. On the other hand, deposit insurance induces higher risk-taking, resulting in a misallocation of resources and larger long-term financial imbalances that increase the need for Government supervision to protect the taxpayers' interests. Deposit insurance reforms must balance these tradeoffs. Moreover, any reforms should be aimed primarily at protecting the interest of the economy overall, and not just the profits or market shares of particular businesses.

The Federal Reserve Board believes that deposit insurance reforms should be designed to preserve the benefits of heightened financial stability and the protection of small depositors without at the same time further increasing moral hazard or reducing market discipline. In addition, we urge that the implementing details be kept as straightforward as possible to minimize the risk of unintended consequences that comes with complexity.

Recommendations for Reform

The FDIC has made five broad recommendations.

1. *Merging BIF and SAIF.* The Board supports the FDIC's proposal to merge the BIF and SAIFs. Because the charters and operations of banks and thrifts have become so similar, it makes no sense to continue the separate funds. Separate funds reflect the past, but neither the present nor the future. Merging the funds would diversify their risks, reduce administrative expenses, and widen the fund base behind an increasingly concentrated banking system. Most importantly, the Federally guaranteed insurance coverage provided to the two sets of institutions are identical, and thus the premiums need to be identical as well. Under current arrangements, the premiums could differ significantly if one of the funds fell below the designated reserve ratio of 1.25 percent of insured deposits and the other fund did not. Should that occur, depository institutions would be induced to switch charter to obtain insurance from the fund with the lower premium. This could distort our depository structure. The Federal Government should not sell an identical service, like deposit insurance, at different prices.

2. *Statutory Restrictions on Premiums.* Current law requires the FDIC to impose higher premiums on riskier banks and thrifts but prevents it from imposing any premium on well-capitalized and highly-rated institutions whenever the corresponding fund's reserves exceed 1.25 percent of insured deposits. The Board endorses the

FDIC recommendations that would eliminate the statutory restrictions on risk-based pricing and allow a premium to be imposed on every insured depository institution, no matter how well-capitalized and well-rated it may be or how high the fund's reserves.

The current statutory requirement that free deposit insurance be provided to well-capitalized and well-rated banks when FDIC reserves exceed a predetermined ratio maximizes the subsidy provided to these institutions and is inconsistent with efforts to avoid inducing moral hazard. Put differently, the current rule requires the Government to give away its valuable guarantee when fund reserves meet some ceiling level. This free guarantee is of value to banks and thrifts even when they themselves are in sound financial condition and when macroeconomic times are good. At the end of last year, 92 percent of banks and thrifts were paying no premium. Included in this group were banks that have never paid any premium for their, in some cases substantial, coverage and fast-growing entities whose past premiums were extraordinarily small relative to their current coverage. We believe that these anomalies were never intended by the framers of the Deposit Insurance Fund Act of 1996 and should be addressed by the Congress.

The Congress did intend that the FDIC impose risk-based premiums, but the 1996 Act limits the ability of the FDIC to impose risk-based premiums on well-capitalized and well-rated banks. And these two variables—capital strength and examiner overall rating—do not capture all the risk that banks and thrifts could create for the insurer. The Board believes the FDIC should be free to establish risk categories based on any well-researched economic variables and to impose premiums commensurate with these risk classifications. Although a robust risk-based premium system would be technically difficult to design, a closer link between insurance premiums and individual bank or thrift risk would reduce moral hazard and the distortions in resource allocation that accompany deposit insurance.

We note, however, that significant benefits in this regard are likely to require a substantial range of premiums but that the FDIC has concluded in its report that premiums for the riskiest banks would probably need to be capped in order to avoid inducing failure at these weaker institutions. We believe that capping premiums may end up costing the insurance fund more in the long run should these weak institutions fail anyway, with the delay increasing the ultimate cost of resolution. The Board has concluded, therefore, that if a cap is required, it should be set quite high so that risk-based premiums can be as effective as possible in deterring excessive risk-taking. In that way we could begin to simulate the deposit insurance pricing the market would apply and reduce the associated subsidy in deposit insurance.

Nonetheless, we should not delude ourselves that even a wider range in the risk-based premium structure would eliminate the need for a Government backup to the deposit insurance fund, that is, eliminate the Government subsidy in deposit insurance. To eliminate the subsidy in deposit insurance—to make deposit insurance a real *insurance* system—the FDIC average insurance premium would have to be set high enough to cover fully the very small probabilities of very large losses, such as during the Great Depression, and thus the perceived costs of systemic risk. In contrast to life or automobile casualty insurance, each individual insured loss in banking is not independent of other losses. Banking is subject to deposit run contagion, creating a far larger extreme loss tail on the probability distributions from which real insurance premiums would have to be calculated. Indeed, pricing deposit insurance risks to fully fund potential losses—pricing to eliminate subsidies—would require premiums that would discourage most depository institutions from offering broad coverage. Since the Congress has determined that there should be broad coverage, the subsidy in deposit insurance cannot be *fully* eliminated, although we can and should eliminate as much of the subsidy as we can.

Parenthetically, the difficulties of raising risk-based premiums explain why there is no private insurer substitute for deposit insurance from the Government. No private insurer would ever be able to match the actual FDIC premium *and* cover its risks. A private insurer confronted with the possibility, remote as it may be, of losses that could bankrupt the insuring entity would need to set especially high premiums to protect itself, premiums that few, if any, depository institutions would find attractive. And, if premiums were fully priced by the Government or the private sector, the issuing entities would likely lower their offering rates, reducing the amount of insured deposits demanded, and consequently the amount outstanding would decline.

3. *Designated Reserve Ratios and Premiums.* The current law establishes a designated reserve ratio for BIF and SAIF of 1.25 percent. If that ratio is exceeded, the statute requires that premiums on well-capitalized and well-rated institutions must be discontinued. If the ratio declines below 1.25 percent, the FDIC must develop a set of premiums to restore the reserve ratio to 1.25 percent; if it appears

that the fund ratio cannot be restored to its statutorily designated level within 12 months, the law requires that a premium of at least 23 basis points be imposed on all insured entities.

These requirements are clearly procyclical, lowering or eliminating fees in good times when bank credit is readily available and deposit insurance fund reserves should be built up, and abruptly increasing fees sharply in times of weakness when bank credit availability is under pressure and deposit fund resources are drawn down to cover the resolution of failed banks. The FDIC recommends that surcharges or rebates should be used to bring the fund back to the target reserve ratio gradually. The FDIC also recommends the possibility of a target range for the designated reserve ratio, over which the premiums may remain constant, rather than a fixed target reserve ratio and abruptly changing premiums.

We support such increased flexibility and smoothing of premiums. Indeed, we recommend that the FDIC's suggested target reserve range be widened in order to reduce the need to change premiums abruptly. Any floor or ceiling, regardless of its level, could require that premiums be increased at exactly the time when banks and thrifts could be under stress and, similarly, that premiums be reduced at the time that depositories are in the best position to fund an increase in reserves. Building a larger fund in good times and permitting it to decline when necessary are prerequisites to less variability in the premium. This approach stands in favorable contrast to the present system that is designed to stabilize the designated reserve ratios of the funds at the cost of, perhaps wide, premium instability.

In addition to widening the range for the designated reserve ratio, the Board would recommend that the FDIC be given the latitude temporarily to relax floor or ceiling ratios on the basis of current and anticipated banking conditions and expected needs for resources to resolve failing institutions. In short, on stability grounds we prefer less hardwiring of the rules under which the FDIC operates and more management flexibility for the Board of the FDIC, operating under broad guidelines from the Congress.

4. *Rebates.* Since its early days, the FDIC has rebated "excess" premiums whenever it felt its reserves were adequate. This procedure was replaced in the 1996 law by the requirement that no premium be imposed on well-capitalized and highly rated banks and thrifts when the fund reaches its designated reserve ratio. The FDIC proposals would reimpose a minimum premium on all banks and thrifts and a more risk-sensitive premium structure. These provisions would be coupled with rebates for the stronger entities when the fund approaches what we recommend be a higher upper end of a target range than the FDIC has suggested, and surcharges when the fund trends below what we suggest be a lower end of a target range.

The FDIC also recommends that the rebates not be uniform for the stronger entities. Rather, the FDIC argues that rebates should be smaller for those banks that have paid premiums for only short periods or that have in the past paid premiums that are not commensurate with their present size and hence FDIC exposure. The devil, of course, is in the details. But this latter proposal makes considerable sense, and the Board endorses it. More than 900 banks—some now quite large—have never paid a premium, and without this modification they would continue to pay virtually nothing, net of rebates, as long as their strong capital and high supervisory ratings were maintained. Such an approach is both competitively inequitable and contributes to moral hazard. It should be addressed.

5. *Indexing Insured-Deposit Coverage Ceilings.* The FDIC recommends that the current $100,000 ceiling on insured deposits be indexed. The Board does not support this recommendation and believes that the current ceiling should be maintained.

In the Board's judgment, it is unlikely that increased coverage, even by indexing, would add measurably to the stability of the banking system today. Macroeconomic policy and other elements of the safety net, combined with the current, still-significant level of deposit insurance, continue to be an important bulwark against bank runs. Thus, the problem that increased coverage is designed to solve must be related to either the individual depositor, the party originally intended to be protected, or to the individual bank or thrift. Clearly, both groups would prefer higher coverage if it cost them nothing. But Congress needs to be clear about the nature of a specific problem for which increased coverage would be the solution.

Depositors

Our surveys of consumer finances suggest that most depositors have balances well below the current insurance limit of $100,000 and those that do have larger balances have apparently been adept at achieving the level of deposit insurance coverage they desire by opening multiple insured accounts. Such spreading of asset holdings is perfectly consistent with the counsel always given to investors to diversify their assets—whether stocks, bonds, or mutual funds—across different issuers.

The cost of diversifying for insured deposits is surely no greater than doing so for other assets. An individual bank would clearly prefer that the depositor maintain all of his or her funds at that bank, and would prefer to eliminate the need for depositor diversification by being able to offer higher deposit insurance coverage. Nonetheless, the depositor appears to have no great difficulty—should he or she want insured deposits—in finding multiple sources of fully insured accounts.

In addition, the singular characteristic of postwar household financial asset holdings has been the increasing diversity of portfolio choices. The share of household financial assets in bank deposits has been declining steadily since World War II as households have taken advantage of innovative attractive financial instruments with market rates of return. There has been no break in that trend that seems related to past increases in insurance ceilings. Indeed, the most dramatic substitution out of deposits in recent years has been from both insured and uninsured deposits to equities and mutual funds holding equities, bonds, and money market assets. It is difficult to believe that a change in ceilings during the 1990's would have made any measurable difference in that shift. Indeed, the data indicate that the weakness in stock prices in recent quarters has been marked by increased flows into bank and thrift deposits.

Depository Institutions

Does the problem to be solved by increased deposit insurance coverage concern the individual depository institution? If so, the problem would seem disproportionately a small bank issue since insured deposits are a much larger proportion of total funding at small banks than at large banks. But smaller banks appear to be doing well. Since the mid-1990's, adjusted for the effects of mergers, assets of the smaller banks, those below the largest 1,000, have grown at an average annual rate of 13.9 percent, almost twice the pace of the largest 1,000 U.S. banks. Uninsured deposits at these smaller institutions have also grown more rapidly than at larger banks—at average annual rates of 22 percent at the small banks versus 11 percent at the large banks, both on the same merger-adjusted basis. Clearly, small banks have a demonstrated skill and ability to compete for uninsured deposits. To be sure, uninsured deposits are more expensive than insured deposits, and bank costs would decline and profits rise if their currently uninsured liabilities received a Government guarantee. But that is the issue of whether subsidizing bank profits through deposit insurance serves a national purpose. I might add that throughout the 1990's, small banks' return on equity was well maintained. Indeed, the attractiveness of banking is evidenced by the fact that more than 1,350 banks were chartered during the past decade.

Some small banks argue that they need enhanced deposit insurance coverage to equalize their competition with large banks because depositors prefer to put their uninsured funds in an institution considered too big to fail. As I have noted, however, small banks have more than held their own in the market for uninsured deposits. In addition, the Board rejects the notion that any bank is too big to fail. In 1991, Congress made it clear that the systemic-risk exception to the FDIC's least-cost resolution of a failing bank should be invoked only under the most unusual circumstances. Moreover, the resolution rules under the systemic-risk exception do not require that uninsured depositors and other creditors, much less stockholders, be made whole. Consistent with this view, the market clearly believes that large institutions are not too big for uninsured creditors to take at least some loss. Spreads on large bank subordinated debt are wider than spreads on similar debt of large and highly rated nonbank financial institutions. Indeed, there are no AAA-rated U.S. banking organizations.

To be sure, failure to index deposit insurance ceilings has eroded the real purchasing power value of those ceilings. But there is no evidence of any detrimental effect on depositors or depositary institutions, with the possible exception of a small reduction in those profits that accrue from deposit guarantee subsidies that lower the cost of insured deposits. The current deposit insurance ceiling appears more than adequate to achieve the positive benefits of deposit insurance that I mentioned earlier in my statement, even if its real value were to erode further.

Another argument often raised by smaller banks regarding the need for increased deposit insurance coverage is their inability to match the competition from those large securities firms and bank holding companies with multiple bank affiliates, offering multiple insured accounts through one organization. The Board agrees that such offerings are a misuse of deposit insurance. But, raising the coverage limit for each account is not a remedy since it would also increase the aggregate amount of insurance coverage that large multibank organizations would be able to offer. The disparity would remain.

Conclusion

Several aspects of the deposit insurance system need reform. The Board supports, with some modifications, all of the recommendations the FDIC made in the spring of 2001 except indexing the current $100,000 ceiling. The thrust of our proposed modifications would call for a wider permissible range for the size of the fund relative to insured liabilities, reduced variation of the insurance premium as the relative size of the fund changes with banking and economic conditions, and a positive premium net of rebates.

There may come a time when the Board finds that households and businesses with modest resources are having difficulty in placing their funds in safe vehicles and/or that there is reason to be concerned that the level of deposit coverage could endanger financial stability. Should either of those events occur, the Board would call our concerns to the attention of the Congress and support adjustments to the ceiling by indexing or other methods. But today, in our judgment, neither financial stability, nor depositors, nor depositories are being disadvantaged by the current ceiling. Raising the ceiling now would extend the safety net, increase the Government subsidy to banking, expand moral hazard, and reduce the incentive for market discipline, without providing any real evident public benefits. With no clear public benefit to increasing deposit insurance, the Board sees no reason to increase the scope of the safety net. Indeed, the Board believes that as our financial system has become ever more complex and exceptionally responsive to the vagaries of economic change, structural distortions induced by Government guarantees have risen. We have no way of ascertaining at exactly what point subsidies provoke systemic risk. Nonetheless, prudence suggests that we be exceptionally deliberate when expanding Government financial guarantees.

PREPARED STATEMENT OF PETER R. FISHER

UNDER SECRETARY FOR DOMESTIC FINANCE, U.S. DEPARTMENT OF THE TREASURY

APRIL 23, 2002

Mr. Chairman, Senator Gramm, and Members of the Committee, I appreciate the opportunity to provide the Administration's views on reform of the deposit insurance system. Chairman Powell and the FDIC staff are to be commended for their valuable contributions to the policy discussion of deposit insurance reform. I am also grateful for the Committee's interest in holding a hearing on this important issue.

Our current deposit insurance system is intended to balance the interests of savers and taxpayers by aiming to protect them both from exposure to bank losses and, thereby, to promote public confidence in the U.S. banking system. Consistent with this objective, the Administration believes that some improvements could be made in the system's operation and fairness. Specifically, the Administration favors reforms that would: (1) Reduce the system's procyclical bias by allowing the insurance fund reserve ratio to vary within a range and eliminating triggers that could cause sharp changes in premiums; (2) Improve the system's risk diversification by merging the bank and thrift insurance funds; and (3) Ensure that institutions appropriately compensate the FDIC for insured deposit growth while also taking into account the past contributions of many institutions to build fund reserves.

While these improvements are worth pursing, there is no sound public policy purpose to be served by an increase in deposit insurance coverage limits. There is no *financial* benefit to savers to be derived from increased coverage limits because individuals can today hold insured deposits, up to the limits, at any number of banks. The only credible benefit to savers is that of greater *convenience,* but this is of potential use to only that small fraction of the population that has sufficient savings, which they choose to hold in the form of deposits, to have any possible need for coverage in excess of $100,000. Increased coverage limits would provide no benefit to the overwhelming majority of Americans but, as taxpayers, it would expose them to additional risk. Higher coverage limits would mean greater contingent liabilities of the Government and weaker market discipline, exposing the insurance fund and taxpayers to increased risk of loss. Weighing the ephemeral benefits of increased coverage against the significant costs of added risk and the erosion of market discipline, the Administration cannot support an increase in coverage limits, whether directly or by indexing.

My statement will first discuss those reforms that we think would enhance the operation and fairness of the system. I will then review why we do not support coverage limit increases.

Reducing the Procyclical Effects of Deposit Insurance Pricing

Reserves should be allowed to grow when conditions are good to better enable the fund to absorb losses under adverse conditions without sharp increases in premiums. Allowing the reserve ratio to vary within a range would help to reduce the potential procyclical effects of deposit insurance pricing.

The existing designated reserve ratio of 1.25 percent of reserves to insured deposits was historically derived roughly as the average reserve ratio over part of the FDIC's history. As it is based on an average, it is logical to provide for reserve growth above that level when conditions are good (and for reserves to decline below that level when conditions are unfavorable).

We support the FDIC's recommendation that it have authority to adjust the designated reserve ratio periodically within prescribed upper and lower bounds. FDIC should also have greater discretion in determining how quickly it achieves the designated reserve ratio that it selects. This flexibility would help reduce potential procyclical effects by stabilizing industry costs over time and avoiding sharp premium increases when the economy may be under stress. In the context of these reforms, it would also be appropriate to eliminate the current requirement that premiums rise to a minimum of 23 cents per $100 of domestic deposits when the fund is expected to remain below the designated reserve ratio for more than a year.

We are mindful that efforts to achieve a more counter-cyclical policy require that depository institutions build insurance reserves in good times to prefund future losses. To do otherwise could leave the fund exposed to years of low reserves following a rash of bank failures in the future and could increase the likelihood of prolonged high premiums (and, at the extreme, taxpayer assistance). Such an outcome would be unwelcome both economically and politically. Determining the appropriate statutory range for the designated reserve ratio requires striking a balance between the burden of prefunding future losses and the procyclical burden of replenishing the insurance fund in a downturn. Within the range, the actual designated reserve ratio should always be under study by the FDIC, with public notice and comment concerning any proposed change. A key benefit to giving the FDIC greater flexibility to adjust the designated reserve ratio is that it may better achieve low, stable premiums over time.

Premiums, Assessment Credits, and Rebates

The FDIC currently lacks authority to charge over 90 percent of banks and thrifts any premium for deposit insurance. The insurance funds' existing capacity to absorb losses comes primarily from the high premiums paid by institutions in the first half of the 1990's. Some large financial companies have rapidly increased insured deposits in recent years through their multiple subsidiary depository institutions—without compensating the FDIC. According to FDIC data, insured deposit growth from sweep programs conducted by two of these companies has reduced the Bank Insurance Fund reserve ratio by 4 basis points. In addition, hundreds of other recently chartered banks and thrifts have never paid insurance premiums.

To ensure that institutions appropriately compensate the FDIC for insured deposit growth, Congress should remove the current restrictions on FDIC premium-setting while authorizing the agency to provide assessment credits (for example, offsets) against future premiums based on each institution's recent history of premium payments. We find reasonable proposals by the FDIC and others that would initially allocate these credits to institutions that contributed to the buildup of insurance reserves in the early-to-mid-1990's. According to FDIC, the credits would allow many of these institutions to continue to pay no premiums for a period of several years under reasonable assumptions about the health of the economy and banking system. On an on-going basis, assessment credits would permit the FDIC to collect proportionally greater payments from institutions with rapid insured deposit growth than from those growing more slowly.

As a tool for managing insurance fund reserve levels, we prefer assessment credits to rebates, which would drain the insurance fund of cash. We would also want to avoid placing a "hard cap" on the fund that would trigger large mandatory cash rebates. Such a cap would conflict with the important objectives of allowing reserve growth under good conditions and smoothing industry payments over time.

We also are sympathetic to the FDIC's request for more flexibility to vary premiums according to the risk that an institution poses to the insurance fund. Ideally, an institution's risk-based premium should account for the riskiness of its assets, the structure of its liabilities, the strength of its capital base and management, and the effect that its failure would have on insurance fund reserves. The range in premiums should be sufficiently wide to reflect the spectrum of relative financial and managerial soundness among the Nation's depository institutions, and thereby to have the desired behavioral effects.

Merging the Bank and Thrift Insurance Funds

We support a merger of the bank (BIF) and thrift (SAIF) insurance funds and we urge the Congress to merge the funds as soon as practicable regardless of whether it chooses to pursue other reforms in the near term. A larger, combined insurance fund would have a greater ability to diversify its risks than either fund separately. It would make sense to merge the funds while the industry is strong and while a merger would not unduly burden either BIF or SAIF members. A merged fund would also prevent the possibility that institutions posing similar risks could pay significantly different premiums for the same FDIC insurance, as was the case in 1995 and 1996. Incentives created by a premium disparity could result in a wasteful expenditure of industry resources in order to avoid higher assessments. Finally, a merger would underscore the fact that BIF and SAIF are already hybrid funds: each one insures the deposits of commercial banks, savings banks, and savings associations. Indeed, commercial banks now account for 43 percent of all SAIF-insured deposits. A merger would simply recognize the commingling of the funds that has already taken place and that is likely to continue.

Deposit Insurance Coverage Limits

While we support the FDIC's efforts to secure the improvements to the deposit insurance system that I have just outlined, we see no sound public policy purpose that would be served by an increase in current or future coverage limits. Consumers do not need an increase in coverage limits and would receive no real financial benefit. An increase in coverage limits would reduce—not enhance—competition among banks in general but would not predictably benefit any particular class or category of banks. Higher coverage limits would mean greater contingent liabilities of the Government and weaker market discipline, exposing the insurance fund and taxpayers to increased risk of loss.

Higher Coverage Limits Would Not Benefit Consumers

Last summer, the Treasury Department testified before a House subcommittee that we "see no evidence that the current limit on deposit insurance coverage is burdensome to consumers." Since then, we have continued to look for such evidence and found none. The vast majority of bankers with whom we have spoken since that time—from institutions of all sizes—have provided no evidence to the contrary. We have received no calls, no letters, from consumers demanding increases in coverage to avoid the inconvenience of having to place deposits in excess of $100,000 at more than one institution.

Increasing the deposit insurance limit would do very little—if anything—for most savers. Consumer finance survey data from the Federal Reserve indicate that the median deposit balance is far below the current ceiling. Only approximately 3 percent of households with deposit accounts held any uninsured deposits, and the median income of these households was approximately double the median income of households with deposits under $100,000.

Ample opportunities already exist for savers with substantial deposits—including retirees and those saving for retirement—to obtain FDIC coverage equal to several times $100,000. Without much difficulty, they may place deposits in several FDIC-insured institutions or establish accounts within the same institution under different legal capacities that qualify for separate coverage (that is, individual, joint, IRA). Many consumers feel comfortable putting substantial amounts into uninsured but relatively safe money market mutual funds, and there are other low-credit risk investments available for retirement savings or for other purposes. Thus there is no widespread consumer concern about existing coverage limits.

Higher Coverage Limits Would Not Benefit Banks or Promote Competition

Proponents of higher coverage limits have claimed that they are necessary for community banks to remain competitive in attracting funds. Yet there is no evidence that community banks have had trouble attracting deposits under the existing coverage limits. In fact, the Federal Reserve has shown that smaller banks on average have grown more rapidly and experienced higher rates of growth in both insured and uninsured deposits than larger banks over the past several years.

Furthermore, because higher coverage limits would apply to all depository institutions, multibank holding companies now offering $200,000 in coverage through two subsidiary banks would be able to offer, for example, $260,000 if the coverage limit was raised to $130,000. Thus these companies could continue offering twice the level of coverage available from a single-bank company. In fact, given the ability of major financial companies to sweep large volumes of funds between uninsured investments and insured deposit accounts in several subsidiary banks, higher coverage limits may improve the competitive position of these companies in deposit-taking vis-à-vis small banks. Therefore, it is hard to see how higher limits could improve community banks' ability to compete with larger banks for deposits.

Competition is very essential to keeping banks vital. Banks compete for large deposits by demonstrating the soundness of their balance sheet and operations to such depositors. This competition for funds enhances the entire credit allocation mechanism. In general, raising coverage limits would reduce the amount and the rigor of credit judgments by large depositors, thereby weakening the competition for funds and the efficiency of credit allocation.

Indeed, there is no credible evidence that increased coverage limits would serve to promote competition among banks. I believe that one reason the issue of coverage limits has surfaced is precisely because the decline in the real value of the coverage limit over the last two decades has served *to promote* a healthy competitive dynamic among banks in vying for the attention of customers. Continuing the current fixed ceiling on deposit insurance coverage, while permitting individuals to hold insured accounts at more than one institution, provides consumers with the potential benefits of greater total insured deposits if they need them and fosters a competitive discipline on bankers to provide quality services to their customers. Indexation of deposit insurance coverage limits would remove this discipline and only serve to reduce competition from what it otherwise would be.

Not only would higher coverage limits erode competition among banks, but also at the same time banks would face upward pressure on premiums. By diluting insurance fund reserves, higher coverage limits would mean that more reserves would be necessary just to meet the *existing* designated reserve ratio of 1.25 percent of reserves to insured deposits. Recent FDIC estimates indicate that, for example, raising the general coverage limit to $130,000 and retirement account coverage to double that amount would lower the combined fund reserve ratio initially by 4–5 basis points as existing uninsured deposits convert to insured status. As new deposits are brought into the banking system by the coverage increase, the total drop in the reserve ratio could be 9–10 basis points. Higher coverage limits for municipal deposits would result in an additional decline in the reserve ratio.

Higher Coverage Limits Would Increase Insurance Fund and Taxpayer Risks

Given the lack of potential benefits for consumers or of potential improvement in banking system competition, we cannot justify the increase in the Government's off-balance sheet liabilities that would result from higher deposit insurance coverage limits. These higher contingent liabilities enlarge the exposure of the insurance fund, and ultimately of taxpayers, to potential future losses.

Moreover, increasing the overall coverage limit could weaken market discipline and further increase the level of risk to the FDIC and taxpayers. Proposals for even higher levels of protection of municipal deposits than of other classes of deposits would only exacerbate this problem. Providing substantially higher coverage for municipal deposits would significantly reduce 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.

Weaker market discipline runs the risk of additional supervisory or regulatory measures that might eventually be necessary to offset the risks to the insurance fund and taxpayers. Because of the absence of identifiable benefits, we would want to avoid actions such as a coverage limit increase that would risk the possibility of greater cost burdens on our banking system.

Funding of Supervision Costs

In considering reform of deposit insurance pricing, it is important to recognize that a significant portion of insurance fund expenditures is not for the resolution of failing institutions, but for the FDIC's supervision of almost 5,500 State-chartered commercial and savings banks. While these State banks pay fees for the fraction of supervision performed by State authorities, they are not charged fees for the significant share of supervision that is performed by the FDIC. (State banks that are supervised by the Federal Reserve are treated in a similar manner.) National banks and savings associations, by contrast, are charged for 100 percent of their supervision, and in addition must subsidize FDIC's costs to supervise State banks through their contributions to the insurance funds (and the fund's earnings on those contributions). This uneven distribution of supervision costs is a real problem that should be addressed. All of the Federal and State bank supervisory agencies should continue to have the resources necessary to promote safety and soundness. We look forward to working with Congress and the FDIC Board to devise a solution to this problem.

Conclusion

Let me conclude by reaffirming the Administration's support for several of the deposit insurance recommendations advanced by the FDIC. We believe that these reforms would improve the operation and fairness of the system, and we look forward to working with Congress and the FDIC on their implementation. However, the Administration does not support an increase in deposit insurance coverage limits, whether by raising the limit directly or by indexation.

Thank you for the opportunity to appear before the Committee today.

PREPARED STATEMENT OF JOHN D. HAWKE, JR.

COMPTROLLER OF THE CURRENCY, U.S. DEPARTMENT OF THE TREASURY

APRIL 23, 2002

Introduction

Chairman Sarbanes, Senator Gramm, and Members of the Committee, I am pleased to have this opportunity to present the views of the Office of the Comptroller of the Currency (OCC) on deposit insurance reform. As the current and most recent past chairmen of the Federal Deposit Insurance Corporation (FDIC) have noted—and as I strongly agree—the system of Federal deposit insurance adopted by the Congress in the early 1930's has served this Nation well for the greater part of a century. No massive overhaul of the system is required to ensure that it will continue to contribute to financial confidence and stability in the 21st century.

Nonetheless, the efforts so far undertaken to address the weaknesses in the system uncovered during the banking and thrift crises of the late 1980's and early 1990's have not been entirely adequate to the task. Indeed, the legislation adopted in response to those crises has actually constrained the FDIC from taking sensible and necessary actions. This is particularly the case with respect to the FDIC's ability to price deposit insurance in a way that reflects the risks posed by different depository institutions, and to the funds' ability to absorb material losses over the business cycle without causing sharp increases in premiums. Failure to address these issues in the current financial environment poses the danger that the next major domestic financial crisis will be exacerbated rather than ameliorated by the Federal deposit insurance system.

Current legislative proposals in the House and Senate to reform deposit insurance address most, albeit not all, of the issues raised by the FDIC staff in its excellent and wide-ranging "Options Paper" released in April 2001. Among these issues are: (1) How much discretion the FDIC should have to set premiums reflecting the risks posed by individual institutions to the insurance funds; (2) Whether strict limits on the size of the insurance funds result in excessive volatility of deposit insurance premiums; (3) Whether the deposit insurance coverage limit should be increased and/or indexed to changes in the price level; and, (4) Whether the Bank Insurance Fund (BIF) should be merged with the Savings Association Insurance Fund (SAIF).

In summary, the OCC recommends that: (1) The FDIC be provided with the authority to implement a risk-based premium system for all banks; (2) The current fixed DRR be replaced with a range to allow the FDIC more flexibility in administering the deposit insurance premium structure; (3) Coverage limits on deposits should not be increased; and (4) The BIF and SAIF should be merged.

We believe that deposit insurance reform also provides an opportunity to strengthen our supervisory structure by eliminating a distortion and unfairness in the current system of funding bank supervision. Currently, a portion of the earnings on the insurance funds, which State and national banks paid into, is diverted to fund the Federal supervision of only one class of institutions, State banks supervised by the FDIC. The FDIC has elected not to pass those costs on to the banks they supervise. As a consequence, State nonmember banks pay only a small percentage of the costs of their supervision. In contrast, national banks in excess of $400 million each year to cover the full costs of their supervision by the OCC. Ending this anomaly is not just a matter of fairness to national banks. It is a necessary component of allocating the costs and benefits of deposit insurance in an equitable and efficient manner among insured banks. For that reason, in addition to our views on the issues addressed by the legislative proposals to reform deposit insurance, my testimony today will include our suggestion for remedying the inequity that exists in the funding of supervision.

Eliminating Constraints on Risk-Based Pricing

The ability of the FDIC to set premiums for deposit insurance that reflect the risks posed by individual institutions to the insurance funds is one of the most important issues in the deposit insurance reform debate. The banking and thrift crises of the 1980's revealed the weaknesses of a flat-rate deposit insurance system in which the great majority of sound, prudently managed institutions subsidize the risks assumed by a few institutions. The Congress responded to this glaring deficiency by enacting the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, which required the FDIC to establish a risk-based system of deposit insurance premiums, thereby bringing the pricing of deposit insurance more in line with the practices of private insurance companies. The FDIC's initial efforts to implement such a system made meaningful, actuarially-based distinctions among institutions based on the risk each institution posed to the insurance funds, but fell short of creating a well-differentiated structure.

Unfortunately, the Deposit Insurance Fund Act (DIFA) of 1996 diminished the FDIC's discretion to maintain, let alone improve, the risk-based structure of deposit insurance premiums. DIFA effectively prohibited the FDIC from charging a positive premium to any institution in the 1A category—that is, well-capitalized institutions with composite CAMELS ratings of 1 or 2—whenever the reserves of the deposit insurance funds are at or above the designated reserve ratio (DRR) of 1.25 percent of insured deposits. As a result, at December 31, 2001, 92.5 percent of all insured banks fell into that category, and therefore pay nothing for their deposit insurance—even though their risk of loss may be far above zero. Thus, today many institutions—some of which have never paid any deposit insurance premiums—receive a valuable Government service free, and very well-managed institutions in effect subsidize riskier, less well-managed institutions. Moreover, quite apart from the risk that a specific bank might present, banks are not required to pay even a minimum "user" fee for the governmentally provided benefit represented by the deposit insurance system—a benefit without which, as a practical matter, no bank could engage in the business of taking deposits from the public.

Aside from the obvious inequity to institutions that contributed heavily to recapitalize the funds after the losses of the 1980's and 1990's, a system in which the vast majority of institutions pays no insurance premium forgoes one of the major benefits of a risk-based pricing system—creating an incentive for good management by rewarding institutions that pose a low risk to the insurance funds. A mandated zero premium precludes the FDIC from charging different premiums to banks with different risks within the 1A category, despite the fact that within the 1A category there are banks that pose very different risks to the funds.[1]

Whenever the reserve ratio of the BIF falls below 1.25 percent, however, FDICIA requires the FDIC to charge an assessment rate to all banks high enough to bring it back to the DRR within 1 year. If that is not feasible, the FDIC must impose an assessment rate of at least 23 basis points. This sharp rise in premiums, or "cliff effect," would hit banks the hardest when they are most vulnerable to earnings pressure. To avoid creating this procyclical volatility in deposit insurance premiums, it would be preferable to offset losses to the funds through more gradual changes in premiums based on the level of the insurance fund relative to the FDIC's assessment of current risk in the banking system. In short, we believe that as risks in the banking system change relative to the level of the insurance funds, the FDIC should have the authority to adjust premiums on all banks.

Increasing Coverage Limits

The question of deposit insurance coverage limits is a challenging one, in part because it is extremely easy for depositors to obtain full insurance of deposits in virtually unlimited amounts through multiple accounts. Along with most academic economists and other bank regulators, we are convinced that the sharp increase in the deposit insurance limit from $40,000 to $100,000 in 1980—at a time when the thrift industry was virtually insolvent—was a serious public policy mistake that increased moral hazard and contributed to the weakening of market discipline that exacerbated the banking and thrift crises of the 1980's and 1990's. By encouraging speculative behavior, it ultimately increased losses to the deposit insurance funds and taxpayers.

[1] In its April 2001 Deposit Insurance Reform Options Paper, the FDIC reported that "the 5 year failure rate for CAMELS 2-rated institutions since 1984 was more than two-and-a-half times the failure rate for 1-rated institutions." (p. 13) As shown in Chart 1 on page 12, the 5 year failure rate for CAMELS 1-rated institutions (commercial and savings banks) was 0.7 percent, while that for CAMELS 2 rated institutions was 1.8 percent.

Proponents of an increase in coverage assert that it would ease liquidity pressures on small community banks and better enable small banks to compete with large institutions for deposits. None of these assertions, however, is supported by substantial evidence.

First, we see no compelling evidence that increased coverage levels would offer depositors substantial benefits. Anyone who wants to use insured bank deposits as a means of holding their wealth can do so today virtually without limits, subject only to the minor inconvenience of having to open accounts at multiple banks. Despite the ability of depositors to achieve almost unlimited coverage at banks, money market mutual funds, which have some of the same features as bank transactions accounts and generally offer higher returns than bank deposits, today hold over $2 trillion. Because these funds could easily be placed in insured accounts, these facts suggest that many depositors are not concerned about the additional risk involved in holding their liquid funds in uninsured form and that households are comfortable with the *status quo.*

Second, it is not at all clear that increasing deposit insurance coverage would result in an increase in the deposits of the banking system. One effect could be to cause a shift in deposits among banks. It is far from clear that any such redistribution of existing deposits would favor community banks. Depositors who multiply insurance coverage today by using multiple banks might consolidate their deposits in a single institution if coverage were raised, but there is no way of determining which institutions would be the ultimate beneficiaries when the switching process ended. Moreover, it is quite possible that larger, more aggressive institutions might use the expanded coverage to offer even more extensive governmentally protected investment vehicles to wealthy customers. That could cause an even greater shift of deposits away from community banks and increase the liquidity pressures felt by some.

For many of the same reasons we object to an increase in the general insurance limit, we are also concerned about proposals to use the Federal deposit insurance system to favor particular classes of depositors such as municipal depositors. For instance, at year-end 2001, commercial banks had $162 billion in municipal deposits. The FDIC estimated in 1999 that less than one-third of municipal deposits was insured. Applying that 1999 ratio to the 2001 total suggests that nearly $115 billion of municipal deposits at banks are uninsured. A significant increase in the insurance limit for municipal deposits, therefore, would undoubtedly raise the level of insured deposits and put pressure on the DRR. In addition, an increase in insured coverage could spur riskier lending because banks would no longer be required to collateralize the municipal deposits with low-risk securities.

Merger of the BIF and the SAIF

One of the least controversial issues of deposit insurance reform is the merger of the BIF and the SAIF. The financial conditions of thrifts and banks have converged in recent years, as have the reserve ratios of the two funds, removing one of the primary objections to a merger of the funds. As of the fourth quarter of 2001, the reserve ratio of the BIF was 1.26 percent, while that of the SAIF was 1.36 percent. The reserve ratio of a combined fund would have been 1.29 percent as of the same date. As is described in greater detail below, many institutions now hold some deposits insured by each fund. But under the current structure, BIF and SAIF deposit insurance premiums could differ significantly depending on the relative performance of the two funds, raising the possibility that institutions with similar risks could pay very different insurance premiums. This would unfairly penalize low-risk institutions insured by the fund charging the higher premiums.

Despite the tendency for the activities of the banking and thrift industries to converge in recent years, substantial differences remain in their portfolio composition. For example, residential mortgage loans constitute 51 percent of the assets of insured savings institutions but only 15 percent of the assets of insured commercial banks. Largely because of these differences, merger of the two funds would result in significant diversification of risks.

A related development affecting the potential for diversification is industry consolidation, which has led to an increased concentration of insured deposits in a relatively few institutions and increased the risks to the deposit insurance funds. According to the FDIC staff, the three largest SAIF-insured institutions held over 15 percent of SAIF-insured deposits in 2001, while the corresponding share of the top three BIF-insured banks was over 13 percent. Merging the funds would reduce these concentrations, and thereby the risk that the failure of a few large institutions could seriously impair the insurance fund.

Further, there is significant overlap in the types of institutions insured by the two funds. As of March 2001, 874 banks and thrifts were members of one fund but also held deposits insured by the other fund, and BIF-member institutions held 41 percent of SAIF-insured deposits. Finally, merger of the BIF and the SAIF would undoubtedly result in operational savings as the two funds were combined into one.

Increased Flexibility for the Deposit Insurance Funds

The OCC supports giving the FDIC the authority to establish a range for the DRR to replace the present arbitrary fixed DRR of 1.25 percent. The FDIC should have the authority to set the range based on its assessment of the overall level of risk in the banking system. We also believe that in establishing the range, the FDIC should provide notice and an opportunity for the public to comment on the proposed range. Adoption of a range and elimination of the 23 basis point "cliff effect" would allow the FDIC more flexibility in administering the premium structure and would minimize the likelihood of sharp increases in premiums during economic downturns when banks can least afford them.

When the funds exceed the upper boundary of the DRR range set by the FDIC, the FDIC should be authorized to pay rebates or grant credits against future premiums. To ensure that rebates or credits to insured institutions are equitable, the FDIC should have the authority to assess the nature of the institutions' claims on the funds. Institutions that have paid little or no insurance premiums to the funds have far less of a claim on rebates or credits than those that contributed to building up the funds.

While such rebates or credits seem reasonable on their face, there are two obvious principles that should be observed in determining their size and allocation. First, a system of rebates and credits should not undermine the risk-based premium system. Institutions that paid high insurance premiums because they posed a higher risk to the funds should not receive larger rebates than less risky institutions of the same size. The fact that these high-risk institutions did not fail during that period does not alter the fact that they subjected the funds to greater than average risks.

The second principle is that the payment of rebates and credits should not have the unintended consequence of exacerbating the disparity in supervisory fees that now exists between State and nationally chartered banks. Today, the FDIC charges the insurance funds for its costs of supervising State-chartered institutions. National banks, in contrast, pay the full cost of their supervision despite the fact that they have contributed almost 55 percent of the amount in the BIF. For example, in 2001, in addition to $400 million in assessments that national banks paid to the OCC for their own supervision, national banks can be viewed as contributing 55 percent, or about $273 million, of the $525 million that the FDIC spent on State nonmember bank supervision. Failure to take this into account in fashioning a rebate program would be unconscionable.

Fee Disparity

State banks, on average, pay only modest assessments to State regulators, which represent about 20 percent of the total costs of State bank supervision. Far and away the largest component of State bank supervision is that provided by their Federal regulators—the Federal Reserve, in the case of State banks that are members of the Federal Reserve, and the FDIC, in the case of nonmember State banks. In 2001, the Federal Reserve and FDIC together spent over $900 million on State bank supervision. None of this was recovered directly from the banks they supervise. The FDIC absorbs the cost of its supervisory and regulatory activities through charging the BIF and SAIF, while the Federal Reserve uses its interest earnings to absorb its supervisory and regulatory costs. Neither the Federal Reserve nor the FDIC assesses State banks for their costs in providing exactly the same supervisory functions as the OCC provides for—and assesses—national banks. As a result of this subsidy provided by the Federal Reserve and the FDIC, there is a continuing incentive for national banks to convert to State charters. Indeed, State supervisors aggressively proselytize for such conversions, heavily exploiting fee disparity as a major part of their sales pitch.

It should be emphasized that fee disparity has no relationship to the relative efficiency of national and State bank supervision. It is entirely a consequence of the fact that State banks are not charged for the major portion of their supervision costs—that provided by their Federal regulators. Indeed, the OCC has a strong externally imposed incentive to run its operations efficiently, for if it fails to do so, and must turn to its banks to pick up additional costs, it runs the risk of causing increased conversions of banks from national charters to State charters. Still, the effectiveness of supervision can suffer, and serious inequities can result, when unavoidable pressures on supervisors' budgets are created. For example, during the wave of large bank failures in the late 1980's and 1990's—a period of stress in the banking system that had not been seen since the Great Depression—significant resource demands were placed on bank supervisors in responding to severe problems in the banking system. Yet just as these demands were being felt, the banking system was under severe earnings pressure.

At the OCC this meant significant increases in direct assessments on national banks—14 percent in 1989, another 11 percent in 1991, and 30 percent in 1992. While there were reductions in assessments in subsequent years, one conclusion is inescapable: the OCC assessment mechanism works procyclically in times of stress in the banking system. At the Federal Reserve and the FDIC, similar cost increases were easily absorbed—at the FDIC out of insurance funds and at the Federal Reserve out of revenues that otherwise would have been paid over to the Treasury Department. In other words, the OCC faces the threat of reduced supervisory resources at the very time they are most likely to be needed. National banks face a higher burden of supervisory costs at the very time they are facing a troubled economy. Just as the need to address the 23 basis point "cliff effect" has gained attention, so also should the procyclical distortions raised by the present system of funding supervision.

The question, of course, is what to do about this disparity. Proposals to level the playing field by requiring the Federal Reserve and the FDIC to impose new fees on State banks have been dead on arrival in Congress. We believe it is necessary to come up with a new method of funding bank supervision—a method that will strengthen both the State and the Federal supervisory processes and ensure that all supervisors have adequate, predictable resources available to carry out effective supervisory programs without imposing additional fees on State banks.

Solution

There are a number of alternative approaches to solving this problem that one might consider, and we believe that now is the ideal time to do so, as the whole topic of the role of deposit insurance is being reexamined. An idea that we think has considerable appeal would draw on the earnings of the FDIC's insurance funds to cover the costs of both State and national bank supervision. Today, with the level of the combined funds at about $42 billion and generating earnings of around $2.5 billion per year, there are considerably more funds available to defray the costs of FDIC, OCC, and State supervision than those agencies today spend in total. Working together, and using the present costs of supervision as a baseline, State and Federal supervisors could develop a nondiscretionary allocation formula that would reflect not only the breadth of responsibilities of the agencies, but also the condition, risk profile, size, and operating environment of the banks they supervise. All agencies would remain free to impose supplemental assessments if they chose, but competitive pressures would presumably work to keep these charges at a minimum.

This arrangement would offer some meaningful advantages. First, it would remedy the inequity to national banks that exists today, resulting from the fact that the FDIC funds the supervision of only one class of banks, State nonmember banks, out of the earnings of the deposit insurance funds, to which all banks have contributed. As I mentioned earlier, we estimate that national banks have accounted for more than half of the contributions to the Bank Insurance Fund.

Another major advantage to a system under which the OCC and the State supervisory agencies would be funded out of the earnings on the insurance funds is that it would reinvigorate the dual banking system. It would create a regulatory system under which banks choose their charters on the basis of factors such as regulatory philosophy, access, and the perceived quality of supervision. The result would be competition based on characteristics of supervisors that are relevant to maintaining a safe and sound banking system.

Conclusion

The OCC supports a merger of the BIF and the SAIF and proposals to eliminate the current constraints on deposit insurance premiums. We favor elimination of the current fixed DRR and its replacement with a range that would allow the FDIC more flexibility in administering the deposit insurance premium structure. We oppose an increase in deposit insurance coverage limits at this time. Finally, as the entire role of deposit insurance is being subjected to scrutiny by policymakers and legislators, it is an opportune time to address the distortions and unfairness in the current system of funding bank supervision I have highlighted in my testimony.

PREPARED STATEMENT OF JAMES E. GILLERAN

DIRECTOR, OFFICE OF THRIFT SUPERVISION, U.S. DEPARTMENT OF THE TREASURY

APRIL 23, 2002

Introduction

Good morning, Chairman Sarbanes, Senator Gramm, and Members of the Committee. Thank you for the opportunity to discuss the Federal deposit insurance reform initiatives currently under consideration by Congress. The Office of Thrift Supervision (OTS) is fully supportive of the ongoing efforts to reform our Federal deposit insurance system.

While our deposit insurance system is the envy of many countries because of the protections and stability it provides to our citizens, it can be improved. Insured institutions continue to enjoy favorable economic conditions, which presents us with the best opportunity to improve our deposit insurance system.

Even as the bank and thrift industries have prospered, the reserve ratios for the Bank Insurance Fund (BIF) and Savings Association Insurance Fund (SAIF) have steadily declined the last several years. In fact, the decline in the BIF ratio has been fairly dramatic, dropping from 1.40 percent in June 1999 to 1.27 percent as of December 2001. The rate of decline has caused BIF-insured institutions to brace for the possibility of having to pay deposit insurance premiums in the near future if the BIF reserve ratio drops below 1.25 percent.

In the event the SAIF remains at or near its current 1.37 percent reserve ratio, which is likely based on our analysis of the current risk profile of the SAIF, this will once again create an artificial difference in the pricing of Federal deposit insurance, this time in favor of the SAIF.

Federal deposit insurance is a critical component of our financial system that enhances financial stability by providing depositors with safe savings vehicles. We should not continue to tolerate aspects of our deposit insurance system that undermine this stability.

In my testimony, today, I will address the issues that we believe are most important to enacting Federal deposit insurance reform legislation.

Federal Deposit Insurance Reform Issues

FUND MERGER

Fund merger would strengthen our deposit insurance system by diversifying risks, reducing fund exposure to the largest institutions, eliminating possible inequities arising from premium disparities, and reducing regulatory burden.

Banking and thrift industry consolidation and our experience since the BIF and SAIF were established in 1989 argue strongly in favor of merging the funds. The BIF no longer insures just commercial banks holding only BIF-insured deposits, and the SAIF no longer insures just savings associations holding only SAIF-insured deposits.[1] Today, many banks and thrifts have deposits insured by both funds. The failure of an institution holding both BIF- and SAIF-insured deposits impacts both funds, regardless of the institution's fund membership. Thus, the funds are already significantly codependent and any reason for maintaining separate funds based on the historical charter identity of each fund—banks in the BIF and thrifts in the SAIF—has diminished.

Maintaining the BIF and SAIF as separate funds also reduces the FDIC's capacity to deal with problems and introduces unnecessary risks to the deposit insurance system. Industry consolidation has greatly increased both funds' risk concentration, *for example,* the possibility that one event, or one insured entity, will trigger a significant and disproportionate loss. A merged fund would have significantly less concentration risk.

Premium disparity is another potential problem. While the funds provide an identical insurance product, keeping them separate raises the possibility of premium differentials that could handicap institutions that happen to be insured by the fund that charges higher rates. Institutions with identical risk profiles, but holding deposits insured by different funds, could pay different prices for the same insurance coverage. The BIF-SAIF premium differential that existed in 1995 and 1996 put institutions at a significant competitive disadvantage simply because they were insured by the higher cost fund. Some institutions reacted to the differential by shift-

[1] As of December 31, 2001, BIF-member institutions held 43 percent of SAIF-insured deposits, and OTS-supervised institutions held less than half—49 percent—of SAIF-insured deposits. The BIF insured almost one-third of all savings association deposits, including 20 percent of the deposits of OTS-regulated institutions.

ing deposits between funds, while others sought nondeposit funding sources. Fund merger would eliminate the possibility of a destabilizing premium differential.

Finally, merging the funds would eliminate regulatory burdens. Institutions with both BIF- and SAIF-insured deposits are required to make arbitrary and complex calculations to estimate the growth rates of deposits insured by each fund. Merging the funds would eliminate the need for these calculations.

FDIC FLEXIBILITY TO SET DEPOSIT INSURANCE PREMIUMS

The current pricing structure, which restricts how the FDIC sets fund targets and insurance premiums, tends to promote premium volatility. These restrictions not only hamper the FDIC's ability to anticipate and make adjustments to address increasing fund risks, but also make the system procyclical. Thus, in good times, the FDIC levies no premiums on most institutions. When the system is under stress, the FDIC is required to charge high premiums, which exacerbates problems at weak institutions and handicaps sound institutions. Increasing the FDIC's flexibility to set fund premiums within a target range would reduce insured institutions' exposure to overall economic conditions and to sectoral problems within the banking and thrift industries.

Providing the FDIC with increased flexibility in setting fund targets and premiums is critical to improving the insurance premium pricing structure. The current structure requires the FDIC to charge at least 23 basis points whenever a fund is below its designated reserve ratio (DRR) and cannot reach its DRR within 1 year with lower premiums. The problem is further exacerbated because the FDIC cannot charge any premiums to its lowest risk institutions when a fund is at or above its DRR and is expected to remain so over the next year. The current system tends to force the FDIC to charge either too little or too much relative to the actual, long-term insurance risk exposure of a fund. Relaxing the DRR target and the restrictions on premium setting will substantially improve the existing premium pricing structure.

OTS supports FDIC flexibility in addressing current and future risks in the deposit insurance fund, including relaxing the current DRR requirement. The FDIC should have the discretion to set the designated ratio of reserves within an appropriate range determined by Congress. The range must, however, provide sufficient flexibility to make adjustments to account for changing economic conditions.

FDIC AUTHORITY TO PROVIDE ASSESSMENT CREDITS

Granting the FDIC authority to issue assessment credits will also improve the insurance premium pricing structure. It is entirely appropriate that the FDIC be provided with sufficient flexibility to extend assessment credits to institutions when sustained favorable conditions result in lower-than-expected insurance losses. The ability to issue assessment credits will also help to reduce assessment fluctuations over time.

Authorizing the FDIC to issue assessment credits is an important element of an effective pricing system. As explained below, assessment credit authority would also help address another vexing problem for the deposit insurance funds—the "free rider" problem.

ADDRESSING THE FREE RIDER PROBLEM

Providing credits to institutions that have paid assessments into the system would address existing inequities in the system attributable to free riders that have not contributed to the fund.

The free rider problem arises from an influx of deposits into the system from new institutions that enjoy the benefits of insurance coverage without ever paying insurance premiums. This burdens the insurance funds. Some financial conglomerates have caused huge sums of funds to qualify for insurance coverage by, for instance, converting money market accounts into deposit accounts. In some cases, billions of previously uninsured dollars have been transferred to insured depositories without any contribution to the insurance fund. The result is that the amount of funds that need insurance coverage increases substantially without additional contributions into the fund to build the reserve for losses.

Perhaps more than eliminating an inequity in the Federal deposit insurance system, addressing the free rider problem will eliminate a practice that clearly undermines the safety and soundness of the Federal deposit insurance funds. Entities that grossly add to the amount of outstanding insured deposits without adding to the reserves required to insure such deposits exploit the shortcomings of the existing insurance premium pricing structure. This is a problem that must be addressed.

DEPOSIT INSURANCE COVERAGE LEVELS

Increasing the Current Coverage Level

Both the House and Senate deposit insurance reform bills propose increasing the current $100,000 insurance cap for standard accounts to $130,000. While I applaud the efforts to increase the ability of institutions—particularly small community-based depositories—to attract more deposits, I am unconvinced that increasing the insurance cap will achieve this result. I do not think this approach can be supported from a cost-benefit standpoint. Increasing the current insurance coverage level to $130,000 would incur significant costs for insured institutions since premiums would necessarily be increased.

The benefits of an increase are unclear. I have heard from many of our institutions that they see no merit to bumping up the current limit for standard accounts. In their view, projected increases in insured deposits would not lead to a substantive increase in new accounts. Moreover, individuals with amounts in excess of $100,000 already have numerous opportunities to invest their funds in one or more depository institutions and obtain full insurance coverage for their funds.

Indexing the Coverage Level

An issue closely related to increasing the current cap is indexing the coverage level so that it adjusts periodically for inflation, tied to the consumer price index or a similar benchmark. I question the practicality of the periodic costs that would be required of insured institutions to update their systems and advise customers of the change. Insured institutions would bear the costs of disclosing the new limit to consumers and changing their logos and signs with respect to the maximum insurance coverage every time the limit changes. In addition, the Federal deposit insurance funds would be exposed to increases in the coverage level from indexing. I also believe there is ample opportunity for customer confusion related to any program that would automatically increase the level of insured deposits on a periodic basis.

Increasing Coverage for Municipal Deposits

I have similar reservations regarding increasing the insurance cap for municipal deposits. Our understanding is that providing insurance coverage for municipal deposits would have a significant impact on a combined fund's reserve ratio. I cannot support the cost of this increase relative to the potential benefit derived by a small number of institutions from the increase in coverage.

Conclusion

The time is ripe for deposit insurance reform. Although the American deposit insurance system is the envy of countries and depositors all over the world, and has worked effectively to enhance financial stability and provide savers with confidence that their savings are secure, there are significant weaknesses that should be addressed.

I strongly urge consideration of a "core" deposit reform bill that would: (1) Merge the BIF and the SAIF, (2) Provide FDIC flexibility to set insurance premiums within a target range, and (3) Eliminate the free rider problem. By all accounts, fund merger is an issue whose time has come. Relaxing the fixed-target DRR and funding shortfall requirement would also eliminate pressure on the system that now exists if a fund drops below its DRR, as well as provide the FDIC the necessary flexibility to manage the fund. Finally, I believe it is imperative that we use this opportunity to eliminate the free rider problem that currently plagues the system.

Thank you for this opportunity to discuss Federal deposit insurance reform. I look forward to working with you, Senator Johnson, on your legislation; and thank you, Mr. Chairman, and the Members of the Committee for your time and attention to this issue.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM DONALD E. POWELL

Q.1. Could you provide your thoughts on Comptroller Hawke's proposal, especially in light of the FDIC's relationship with the State institutions and State banking agencies? Do you think what Comptroller Hawke has suggested is workable? If not, do you believe there is an alternative that might work better?

A.1. Well funded and independent primary supervisors are in the best interest of the FDIC. We certainly do not want to see funding problems jeopardize the ability of the financial regulators to do their job. However, it is hard to agree that the insurance funds should be used to fund the Treasury agencies' operations without accountability to the FDIC's board of directors for how the money is spent. There may be other areas we can agree to, and I hope we can make some progress on this going forward.

I asked the question, why do all of the banking regulators maintain separate offices, separate regional offices, separate administration staffs, separate computer systems, separate contracting offices, separate personnel offices, separate data collection and dissemination facilities, separate economic analysis and research functions, and separate training facilities? The FDIC is prepared to work with the OCC and OTS to eliminate back-office inefficiencies. Further, I would offer to make available more of the FDIC's supervisory resources to help these agencies with troubled banks and thrifts. This would compliment all of our interests and allow the agencies to realize some savings themselves.

Q.2. It has come to the New England delegation's attention that the Boston regional office of the FDIC will be downgraded in status, and that field offices in the region may be closed shortly as well. Would you mind briefly discussing this issue further, and what benefits these actions would pose to the industry and to the consumers alike in the region?

A.2. The FDIC's realignment of its regional structure is designed to move bank supervision and compliance and consumer affairs decisionmaking authority closer to banks and their customers. Over the years, decisionmaking authority at the FDIC has become concentrated in Washington and the regional offices. Even relatively simple functions, such as the review and approval of bank safety and soundness and compliance examination reports, have not been vested in the field offices that conduct the examinations and are closest to the situation. Rather, staff in the regional offices and sometimes in Washington have handled these functions.

The changes I announced in February will delegate substantial authority and responsibility to our field offices nationwide. Under the streamlined procedures the FDIC will implement later this year, the responsibility for reviewing and approving most examination reports and related correspondence will be shifted from our regional offices to our field offices. Rather than having to go to a regional office or Washington to discuss safety and soundness or compliance issues, banks with low-risk profiles and their customers will be able to go to their local field offices that will be fully empowered to address most issues that arise. This means the day-to-day contact between banks and the FDIC will be conducted by

FDIC staff who are most familiar with the institutions and any special local circumstances.

Our New England operations currently are dispersed among five field offices with a combined authorized staff of 152 safety and soundness and compliance examiners. These offices are located in Waltham, MA; Foxboro, MA; Holyoke, MA; Concord, NH; and Hartford, CT. The overwhelming majority of FDIC-supervised institutions in New England will have little or no need to deal with any FDIC office other than their local field offices, which will have the necessary delegated authority to address routine safety and soundness and compliance issues for most institutions. We are now in the midst of a comprehensive review of our field office infrastructure nationwide to determine whether it continues to be supported by our current workload. We do not yet know how this review might impact any of the five New England field offices. A final decision on changes to the existing nationwide field office infrastructure will be made in the near future. Regardless of the substance of those decisions, however, I want to emphasize that our current overall examiner staffing levels in New England accurately reflect our 2002 workload projections and will be unaffected by realignment of our New England field office infrastructure.

Large institutions and a few small institutions with higher risk profiles will have more substantial contact with regional officials. For that reason, our regional structure is being intentionally realigned in a manner that ensures that all or most of that contact for New England institutions will occur in the Boston office. We are retaining case managers, compliance review examiners, community affairs professionals and other technical staff in the Boston office. We also are retaining an executive-level position in the Boston office to oversee and direct our safety and soundness examination program in New England and will delegate broad authority to that individual to resolve bank supervisory issues.

We agree that we must continue to maintain effective oversight of FDIC-supervised institutions in New England in order to avoid a repetition of the problems that we experienced a decade ago. This was a key consideration in our decision to retain a dedicated executive and other staff in the Boston office to focus exclusively on the safety and soundness of FDIC-supervised institutions in the New England States. Under our streamlined procedures, even if an institution's issues cannot be handled by the local field office, there should be little or no need for bank supervisory issues arising from New England institutions to be referred to the New York regional office. This approach also will ensure that economic conditions or potential risks that are unique to the region are fully and appropriately considered.

In addition to moving decisionmaking closer to banks and consumers, the FDIC's realignment will achieve a reduction in the size and costs of our regional management and support infrastructure. Our current eight-region structure has been in place since 1987, when we had approximately 8,500 FDIC-supervised institutions nationwide. The number of FDIC-supervised institutions has declined by 35 percent, to about 5,500 since that time, but there has been no corresponding reduction in the size of our regional infrastructure. Our plans to streamline our regional and field office structure nationwide will result in an estimated $11.7 million in savings annually in salary and benefits costs. The elimination of five authorized positions (three executives and two support positions) in the Boston office is one component of these savings.

The decision to realign our Boston and New York offices into a single region reflects a continuing decline in workload, particularly in the Boston office's jurisdiction. In the 5 year period from 1997 to 2002, the number of bank examiners that are required in the five New England field offices to perform safety and soundness examinations has declined from 215 to 122, a 43 percent decline. That is the largest drop of any of our eight regions. The realigned region will have 282 safety and soundness bank examiners (approximately 18 percent of our safety and soundness bank examination workforce nationwide) and they will be responsible for 665 FDIC-supervised institutions (approximately 12 percent of FDIC-supervised institutions nationwide). That is comparable to the current workload in the other regions in our realigned structure. This decline in workload reflects the significant changes that have occurred in the financial industry and is not unique to New England.

I want to assure you that the FDIC shares your concern that we maintain an active and vigilant presence in the New England States. I believe that our planned regional realignment has been carefully and prudently structured to accomplish that purpose. By taking greater advantage of our existing field office structure and shifting decisionmaking authority closer to the banks and their customers, I believe that we will improve service both in New England and across the country.

Q.3. What are the potential costs to the deposit insurance system, and to the U.S. taxpayer that uses it, if the system is not reformed soon? In other words, if the funds remain unmerged, if the designated reserve ratio remains a "hard target," and if the premium system remains procyclical, what effect will that have on institutions and the customers they serve when we have a severe economic downturn and there are several more large bank failures?

A.3. If a deposit insurance fund's reserve ratio falls below the 1.25 percent DRR, the FDIC is required by law to raise premiums by an amount sufficient to bring the reserve ratio back to the DRR within 1 year, or charge at least 23 basis points until the reserve ratio meets the DRR. Thus, if a fund's reserve ratio falls sufficiently below the DRR, then current law requires that the average premiums must increase to 23 basis points, at a minimum. The potential for 23 basis point rates is problematic because, during a period of heightened insurance losses, both the economy in general and depository institutions in particular are more likely to be distressed. A 23 basis point premium at such a point in the business cycle would drain over $10 billion (before taxes) from depository institutions in 1 year, assuming current assessment bases. This money could be used to create a multiple amount of new loans.

Because the funds are separate, high rates could apply only to members of one fund, which would mean that institutions that posed identical risk to the fund could be paying very different rates for deposit insurance, simply because of their fund membership. These differing rates would lead to competitive imbalances and time consuming and wasteful attempts to switch deposits from one fund to another, as we saw in the early 1990's.

An umnerged fund also creates higher risk for the taxpayers. In FDIC simulations of a combined versus separate funds, a combined fund was less likely to become insolvent.

In addition, because we cannot price deposit insurance properly for risk right now, some riskier banks are not bearing their fair share of deposit insurance costs. At present, 92 percent of banks and thrifts are well-capitalized and well-managed and, under the restraints of current law, pay the same rate for deposit insurance—zero. Significant and identifiable differences in risk exposure exist among these 92 percent of insured institutions. To take just one example, since the mid-1980's, institutions rated CAMELS 2 have failed at more than 2½ times the rate of those rated CAMELS 1.

Over the course of the business cycle, some riskier banks will pay too little for deposit insurance. Conversely, some less risky banks will pay too much. Because the current law does not allow the FDIC to charge appropriately for risk, the potential for moral hazard is increased. The FDIC's proposals would decrease the potential for moral hazard, resulting in safer and sounder banks.

RESPONSE TO WRITTEN QUESTION OF SENATOR BUNNING FROM DONALD E. POWELL

Q.1. Chairman Powell, I wanted to follow up on my question from the April 23, 2002, Senate Banking Committee hearing about the cost of FDIC reform proposals to individual banks. Can you tell me how much both S. 1945, and the House-passed H.R. 3717 would cost a small bank, under $100 million in assets with a 1 or 2 rating? I realize this question may be somewhat subjective, but my Kentucky bankers need to know how much these proposals will cost them, if at all, before they can decide whether or not to support the legislation.

A.1. Initially, I would point out that there could be a cost to individual banks if no legislation is passed. The reserve ratio of the Bank Insurance Fund currently is 1.26 percent of insured deposits. If the reserve ratio drops below 1.25 percent, the FDIC is required by law to increase premiums on all institutions to return the reserve ratio to 1.25 percent within 1 year or charge a minimum premium of 23 basis points until the fund reaches that level. There is a potential cost to the industry whether or not the legislation passes. The issue is really who pays, how much, and when do they pay. The legislation would place the assessment burden on riskier, new, and fast-growing institutions. In addition, the proposal would provide the FDIC with the flexibility to manage the fund within a range and avoid the procyclical effect of the current law.

Disregarding the effect of coverage increases, the net cost to the industry of the FDIC's recommendations over the long run should be zero. Our goal is not to increase overall revenues, rather, to distribute the assessment burden more evenly over time and more fairly across insured institutions, so that riskier banks pay more.

Higher coverage complicates this picture. If the reserve ratio drops, but the designated reserve ratio (DRR) remains at 1.25 percent, the industry will pay to get back to 1.25 percent. The actual assessment burden will be different for different institutions. For example: (1) Those who paid in the past will have credits and will be able to defer payments (please see the attached estimated assessment credits for Kentucky institutions); (2) The safest banks will face a maximum charge of one basis point annually so long as the fund reserve ratio is not below 1.15 percent; and (3) Riskier banks likely will pay more than under the current system (this will be subject to notice and comment rulemaking). The ultimate cost to safer institutions depends on how long their credits last. Some institutions may have enough credits to avoid paying any assessments to return the fund to the DRR. In any case, much of the assessment burden due to higher coverage (if any) will fall on riskier, new and fast-growing institutions.

* * * * *

ESTIMATED ASSESSMENT CREDITS FOR FDIC-INSURED INSTITUTIONS IN KENTUCKY

Because many banks will receive an initial assessment credit, they should initially be able to offset the credit against their premium for some time. Attached are estimates based on the best available information of the initial assessment credit that each Kentucky bank and thrift would receive under S. 1945, as introduced, and under H.R. 3717, as amended and adopted by the House of Representatives. *

Under both bills, eligible FDIC-insured institutions would share a one-time assessment credit pool. That pool would be $5.4 billion under H.R. 3717 (12 basis points of the combined assessment base of the Bank Insurance Fund and the Savings Association Insurance Fund as of December 31, 2001) and $4 billion under S. 1945 (9 basis points of the combined assessment base as of December 31, 2001). Under both bills, each institution's share of the assessment credit would be calculated by dividing its 1996 assessable deposits by the combined industry assessment base. Assessment credits would be applied to reduce deposit insurance assessments payable after the law becomes effective.

The attached estimates also show how long the assessment credit would last if the institution were charged assessment rates of 2, 3, or 4 basis points. Actual rates may differ, of course, and will be substantially higher for riskier institutions.

The estimates are only intended to provide illustrative examples of how individual institutions might be affected given present versions of the bills and given reasonable assumptions. The actual effect of the bills could be different.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM ALAN GREENSPAN

Q.1. Can you elaborate a bit more on why you think that, at the very least, there should not be any indexing of deposit insurance coverage for individual accounts? Isn't it inequitable to subject the value of deposit insurance coverage to annual inflationary erosion, when we constantly index Social Security and Medicare? Don't you think this difference is highlighted even more so since the level of deposit insurance coverage has not changed for 22 years?

* Estimates are held in Banking Committee files.

A.1. The Board understands that not indexing deposit insurance means that the real level of insurance coverage per account will continue to decline. The Board and many other observers, however, believe that raising the level to $100,000 in 1980 was a serious mistake, contributing significantly to the thrift crisis of the 1980's. In this sense, not increasing the insurance cap now helps to reverse a previous policy mistake.

Equally important, and as I indicated in my statement, there is virtually no evidence that either consumers of financial services or small banks need an increase in coverage. There is every indication that, especially given the innovations in financial services in recent years, depositors are able to acquire safe assets, that it is not difficult for households to diversify their risks by using multiple banks or multiple accounts, and that small banks are able to compete successfully for uninsured deposits. On balance, this seems hardly the time to increase moral hazard or undermine market discipline, especially since we can find no problem that an increase in coverage is designed to solve.

Q.2. What are the potential costs to the deposit insurance system, and to the U.S. taxpayer that uses it, if the system is not reformed soon? In other words, if the funds remain unmerged, if the designated reserve ratio remains a "hard target," and if the premium system remains procyclical, what effect will that have on institutions and the customers they serve when we have a severe economic downturn and there are several more large bank failures?

A.2. Today, both the BIF and the SAIF provide identical products to insured depository institutions at the same price. However, unless the funds are merged, in a future crisis prices in the two funds could easily diverge, thereby creating unjustified inequities between insured depositories and destabilizing incentives for depositories, and perhaps their customers, to move between the funds. Both effects would tend to make the banking system less stable precisely at the time other policy actions are trying to increase stability. Leaving the designated reserve ratio as a "hard target" and continuing to limit the FDIC's pricing flexibility could be even more destabilizing. Under current rules, even fairly mild losses to either fund could result in a very large premium increase in a crisis. Such an increase would, among other things, impair the ability of banks and other insured depositories to make loans to households and businesses when such credit might be very important to encouraging an economic recovery. In addition, under current rules the FDIC is highly constrained in its ability to build up the insurance funds in good times and draw down the funds in bad times, a limitation that is also procyclical. As I indicated in my statement, greater flexibility both in managing the funds' reserve ratio and in pricing deposit insurance would substantially reduce the procyclicality of the current deposit insurance system and thus facilitate management of any future banking crisis. The Board strongly supports increased flexibility in both dimensions and urges the Congress to act now when a crisis is not upon us.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM PETER R. FISHER

Q.1. Can you elaborate a bit more on why you think that, at the very least, there should not be any indexing of deposit insurance coverage for individual accounts? Isn't it inequitable to subject the value of deposit insurance coverage to annual inflationary erosion, when we constantly index Social Security and Medicare? Don't you think this difference is highlighted even more so since the level of deposit insurance coverage has not changed for 22 years?

A.1. Unlike all other Government programs where benefits have been indexed, the deposit insurance system permits individual savers to choose to receive deposit insurance benefits in excess of the fixed, nominal limit. In fact, those individuals with substantial deposits, at very little inconvenience to themselves, may place funds in any number of insured institutions in order to obtain 100 percent coverage. And, as the FDIC's own website explains, they may also place funds in the same institution under different legal capacities that qualify for separate coverage. Consequently, the erosion over time in the real value of the $100,000 limit—a limit per depositor per bank—does not reduce the benefits of FDIC insurance available to depositors.

We believe that the relevant issue is whether the erosion in the $100,000 limit by inflation has had, or will have in the foreseeable future, a material adverse effect on consumers. We see no evidence of such an effect, nor do we see evidence that any consumer benefits from indexing would outweigh the risks to the insurance funds and taxpayers of weakened market discipline and greater Government contingent liabilities.

In our view, the decline in the real value of the $100,000 limit over the last two decades has served *to promote* a healthy competitive dynamic among banks in vying for the attention of customers. Maintaining the current fixed limit, while permitting individuals to hold insured deposits at more than one institution, provides consumers with the potential benefits of greater FDIC coverage if desired and fosters a competitive discipline on bankers to provide quality services to their customers. Indexing would reduce this discipline and serve to reduce competition from what it otherwise would be.

Q.2. What are the potential costs to the deposit insurance system, and to the U.S. taxpayer that uses it, if the system is not reformed soon? In other words, if the funds remain unmerged, if the designated reserve ratio remains a "hard target," and if the premium system remains procyclical, what effect will that have on institutions and the customers they serve when we have a severe economic downturn and there are several more large bank failures?

A.2. Our current deposit insurance system fulfills its primary objective of balancing the interests of savers and taxpayers by aiming to protect them both from exposure to bank losses and, thereby, to promote public confidence in the U.S. banking system. If unchanged, we believe it will continue to work as is. We support many of the reform proposals, however, because we believe they will make meaningful improvements to the current system, improvements that may be particularly noticeable during periods of economic stress. For example, the rigidities in the current pricing structure and reserve ratio could exacerbate an economic downturn in which the FDIC suffered substantial losses. By allowing the insurance fund reserve ratio to vary within a range and eliminating triggers that could cause sharp changes in premiums, the deposit insurance system should be less procyclical. Similarly, it makes sense to merge BIF and SAIF because a larger, combined insurance fund would have a greater ability to diversify its risks than either fund separately.

We are mindful that efforts to achieve a more countercyclical policy require that depository institutions build insurance reserves in good times to prefund future losses. To do otherwise could leave the fund exposed to years of low reserves in the event of a rash of bank failures in the future and could increase the likelihood of prolonged high premiums (and, at the extreme, taxpayer assistance). Such an outcome would be unwelcome. Determining the appropriate statutory range for the designated reserve ratio requires striking a balance between the burden of prefunding future losses and the procyclical burden of replenishing the insurance fund in a downturn. Within the range, the actual designated reserve ratio should always be under study by the FDIC, with public notice and comment concerning any proposed change. A key benefit to giving the FDIC greater flexibility to adjust the designated reserve ratio is that it may better achieve low, stable premiums over time.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM JOHN D. HAWKE, JR.

Q.1. Can you elaborate a bit more on why you think that, at the very least, there should not be any indexing of deposit insurance coverage for individuals' accounts? Isn't it inequitable to subject the value of deposit insurance coverage to annual inflationary erosion, when we constantly index Social Security and Medicare? Don't you think this difference is highlighted even more so since the level of deposit insurance coverage has not changed for 22 years?

A.1. Under our current deposit insurance system depositors can obtain insurance in virtually unlimited amounts through multiple accounts. Unlike other Federal entitlement programs, such as Social Security and Medicare whose value to recipients erodes with increases in the price level, the value of deposit insurance coverage that individuals can obtain is not meaningfully reduced by inflation, because of the current flexibility that depositors have to obtain multiple coverage. At worst, inflation simply adds to the transactions costs associated with maintaining coverage for individuals who find it necessary to open multiple accounts to obtain the insurance coverage they desire. Nonetheless, I would not object if a provision to index the present coverage level were to be included in a comprehensive deposit insurance reform bill.

Q.2. Can you elaborate a bit more on why the proposal you have offered dealing with a funding mechanism for State bank supervision is a fair one for State banks and national banks alike? Do you believe that if a mechanism, such as the one you have proposed, is not instituted shortly, that the status quo could prove harmful to the national bank system?

A.2. As a matter of fairness to State and national banks, our proposal is far superior to the current system. As detailed in my written statement, national banks pay the full cost of their supervision through assessments they pay to the OCC. In contrast, State supervisors levy fees that vary widely and on average, cover only about a fifth of the total cost of supervising State banks. State banks make no explicit payments for the largest component of their supervision—supervision at the Federal level provided by the Federal Reserve, in the case of Federal Reserve member State banks, and the FDIC, in the case of nonmember State banks.

Our proposal would address these inequities by providing an identical mechanism for funding the supervisory activities of the FDIC, State supervisors, and the OCC. Each supervisor's activities—not solely the FDIC's supervisory activities—would be funded from income earned by the insurance funds. As a result, going forward, neither State supervisors nor the OCC would have to rely solely on assessments on supervised banks to fund their activities.

Under our proposal, the FDIC, OCC, and the State supervisors would jointly develop an objective allocation formula for the funding of bank supervision. The starting point for that process would be the current levels of each agency's supervisory expenditures. For an agency like the OCC, whose entire mission is bank supervision, all of its operations would be funded under the formula. On the other hand, for entities that carry out multiple functions, only the entities' direct and indirect supervisory expenditures attributable to State-chartered banks would be funded under the formula.

The formula would take account of both the number of institutions that an agency supervised and the total assets under supervision. It would also incorporate the financial condition and growth of the institutions. The objective, quantitative nature of the formula for determining the amount paid to each supervisory agency would provide State supervisors with a more regular, predictable source of funds and enable them to supervise more effectively and independently.

Addressing the fee disparity issue would strengthen the dual banking system and eliminate an artificial distortion in the funding of bank supervision. I agree with the other witnesses at the hearing that the national bank charter is and will remain an attractive means of offering financial services. I am concerned, however, about the potential for a longer term erosion in the viability of the national bank charter if national banks alone are required to cover the full cost of their supervision, as well as a significant portion of the cost of the Federal supervision of State banks through their contributions to the deposit insurance fund.

Q.3. Comptroller Hawke, I understand that the OCC has prepared a "White Paper" detailing your proposal on how to deal with national bank State bank examination fees. Could you please submit that for the record?

A.3. We are pleased to submit our paper, "Reforming the Funding of Bank Supervision," for the record.

Q.4. I was also intrigued by Fed Chairman Alan Greenspan's comments proposing an alternative funding source for the OCC. Would you please comment on the Chairman's idea that the OCC should be funded by appropriated money from Congress? Why do you think this might be a bad idea? Are there any other alternatives besides the current system and an appropriations-driven system? Do we need to change the current funding system in your view?

A.4. If providing appropriated funds to the OCC would subject the supervision of national banks to the budget and appropriations process, we would oppose the idea.

Since the very inception of the national banking system, Congress has scrupulously insulated bank supervision from the political process—just as it has insulated the formulation and execution of monetary policy. Today, none of the bank regulatory agencies are subject to the appropriations process. Removing that critical separation of bank supervision and the appropriations process would clearly run the risk of injecting political considerations into banking supervision, thus undermining the objectivity and integrity of the supervisory process.

The FDIC's operating revenues are taken out of the deposit insurance funds, which have been built up over the years through the payment of premiums by all insured banks. The Federal Reserve System's primary source of income is earnings on its holdings of U.S. Treasury securities. After covering its expenses, the Federal Reserve returns those funds to the Treasury. Thus, one could argue that taxpayer dollars, in effect, fund the Federal Reserve System. But this use of taxpayer funds is a vastly different process than subjecting a banking agency's budget to annual appropriations. Certainly, if there were any serious case for subjecting bank supervision to the kind of political oversight involved in the budget and appropriations process—and we do not believe that there is any—it would be impossible to rationalize treating *only* national banks in this fashion, while leaving Federal supervision of State banks to be self-funded through the use of the Federal Reserve's earnings and the FDIC insurance fund.

Comptroller of the Currency
Administrator of National Banks

Reforming the FUNDING OF BANK SUPERVISION

MAY 2002

Introduction

This paper addresses a fundamental flaw in our system of bank supervision — the way supervision is funded.[1] It also offers a proposal for fixing this flaw. The proposal not only would enhance the resources available to assure quality supervision of our nation's banking system, but would reduce the assessments now imposed on both national and state banks to pay for their own supervision — with no additional cost to taxpayers.

Background

Under the present system, national banks pay the full costs of their supervision through assessments levied on them by the Office of the Comptroller of the Currency (OCC), the federal agency that charters and supervises national banks.

State-chartered banks, by contrast, pay only for that small fraction of their supervision that is provided by state supervisory agencies. The predominant part of state bank supervision actually comes from two *federal* agencies, the Federal Reserve System (FRS) and the Federal Deposit Insurance Corporation (FDIC).[2] These federal agencies perform exactly the same supervisory functions for state banks as the OCC performs for national banks. The main difference is that the FRS and the FDIC do not assess state banks for the costs of their supervisory services.

In 2001, these two federal agencies spent almost $913 million on state bank supervision, none of which was recovered from the banks they supervise.

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[1]This is the second edition of *Reforming the Funding of Bank Supervision,* which supersedes the July 2001 edition.

[2]The FRS supervises state banks that have elected to become members of the Federal Reserve System. The FDIC supervises federally insured nonmember state banks.

The current situation is a problem that Congress needs to fix because:

It's Unfair. The present system is doubly unfair to national banks: they not only are fully charged for the costs of their own supervision, but they also have contributed a substantial portion of the deposit insurance premiums that the FDIC relies on to fund its supervision of state nonmember banks. The present system also unfairly imposes on taxpayers and on the FDIC insurance fund the costs of federal supervision of state banks.

It Distorts the Dual Banking System. Healthy competition in the quality of supervision and innovation in meeting the needs of banks and their customers should lie at the heart of our dual banking system. Unfortunately, today a primary focus of this competition is on price. Because state banks receive a federal subsidy for the predominant part of their supervision, there is a cost incentive for banks to avoid or depart from the national charter in favor of the heavily subsidized state charter. This tends to undermine a vigorous and healthy dual banking system.

It Compromises Safety and Soundness. The present system of funding bank supervision works procyclically. It threatens national banks with additional cost burdens in times of economic stress, and it imposes constraints on supervisory resources at the very time they are most likely to be needed. When there is widespread stress in the banking system, as there was in the late 1980s and early 1990s, significantly increased supervisory attention is demanded and supervisory costs rise. As this occurs, healthy national banks, which already pay more than their state counterparts, face the prospect of substantial increases in assessments to pay the costs of more intensive supervision of problem banks. This creates a strong incentive to convert to a state charter. Such conversions, in turn, reduce the resources available to OCC to fund increased supervisory needs.

It's Inconsistent with Deposit Insurance Reform. A fundamental principle at the heart of deposit insurance reform is that subsidies should be eliminated. Healthy, well-managed banks should not be required to bear the costs and risks presented by less well-managed, riskier banks. By the same token, national banks should not be forced to bear the costs of supervising and insuring state banks. Any proposals to reform the deposit insurance system must inevitably come to grips with this inequity in the system, just as they must focus on such fundamental issues as the appropriate size of the insurance fund and how rebates, if any, should be distributed. Since the principal purpose of bank supervision is to protect the insurance fund, the manner in which supervision is funded is inextricably bound up with the subject of reform of the deposit insurance system.

Discussion

The following discussion elaborates on each of these points.

The Present System is Unfair to National Banks and to Taxpayers

The three federal bank supervisory agencies — the OCC, the FRS, and the FDIC — perform virtual identical functions with respect to the banks they supervise, as is demonstrated by Table 1.

Table 1 The Federal regulatory agencies have virtually identical supervisory responsibilities.

Responsibilities	OCC	FDIC	FED
Safety and soundness exams	X	X	X
CRA Exams	X	X	X
Fair Lending Exams	X	X	X
Enforce Bank Secrecy Act	X	X	X
Regulation	X	X	X
Entry	X	X	X
FFIEC	X	X	X
Enforce the Securities Exchange Act of 1934	X	X	X
Branch Applications	X	X	X
Merger & Consolidation Applications	X	X	X
Enforce Capital Requirements and PCA	X	X	X
Truth in Lending Act Examinations	X	X	X
Right to Approve Directors and Senior Execs	X	X	X
Authority to Prescribe Oper and Mgrl Stds	X	X	X
Supervisory Enforcement Actions	X	X	X
Supervise Foreign Activities	X	X	X

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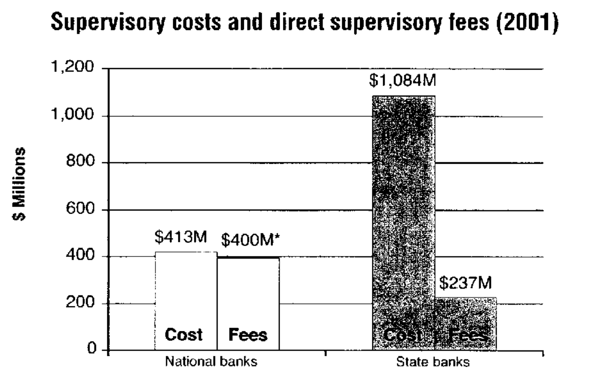
Indeed, for more than 30 years, whenever Congress has enacted new bank regulatory laws, it has almost always parceled out identical supervisory and enforcement responsibilities to the three federal agencies. As a result, the FRS and the FDIC today perform the predominant part of state bank supervision.

Yet the burden of funding supervision falls with vastly disproportionate weight on national banks. As shown in Table 2, virtually the entire

Table 2 Supervisory fees paid by national banks cover 100% of their supervision costs. Supervisory fees paid by state banks cover only 22% of their supervision costs.



* The OCC's total revenue for 2001 was $413M. The additional $13M represents ancillary income.

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amount of the cost of national bank supervision in 2001 was borne by national banks. By contrast, only 22 percent of the total cost of state bank supervision — that is, the costs of both state and federal supervisors — was paid by state banks, in the form of assessments by their state supervisors. The lion's share of these costs — 78 percent — reflecting the costs of the FRS and the FDIC, were absorbed by those federal agencies.

To understand how this federal subsidy unfairly impacts taxpayers and national banks, it is important to understand how the FRS and the FDIC are funded and how those funds are spent.

The FRS derives most of its revenues from open market operations — that is, from the earnings on its portfolio of government securities. Any portion of those earnings remaining after the FRS subtracts its costs of operation are paid over to the U.S. Treasury for the benefit of taxpayers. As shown in

Table 3, in 2001, the FRS spent about $322 million (out of $32 billion in total revenue) on its supervision of state banks. Thus, the costs of supervision of state banks by the FRS are, in practical effect, borne by all American taxpayers.

Table 3 It cost $1.5 billion to supervise BIF insured banks in 2001.

State Bank Supervision	$ Millions	%
➢ FED allocated approximately $644 million of its $2.6 billion budget to supervision of banks and bank holding companies (1,500). Approximately half of this amount was allocated to supervision of state member banks.	322	30
➢ FDIC allocated approximately $525 million of its $1.4 billion budget to supervision of BIF-insured state non-member banks.	525	48
➢ State bank supervisors spent approximately $237 million on the supervision of state banks in 2001.	237*	22
Total Cost of State Bank Supervision	**1,084**	**100**
National Bank Supervision		
➢ OCC allocated $413 million for its operations.	413	
Total Cost of Commercial Bank Supervision	**1,497**	

* Based on state banking department FY 2001 budgets as reported in CSBS, *A Profile of State Chartered Banking*, 2000.

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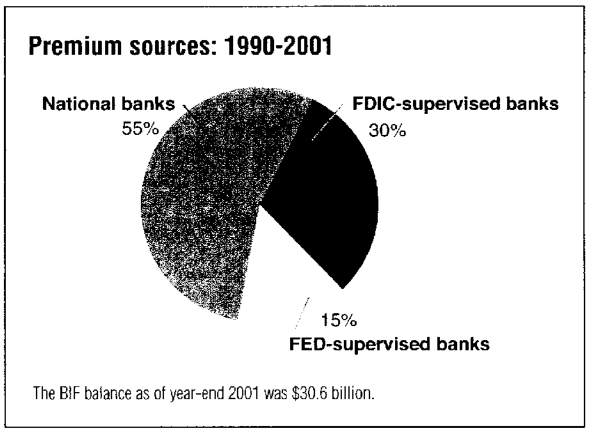
The FDIC's operating revenues are taken out of the deposit insurance funds, which have been built up over the years through the payment of premiums by all insured banks. In 2001, the FDIC tapped into the funds for a total of $1.4 billion, of which $591 million was spent on the supervision of state banks. Of this amount, $525 million was attributable to the FDIC's supervision of state-chartered commercial banks, and $66 million to its supervision of state-chartered thrift institutions.

As the holders of the largest share of the nation's bank deposits, national banks have always been the largest contributors to the bank insurance fund, and therefore to FDIC revenues. As shown in Table 4, national bank

Table 4 Over one-half of the premiums paid into the Bank Insurance Fund since 1990 have come from national banks.



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contributions today account for almost 55 percent of the funds in the FDIC's Bank Insurance Fund — and, by extension, 55 percent of the earnings that are used by the FDIC to supervise state nonmember commercial banks. *In other words, 55 cents of every dollar expended by the FDIC on state nonmember commercial bank supervision is attributable to payments by national banks.*

To be sure, state banks have contributed to the insurance funds just as have national banks. *But the fact remains that state banks receive their federal supervision free of cost, while national banks bear the full cost of their supervision.*

There is no justification for a federal policy that subsidizes state banks, yet leaves national banks to bear the full cost of their supervision. Such a policy is especially unwarranted when the majority share of that subsidy is involuntarily funded by national banks through their contributions to the FDIC insurance fund.

The Present System Undermines the Dual Banking System

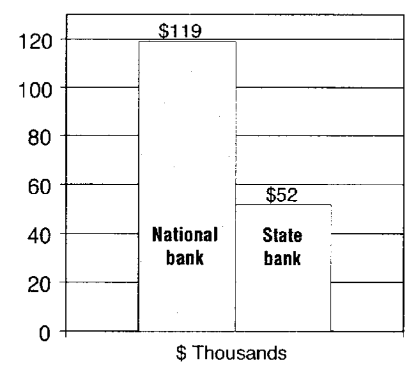
Historically, the choice between a national or state charter centered on such things as supervisory philosophy and responsiveness, examination quality, and the scope of permissible activities. The cost of supervision was generally a minor factor. But that's no longer the case.

Today the costs of supervision have increased by orders of magnitude, largely because of laws that Congress has put in place over the past three or four decades to strengthen supervision and to increase protections for consumers — laws that Congress has charged the *federal* supervisors with the responsibility for enforcement. Since the FRS and the FDIC absorb those costs for state banks, while the OCC must pass them on to national banks, the disparity in supervisory costs paid by state and national banks has increased commensurately.

Thus, as shown in Table 5, state banks today pay supervisory costs on average less than half of what comparably sized national banks pay.

Table 5 Because state banks do not pay for their federal supervision costs, their supervisory fees average less than half those of national banks.

Average Assessment for a $500 million bank*



* Average fees paid in California, Delaware, Florida, Illinois, New York, and Texas, 2001.

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To compound the unfairness, many state bank supervisors today actively proselytize for charter conversions on the basis of the fee differential, in effect exploiting the value of the subsidy provided to state banks by the taxpayers and the FDIC. Thus, the fee disparity creates a significant incentive for a banker to choose a state over a national charter — to opt, in effect, to be the recipient, rather than the donor, of a subsidy.

If large numbers of banks were to make that choice — and the current pressures for cost reduction gives them a strong incentive to do so — the national bank charter could be seriously undermined. The result, perversely, would ultimately be to increase the cost to taxpayers and the insurance fund, since banks that convert from national to state charters would no longer pay the full costs of their federal supervision, and it would fall to the FRS and the FDIC to pick up *all* of the additional supervisory costs.

The Present System Compromises Safety and Soundness

The current funding system works procyclically to reduce supervisory resources precisely when they are most likely to be needed and to increase the cost burdens on national banks at the very time they are grappling with an economy under stress. Of all the perversities in our system, none is more serious.

We saw this process at work during the wave of large bank failures in the late 1980s and early 1990s — a period of stress in the banking system not seen since the Great Depression. Supervisors were under mounting pressure to monitor and manage the crisis. Yet each bank failure translated into a reduction in the base on which assessments could be levied to support the agencies' increased costs. At the OCC this meant significant increases in assessment rates — 14 percent in 1989, another 11 percent in 1991, and a whopping 30 percent in 1992.

Assessment rates were subsequently lowered when the crisis subsided and the industry returned to health. But it is unfair that our system requires well-managed banks to provide the additional supervisory resources needed to deal with problem institutions. *This is a flaw in the system that must be addressed.*

Moreover, even in times of relative economic calm, the present system can adversely affect the supervision of national banks. Given the concentration of assets in the banking system today, the loss of even a single large national bank — whether due to merger, conversion, or failure — could have a huge impact on the OCC's operating budget. Faced with the loss of a substantial part of its assessment base, the OCC would have only two choices: either to reduce its supervisory resources or to increase assessments on the remaining institutions.

State bank supervisors face a similar problem. In half the states, a single bank accounts for 25 percent or more of the asset base on which state supervisors base the assessments they need to fund their offices. Thus, the loss of such a large bank could have a crippling effect on a state supervisor's ability to provide quality supervision.

Deposit Insurance Reform Offers an Opportunity to Mend the Present System

A fundamental principle on which all of the current proposals for deposit insurance reform are based is that cross-subsidies in the system should be eliminated. Banks should contribute to the insurance funds based on the risks they present, and healthy banks should not be required to bear the costs and risks of providing deposit insurance to poorly managed, troubled banks.

Eliminating the fee disparity between national and state banks is an inextricable component of deposit insurance reform. National banks have, in effect, been forced to contribute more to the deposit insurance fund than they rightfully should, because more than half of their contributions to the fund go not for insurance coverage, but to defray the FDIC's costs of supervising state banks. *Any proposal to reform deposit insurance must deal with this cross-subsidy as much as it must deal with the risk subsidy provided by less risky banks.*

The FDIC's initiative to review and revise the deposit insurance system has focused on a number of fundamental issues relating to such questions as how deposit insurance premiums should be set, what the appropriate size of the deposit insurance funds should be, and how rebates, if any, should be distributed once the size of the fund exceeds some specified limit. Although some aspects of the FDIC's proposal are controversial, the debate over deposit insurance reform has been characterized by broad agreement that any reform program should advance the goals of efficient and equitable distribution of the costs and benefits of deposit insurance.

In that context, it's particularly important that we address the supervisory funding issue. *As long as premium income or the revenue it generates is used to fund the federal supervision of only one part of the industry, the FDIC's deposit insurance premium structure — even a revised one — cannot equitably price insurance coverage.* Remedying this inequity and separating the actual costs of the FDIC's supervisory functions from the costs of providing deposit insurance is an essential step toward efficient and rational pricing of both.

How to Fix the Problem

Any proposal for reform of our system of supervisory funding must pass several basic tests. It should

- Strengthen both the federal and state supervisory processes, and protect them from the impact of random structural changes in the banking system;
- Enhance the *qualitative* aspects of competition within the dual banking system;
- Promote a fair and efficient deposit insurance system;
- Ensure that all supervisors, state and national, have adequate, predictable resources available to carry out effective supervisory programs.

While there have been many different proposals to those ends, we believe that the most straightforward solution would be to develop a common approach to funding supervision. Since effective supervision is a critical component of a sound deposit insurance system — and since state nonmember supervision is already funded from the FDIC insurance fund — it makes sense to extend the existing arrangement to cover the costs of both state *and* national bank supervision from the FDIC fund. In other words, instead of funding supervision through direct assessments on banks, it should be funded by payments to supervisors — the OCC and state supervisors — from the insurance fund, to which *all* banks contribute.

How Would It Work?

Under a proposal the OCC has developed, the costs of both national bank supervision by the OCC and state bank supervision by the states would be paid from the FDIC insurance funds, as follows:

- Working with the FDIC, the OCC and state supervisors would jointly develop a formula for allocating funding based initially on current levels of funding.

- The formula would take into account both the number of institutions and total assets under supervision, as well as the financial condition and growth of the institutions.
- In subsequent years, the baseline allocation would be no less than the supervisors' costs for the preceding year, unless the baseline were adjusted to take account of changes in relevant factors.
- In no event would allocations exceed the investment earnings of the insurance funds for the preceding year. If earnings were insufficient to cover the baseline allocations, payments would be reduced pro rata. No payments could be made from the funds' principal.
- The agencies would retain the authority to impose supplemental assessments on their banks to meet unusual demands.

In short, this proposal would transfer the direct costs of supervision from the assessment process to the insurance funds — which, of course, have been built up by the very same banks that have paid national and state assessments.

The proposal would not involve any new costs for state banks. Indeed, the proposal envisages that assessments on state banks would be eliminated or reduced significantly.

Won't FDIC funding of state supervisors' activities subject those state agencies to FDIC control?

No. The OCC recognized the potential for increased FDIC control over the supervisory activities of the states (as well as over the supervisory activities of the OCC) when we designed our proposal. To preclude that possibility, our proposal would have the FDIC, OCC and the state supervisors jointly develop an objective allocation formula for the funding of bank supervision. The starting point for that process would be the current levels of the respective agencies' expenditures. For an agency like the OCC, whose entire mission is bank supervision, all of its operations would be funded under the formula. On the other hand, for entities that carry out multiple functions, only the entity's direct and indirect supervisory expenditures attributable to state-chartered banks would be funded under the formula. The formula would accommodate both the number of institutions that an agency supervised and the total assets under supervision. It would also incorporate the financial condition and growth of the institutions.

The OCC believes that the objective, quantitative nature of the formula determining the funding for bank supervision would eliminate the basis for the FDIC exercising any type of policy control over the budgets of the state supervisors or the OCC. In fact, our proposal will provide state supervisors with a more regular, predictable source of funds, which may enable them to reduce their reliance on the FDIC's and Federal Reserve System's supervisory resources. This will enable the states to enhance their role in the supervision of their own state-chartered banks.

Can the Funds Afford It?

It is clear that the FDIC funds could easily carry the costs of these allocations. In fact, the Bank Insurance Fund (BIF) alone could support the additional OCC and state supervisory costs. Today BIF holds almost $31 billion in assets. Over the past seven years, BIF's investment income — that is, excluding any premium income — has averaged more than $1.6 billion a year, or nearly 144 percent of the *combined* 2001 supervisory expenses of the OCC, FDIC, and the 50 state supervisors. Thus, even in the absence of premium payments, BIF is currently generating more than enough investment income to defray the supervisory expenses of the OCC and the states, and the FDIC as well.

What Benefits Would It Bring?

There would be enormous benefits to such a new approach to the funding of supervision, with no perceptible downside. Specifically,

- It would place supervision on a sounder and fairer footing, relieving national banks of the burden of subsidizing their state bank competitors, without threatening FDIC resources.
- It would be a step toward allocating the costs and benefits of deposit insurance in an equitable and efficient manner, thus facilitating deposit insurance reform.
- It would ensure that all supervisors have the resources necessary to provide effective bank supervision, regardless of changes in the economy or the structure of the banking system.
- It would revitalize the dual banking system to move beyond the current charter price competition and recapture the elements of the dual banking system that have made it vital to the fabric of our nation's banking system: creativity, efficiency, and healthy competition.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM JAMES E. GILLERAN

Q.1. Can you elaborate a bit more on why you think that, at the very least, there should not be any indexing of deposit insurance coverage for individual accounts? Isn't it inequitable to subject the value of deposit insurance coverage to annual inflationary erosion, when we constantly index Social Security and Medicare? Don't you think this difference is highlighted even more so since the level of deposit insurance coverage has not changed for 22 years?

A.1. There are four factors that frame my view on indexing:

First, current rules governing Federal deposit insurance coverage provide substantial latitude to depositors interested in obtaining full insurance coverage for all of their savings. By distributing their savings among different types of accounts and at different depository institutions, the minority of the families holding more than $100,000 in deposits can protect every dollar of savings with FDIC deposit insurance. Although individual accounts are limited to $100,000 deposit insurance coverage, American families are not. There does not appear to be a need for indexing in order to preserve full coverage of individual savings.

Second, the Federal deposit insurance funds would be exposed to higher risks from increases in the coverage level from indexing. Current reserves in the Federal deposit insurance funds are based on the current exposure of the funds from existing insured deposits. Increasing the amount of deposits covered by the insurance funds increases the funds' exposure because the same amount of reserves must now protect more deposits.

Third, the increase in insured deposits covered by the funds from indexing will eventually require higher deposit insurance premiums from insured institutions. While it has been suggested indexing is an important issue for smaller institutions, I have seen no data supporting the notion that raising deposit coverage levels will benefit smaller institutions. In addition, this creates the possibility that larger institutions, able to draw on a much larger (existing and potential) customer base, would be able to attract new deposits, with the result that smaller institutions will bear part of that cost.

Finally, indexing would incur significant and ongoing administrative costs related to disclosing the new limit to consumers and changing forms, contracts, signs, and informational materials. These costs would ultimately be borne, at least in part, by customers in the form of higher fees or lower interest rates paid on deposits. Many of the institutions I have spoken to regarding this issue have highlighted the cost aspects of indexing as a reason why it should be viewed negatively by institutions *and* their customers.

Q.2. What are the potential costs to the deposit insurance system, and to the U.S. taxpayer that uses it, if the system is not reformed soon? In other words, if the funds remain unmerged, if the designated reserve ratio remains a "hard target," and if the premium system remains procyclical, what effect will that have on institutions and the customers they serve when we have a severe economic downturn and there are several more large bank failures?

A.2. I support enactment of core deposit insurance legislation that merges the funds, gives the FDIC flexibility to set premiums based on a target reserve ratio range, and eliminates the free rider problem. Without this legislation, a severe economic downturn and additional large institution failures exposes the funds to the following effects:

- **BIF-SAIF Premium Disparity.** A premium disparity between the BIF and the SAIF could develop if one of the funds is exposed to proportionally higher losses or deposit growth than the other. This could occur despite the fact that both funds provide identical deposit insurance coverage. The BIF-SAIF disparity of the mid-1990's demonstrated that premium differentials are destabilizing because institutions shift deposits to the less expensive fund or, alternatively, seek nondeposit funding sources to avoid the cost of the higher premium. Fund merger eliminates this problem.
- **Increased Concentration Risk.** Industry consolidation will continue to increase both funds' concentration risk, for example, the risk that one event, or one insured entity, will trigger a significant and disproportionate loss. As of December 31, 2001, the largest BIF-insured institution, accounted for 7.8 percent of BIF-insured deposits; and the largest SAIF-insured institution, held 8.2 percent of SAIF-insured deposits. A fund merger as of December 31, 2001, would have had the largest BIF institution accounting for only 6.9 percent of combined deposits and the largest SAIF member holding only 2.1 percent of combined deposits. Fund merger would moderate concentration risk and reduce pressure for higher premiums.
- **FDIC Flexibility to Address Problems.** A severe economic downturn coupled with several large institution failures could force the FDIC to impose high premiums under the current statutory premium framework. This could increase the risk of failure of other troubled institutions, stress healthy institutions, and hamper the ability of all institutions to finance activities that would help to improve the economy. FDIC flexibility to anticipate insurance fund needs and to build sufficient reserves (within a statutory designated range) while the economy is growing would better equip the funds to address problems during an economic downturn.
- **Free Rider Problem.** A number of large financial firms continue to shift customer assets into insured accounts without paying insurance premiums for that coverage. This increases the insurance risk to the funds, accelerates the likelihood of a deposit insurance premium, and obligates all member institutions to pay higher premiums when necessary to restore fund reserve ratios.