S. HRG. 108–340

THE FEDERAL DEPOSIT INSURANCE SYSTEM

HEARING

BEFORE THE

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

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

ON

THE CONDITION OF THE FEDERAL DEPOSIT INSURANCE SYSTEM AND TO CONSIDER REFORMS WHICH WOULD MAKE IT MORE EFFECTIVE

FEBRUARY 26, 2003

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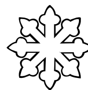

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THE FEDERAL DEPOSIT INSURANCE SYSTEM

WEDNESDAY, FEBRUARY 26, 2003

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

The Committee met at 9:40 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The Committee will come to order.

Chairman Greenspan, Under Secretary Fisher, Chairman Powell, Comptroller Hawke, Director Gilleran, good morning. Thank you for coming. Sorry you had to wait a few minutes.

The purpose of this hearing is to discuss the present condition of the Federal Deposit Insurance System and to consider reforms which would make it more effective.

Deposit insurance has been a crucial part of the overall banking regulatory structure for almost 70 years. It has functioned well in protecting the deposits of millions of Americans. In turn, by providing this protection, it has virtually eliminated the bank panic phenomenon, thus serving to stabilize the banking system and the overall economy.

These positives aside, however, providing deposit insurance creates the real possibility that taxpayers could be forced to bear significant liabilities. This is due to the fact that the system operates by putting the full faith and credit of the Federal Government behind every insured deposit.

Let's be clear on this point—"full faith and credit" of the Federal Government means "full and direct access" to the taxpayer's wallet. Those of us who participated in the clean-up of the savings and loan mess right here in this Committee know firsthand the potential magnitude of this cost to taxpayers.

Such are the tensions within the deposit insurance system: It stands to protect individual depositors, thereby protecting banks and the overall economy. But this can only be achieved by exposing taxpayers to considerable liabilities.

I believe it is our responsibility to appreciate and maintain the appropriate balance between these forces, should we entertain any reforms of the system.

In this regard, I believe that the FDIC has raised some reform proposals that appropriately achieve this balance. For example: I support building more flexibility into the system to provide the regulators greater ability to work with, rather than against, the

economic cycle; I think developing a more finely-tuned, truly risk-based methodology for pricing insurance would be a positive development because, under such a system, the cost of insurance would be more closely linked to risks of claims against the fund; the system would also be better served if every institution holding insured deposits actually paid some amount for the coverage provided; and, it seems the factors which led to the creation of separate banking and savings insurance funds no longer exist and greater efficiencies could be achieved by combining these funds.

It is my hope that the witnesses can provide more comprehensive analysis regarding these reforms proposals.

I would like to close by again thanking the panelists for appearing today and by pointing out that a narrow window of opportunity is presently open—the insurance system is basically sound and the banking industry is in relatively good condition.

Working together, I think that we can seize this opportunity and move forward common-sense reforms—reforms which protect depositors and taxpayers and ultimately make a good system better.

Senator Enzi.

STATEMENT OF SENATOR MICHAEL B. ENZI

Senator ENZI. Thank you, Mr. Chairman. I also want to thank you for holding this hearing. I want to thank the distinguished witnesses for being here today.

As everyone knows, the House Financial Services Committee passed its version of deposit insurance reform last year. And I think it is important that the Senate keep pace on this critical issues. I am very happy that the Chairman has included this as a priority and made this one of the first topics that the Committee will address.

I also want to thank the Members with whom I have worked on this issue in the past. There is legislation that we cosponsored. I believe this legislation will be an excellent starting point that provides good direction for the Committee as we deliberate the issue.

I think a number of issues can be agreed upon by nearly everyone, and I would hope that the few remaining issues won't 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.

The legislation which I have been supportive of, addresses a number of problems in 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. Therefore, they should 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, the 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 that this issue is of critical importance. I thank you for holding this hearing and I look forward to working with you and the other Members and for the information we will get today.

Chairman SHELBY. Thank you, Senator.

Senator Carper.

COMMENTS OF SENATOR THOMAS R. CARPER

Senator CARPER. Thank you, Mr. Chairman. And welcome to our witnesses this morning.

I am the only Democrat here today. I am the only Democrat on the Committee who is not running for President.

[Laughter.]

Chairman SHELBY. Yet.

[Laughter.]

Senator CARPER. If we get any more Senate Democrats running for President, I may get to be leader or something before we are done. But I wouldn't bet on that.

[Laughter.]

I am delighted that you are each here. Chairman Greenspan was just with us 2 weeks ago and spoke at some length about the geopolitical uncertainties that we face around the world and how those need to be addresses and resolved in order for our economy truly to be moving forward.

We talked a bit about the uncertainties that can hamper and hinder an economic recovery. One of the uncertainties that we never want to grapple with again is the uncertainty that when people put their money in the bank, their credit union, their thrift, that that money is safe when they need it and when they need it, it is there to be called upon.

These are fairly complex issues, as you know. And my experience both in the House Banking Committee where I served with our Chairman and some others here, was that, to the extent that the regulators and the industry can find common ground on most of these issues, it certainly helps us in figuring out what course we should pursue.

So, we are looking for that consensus here today and we thank you for your testimony, and for your stewardship.

I am going to leave because I have a couple of other hearings to attend. When I leave, I am not going to announce my departure, but I will be back later this morning and pick up on the questions and answers.

Again, thank you all.

Chairman SHELBY. Senator Hagel.

COMMENTS OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Chairman, thank you. I add my appreciation to Senator Enzi's and Senator Carper's comments about your initiative in holding this hearing.

As you know, Mr. Chairman, I am one of the Senators who sponsored legislation in the last Congress, and again have introduced, along with Senator Enzi and others, a piece of legislation which I appreciate again your consideration of in this hearing.

I would add my thanks to our panelists. We appreciate you being here this morning. We also appreciate very much what you do day-to-day and your colleagues. Please give them our thanks as well.

These are important times. Some, at the risk of being a shameless politician, might even dare say, historic times. Certainly, they are times that will frame and shape much of the history of our country and the world, not just in the financial institutions industry, but everything connected to that, and everything is connected to what you do. We do not deal with these issues in vacuums, whether it is war or peace or terrorism. They are driven, much as Chairman Greenspan said before this Committee a couple of weeks ago, by the two pillars of anything that maintains order and prosperity and growth, and those are confidence and stability.

So, we appreciate you being here, Mr. Chairman. I have a statement that I will ask to be submitted for the record.

Chairman SHELBY. It will be made a part of the record, without objection.

Senator HAGEL. Thank you very much.

Chairman SHELBY. Senator Corzine.

COMMENTS OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman. I also welcome all the witnesses, an august group who I think have done a great job in protecting our financial system and I am looking forward to hearing their comments.

I think there is a lot of agreement with respect to the subject matter. It is one that needs attention while so many other major things go on in our world. But I hope that we can have a good question and answer session and get this issue wrapped up and moved forward.

Thank you.

Chairman SHELBY. Senator Sununu.

COMMENTS OF SENATOR JOHN E. SUNUNU

Senator SUNUNU. Thank you, Mr. Chairman.

Given the amount of agreement that there seems to be, I only hope that as we go through this legislation, that it is really just good policy considerations that drive the structure of the final legislation, that we maybe can put aside some of the more parochial political dots or drivers in this debate and just get the job done. There is a lot of consensus, and I look forward to the testimony.

Thank you.

Chairman SHELBY. Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman.

I want to commend you for putting together such a distinguished panel that can give us a great deal of advice, and thank our panelists for taking the time to meet us. Chairman Greenspan has been particularly generous with his time lately.

I want to comment on a matter of grave concern to me.

Just two weeks ago, Chairman Greenspan appeared before our Committee as part of our oversight of the Federal Reserve Board and he has been very generous with his time in that regard. And

while some of us may have disagreed from time to time with the Chairman, we have always respected his service and recognized the importance of an independent Federal Reserve Board. When differences have come up, they have been over policy. They have not been personal.

I just have to say, Mr. Chairman, that I am deeply troubled by the public reports of the Administration's anger at Chairman Greenspan. There seems to be an ongoing orchestrated whisper campaign to discredit the Chairman and certainly the views that he sent out 2 weeks ago.

It seems there is a clear message being sent out—you are either with us or against us. There can be no independent view.

Well, in my judgment, Chairman Shelby, this is an extremely dangerous precedent. It violates the very structure of the Federal Reserve since 1913, I think, when it was first set up. It should be independent and there should be no heavy-handed attempts to corrupt the objectivity of the Fed that is so vital to the confidence of our markets.

So given the fragile state of those markets, and I come from New York, I have to seriously question the judgment when some in the Administration publicly pursue this kind of course.

Two years ago, Chairman Greenspan supported the principle of tax cuts. The Administration was very comfortable then with his remarks, presumably, because at that time, they could be interpreted to support the Administration's position. I did not like those. But that is not the issue here.

I do not believe that the Chairman was taking a Republican position then. I do not think he is taking a Democratic position now. I think the Chairman speaks with the best interests of the economy and the country in mind.

So all of this whispering and all of this desire to muffle the Fed, not to say that they disagree with the views, but to say that the Chairman should go, the Chairman has outlived his usefulness, I think is very bad, for the Fed, for investors, and for our country.

And so, today, along with Senator Corzine, I will be introducing a sense of the Senate resolution supporting the independence and objectivity of the Fed and of keeping Chairman Greenspan in as long as he wants to.

I hope every Member of this Committee will join in supporting me in this resolution, and I thank you, Mr. Chairman.

Chairman SHELBY. Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Thank you, Mr. Chairman.

I have to say something briefly about my colleague's comments.

I have been talking with Members of the Administration and they were pleased with the testimony from the Chairman. The Members of the Administration that I have talked with felt that the comments Chairman Greenspan was making were actually quite helpful. I think most of the Members on this side thought his comments that were made in the past were helpful.

I do not understand all of the furor or currently, any kind of whisper campaign. I have certainly not heard anything about that.

I have always greatly respected Chairman Greenspan and his comments and I look forward to hearing his testimony today. In fact, my colleagues have already congratulated you, Mr. Chairman, for the quality of the testimony you have brought before the Committee today. I would like to join that chorus in thanking you for getting such good quality here before us.

As cosponsor of the deposit insurance reform, obviously, I am pleased that you have made this one of your priorities, Mr. Chairman. The time is right, I believe, to move forward with deposit insurance reform. We are approaching the point where the FDIC may be forced to impose premiums. Should this be necessary, I want to ensure that they have the tools and flexibility necessary to maintain an adequate reserve without imposing unnecessary or unfair standards on banks.

I am very pleased that we may be reaching consensus on many elements of deposit insurance reform. In fact, I believe that there is an agreement on the majority of issues. I am hopeful that we can work together in a bipartisan manner to find solutions to the remaining concerns.

I have heard from many of my Colorado banks about the importance of the reforms. By moving forward in a careful manner, we can ensure that they are best able to serve their customers and that American consumers retain their confidence in our Nation's banking system. In Colorado, we have a lot of smaller banks. Deposit insurance reform has been an important issue as far as our community banks are concerned.

Finally, I would like to offer my sincere thanks to the witnesses for being here today. As top Administration officials, I can appreciate the incredible demands on all of your time. Your testimony at today's hearing will certainly provide the expertise necessary to move this issue forward, and I do look forward to your testimony.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Crapo.

COMMENTS OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you, Mr. Chairman. I would like to just echo the comments of my colleague, Senator Allard. I was present when the Chairman was giving his testimony as well and did not notice anything that I found objectionable in it, nor have I heard anything coming from the Administration or otherwise. In fact, I have heard in my discussions with officials in the Administration that they felt that the Chairman's comments have been very helpful in helping the country to understand the dynamics that we face in our budgeting process this year.

I want to again thank the Chairman for his continued efforts to work with this Congress and with this Administration and the people of this country as we deal with some of the more difficult economic times that we have faced in a long time.

I think that with regard to the legislation we are facing today, it also needs to have very serious focus. I thank the Chairman for holding this hearing and I look forward to the information that we will get from this distinguished panel.

Thank you.

Chairman SHELBY. Senator Bennett.

COMMENTS OF SENATOR ROBERT F. BENNETT

Senator BENNETT. I will stipulate that the Fed should be independent, that Mr. Greenspan should be retained, and that *The New York Times* should be disbelieved.

[Laughter.]

Senator SCHUMER. Mr. Chairman, I would just ask unanimous consent to——

Chairman SHELBY. Let's finish our order first.

Senator SCHUMER. Okay.

Chairman SHELBY. Senator Stabenow.

COMMENTS OF SENATOR DEBBIE STABENOW

Senator STABENOW. Thank you, Mr. Chairman. And welcome to all of our guests who are testifying today. Chairman Greenspan, it is good to see you again.

I would like to commend the Chairman for reigniting the debate over deposit insurance reform early in the session. We appreciate that very much.

I would commend Senators Johnson and Hagel for the excellent work that they have done in putting together a reform proposal. Their bill, the Safe and Fair Deposit Insurance Act, is a solid and reasoned approach and I was proud to be a cosponsor in the last session and to be a cosponsor again this session with them.

It was almost 2 years ago that then-FDIC Chair Donna Tanoue brought her case to the Congress that it was time to address flaws in the deposit insurance system—while the industry was in good shape, she said, and the overwhelming majority of institutions remain healthy. I agreed with her then, and agree with her now, that we still need to be addressing these issues.

So, I look forward to working in a bipartisan way, Mr. Chairman, and with Members of the Committee, and hopefully, we will be successful in passing this important legislation.

Chairman SHELBY. Thank you.

Senator Miller.

COMMENT OF SENATOR ZELL MILLER

Senator MILLER. I do not have any statement, Mr. Chairman. Thank you.

Chairman SHELBY. Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman. I would just ask unanimous consent to submit into the record an article by Robert Novak, hardly someone who agrees with *The New York Times* and someone close to the Administration saying, "Goodbye, Greenspan," the first sentence of which reads: "It is difficult to exaggerate the aggravation at the White House over Alan Greenspan's gratuitous shot at President Bush's tax cuts. So angry are the President's advisors that they are willing to consider not reappointing Greenspan next year."

Chairman SHELBY. Without objection, so ordered. I think it has been all over America, anyway. So it can come into the record.

[Laughter.]

Chairman Greenspan, you have a statement. Please proceed as you see fit.

[Laughter.]

You take as long as you want, Mr. Chairman.
[Laughter.]
I hope you are there as long as you want to be.
[Laughter.]
We all would stipulate that the Fed is independent, both Democrats and Republicans. And gosh, it is going to remain independent. Especially under your tenure. I know that.

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

Chairman GREENSPAN. Thank you, Mr. Chairman. Speaking for my colleagues, as well as for myself, we thank you.

Chairman SHELBY. Thank you.

Chairman GREENSPAN. Mr. Chairman and Members of the Committee, it is a pleasure to appear once again before this Committee to present the views of the Board of Governors of the Federal Reserve System on deposit insurance reform.

As I indicated to this Committee last April, the Board strongly supports a number of changes to deposit insurance, including a wider permissible range for the size of the fund relative to insured deposits, reduced variation of the insurance premium over the economic cycle, a positive and more risk-based premium net of rebates for all insured depositories, and merging of the BIF and the SAIF.

However, the Board continues to be very much in opposition to any increase in the deposit insurance coverage limits.

The reasons for our views are discussed more fully in my full statement, which I ask to be included in the record. In the next few minutes, I hope to highlight some of the critical points.

Deposit insurance was adopted in this country as part of the Great Depression legislative framework for limiting the impact of that disaster on the American public. My reading of the debates 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.

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 applied to deposits, as you may recall, 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 very beginning, deposit insurance involves a trade-off. 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 by inducing greater 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' interests. The crafting of reforms of the deposit insurance system must struggle to balance these trade-offs.

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, causing a further reduction in market discipline and inducing additional risk-taking by 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, of course, the economy.

The Board supports merger of the BIF and the 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 reached 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 important bulwarks 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.

Our surveys of consumer finances indicate 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 institutions.

If the problem that raising the ceilings is seeking to address is at depository institutions, it would seem disproportionately related

to small banks 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, the smaller banks' assets and uninsured deposits have expanded at over 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 additional deposit insurance serves a national purpose.

I might add that throughout the 1990's, and into the present century, small banks' return on equity has been 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 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 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 we be exceptionally deliberate in expanding Government financial guarantees.

Thank you, Mr. Chairman. I look forward to your questions.

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

I have a written statement I would like to be a part of the record.

Chairman SHELBY. It will be made part of the record.

Mr. FISHER. Let me summarize our views.

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

We support a merger of the Bank Insurance Fund, the BIF, and the Savings Association Insurance Fund, the SAIF, as soon as prac-

ticable. A larger, combined insurance fund would be better able to diversify risks, and thus withstand losses, than would either fund separately. Merging the funds while the industry is strong and both funds are adequately capitalized would not burden either BIF or SAIF members.

We support greater flexibility for the FDIC in managing the level of fund reserves. Reserves should be allowed to grow when conditions are good. This would enable the fund to better absorb losses under adverse conditions without sharp increases in premiums. In order to achieve this objective and also to account for changing risks to the insurance fund over time, we support greater latitude for the FDIC to alter the designated reserve ratio within statutorily prescribed upper and lower bounds. Within these bounds, the FDIC should provide for public notice and comment concerning any proposed changes to the designated reserve ratio. The FDIC should also have discretion in determining how quickly it meets the designated reserve ratio as long as the actual reserve ratio is within these bounds. If the reserve ratio were to fall below the lower bound, the FDIC should restore it to within the statutory range promptly, over a reasonable but limited timeframe.

Every day that they operate, banks and thrifts benefit from their access to Federal deposit insurance. For several years, however, the FDIC has been allowed to obtain premiums for deposit insurance from only a few insured institutions. Currently, over 90 percent of banks and thrifts pay nothing to the FDIC. Thus, there is little opportunity to do what any prudent insurer would do—adjust the premiums for risk.

Today, a bank can rapidly increase its insured deposits without paying anything into the insurance fund. Some large financial companies have greatly augmented their insured deposits in the past few years by sweeping uninsured funds into their affiliated depository institutions—without compensating the FDIC at all.

To rectify this “free rider” problem and ensure that institutions appropriately compensate the FDIC commensurate with their risk, Congress should remove the current restrictions on FDIC premium-setting. In order to recognize past payments to build up current reserves, we support the proposal to apply temporary transition credits against future premiums that would be distributed based on a measure of each institution’s contributions to the build-up of insurance fund reserves in the early to mid-1990’s.

We would prefer to avoid rebates, which could drain the insurance fund of cash. Over much of its history, the FDIC insurance fund ratio remained well above the current target, only to drop into deficit conditions by the beginning of the 1990’s. However, we think a system of ongoing transition credits to compensate for the rapid growth of funds in some institutions as opposed to others could achieve much the same end.

The improvements to the deposit insurance system that I have just outlined are vital to the system’s long-term health. Increases in FDIC benefits, however, including any increases in the level of insurance coverage are not part of the solution to these problems and should be avoided.

When I testified before this Committee last April, I argued at some length that an increase in deposit insurance coverage limits

would serve no sound public policy purpose. Nothing has occurred since that would change that view.

The Administration continues to propose raising coverage limits in any form. Unlike other Government benefit programs, there is no need for indexation of deposit insurance coverage because savers can now obtain all the coverage that they desire through multiple banks and through other means. We feel that the entire issue of coverage limits, regrettably, diverts attention from the important reforms that are needed.

In conclusion, I reaffirm the Administration's support for the three-part framework that I have outlined and I encourage this Committee and Congress to give Chairman Powell and the FDIC staff the tools they need to run a better deposit insurance system for the country.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you.

Chairman Powell.

STATEMENT OF DONALD E. POWELL
CHAIRMAN, BOARD OF DIRECTORS OF THE
FEDERAL DEPOSIT INSURANCE CORPORATION

Chairman POWELL. Chairman Shelby and distinguished Members of the Committee, thank you for your leadership in holding this hearing today. Deposit insurance reform is a top priority of the FDIC this year and we appreciate the Committee making it an early priority as well.

An effective deposit insurance system contributes to America's economic and financial stability by protecting depositors. For more than three generations, our deposit insurance system has played a key role in maintaining public confidence. While the current system has been effective to date, we are committed to working with you and the financial services sector to improve it.

Today, I want to emphasize three elements of deposit insurance reform that would do just that: One, merging the Bank Insurance Fund and the Savings Association Insurance Fund; two, improving the FDIC's ability to manage the merged fund; and, three, effectively pricing premiums to reflect risk.

First, merging the funds. As most of you know, the banking and thrift crisis of the last decade left the FDIC administering two deposit insurance funds—one to guarantee bank deposits, and the other to guarantee thrift deposits. But now, 10 years later, industry trends have left no meaningful distinction between the two. We should merge the funds into a single Deposit Insurance Fund that will be stronger and will treat all deposits the same.

Second, improving the FDIC's ability to manage the merged fund. The FDIC is prohibited from charging any premiums to most banks in good economic times. That means that during difficult economic times, the FDIC is forced by law to levy steep premiums on the industry. Doing so would further stress the country's financial institutions at the very time when, as a matter of economic necessity, we would be asking banks to strengthen their balance sheets and to extend credit.

Third, effectively pricing premiums to reflect risk. Under current law, safer banks are forced to subsidize riskier banks. This is un-

fair. Just as unfair is the fact that new deposits are able to enter the system in good times without paying any premiums for deposit insurance. Almost one thousand banks have entered the system since 1996 without paying any premiums for Federal deposit insurance. We have an opportunity and, in my view, the responsibility to the American people to remedy these problems.

So the Federal Deposit Insurance Corporation recommends the following:

—Eliminating the hard targets and triggers in the current law.

—Allowing the FDIC to manage the size of the insurance fund within a range.

—Permitting the FDIC to charge steady, risk-based premiums to allow the insurance funds to build up in good times and to be drawn down during bad times.

—Permitting the FDIC to charge all insured institutions appropriately for risk at all times so that safer banks do not unnecessarily subsidize riskier banks.

These methods for pricing and managing financial risk are best practices in the private sector and we would like to manage our system in much the same way.

With some flexibility in fund management, we can alleviate the problems with the current system while strengthening our ability to deal with any future crisis. We are not asking for absolute discretion. We recognize the need for accountability and will work with you to ensure a system that provides it.

The reforms I just described are critical to improving the deposit insurance system. Another issue that has been the subject of much discussion is deposit insurance coverage. Some have said that coverage should be higher; some have said lower. Our position is simply to maintain its value through indexing.

Again, we appreciate the Committee's leadership in deposit insurance reform. I look forward to working with you to get this job accomplished.

Thank you.

Chairman SHELBY. Comptroller Hawke.

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

Mr. HAWKE. Chairman Shelby and Members of the Committee, I am very pleased to have this opportunity to present the views of the Office of the Comptroller of the Currency on deposit insurance reform.

For almost 70 years, Federal deposit insurance has been one of the cornerstones of our Nation's economic and financial stability. Federal deposit insurance restored public confidence in the banking system after the Great Depression and made it possible for the United States to weather subsequent banking crises with minimum disruption to our economy.

Nonetheless, our current deposit insurance structure is flawed. Some of these flaws date to the inception of the deposit insurance system. Others have been introduced over the years, sometimes with the best of intentions. For example, legislation adopted in response to the banking and thrift crises of the 1980's and the early

1990's has had the effect of preventing the FDIC from taking what it had reason to believe were sensible and necessary actions. Due in large part to those statutory restrictions, the FDIC cannot price deposit insurance in a way that accurately reflects the risks posed by different depository institutions and avoids the need for sharp increases in premiums if a fund experiences significant losses.

The Office of the Comptroller of the Currency believes that the FDIC should be free to set risk-based premiums for all insured institutions. Currently, it is prohibited from charging premiums to roughly 91 percent of all insured depository institutions. Deposit insurance pricing should create an incentive for good management by rewarding institutions that pose a low risk to the insurance funds. A system in which the vast majority of institutions pay no insurance premium does not do that.

Under our current system, most institutions pay no premiums when the funds are well-capitalized. If a fund falls below the designated reserve ratio of 1.25 percent of insured deposits, the FDIC may be required to charge an assessment rate of at least 23 basis points. This sharp rise in premiums is most likely to take effect when banks can least afford it—during an economic downturn. To avoid this situation, the FDIC should be given the authority to establish a range for the DRR and to rebuild a fund gradually if its balance falls below the bottom of the range.

If a fund exceeds the upper boundary of the range, the FDIC should be authorized to pay rebates or to grant credits against future premiums. However, any arrangement for rebates or credits should reflect the fact that not all insured institutions receive the same services for their deposit insurance dollars. The FDIC uses deposit insurance funds to offset the cost of supervising State-chartered banks. It would be unconscionable in our view for the FDIC to issue credits or rebates to all banks without first taking into account the subsidy it provides to State-chartered banks, provided in large part by national banks.

Finally, the BIF and SAIF should be merged. There is already significant overlap in the types of institutions insured by the two funds, and a combined fund would provide even greater diversification. Moreover, under the current structure, the 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. Deposit insurance premiums should be based on the degree of risk posed by an institution and not on which fund happens to insure a particular institution's deposits.

Thank you, and I would be glad to address your questions.

Chairman SHELBY. Mr. Gilleran.

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

Mr. GILLERAN. Mr. Chairman and Members of the Committee, it is a pleasure to be with you this morning.

I would ask that my written statement be placed in the record.

Chairman SHELBY. Without objection, it will become part of the record in its entirety.

Mr. GILLERAN. In order to get to the questions more quickly, just let me say that we too support the merger of the funds as being a more logical way in terms of having the same assessment charge for like institutions and like condition. And we think that the fund will be much safer merged than separate.

Separately, we are in favor of giving the FDIC more flexibility in setting the total reserves and in the method of assessment.

Thank you very much. It is a pleasure to be here.

Chairman SHELBY. Thank you.

Chairman Greenspan, from an economist's perspective, what are the macroeconomic issues involved in the so-called procyclical nature of the current system?

Chairman GREENSPAN. Well, Mr. Chairman, as you know, if the designated reserve ratio was, say, at a fixed point currently in the area of 1.25, then one would presume that you would get rebates as the economy is rising when the banks do not need them.

Chairman SHELBY. At the wrong time.

Chairman GREENSPAN. You would get increased premiums as the economy was going down at exactly the wrong time.

And I think the general notion of creating significant flexibility on the part of the FDIC to manage that process is one of the more important parts of this prospective legislation.

Chairman SHELBY. Thank you, Mr. Chairman. Do you have any comments, Secretary Fisher?

Mr. FISHER. [Nods in the negative.]

Chairman SHELBY. Chairman Powell, the FDIC currently operates under legal requirements that are quite rigid, to say the least. Can you expand on your testimony regarding the benefits of a more flexible system? What would a more flexible system give you?

Chairman POWELL. It would alleviate exactly what Chairman Greenspan just mentioned a moment ago, that is the primary focus. But we would operate much like the private sector also.

Let me emphasize that part of the whole notion of deposit insurance reform is based upon risk-based premiums. But to answer your question directly, it would be exactly the flexibility that Chairman Greenspan mentioned.

Chairman SHELBY. Chairman Greenspan, you mentioned this earlier, but just to expand a little. In discussing coverage increases, it seems the proposals involve providing a marginal benefit of convenience to a select number of depositors while consequentially increasing the potential exposure or risk of all taxpayers. Is that how you conceptualize that?

Chairman GREENSPAN. Yes. Mr. Chairman, I think it is probably worthwhile to think in terms of the fact that there is not a $100,000 ceiling that exists for depositors because if you choose to go higher, with a little effort, and perhaps a little cost, you can expand it. And indeed, it is quite possible, for example, for a family of four to have, under extreme conditions, $2 million worth of deposit insurance at a single bank.

This is probably not a bad structure in that regard in the sense that, hopefully, we stay at $100,000, but recognize that as the improved capacity of getting multiple accounts occurs, what we are effectively doing is setting up a system in which those who really perceive the need for increased coverage on their deposits would

pay a modest fee to do it, which is effectively the cost of either taking on multiple deposits in an individual bank, or going to other banks. And it strikes me, instead of having a strict cut-off point, from an economic point of view, having a structure as it stands now, has a certain sensibleness to it.

Now, we do not approve of multiple deposits on the grounds that we think it is not necessary. But if you are going to have a system such as we have, thinking of it in terms of solely of the $100,000 limit, in my judgment, is to misunderstand what, in fact, the form and scope of the protection is for American depositors.

Chairman SHELBY. Secretary Fisher, along the same lines, if we were to, and I hope we won't, increasing taxpayer exposure, we must be getting something for it. The theory would be we would be getting something for it. Is there such a beneficial trade-off involved here? If there is, I haven't found it.

Mr. FISHER. No. I think as I said last year before the Committee, it looks like an ephemeral benefit to me. It is really just this illusion that it is a convenience factor, and maybe modest fees, but very modest, as Chairman Greenspan was saying, that savers simply can get more coverage if they desire it. So it strikes us that there really is no benefit to the consumer, but there is an added risk for the taxpayer.

Chairman SHELBY. Thank you.

Senator Stabenow, I believe you are the only Democrat that is still here.

Senator STABENOW. Thank you, Mr. Chairman.

I am wondering if our witnesses might respond to an article in the February 19, *American Banker* that indicated, a survey by Synergistics Research Corporation that found that three-fourths of the people who bought an annuity through a bank or a credit union thought that the annuity was insured like a bank account and covered by the FDIC.

I am wondering if you might respond to that and what might be done—it was quite astounding, I thought, that three-fourths of those who are investing in annuities believed, in fact, that they were covered in the same way. So, Chairman Powell, if you could respond, would have any thoughts in terms of addressing this confusion on behalf of consumers.

Chairman POWELL. I think it is unfortunate. I think most banks do a good job in attempting to make sure that they distinguish between what is FDIC insured and what is not FDIC insured. But we can do better, from an education standpoint. I think we as regulators need to be sure, through the examination process, that the literature is clear, that consumers are told if a product is not FDIC insured. And hopefully, that survey will be better as time goes by.

Senator STABENOW. Okay. Does anyone else want to respond?

Mr. GILLERAN. It has been my experience, Senator, that financial institutions try very hard to separate the deposit-taking areas from the areas that are selling nondeposit-insured products. This is of great concern. I believe on our examinations, that we see that the institutions are trying very hard to communicate this difference. But this is something that we should always emphasize our continued surveillance of, because it is important that the consumer knows the difference.

Senator STABENOW. On a very different topic, given the difficult economic times that we have experienced in the last 2 years, the downturn, obviously, in the economy and in the stock market, a lot of people have been leery about investing in high-risk, high-yield investments.

I am wondering if any of you could speak to the observation that people are moving to FDIC-insured accounts over other places in which they are investing their money. And if the economy continues to stall, if in fact that is true, that people are moving to FDIC-insured accounts, would this have any significant effect on the capitalization of the insurance funds?

Chairman Greenspan.

Chairman GREENSPAN. Senator, I think you are pointing out an issue which is fairly pronounced in the most recent period in the sense that various deposit accounts have gone up considerably. We do not have actual data on where those monies are coming from, but it is fairly evident that a significant part of the acceleration of deposits has been coming from accounts which have previously been committed to the stock market, and probably to other investments of high volatility as well.

Senator STABENOW. Chairman Powell.

Chairman POWELL. I do not see any undue pressure, though, on the funds. However, I think what we are experiencing is a flight to safety and if, in fact, deposits are increasing in commercial banks, it is just another reason for deposit insurance reform—to merge the two funds because the combination of the two funds will be much stronger together than separate. It is also important to look at some of these other issues of deposit insurance.

Senator STABENOW. Mr. Fisher.

Mr. FISHER. I think it is worth noting that even without the equity market events of the last couple of years, as we move to lower and more predictable inflation, the deposit-taking franchise of our banking system is really quite healthy.

Obviously, there has been an acceleration that maybe we can find in the data that Chairman Greenspan alluded to. However, I think the demise of the deposit-taking franchise has perhaps been overstated.

Senator STABENOW. Okay.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Enzi.

Senator ENZI. Thank you, Mr. Chairman. I want to probe just a little bit more on increasing the coverage.

I am from Wyoming. Our biggest city is 52,752 people. That is the biggest city in 96,000 square miles. Of course, we call anything a city with a 3,500 population or above. And many of those are as far as 100 miles from another town. They may have one, maybe two financial institutions in the town. The towns feel a little more secure keeping their money in town. When the towns are spending money, they are drawing warrants against those banks which are, in essence, loans, which when I was Mayor, I found out that they had to meet loan requirements as well. We almost created a banking crisis building a little water system.

But I know from the last banking difficulties that we had, that people thought that they could have multiple accounts and be insured. But they weren't, and they lost money that way.

So, I am getting a lot of questions from people at home as to why, if we are going to go to a premium system that is truly risk-based, why can't there be an increase in the coverage that is provided at the same time, so that people can put more money in a single bank in a single account and still feel secure with it?

We are talking about the stability, the security, the perception that people have of the banking industry. And they are not inclined to try and beat the system by doing multiple accounts.

I am interested in what you think about municipal coverage, what you think about retirement coverage, and of course, the individual one is important, too. But I think you have all expressed something on the individual level. So if you could give me some kind of an idea of whether you would consider coverage increases for retirement or for municipal accounts.

I will start with Chairman Powell.

Chairman POWELL. On the retirement accounts, Senator, I think they are uniquely important, consistent with the existing Government policies that encourages one to save for retirement. The FDIC would support an increase in the requirement accounts.

We do not support increasing coverage for municipal deposits. Most commercial banks in most States are required by law to securitize those municipal deposits. Thus, the deposit is safe. And I think that system has worked very well. That is not to say that the FDIC would not be willing to study any proposals that would increase the municipal deposit coverage for additional fees. But our position today is that we oppose that.

Senator ENZI. Mr. Greenspan.

Chairman GREENSPAN. Senator, if the deposit insurance fund were truly, fully, a risk-based insurance system in which premiums actually directly related to the underlying risks, there shouldn't be any coverage limit at all.

In other words, if, in effect, what is being sold is properly priced, then limiting the amount that there should be makes no sense, any more than a grocer saying, I won't sell more than a dozen apples to you.

The reason there are limits is the fact that, of necessity, the Federal Deposit Insurance System is subsidized. It really cannot be otherwise because if you actually impose the premiums which truly would be required in a private system to guarantee those deposits, no one could afford to pay those premiums.

And the reason is that, while we call this an insurance system, it is really a guarantee system. There is a small probability of huge losses because the default of banks, one versus another, is not an independent event like, say, life insurance.

There is a very high probability that if you have a major systemic problem, the vast majority of banks would be in difficulty as they were during the Great Depression.

You cannot really get full insurance. So that there has to be a limit of some form.

On the retirement account, our data show that the vast majority of retirement accounts are well below $100,000. Those that are not

are the few very large deposits. And the only people who, in my judgment, would be helped by a significant increase in the coverage limit on, say, IRA's and Kehoes would be our very wealthy depositors and those with exceptionally high incomes, who shouldn't need it, and certainly have other means of protecting themselves.

The type of problem that you have in Wyoming is a problem, I do not deny that. And I think your banks are raising important questions.

There is always the possibility for those who have more than $100,000, to buy Treasury bills or other guarantees which may give them slightly less interest, but it really is a slight difference, and in today's environment, hardly anything.

So that there are alternate means of protection. And I doubt very much if we should make major changes in the overall depository system and the insurance system to effectively come at a problem which unquestionably exists, but is resolvable in another manner.

My own judgment is that if there is a real need, that means will come to those markets to help solve it. But I do not deny that when you have a small town, small banks, that there is an issue here. If there were a way to handle it in another way, I would sense that would be the way to do it.

Senator ENZI. I see that my time has expired. I will submit some written questions so that I can get additional answers.

I would like to mention, though, that Gillette, Wyoming, is also a mining area. We have a lot of blue collar workers that work at the mine. They are paid well. And their retirement accounts sometimes now are in excess of a million dollars.

Chairman SHELBY. Any job openings there?

[Laughter.]

Senator ENZI. They are kind of curious about that.

Thank you.

Chairman SHELBY. Senator Miller.

Senator MILLER. Continuing along the line of small town banks, I would like to address this question to Mr. Fisher. But if Chairman Powell wants to jump in, I would appreciate that as well.

I am concerned what the cost will be to community banks of my State if the deposit insurance is raised. One of my bankers back home told me this last weekend, that some way or another, he went into the FDIC website. He had calculated what he thought it would cost his bank if the coverage level was increased. And he said that it would cost his bank about $89,000 to raise it, and that that was about the salary for a full-time employee at his bank. You can imagine that he is not anxious to increase his insurance coverage if it is going to cost him a full-time employee.

I guess my question is, are you aware of other costs to the community banks of this Nation, of my State, of increasing coverage?

Mr. FISHER. I think for the direct cost that perhaps Chairman Powell can speak more directly to, clearly, there will be increased premium costs if coverage increases are raised, and they will have to be passed on directly to banks. There may be some dynamic effects if there are going to be added deposits that may make those even higher. Certainly, there is going to be a direct cost there.

In terms of the other costs that concern me the most, actually, it is some of the perverse incentives that I fear might be set up by the proposal on municipal deposits.

Small, well-run, local-managed banks actually won't be benefited, I fear. But they will be put in the condition of having to compete by raising the rates against weaker banks elsewhere in a State who might be trying to attract the larger deposits of municipalities and States.

I think it sets up some perverse incentives in our banking system. It sets up really perverse incentives for the custodians of State and municipal funds to look around and shop around for higher rates. We are sending them conflicting messages.

The current system gives them more of a focus on security of their funds, which I think is more appropriate.

Mr. HAWKE. Senator, if I may address that question, as well.

Senator MILLER. Sure.

Mr. HAWKE. Another potential cost for community banks is the potential loss of deposits, notwithstanding an increase in coverage. It is not at all clear who the winners and losers are going to be if deposit insurance coverage is increased by a substantial amount. For one thing, it will increase the ability of very large, aggressive banks to offer larger volumes of insured deposits, and funds may flow out of small banks rather than into small banks as a consequence of that. So there is no really good factual information about what the consequences of an increase in deposit insurance coverage would be.

Mr. GILLERAN. Senator, before coming here, I ran a community bank in San Francisco. One of my surprises is the fact that since being here 14 months, not one community bank or thrift has come forward and requested in any substantial way an increase in coverage because they do not believe that they will receive more deposits because of it and because of the competition that they have. And in addition to that, it will increase their costs.

So one of my big surprises is that I have not seen the support from the banks themselves for it.

Senator MILLER. Mr. Powell, do you want to get in on that?

Chairman POWELL. Sure. Senator, I want to be sure that everybody understands what we are proposing at the FDIC. We are not proposing to increase coverage. We are proposing to index coverage.

To answer your question directly, if the funds are merged, if this bill goes through and Congress approves it, the reserve ratio would be right at 1.28.

If deposit insurance coverage increased by $30,000 to $130,000, and if retirement accounts increased up to $250,000, the cost would be something like $335 million per basis point, and the fund would be impacted by 4.4 basis points. That does not necessarily trigger additional premiums to the industry because the fund would be within the range. Potentially, obviously, it could increase premiums to the industry.

Senator MILLER. I thank the panelists. I have another question, Mr. Chairman, but I will just submit it.

Chairman SHELBY. Thank you, sir.

Senator Sununu.

Senator SUNUNU. Thank you, Mr. Chairman. I want to be the first to congratulate the Chairman on his presumed lifetime tenure. For a second, I thought you were going to be nominated to the Supreme Court by the Senator from New York.

[Laughter.]

In your testimony, you talk about raising the ceiling and the concern that it would extend the safety net, increase the Government subsidy, expand moral hazard, reduce the incentive for market discipline, all without providing any clear public benefit. Do you have anything good to say about raising the ceiling?

Chairman GREENSPAN. Senator, I am hard pressed.

[Laughter.]

Senator SUNUNU. Mr. Fisher.

[Laughter.]

You shouldn't feel the need. I have found that when I ask you questions and you answer my questions, my phone starts ringing. So feel free to leave your answer at that, if you are comfortable with it.

Let me ask Mr. Fisher, though, about the last piece there, the concern you have about reducing the incentive for market discipline. When that incentive is reduced, what does that do to the cost of regulation?

I do not know that you addressed it in your testimony, but if there is less incentive out there for pure market discipline, does that force us as policymakers or you as an organization looking at regulation and regulatory costs to incur additional costs to compensate for the loss of market discipline?

Mr. FISHER. Yes, it certainly does, and I think it would add to the burden of the bank regulators and supervisory functions of my colleagues here on the panel, yes.

Senator SUNUNU. Have you tried to quantify that to make any specific assessment of how you might have to react?

Mr. FISHER. No. I think I would be hard pressed to put a number on that. Ten or 15 years ago, we have made a lot of improvements in the bank supervisory process. We are happy to have those.

I think, though, if we set up some perverse incentives over the next 10 years, we find that we have to go back to the mill and work on new improvements in the supervisory process.

Senator SUNUNU. Yes, go ahead.

Mr. GILLERAN. In response to your question, Senator, in the interest of fairness, I have to say, as a former community banker, that there are those banks who would be aided. There is no question about that. And there are those circumstances where you would have a customer who would keep more money with you if you were to raise the ceilings. But the problem is, in the overall, taking all banks into consideration, that there doesn't seem to be enough benefit to increase the cost.

Senator SUNUNU. And on that point, though, maybe I should ask Mr. Hawke. The general health of the community banking system, the smaller banks—and I can speak with anecdotal experience in New Hampshire—but could you quantify or attempt to quantify the overall health of smaller banks across the country?

Mr. HAWKE. I think that the smaller banks are really in quite good condition. They are generally better capitalized, frankly, than the larger banks.

Senator SUNUNU. So although the statement that there may be banks that are assisted by raising the cap, where you might find specific cases? Is it fair to say that the small banks haven't been harmed, collectively, by having a $100,000 cap in place?

Mr. HAWKE. I do not think they have been harmed. The point I was making was that nobody knows who the winners and losers are going to be. Certainly, if coverage were increased, there would be some banks who would be able to offer a particular customer a higher level of coverage. But there will be another bank down the street who will lose a depositor because of the move. And until the dust settles and the comings and goings are all measured, it is impossible to tell who the winners and losers are going to be.

Senator SUNUNU. Mr. Chairman.

Chairman GREENSPAN. Senator, the Federal Reserve has concluded that we can find no problem that an increase in coverage is designed to solve. We observe a very viable community banking industry. That is not to say that we would remain silent in the event that we find that problems do arise—because remember, the real value of deposit insurance is going down.

At some point, it will erode to a point where I think it is probably wise to address it. It is our view that we are not anywhere near that point as yet.

We do not deny that at some point, you have to either index it or raise it because certain problems could arise as a consequence of having inadequate coverage. But we are nowhere near there.

Senator SUNUNU. What is the most significant problem that could occur if it goes too low, in the extreme? Just lack of confidence? Is that a consumer confidence issue? Is it some other systematic risk?

Chairman GREENSPAN. The real danger is that we get to a level where, in the event of a financial crisis, that consumers or depositors would feel sufficiently insecure that we would find the equivalent of bank runs occurring similar to those which occurred in the 1930's. But we are nowhere near that point from any measure that I can see.

Senator SUNUNU. Thank you.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Johnson.

COMMENTS OF SENATOR TIM JOHNSON

Senator JOHNSON. Let me direct this to the non-FDIC regulators, whichever of you choose to respond.

Several of you noted your concern that the current risk-pricing system places 91 percent of all insured depositories in the same system, although not all of these banks and thrifts actually pose the same level of risk to the system. It appears that all of you support giving the FDIC additional flexibility in determining a risk-based pricing system.

Do you believe that the FDIC has the appropriate knowledge about the institutions you regulate to rate the risk of a given insti-

tution? And do you believe that your agency should play a role in evaluating those risks?

Mr. HAWKE. I think that, working together, the FDIC and the other primary regulators can come up with an appropriate assessment of the risks of the banks that the FDIC insures and that we supervise.

Senator JOHNSON. Mr. Gilleran.

Mr. GILLERAN. Since Comptroller Hawke and I both serve on the FDIC Board, I can say that the working together of the primary regulators and the insurer has been excellent and that each one of us in our evaluation of the institutions that we regulate, we grade them in terms of how they stand within the CAMEL's rating system. So the evaluations of the institutions are very clear. And therefore, the FDIC has all the information they need to do this.

Senator JOHNSON. Mr. Greenspan.

Chairman GREENSPAN. I agree with that, and I would also like to point out that there is an increasing amount of market available information which would assist the FDIC in calibrating various different risk assessments and premiums.

We have, obviously, debentures issued by a number of institutions. And very recently, there is the evolution of the credit derivative default swap market which is giving a market sense of what these various risks are.

So I think, with the combination of the data the FDIC has and the primary regulators have, that the FDIC has more than enough information to, at least, get a rough calibration of what the differential risks are. And that is as good as you can do and it is very helpful, in my view.

Senator JOHNSON. Mr. Greenspan, in your testimony, you emphasized the importance of calibrating the risk-based pricing system to force institutions to internalize a more appropriate percentage of their actual cost to the deposit insurance funds.

You noted that the current system where most banks receive the same risk rating clearly forces some institutions to subsidize other institutions' deposit insurance.

One reform proposal includes a provision that would cap allowable premiums to the most highly rated institutions at one basis point regardless of economic conditions. Some have argued that such a cap merely shifts the point of subsidy to a smaller category of financial institutions, but clearly undermines the fundamental reform proposal. Would you please comment on the one-basis-point cap proposal?

Chairman GREENSPAN. Well, all I would say with respect to that is that, if you take the few large institutions, for which there is an active market in credit derivative default swaps, you will find that one basis point is a very small fraction of what the private market's estimate of potential risks of those institutions is.

Senator JOHNSON. Mr. Fisher, in your testimony from last April, you express support for the FDIC's recommendation that you have authority to manage the reserve ratio within a range. You noted that it is logical to provide for reserve growth above 1.25 percent when conditions are good, and for reserves to decline below that level when conditions are unfavorable.

Chairman Greenspan has noted that the FDIC's suggested target reserve range be widened in order to reduce the need to change premiums abruptly.

Do you still believe that a range should extend below the current designated reserve ratio? And if not, would you please provide a rationale for your current thoughts on this issue?

Mr. FISHER. Certainly, Senator Johnson. Thank you for asking that question.

I think experience teaches us that if the reserve ratio moves much below the current 1.25, now, I do not want to put a fine point on that, but if you look back to 1934, and if it moves below that, it is not going to be stable. This is not a question of logic. It is a matter of experience of over 70 years.

I can support a modest movement below the current level of the designated reserve ratio. But much below that, you find that it accelerates and we get into the pickle we were in in the early 1990's.

We do see room for it to grow on the upside, a modest movement below the current level, but not much wider than a modest movement below, does seem to us to be appropriate.

Senator JOHNSON. My time is expired. Thank you very much, Mr. Chairman.

Chairman SHELBY. Thank you, Senator Johnson.

Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

In trying to evaluate the risk of a bank, I am thinking of an instance, somebody wants to start a bank. He has no past history, no past performance. How does a banker get into the market? It seems to me that we run a potential here of making it difficult for new banks to get into the market. By doing that, you begin to reduce competition in the market.

I am wondering if the members of the panel would care to comment on that. How do you assess risk? I think the natural reaction is that when you assess—when somebody's starting a bank, they are riskier.

Mr. HAWKE. Senator Allard, by the same token, when a bank is chartered, and we charter banks all the time, the initial capital that is required of the bank is generally calculated to cover anticipated deposit growth over a 3-year period. So capital is kind of front-end loaded in the chartering process. And by the time a bank is up and running, the examiners are in there and they are able to make a pretty good assessment of the risk as the bank undertakes its business.

Senator ALLARD. You do not believe that that would increase the capital requirements of the bank because it is just starting, or increase the insurance rates because it is just starting?

Mr. HAWKE. The capital is taken into account when the charter is issued. I think that it remains to be seen how the FDIC would calculate the premiums for a newly chartered bank.

Chairman POWELL. Senator, I do not think there would be any burden—I should not say burden—any discrimination to a start-up bank versus an existing bank. I think the premiums would be based upon lots of factors—capital, management, and other factors. But I do not think that there would be any discrimination.

Mr. GILLERAN. Senator, the capital-setting for a new bank takes into consideration where that new financial institution is going to be headquartered, a small town or a major city. Therefore, the capital levels are flexible that are set between the bankers that are proposing the bank and the regulator based upon how large you have to grow in order to be profitable in the environment that you are in.

So that a bank proposed for a large city, you would expect it to have a larger capitalization than in a smaller community. And in the process of setting that capital, you would also take into consideration the fact that for the first 3 years, generally, that the bank would be in a loss position as it is growing its deposit base. The capital does take into consideration the growth required to get you up to the point of profitability.

Senator ALLARD. We seem to have a disagreement between the large banks and the small banks as to whether we increase the amount that we insure.

Isn't it true that large banks rely on a too-big-to-fail attitude? In the State of Colorado, we have had both industrial banks and small savings banks fail. And it seems like there are two phenomena contributing to those failures.

One is that depositors, who thought that they had multiple accounts, all of a sudden find out that they are not covered because they have several accounts in their name in one way or another.

Then the big banks said, you cannot apply the same standards to us because we are too-big-to-fail and if you let us fail, the economy is going to be just that much worse and you will get yourself in a box.

I wonder if you could comment about that.

Mr. GILLERAN. Well, I would like to comment on it. I would like to say that it is clear that in the community banking system, they believe that too-big-to-fail exists. However, I personally believe that there is no bank that is too-big-to-fail. And if a bank does get themselves into trouble, that they will be closed no matter what their size is, and the stockholders will lose their investment.

I have to say that in reaction to Senator Sununu's question about is there anything good about increasing coverage and what would happen if we did not have coverage, is that the coverage I believe really supports the continuation of the community banking system in this country, which I think is very highly prized and very highly regarded.

We must have a deposit insurance coverage level that is adequate to make sure that the community banking system can attract deposits. So the deposit level supports the community banking system very much. However, I think $100,000 is completely enough to do that at this time.

But in answer to your question, I think that the too-big-to-fail is something that relates more to the fact that there is an inherent risk in a larger bank closing because of the fact that many of the smaller banks have their overnight money on deposit with them.

So, therefore, those situations will have to be resolved by the FDIC in cooperation with the Treasury. But too-big-to-fail is a misnomer. They will fail if they have to.

Senator ALLARD. Chairman Greenspan.

Chairman GREENSPAN. I agree that there is no such concept as too-big-to-fail. What there is, however, is a concept that very large institution will be liquidated slowly. That is, the shareholders will be out immediately. Management can be changed.

The only possibility that can exist is that the need to prevent the types of problem which Chairman Gilleran is suggesting, to prevent those, is there is no need to liquidate very rapidly, and indeed, we probably would not want that to happen. But at the end of the day, they will get liquidated.

So the time issue is the question here, not whether an institution is not too-big-to-fail. It will just fail more slowly. But at the end of the day, it will fail.

Senator ALLARD. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Dodd.

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you, Mr. Chairman, and I want to thank our witnesses.

I apologize for getting over here late. But as I told the Chairman, we were dealing in the Rules Committee——

Chairman SHELBY. They had important business.

Senator DODD. We were dealing in the Rules Committee with the budgets of the various committees in the Congress. And I am pleased to announce to you, Mr. Chairman, that you have a budget for this year.

Chairman SHELBY. Very important.

[Laughter.]

Senator DODD. I know that is of primary importance.

I am sorry I was not here for the opening statements. But I want to thank you, Mr. Chairman. This is the second hearing we have held on this subject matter. We had one in the last Congress, on this very, very important issue—reforms in the Federal Deposit Insurance System.

I want to thank the regulators here for their diligent work. This is not the most exciting subject matter, except for those who are directly interested in it, but a critically important issue. I also want to thank Senator Tim Johnson, who is now the Ranking Member of the Subcommittee for Financial Institutions, for his leadership in this area, which has been tremendously important.

I appreciate, Peter, your comments a few moments ago. I tried to look over the Committee Membership here and I think that, with the exception of just a handful of us who were around here in the late 1980's or early 1990's, when we tried dealing with the subject matter of the crisis at hand and the structural reforms that went along with them, was not the ideal environment in which to be legislating. This was a very, very difficult time, as Senator Shelby and Senator Sarbanes will recall. Senator Bennett, I think you were here as well at the time.

Senator BENNETT. Just barely.

Senator DODD. It was just tremendously difficult. So it is very important that we are doing this proactively ahead of time and talking about this, rather than from some event or events that could cause us to have to rush back here. So, I thank you for all of that. It is tremendously important to be doing it.

Let me, if I can, because I think a lot of the questions here have been covered on this subject matter. But I would like to raise with Peter, and you, Mr. Chairman, this consumer confidence issue. It is a little bit off subject, obviously, but it relates in many ways because what we are talking about does hinge on the consumer confidence issues.

I wonder if you just might share some thoughts with us here this morning. We are seeing now these reports of the index sinking to 64 from a high of almost 79—not a high, but where it was in January. The lowest level since 1993 was reported, a 17 point drop, was the largest one in September. This was I think 13, 14 points, whatever that number is.

Unemployment rates are going up. Equity markets—I do not need to tell you. You all are familiar with this stuff. I wonder if you might share with the Committee, in addition to the good work being done here on the Federal Deposit Insurance System, any thoughts you have this morning on the consumer confidence issues and what steps may be taken.

Peter, maybe you can begin. I see you looking at Alan. That is not going to work.

[Laughter.]

We are going to start with you, if we can. As I say, it is a little off the subject matter, but not entirely, given the consumer confidence issues related to the FDIC system. So, I cannot have you here and not ask you about this in light of the significance of this report.

Mr. FISHER. Well, obviously, the report was a jarring number as it comes out. One of the reasons it is jarring is because we do see modestly a continued pace of consumer confidence as expressed in their acquisitions of housing and of major durable items in the auto sector.

It is not accelerating here, but so we do see their behavior on big-ticket items at least holding up. But the sentiment number took a big swing and obviously is moving.

I would defer to the Chairman on the overall status of the economy. But we do see corporate earnings coming in a little better than people had been expecting. We continue to see productivity, continue to see the consumers on the big-ticket items of housing and autos holding up their demand. Obviously, the sentiment number is something to pay attention to and is a cause for concern on the economy going forward.

Senator DODD. But it wouldn't cause you to adjust or rethink any of the major economic items before the Congress coming up in the coming months?

Mr. FISHER. Well, at least to my own thinking, over the last 24 hours since the number came out, it seemed to underscore the need for us to focus on improving potential growth in the economy over the coming 5 to 10 years and really focus on that.

We want to immunize ourselves as best we can against the slow and no-growth economies in Europe and Japan. We should be doing the best we can to stimulate growth in our economy.

Senator DODD. Mr. Chairman, do you have any comments this morning on this?

Chairman GREENSPAN. Senator, I think our experience has always been that consumer confidence indexes tend to be affected by events which consumers are acutely aware of, such as the dramatic rise in gasoline prices.

That has had two effects. One, it has been an actual constriction in the available cash that households have for other things. Their real incomes in that regard have been taxed by this fairly significant rise in gasoline prices. But that rise in gasoline prices, of course, is related to the pending geopolitical issues which have emerged—specifically, the issues in Iraq and Venezuelan problems with respect to crude oil capacity which have also emerged.

So it is a very significant decline. But as Peter said, it is not a particular surprise. The order of magnitude is certainly a surprise, but not the direction in that regard.

Mr. GILLERAN. Senator, I can report that from the thrift industry that supports the home industry in America, 2002 is the best year that the industry ever had. And that is, of course, fueled by the number of refinancings that are going on that are supported by low interest rates. However, new home sales are also in there. That is a reflection of the consumer confidence. So from the homeownership point of view, consumer confidence is very high.

Senator DODD. Aren't the foreclosure rates pretty high as well?

Mr. GILLERAN. They have gone up a little bit in the fourth quarter of 2002. Yet, they are within very acceptable limits, and as far as the thrifts are concerned, extremely well-covered by reserves.

Senator DODD. These numbers do not bother you, then?

Mr. GILLERAN. No.

Senator DODD. The consumer confidence numbers.

Mr. GILLERAN. Well, I am always concerned about anything that affects the consumer because, eventually, if they do lose confidence, it will affect homebuying and that will affect the housing industry. But I see nothing right now that is evident in the thrift business that would indicate that there is any downside to the housing business going forward.

Senator DODD. My time is up. Thanks.

Chairman SHELBY. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman.

Mr. Powell, you want to move from the hard target of 1.25 percent to a range. Treasury has indicated they think that makes some sense. It does sound like a logical policy position to go away from a particular hard target if conditions are different. You need some flexibility. Help me understand where the hard target came from. Who came up with 1.25 percent and what was the rationale?

Chairman POWELL. Well, I think the testimony of Chairman Greenspan spoke to that at the last hearing.

Chairman GREENSPAN. You remember?

Chairman POWELL. Yes, I do remember it.

[Laughter.]

Senator BENNETT. Have I touched a nerve here?

[Laughter.]

Chairman GREENSPAN. No. I am not sure I am accurate on this, but everyone tells me that what I am about to tell you is correct.

[Laughter.]

There was a meeting at Camp David a little bit more than 10 years ago.

Senator BENNETT. I remember it.

Chairman GREENSPAN. In which a number of people were sitting around discussing exactly what the target should be, and nobody said anything.

I looked at the particular type of table which Peter Fisher has in front of him which shows the history. Remember, at this time, the reserve ratio was very low. I said, well, recent history suggests 1.25. And I never considered that that was more than just an evaluation of what the recent past would be without any notion that that had any significant meaning. But no one else apparently had any other number. So it occurred. It is no more meaningful than a number that you could pick out of the air, frankly.

Senator BENNETT. So, basically, you made it up.

[Laughter.]

Chairman GREENSPAN. No, I did not make it up.

[Laughter.]

I just merely looked at what the recent past had been. Whether the recent past was right or wrong was not an issue. I was interjecting a comment, and I did not expect it to extend as far as it apparently did.

[Laughter.]

Senator BENNETT. That is the way things happen around here. I made a comment on the floor that is now being touted as the Bennett Solution to the Estrada Problem.

[Laughter.]

Well, that would argue, then, would it not, for looking at that particular number to see if it should not be reviewed.

So looking for areas of agreement on the panel, I hear that everybody agrees that the BIF and the SAIF should be merged. And that is one thing that we could proceed with that is virtually noncontroversial.

Senator SARBANES. The Reporter should note they all nodded, because none of them answered.

Senator BENNETT. All right. And do I perceive then that everybody agrees that the FDIC should have a range rather than a hard target?

And again, they are all nodding.

Basically, the one thing we are arguing about is whether or not the level of coverage should be indexed. And the Administration and Chairman Greenspan say no. Chairman Powell, you say yes. Can I pin down the other two? Are you yeses or noes?

Mr. GILLERAN. No.

Senator BENNETT. You are a no.

Mr. Hawke.

Mr. HAWKE. I do not have a great deal of trouble with indexation, but it raises a couple of problems. One is the choice of a base year for indexing. And if you go back to the original deposit insurance coverage level and index from 1933 on, you wouldn't come out to $100,000. The other problem is a cost problem for banks if indexation results in a change in the deposit insurance coverage limit periodically. There are going to be costs for banks in changing their signage and documentation to deal with that.

Mr. GILLERAN. There is also the communication problem of the thrifts I have talked to, in addition to the cost factors and the signage changes. The communicating to the depositor what the coverage is during the indexing is an additional cost, also.

I was very surprised in all the thrifts I have talked to, there was no support for doing that.

Senator BENNETT. All right. We have unanimity on two issues and a four-to-one vote on the other. The only issue remaining being risk-based premiums. How close are we to unanimity on that one? Everybody thinks we should have risk-based premiums?

Mr. FISHER. I think we all agree in principle. Others can speak. And there may be some nuances between us on the details.

Chairman SHELBY. The record should show that everybody is nodding in the affirmative.

Senator BENNETT. All right. This strikes me——

Chairman GREENSPAN. I also think it is the FDIC which should make those judgments.

Senator BENNETT. Okay. Well, this strikes me as one of the more unusual circumstances, Mr. Chairman, where we probably can legislate without controversy in this area.

Chairman Powell would be disappointed in the one issue if we go with the majority of the panel. But we have an amazing unanimity on all of the other issues we have before us.

Chairman SHELBY. Senator Sarbanes.

COMMENTS OF SENATOR PAUL S. SARBANES

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

I want to commend you for holding this hearing focusing on a very important issue. I also want to acknowledge the strong interest and the leadership of Senator Tim Johnson, who Chaired the Financial Services Subcommittee in the last Congress and is its Ranking Member now. Senator Johnson has held a number of Subcommittee hearings on this issue, in addition to a Full Committee hearing that was held.

I have a couple of issues I want to probe with the members of the panel and then I want to try to draw Secretary Fisher out on a paragraph in his statement.

First, my understanding is that since 1996, well-capitalized banks have not been paying any premiums. Is that correct?

Chairman POWELL. That is right.

Senator SARBANES. Now, as I also understand, a number of banks have been founded since 1996, which I guess were founded under the arrangements that enabled them to be termed well-capitalized. Their depositors got the benefit of this insurance and the institution itself got the economic benefit that flows from that. They paid no premiums.

Second, I understand that there have been these sweeps that are now taking place, large amounts being swept into the system gaining coverage, again without paying any premiums. Am I correct in that regard?

Chairman POWELL. [Nods in the affirmative.]

Senator SARBANES. How do we address that problem? Where is the fairness in institutions having previously paid premiums, in some instances, quite substantial, getting the fund up above the

level. Then you do not charge any more premium for the well-capitalized. I want to keep that distinction in all the time. And yet, other institutions come in and they pay no premiums at all. How do we address that situation in any reform?

Chairman POWELL. Senator, I could not help think as you were making those comments, I am guilty.

Senator SARBANES. I wasn't trying to make you guilty of that. I just want to probe the problem.

Chairman POWELL. I know, I chartered a bank 3 years ago and we did not pay any premiums. That is what deposit insurance reform speaks to as it relates to the so-called free riders. It is unfair and it is wrong. All should pay.

We also believe that all should pay as it relates to risk. Approximately, 91 percent of the banks in America do not pay today. They are all in the category of well-capitalized and well-managed.

The FDIC believes that we should fine-tune that also and that all of the banks that fall into that 91 percent are not all equal. Premiums should be based upon risk as we attempt to determine what the risk profile of those institutions are.

Senator SARBANES. Presumably, all should pay some premiums before you start making the risk distinction. Or am I incorrect about that?

Chairman POWELL. Absolutely. All should pay, yes, sir.

Senator SARBANES. Up to a point, at least. And then beyond that, you may make the risk distinction.

Chairman POWELL. Yes.

Senator SARBANES. Otherwise, you are still going to have some free riders.

Chairman POWELL. Yes, sir. All should pay.

Senator SARBANES. How are we going to do that? How will you do that?

Chairman POWELL. We are going to pass deposit insurance reform that call for all institutions to pay.

Senator SARBANES. I want to touch very quickly on the 1.25.

The ranges that are being talked about are obviously using the 1.25 as a working figure, so to speak, because they stay in that range. But is there some independent rationale that has been worked out as to what the percentage should be? Shouldn't we try to arrive at that? Maybe it should be 3 percent. Or 5 percent. I do not know. What is the rationale that sets what the percentage is?

Let me underscore that with the other question I wanted to ask about this too-big-to-fail point. Now that is the mantra. We all say that they cannot be too-big-to-fail because the system is basically structured that way.

But I understand that there are eight financial institutions, in the BIF which, if they were to fail and lose only 25 percent of their assets, so you are down in a fairly low range on this premise—and I can work it up with other percentages—25 percent of their assets would completely consume the FDIC fund. Is that correct?

I gather with SAIF, it is only one institution at the 25 percent figure. If you go to 50 percent of the assets, you get 16 of the BIF institutions and four of the SAIF institutions.

Now the failure of only one of those institutions on these assumptions would completely exhaust the fund. It seems to me we

are too exposed to the possibility of a one-institution failure in that regard. What can we do about that situation?

One thing, obviously, is you take the percentage up on some rationale geared to this so you at least have more money in the fund. Another, I do not know how you would work it out, is some kind of way of levying some additional assessment on these very large institutions to create—it is almost like a reinsurance concept. I do not know whether this works, but I am concerned about how serious a potential problem you see this as being?

Anyone who wants to take a crack at that.

Chairman POWELL. Let me make some comments, Senator. You are raising, obviously, some complex, very serious issues.

The first line of defense obviously is a sound banking system. And we as regulators I think are keenly aware that to the supervision of these institutions, it is very important that they remain safe and sound.

As it relates specifically to the reserve ratio and the exposure of these large institutions, you are correct. I think a 25 percent loss of the assets of these institutions, it covers about eight institutions, would absorb the fund.

Senator SARBANES. Right.

Chairman POWELL. I would also indicate that there is something like $750 billion of book value of equity in the commercial banking industry in America today, and that we can assess the industry before going to the taxpayers to cover any loss the fund may take.

Some would say that there is in excess of $200 billion of equity in the banking system today. Supervision is extremely important so that the scenario you describe doesn't happen. But the FDIC can assess the industry to absorb any losses that could, in fact, occur if one of these large institutions failed.

Senator SARBANES. Does anyone else want to address that?

Alan.

Chairman GREENSPAN. Senator, if I may suggest, this is a very difficult issue, as I think you are pointing out. It would take some time to do an evaluation. And it strikes me that if the Senate were to wait for that evaluation to be completed, that too much time would go by.

It may very well be that we should tentatively accept the various different ranges, but put into the legislation a requirement for study of what the appropriate ratio should be for further evaluation by the Congress.

Senator SARBANES. Peter.

Mr. FISHER. If I could add, underscoring that, really. I think one of the reasons for some urgency is because the banking system is always changing. Even though we look at the funds today and we are comfortable with their health and their management, it is an extraordinary series of events that our financial sector has been through in the last 2 years and it is a wonderful outcome that both the commercial banking system and the financial system as a whole has been as resilient as it is.

But given the ongoing changes and concentration in the banking industry, we do not want to take that resilience for granted. And that is why some of the urgency that some of us feel, to fix the roof while it is not raining and get the funds merged and do some of

the changes that will get the risk-based assessment in that most of us, I think we all agree to the principles, is why we feel a sense of urgency.

If I could just add, I think it may have been before you came in, Senator, but, really, this is an area where I feel it is much as Justice Holmes said—the life of the law is not logic but experience.

If we look back at the experience of the fund from the 1930's forward, in good times, it was allowed to grow and get above critical thresholds.

After our experience in the early 1990's, we were fixated on not letting it drop. I think now we are all in agreement that we would like to see it growing in good times because of our lack of confidence that we really know the precise number, that this is not a problem that can be answered with logic, but perhaps with more experience and with more study of what our experience has been.

Senator SARBANES. Does the range that is in the bill, in your judgment, constitute a sufficient margin for growth in good times?

Mr. FISHER. I think at the high end, the figures that are in different bills, 1.5 and in that area, look like a good margin of growth. However, we may want to study that further, given the changes in the industry.

As I mentioned earlier, I fear that looking back at the experience, when we have seen it drop below the current target ratio, much below 1.25, below 1.2, we see the acceleration and we get into the very awkward situations we were in in the 1970's and the early 1990's. So, I can see some room for flexibility on the downside, but not a great deal.

Senator SARBANES. Mr. Chairman, may I make one more point?

Chairman SHELBY. Go ahead, Senator.

Senator SARBANES. My time is now up, but would you take a look at your prepared statement, Secretary Fisher?

Mr. FISHER. Yes, sir.

Senator SARBANES. In it you say: "There are other important structural issues that need to be addressed sooner or later." Could you very quickly elaborate with respect to each of the next sentences, what it is that you have in mind?

Mr. FISHER. Well, I want to be clear, I am not suggesting here that these are issues that should be resolved in this bill, in a bill that we hope Congress moves on. But we think that these are issues that are so connected to the subject at hand, we wanted to alert the Committee to them and make the Committee aware.

I think if we are looking at the whole structure of deposit insurance for the banking sector, we should evaluate to see whether there are lessons we have learned from BIF and SAIF that should be applied to the National Credit Union Share Insurance Fund.

And so, I think it is just a question, we have had a lot of experience and a lot of focus on the BIF and SAIF. We should pause here and make sure that we are learning those lessons and applying them to the credit union insurance——

Senator SARBANES. Well, could you give us a couple of examples of what you are thinking of?

Mr. FISHER. I think in all the dimensions, the critical areas of reform, whether there are adequate reserves, whether risk-based premiums are appropriate. I do not want to purport that I have

delved myself as far as I perhaps should have into that subject, but all the dimensions that we have touched on today for the deposit insurance funds.

I think, as Comptroller Hawke has brought up, there is also the fee issue, the fee structure. Again, we do not feel that is urgent to be in this bill, but it is something that we think needs to be addressed, the fee disparity issues between the supervisors.

Senator SARBANES. All right.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you, Senator Sarbanes.

Chairman Greenspan, in your testimony, you referred to the fact that deposit insurance dampens the effect of the disciplinary forces of free markets. Would you elaborate on this point and would you comment on the manner in which coverage increases would exacerbate this problem?

Chairman GREENSPAN. Mr. Chairman, we need only look at the history of banking in the United States. And what you find is that, say, 1850 or 1860, you needed very high capital ratios in order to attract deposits or essentially to get people to hold your currency, which you recall was then issued.

Chairman SHELBY. The confidence level.

Chairman GREENSPAN. It is wholly a confidence question.

Chairman SHELBY. Sure.

Chairman GREENSPAN. If you get to the years prior to 1933, you find that the required level of capital to induce people to hold your liabilities was a good deal under where it was 75 years earlier.

Chairman SHELBY. A lot of erosion.

Chairman GREENSPAN. Well, because as the system became more complex, there was an ability to have lower levels of capital in, say, the 1920's than you had in the 1850's because the integration of the system was far more impressive by the 1920's. But the actual level of capital required when deposit insurance came in went down, as it should have, largely because there is an ability to have a guarantee of a significant part of your liabilities.

It is fairly apparent that while that had a major effect on eliminating bank-runs and eliminating a lot of the crisis aspects in the financial system, it did lower the discipline that occurs of requiring people who hold your liabilities to believe they are at risk and, hence, they impose a degree of discipline on you, the depository institution; that discipline is clearly lessened by the onset of deposit insurance. And as I said in my prepared remarks, it is a trade-off.

Chairman SHELBY. Thank you.

Last year, the controversy surrounding coverage increased block reform from advancing. What are the costs or potential hazards associated with delaying enactment of reform here?

Secretary Fisher.

Mr. FISHER. As I mentioned a few minutes ago, Mr. Chairman, I think it has been marvelous and really a sight to behold how our financial sector has come through the events of the last 2 years with the extraordinary disruption of wealth that has occurred. But that is not something that we can take for granted, that our banking system will remain that resilient over the coming decade.

I think the urgency I feel comes out of the continued changes in the industry and that we are sitting still in the structure and man-

agement of the deposit insurance fund, really even on the weaknesses that we have identified from the last decade. There may be weaknesses that come to the surface over the coming decade that we will also need to address. But we haven't even yet addressed the backlog. That is my sense of urgency. We cannot take the strength of our banking system for granted.

Chairman SHELBY. Thank you.

It seems to me that all of you here have identified significant costs and concerns with proposals to increase coverage with little or no identifiable offsetting benefit to depositors and institutions. At the same time, you have identified several key reforms that are beneficial and I believe, indeed, necessary.

Senator Sununu, do you have another question?

Senator SUNUNU. Thank you, Mr. Chairman. I have one final question about the risk-adjusted premium structure. And it has to do with Mr. Fisher's testimony and Mr. Greenspan's testimony. I do not know if it is a big distinction.

I understand that the Chairman believes that the details of the system should be developed by the FDIC, and I certainly agree. But I did want to try to understand how significant a disagreement this is.

In Chairman Greenspan's testimony, he talks about the FDIC's 2001 proposals. There are provisions that are coupled with rebates for stronger entities so that when the fund approaches the upper end of the target, the rebates go into place. And I think the Chairman also says that varying the rebates in this way makes considerable sense.

In Mr. Fisher's testimony, you talk about a proposal to apply temporary transition credits against future premiums and then you say explicitly, we strongly oppose rebates which would drain the insurance fund of cash.

I would like you both to comment on whether this is a substantial disagreement, a significant disagreement, or just different use of terminology.

Mr. FISHER. Let me first point out that I think, I would separate in my own logic first the risk-based structure. We should begin with a risk-based premium structure administered——

Senator SUNUNU. And it was noted that you were all nodding and I think there is strong agreement there.

Mr. FISHER. That then sets the base for the premiums the companies, banks would pay.

Senator SUNUNU. Yes.

Mr. FISHER. Then, in our view, a model both to deal with the current free rider problem and with future free riders problems. Both have some transition credit systems where in individual years, it is imaginable that banks may pay no premiums if their credits were larger than their risk-based premiums. And we think that is the process going forward to not actually drain money out of the fund, which sets up some incentives for the banking sector.

We think it can get to much the same beneficial effect for the fund as rebates and avoid some of the draining that would set up banks to encourage asking for rebates we would prefer to avoid.

Senator SUNUNU. Chairman Greenspan, were you aware of the credit proposal? And do you make a distinction between a rebate system and a credit system?

Chairman GREENSPAN. Senator, the difference between us is really quite marginal. The reason for it is that there are a number of different ways to get to the same end. We both agree on where we wish to be, as indeed, I believe the rest of the panel agrees.

This is a relatively minor issue and I suspect that if we were all to sit around and try to find in the context of the type of structure which the FDIC eventually decided to construct, we would all find it very easy to find a mechanism that we would all be comfortable with. If this is the only disagreement that we have, it is, indeed, *de minimus.*

Senator SUNUNU. I appreciate that. I was struck by it only because of the use of the word strongly in your testimony. I appreciate, while it may not be a significant difference of opinion, I wanted to make sure that it wasn't anything that would preclude you from coming to some consensus. And I am pleased to say that this seems to be a situation where everyone in the room is not silent, as the Chairman says, rebates or suggest anything else, and that you will be able to reach consensus.

Thank you.

Mr. FISHER. If I could just echo.

Chairman SHELBY. Go ahead.

Mr. FISHER. I would just add to the broad categories that we agreed to that Senator Bennett ran us through, addressing the whole free rider problem. That is the big umbrella issue here and I think we are all in agreement on the need to address the free rider problem.

Senator SUNUNU. Thank you, Mr. Chairman.

Chairman POWELL. Senator Sununu, we would be on the credit versus the rebate side.

Senator SUNUNU. Thanks.

Chairman SHELBY. In light of the support that has been talked about here, and in consideration that further delay may only make reform more difficult, Secretary Fisher, is it possible that in conjunction with other regulators, could you develop a legislative proposal that incorporates these key reform concepts and submit a draft for the Committee's consideration? Working with you, that is what we want to do and we want to make sure that we do proper reform, make sure that it is substantive, make sure that nobody's getting a free ride.

Mr. FISHER. Mr. Chairman, we would be happy to work with you.

Chairman SHELBY. To talk with the staff.

Mr. FISHER. And all of the members of the panel.

Chairman SHELBY. And the regulators.

Mr. FISHER. Let me conclude by noting that we respect and cherish the independence of each of the four agencies that share the panel with me today. And so, we will work with them to coordinate putting forward the best areas of agreement that we can on the major areas of reform that we have identified.

Chairman SHELBY. Sure. And where you dissent, perhaps. I think that will be very minimal. I hope so, anyway.

Mr. FISHER. That would certainly be for all of us.

Chairman SHELBY. Thank you all for appearing here today and we look forward to moving this if we can get something together.

The Committee is adjourned.

[Whereupon, at 11:40 a.m., the hearing was adjourned.]

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

PREPARED STATEMENT OF SENATOR CHUCK HAGEL

Thank you, Mr. Chairman, for holding this hearing today. It is an important and timely issue that deserves the full attention of this Committee and the Congress.

I appreciate Senator Johnson's leadership on this issue along with the work of Senators Enzi and Reed and the support of Senators Allard and Stabenow on the Safe and Fair Deposit Insurance Act of 2003.

Deposit insurance has been the bedrock of our banking system for nearly 70 years. It is especially significant to our Nation's community banks as the guarantee on deposits gives people confidence that their money will be safe.

The Federal Deposit Insurance Corporation (FDIC) has 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" perceptual advantage big banks enjoy.

Increasing coverage levels to $130,000 will help community banks raise core deposits and allow them to lend more back into farms, small businesses and their communities. This rotation of each dollar invested back into the community ensures stability. The viability of community banks is dependent on deposit insurance. In order to ensure their ability to continue serving 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.

Let me share with you one example of why our community banks need coverage level increases:

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 will not hold accounts above the $100,000 limit, and have often left the bank for competitor banks. This may be a viable option in Washington or in 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 Bank of America or a CitiBank.

Customers are not well served by having to drive to the next town to do their banking, and the Dalton, Nebraska bank loses deposits. Raising the coverage level, even a small amount, will allow communities to keep more deposits in their banks and expand their lending capacity.

A 2001 report by the Federal Reserve Bank of Kansas City supported this position by stating: ". . . a path that could help ease community bank funding problems is legislative changes in the form of greater deposit insurance coverage. . . ." Such changes have the potential to put community banks in a better position to attract and maintain deposits.

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 happen regardless of a slight increase in coverage levels, not because of it.

The proposals we are discussing 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.

PREPARED STATEMENT OF SENATOR TIM JOHNSON

Mr. Chairman, thank you for holding today's oversight hearing on the Federal Deposit Insurance System. I would like to welcome our distinguished panel of witnesses, and thank them for their time and for their thoughtful testimony. I would note that we are not giving Chairman Greenspan much time to catch his breath from the monetary policy hearings 2 weeks ago, but we are always pleased to have him here before the Senate Banking Committee.

While the political landscape has undergone significant change since we looked at the issue last year, the underlying need for reform has not. In fact, the Bank Insurance Fund has dropped back to 1.25 percent, underscoring the importance of this discussion. I am pleased that Chairman Shelby understands the critical nature of these reforms.

I have worked very hard over the past 2 years with my colleagues, in particular Senator Hagel, to focus attention on the need for deposit insurance reform. And I am pleased to see a growing consensus around many of the proposals contained in S. 229, the Safety Act. Again this year, we have significant support for the Safety Act from Members of this Committee, including Senators Hagel, Reed, Enzi, Stabenow, and Allard. I believe that the absolutely bipartisan support for the Safety Act shows the importance of this issue to our financial system.

If deposit insurance reform does not grab a lot of headlines, that means, as a general matter, it is working. Many of the reforms that we put in place following the S&L crisis, including prompt corrective action system, have been effective in reducing claims on the insurance funds. Nevertheless, the FDIC has identified some legitimate problems with the current system, and we should enact responsible reforms now while the system is relatively healthy.

In fact, the written testimony of today's witnesses highlights 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, the witnesses seem to 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 these weaknesses.

I 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 least indexed to keep pace with inflation.

Now 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.

In particular, I want to emphasize the importance of indexing deposit insurance to inflation. First, the real value of coverage has eroded by over half since 1980. Failure to index going forward means that the value of coverage will continue to decline, placing our community banks at a competitive disadvantage compared to large bank holding companies that currently offer more than $100,000. Second, failure to index coverage means that the level will remain subject to political forces. The strongest opponents of a coverage adjustment point to 1980, and say that the system should not have permitted a sudden increase in coverage from $40,000 to $100,000. I would respond that if we index coverage, we take the matter out of the political arena, and put it on auto-pilot. This is a common sense reform, and I believe that it should be a prerequisite for any final reform bill.

I also believe we should focus on the right level of coverage for retirement savings. Retirement coverage merits separate discussion, and I would commend to Members of this Committee the record from the Financial Institutions Subcommittee hearing that I held on November 1, 2001.

In fact, President Bush's continued emphasis on saving for retirement reinforces the notion that many retirees would like to have more than $100,000 in savings to guarantee a comfortable retirement. And those savings are critical, especially given some uncertainty about the long-term health of Social Security.

While many Americans have put those savings to work for them in a variety of investments, we have been reminded that while equity markets can provide unparalleled opportunities for economic growth, those opportunities come with volatility. Younger investors may have enough time to ride out ups and downs; however, those of us who are closer to retirement age have to make sure we have enough savings in secure investments to retire comfortably.

Yet while Congress has created significant incentives to encourage Americans to save for their retirement, we have not taken the necessary steps to let our retirees keep their life-savings safe in their local communities. We are just waking up to the fact that our current deposit insurance coverage of retirement savings is simply inadequate to support the cost of retirement in 2003. For these reasons, I would urge the Committee to examine the topic of coverage for retirement savings separately.

With that, Mr. Chairman, I once again thank you for holding today's hearing, and look forward to hearing from our witnesses.

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. And 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 a number of my colleagues, the House bill, and the Administration's 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.

I think I am in agreement with most of the experts here, although I have a slight disagreement with the FDIC on coverage limits. I even agree with the Fed. I have pointed out on the occasions when I think Chairman Greenspan is wrong. I think it is only fair I point out when I think he is right.

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 ELIZABETH DOLE

Mr. Chairman, I would like to express my appreciation for your holding this hearing today. As we are all aware, FDIC insurance plays a critical role in our Nation's financial system by ensuring consumer confidence and stability in the banking system. It has been almost 2 years since the FDIC issued a position paper recommending various reform measures meant to strengthen the system. It is my hope that we can move forward with legislation to implement these recommendations in a timely manner.

There are a number of issues involved in FDIC reform for which there appears to be widespread consensus. For instance, the merging of the Bank Insurance Fund and the Savings Association Insurance Fund into a single deposit insurance fund is long overdue. The much-publicized failure of thrifts in the late 1980's and early 1990's drastically reduced the number of thrifts that participate in the Savings Association Insurance Fund, creating greater volatility in the fund. The merger is a commonsense way to address this problem.

Most would also agree that we should remove the current hard target for the designated reserve ratio and replace it with a flexible range. This change would allow banks to do their job and provide credit when it is most important: When the economy is struggling. Both this issue and the merger issue were raised by the FDIC in their position paper, and I believe these changes will meet with little dissent.

However, there are some issues that have generated a great deal of debate. The first such issue where we will find different views among our very distinguished panel of witnesses is on the proposed increase of FDIC coverage levels above the current $100,000. My major concern on this issue is that increasing coverage levels will result in sharply higher premiums, especially at a time in our economy when we need more, not less, funds available for consumer and commercial lending. We cannot overlook this complication.

Second, we must deal effectively with the so-called "free riders." We have more than 900 new institutions, with billions of insured deposits, which have never paid premiums for the deposit insurance they receive. Meanwhile, other institutions have greatly increased their deposits since 1996 but have not paid any additional premiums. This is an issue of basic fairness on which we must act equitably.

I want to thank the witnesses before us today for taking the time to share their considerable knowledge on these important issues. I look forward to an informative discussion and trust that we can work toward a consensus and proper legislative response to these issues.

Thank you.

PREPARED STATEMENT OF ALAN GREENSPAN

CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

FEBRUARY 26, 2003

Chairman Shelby, Senator Sarbanes, and Members of the Committee, it is a pleasure to appear once again before this Committee to present the views of the Board of Governors of the Federal Reserve System on deposit insurance. Rather than refer to any specific bill, I will express the broad views of the Federal Reserve Board on the issues associated with modifications of deposit insurance. Those views have not changed since our testimony before this Committee on April 23, 2002.

At the outset, I note that the 2001 report of the Federal Deposit Insurance Corporation (FDIC) on deposit insurance highlighted the significant issues and developed an integrated framework for addressing them. Although as before the Board opposes any increase in coverage, we continue to support the framework constructed by the FDIC report for addressing other reform issues.

Benefits and Costs of Deposit Insurance

Deposit insurance was adopted in this country as part of the legislative effort to limit the impact of the Great Depression on the public. Against the backdrop of a record number of bank failures, the Congress designed deposit insurance mainly to protect the modest savings of unsophisticated depositors with limited financial assets. With references being made to "the rent money," the initial 1934 limit on deposit insurance was $2,500; the Congress promptly doubled the limit to $5,000 but then kept it at that level for the next 16 years. I should note that the $5,000 of insurance provided in 1934, an amount consistent with the original intent of the Congress, is equal to slightly less than $60,000 today, based on the personal consumption expenditures deflator in the gross domestic product accounts.

Despite its initial quite limited intent, the Congress has raised the maximum amount of coverage five times since 1950, to its current level of $100,000. The last increase, in 1980, more than doubled the limit and was clearly designed to let depositories, particularly thrift institutions, 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 thrift institutions 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 thrift institutions but unconcerned about the risk because the principal amounts of their $100,000 deposits were fully insured by the Federal Government. In this way, the 1980 increase in deposit insurance to $100,000 exacerbated the fundamental problem facing thrift institutions—a concentration on long-term assets in an environment of high and rising interest rates. Indeed, it significantly increased the taxpayer cost of the bailout of the bankrupt thrift institution deposit insurance fund.

Despite this problematic episode, deposit insurance has clearly played a key—at times even critical—role in achieving the stability in banking and financial markets that has characterized the nearly 70 years since its adoption. Deposit insurance, combined with other components of our banking safety net (the Federal Reserve's discount window and its payment system guarantees), has meant that periods of financial stress no longer entail widespread depositor runs on banks and on thrift institutions. Quite the opposite in fact: The asset holders now seek out deposits—both 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 importance of the security it has brought to millions of households and small businesses with relatively modest financial assets. Deposit insurance has given them a safe and secure place to hold their transaction and other balances.

The benefits of deposit insurance, as significant as they are, have not come without a cost. The very process that has ended deposit runs has made insured depositors largely indifferent to the risks taken by their depository institutions, just as it did with depositors in the 1980's with regard to insolvent, risky thrift institutions. The result has been a weakening of the market discipline that insured depositors would otherwise have imposed on institutions. Relieved of that discipline, depositories naturally feel less cautious about 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 risks it takes with its creditors' resources. This incentive to take excessive risks at the expense of the insurer, and potentially the taxpayer, is the so-called moral hazard problem of deposit insurance.

Thus, two offsetting implications of deposit insurance must be kept in mind. On the one hand, it is clear 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, even the current levels of deposit insurance may have already increased risk-taking at insured depository institutions to such an extent that future systemic risks have arguably risen.

Indeed, the reduced market discipline and increased moral hazard at depositories 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 thrift institutions to attract more resources, at lower costs, than would otherwise be the case. In short, insured institutions 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.

In sum, from the very beginning, deposit insurance has involved a tradeoff. Deposit insurance contributes to overall short-term financial stability and the protection of small depositors. But at the same time, because it also subsidizes deposit growth and induces greater risk-taking, deposit insurance misallocates resources and creates 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 a further increase in moral hazard or reduction in 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.

Issues for Reform

The FDIC has made five broad recommendations.

MERGE BIF AND SAIF

The Board supports the FDIC's proposal to merge the Bank Insurance Fund (BIF) with the Savings Association Insurance Fund (SAIF). Because the charters and operations of banks and thrift institutions 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 expense, and widen the fund base of an increasingly concentrated banking system. Most important, because banks and thrift institutions receive the same level of Federally guaranteed insurance coverage, the premiums faced by each set of institutions should be identical as well. Under current arrangements, the premiums faced by equally risky institutions could differ significantly if one of the funds falls below the designated reserve ratio of 1.25 percent of insured deposits and the other fund does not. Should that occur, depository institutions would be induced to switch charters to obtain insurance from the fund with the lower premium, a result that could distort our depository structure. The Federal Government should not sell a single service, like deposit insurance, at different prices.

REDUCE STATUTORY RESTRICTIONS ON PREMIUMS

Current law requires the FDIC to impose higher premiums on riskier banks and thrift institutions but prevents it from imposing any premium on well-capitalized and highly rated institutions when 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 would 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 highly rated institutions when the ratio of FDIC reserves to insured deposits exceeds 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 to many institutions when fund reserves meet some ceiling level. This free guarantee is of value to institutions even when they themselves are in sound financial condition and when macroeconomic times are good. At the end of the third quarter of last year, 91 percent of banks and thrift institutions were paying no premium. That group included many institutions that have never paid a premium for their, in some cases substantial, coverage, and it also included 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 highly rated banks and thrift institutions. And these two variables—capital strength and overall examiner rating—do not capture all the risk that institutions could create for the insurer. The Board believes that the FDIC should be free to establish risk categories on the basis of any economic variables shown to be related to an institution's risk of failure, and to impose premiums commensurate with that risk. Although a robust risk-based premium system would be technically difficult to design, a closer link between insurance premiums and the risk of individual institutions would reduce moral hazard and the distortions in resource allocation that accompany deposit insurance.

We note, however, that although significant benefits from a risk-based premium system are likely to require a substantial range of premiums, the FDIC 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 on premiums 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 that the market would apply and reduce the associated subsidy in deposit insurance.

Nonetheless, we should not delude ourselves into believing that even a wider range in the risk-based premium structure would eliminate the need for a Government back-up 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 those incurred 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 systemic risk and is thus subject to a far larger extreme loss in the tail of 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—could well require premiums that would discourage most depository institutions from offering broad coverage to their customers. 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.

I note that the difficulties of raising risk-based premiums explain why there is no real 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 it 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 by the private sector, the de-

pository institutions would likely lower their offering rates, thereby reducing the amount of insured deposits demanded, and consequently the amount outstanding would decline.

RELAXING THE RESERVE RATIO REGIME TO ALLOW GRADUAL ADJUSTMENTS IN PREMIUMS

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 be discontinued for well-capitalized and highly rated institutions. 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 the fund ratio is not likely to 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: They lower or eliminate fees in good times, when bank credit is readily available and deposit insurance fund reserves should be built up, and abruptly increase 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 institutions. The FDIC recommends that surcharges or rebates 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 changes in premiums. Indeed, we recommend that the FDIC's suggested target reserve range be widened 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.

In addition to supporting a widening of the range for the designated reserve ratio, the Board recommends that the FDIC be given the latitude to temporarily 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, to enhance macroeconomic stability, we prefer a reduction in the specificity of the rules under which the FDIC operates and, within the broad guidelines set out by the Congress, an increase in the flexibility with which the board of the FDIC can operate.

MODIFY THE REBATES SYSTEM

Since its early days, the FDIC has rebated "excess" premiums whenever it considered its reserves to be adequate. This procedure was replaced in the 1996 law by the requirement that no premium be imposed on well-capitalized and highly rated institutions when the relevant fund reached its designated reserve ratio. The FDIC's 2001 proposals would reimpose a minimum premium on all banks and thrift institutions and a more risk-sensitive premium structure. These provisions would be coupled with rebates for the stronger entities when the fund approaches the upper end of a target range and surcharges when the fund trends below the 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 consequent FDIC exposure. The devil, of course, is in the details. But varying the rebates in this way 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.

INDEXING CEILINGS ON THE COVERAGE OF INSURED DEPOSITS

The FDIC recommends that the current $100,000 ceiling on insured deposits be indexed to inflation. The Board does not support this recommendation and believes that the current ceiling should be maintained.

In the Board's judgment, increasing the coverage, even by indexing, is unlikely to 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 important bulwarks against bank runs. Thus, the problem that increased coverage is designed to solve must be related either to

the individual depositor, the party originally intended to be protected, or to the individual bank or thrift institution. Clearly, both groups would prefer higher coverage if it cost them nothing. But the Congress needs to be clear about the nature of a specific problem for which increased coverage would be the solution.

Depositors

Our most recent 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 assets 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. A bank would clearly prefer that the depositor maintain all of his or her funds at that bank and would prefer to reduce the need for depositor diversification by being able to offer higher deposit insurance coverage. Nonetheless, depositors appear to have no great difficulty—should they want insured deposits—in finding multiple sources of fully insured accounts.

In addition, one of the most remarkable characteristics of household holdings of financial assets has been the increase in the diversity of portfolio choices since World War II. And since the early 1970's, the share of household financial assets in bank and thrift deposits has generally declined steadily as households have taken advantage of innovative, attractive financial instruments with market rates of return. The trend seems to bear no relation to past increases in insurance ceilings. Indeed, the most dramatic substitution out of deposits has been the shift from both insured and uninsured deposits into equities and into mutual funds that hold 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. Rather, the data indicate that the weakness in stock prices in recent years has been marked by increased flows into bank and thrift deposits even without changed insurance coverage levels.

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 related to small banks because 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 banks smaller than the largest 1,000 have grown at an average annual rate of 13.8 percent, more than twice the pace of the largest 1,000 banks. Uninsured deposits, again adjusted for the effects of mergers, have grown at average annual rates of 21 percent at the small banks versus 10 percent at the large 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 additional deposit insurance serves a national purpose. I might add that throughout the 1990's and into the present century, return on equity at small banks has been well-maintained. Indeed, the attractiveness of banking is evidenced by the fact that more than 1,350 banks were chartered during the past decade, including more than 600 from 1999 through 2002.

Some small banks argue that they need enhanced deposit insurance coverage to compete 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 the FDIC Improvement Act of 1991 (FDICIA), the 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. The market has clearly evidenced the view, consistent with FDICIA, that large institutions are not too big for uninsured creditors to take at least some loss should the institution fail. For example, no U.S. banking organization, no matter how large, is AAA-rated. In addition, research indicates that creditors impose higher risk premiums on the uninsured debt of relatively risky large banking organizations and that this market discipline has increased since the enactment of FDICIA.

To be sure, the real purchasing power of deposit insurance ceilings has declined. But there is no evidence of any significant detrimental effect on depositors or depository 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, even if its real value were to erode further.

Another argument that is often raised by smaller banks regarding the need for increased deposit insurance coverage. Some smaller institutions say that they are unable to match the competition from large securities firms and bank holding companies with multiple bank or thrift institution affiliates because those entities offer multiple insured accounts through one organization. I note that since the Committee's last hearings on this issue, the force of small banks' concerns has been reduced by recent market developments in which small banks and thrift institutions can use a clearinghouse network for brokered deposits that allows them to offer full FDIC insurance for large accounts. The Board agrees that such practices by both large and small depositories are a misuse of deposit insurance. Moreover, raising the coverage limit for each account is not a remedy for small banks because it would also increase the aggregate amount of insurance coverage that multidepository 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 to inflation. The thrust of our recommendations would call for a wider permissible range for the size of the fund relative to insured deposits, reduced variation of the insurance premium as the relative size of the fund changes with banking and economic conditions, a positive and more risk-based premium net of rebates for all depository institutions, and the merging of BIF and SAIF.

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 or that the level of deposit coverage appears to be endangering financial stability. Should either of those events occur, the Board would call its 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 depository institutions, expand moral hazard, and reduce the incentive for market discipline without providing any clear public benefit. 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 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

FEBRUARY 26, 2003

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

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

Our current deposit insurance system managed by the Federal Deposit Insurance Corporation (FDIC) serves to protect insured depositors from exposure to bank losses and, as a result, helps to promote public confidence in the U.S. banking system. I am concerned today that our deposit insurance system has structural weak-

nesses that, in the absence of reform, could deepen over time. I want to emphasize that there is no crisis in the FDIC; both of its funds are strong, well-managed, with adequate reserves. This is the right time to act—when we do not face a crisis—and the Administration supports legislation focused on the repair of these structural weaknesses.

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

Merging the Bank and Thrift Insurance Funds

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

Flexibility in the Management of FDIC Reserves

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

Reserves should be allowed to grow when conditions are good. This would enable the fund to better absorb losses under adverse conditions without sharp increases in premiums. In order to achieve this objective and also to account for changing risks to the insurance fund over time, we support greater latitude for the FDIC to alter the designated reserve ratio within statutorily prescribed upper and lower bounds. Within these bounds, the FDIC should provide for public notice and comment concerning any proposed change to the designated reserve ratio. The FDIC should also have discretion in determining how quickly the fund meets the designated reserve ratio as long as the actual reserve ratio is within these bounds. If the reserve ratio were to fall below the lower bound, the FDIC should restore it to within the statutory range promptly, over a reasonable but limited time frame. We would also support some reduction in the prescribed minimum premium rate—currently 23 basis points—that would be in effect if more than 1 year were required to restore the fund's reserves.

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

Full Risk-Based Shared Funding

Every day that they operate, banks and thrifts benefit from their access to Federal deposit insurance. For several years, however, the FDIC has been allowed to obtain premiums for deposit insurance from only a few insured institutions. Cur-

rently, over 90 percent of banks and thrifts pay nothing to the FDIC. This is an untenable formula for the long-term stability of the FDIC.

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

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

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

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

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

Deposit Insurance Coverage Limits

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

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

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

Higher Coverage Limits Not Sought by Savers

First of all, the clamor for raising coverage limits does not come from savers. The evidence that current coverage limits constitute a burden to savers is scant; there has been little demand from depositors for higher maximum levels. The recent consumer finance survey data released by the Federal Reserve confirm what we found in the previous survey, namely that raising the coverage limit would do little, if any-

thing, for most savers. Median family deposit balances are only $4,000 for transaction account deposits and $15,000 for certificates of deposit, far below the current $100,000 ceiling. The same holds true even when considering only older Americans, a segment of the population with higher bank account usage: Median transaction account balances and certificates of deposit total $8,000 and $20,000, respectively, for those households headed by individuals between the ages of 65 and 74.

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

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

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

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

Coverage Limits and Bank Competition

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

Higher Coverage Limits for Municipal Funds Erode Discipline

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

Conclusion

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

PREPARED STATEMENT OF DONALD E. POWELL

CHAIRMAN, BOARD OF DIRECTORS OF THE
FEDERAL DEPOSIT INSURANCE CORPORATION

FEBRUARY 26, 2003

Chairman Shelby, Senator Sarbanes, and Members of the Committee, it is a pleasure to appear before you this morning to discuss deposit insurance reform. This remains the top priority of the Federal Deposit Insurance Corporation and I appreciate this Committee's continuing interest in pursuing reform.

The need for reform—and the FDIC's reform recommendations—have not changed since the last time I testified before this Committee, and much of our testimony will sound familiar to most of you. An effective deposit insurance system contributes to America's economic and financial stability by protecting depositors. For more than three generations, our deposit insurance system has played a key role in maintaining public confidence.

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. These flaws can be corrected only by legislation.

Today, I want to emphasize three elements of deposit insurance reform that the FDIC regards most critical—merging the funds, improving the FDIC's ability to manage the fund, and pricing premiums properly to reflect risk. These changes are needed to provide the right incentives to insured institutions and to improve the deposit insurance system's role as a stabilizing economic factor, while also preserving the obligation of banks and thrifts to fund the system. There is widespread general agreement among the bank and thrift regulators for these reforms.

Merging the BIF and the SAIF

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

A merged fund would be stronger and better diversified than either fund standing alone. From the point of view of the insured depositor, there is virtually no difference between banks and thrifts. Moreover, many institutions currently hold both BIF- and SAIF-insured deposits. More than 40 percent of SAIF-insured deposits are now held by commercial banks.

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. Such a price disparity has led in the past, and would inevitably lead in the future, to wasteful attempts to circumvent restrictions preventing institutions from purchasing deposit insurance at the lower price. The potential for differing rates is not merely theoretical. The BIF reserve ratio on September 30, 2002, stood at 1.25 percent, the absolute minimum required by law, while the SAIF reserve ratio stood at 1.39 percent.

For all of these reasons, the FDIC has advocated merging the BIF and the SAIF for a number of years. 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 statutorily mandated designated reserve ratio (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 mandatory high average premiums 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, the requirement for high premiums could be triggered.

The statutory provision requiring a 1.25 percent DRR and mandatory high premiums when a fund falls sufficiently below the DRR were intended to protect the taxpayers and prevent the deposit insurance funds from becoming insolvent, as the Federal Savings and Loan Insurance Corporation (FSLIC) became during the 1980's. However, these provisions, intended as protections, could cause unintended problems. During a period of heightened insurance losses, both the economy in general and the depository institutions in particular are more likely to be distressed. High

premiums at such a point in the business cycle would be procyclical and would result in a significant drain on the net income of depository institutions, thereby impeding credit availability and economic recovery. As I will discuss later, there are ways to protect the taxpayers while avoiding some of the procyclicality of the present system.

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] Today, 91 percent of banks and thrifts are well-capitalized and well-managed and pay the same rate for deposit insurance—zero. Yet, significant and identifiable differences in risk exposure exist among these 91 percent of insured institutions. To take one example, since the mid-1980's, institutions rated CAMELS 2 have failed at more than two-and-one-half 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. The current system does not charge appropriately for risk, which increases the potential for moral hazard and makes 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, almost 1,000 new banks and thrifts have joined the system and never paid for the insurance they received. Other institutions have grown significantly without paying additional premiums.

These problems can be addressed by eliminating the existing inflexible statutory requirements and by giving the FDIC Board of Directors the discretion and flexibility to charge regular risk-based premiums over a much wider range of circumstances than current law now permits.

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 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; rather, it is to distribute the assessment burden more evenly over time and more fairly across insured institutions.*

Under the FDIC's recommendations, the reserve ratio would be allowed to move up and down within a specified range during the business cycle so that premiums can remain steady. The key to fund management would be to maintain the fund within the statutory range and to bring the fund ratio back into the range in an appropriate timeframe when it moves outside in either direction. As the reserve ratio moves, the Board should have the flexibility to use credits, rebates, or surcharges in order to keep the ratio within the range. Moreover, 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. To manage the insurance fund effectively, the Board must have the flexibility to respond appropriately to differing economic and industry conditions.

While I believe that the FDIC Board needs greater discretion to manage the fund, we are not suggesting the FDIC be given absolute discretion—there is a need for accountability. The FDIC will work with the Congress to develop parameters for an appropriate range for the fund ratio. The FDIC also will work with the Congress

[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.

to provide 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.

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. The goals of risk-based premiums can be accomplished 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 objective indicators are used to the extent possible to measure risk in institutions. Any system adopted by the FDIC 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 is considering 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. As the result of many discussions with bankers, trade-group representatives, and other regulators, as well as our own analysis, we are looking at several possible pricing methodologies. We actively seek input from the industry and the Congress regarding possible pricing schedules that are analytically sound.

For the largest banks and thrifts, it will be necessary to augment the financial information banks report with other information, including market-based data. The final risk-based pricing system must be fair and must not discriminate in favor of or against banks merely because they happen to be large or small.

In short, 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 that there is a need to exercise 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. Almost 1,000 newly chartered institutions, with more than approximately $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.

New institutions and fast-growing institutions have benefited from the assessments paid by 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. One way to address the fairness issue that has arisen and to acknowledge the contributions of the banks and thrifts that built up the funds during the early 1990's is to provide transitional assessment credits to these institutions.

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 year-end 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 their higher future premiums. Institutions that never paid premiums would receive no assessment credit. Institutions that made significant contributions to 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 during which banks that contributed in the past could offset their premium obligations through the use of credits.

The combination of risk-based premiums and assessment credits tied to past contributions to the fund would address the issues related to rapid growers and new

entrants. Regular risk-based premiums for all institutions would mean that the fast-growing institutions would pay increasingly larger premiums as they gather the 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

The reforms just described are critical to improving the deposit insurance system. Let me conclude my discussion with the most controversial, but the least critical, of the FDIC's recommendations, the recommendation on coverage. The FDIC's recommendation is simple: Whatever the level of deposit insurance coverage Congress deems appropriate, the coverage limit should be indexed to ensure that the value of deposit insurance does not wither away over time. If Congress decides to maintain deposit insurance coverage at its current level, indexing will not expand coverage or expand the Federal safety net. It will simply hold the value of coverage steady over time. In addition, without arguing about the causes and contributing factors of the thrift crisis, indexing the limit on a regular basis may prevent possible unintended consequences of large, unpredictable adjustments made on an ad hoc basis in the future.

Conclusion

Federal deposit insurance was created in a period of economic crisis to stabilize the economy by protecting depositors. By any measure, it has been remarkably effective in achieving its goals over the years. It is no less important today.

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, the goal of reform is to distribute the assessment burden more evenly over time and more fairly across insured institutions. This is good for depositors, good for the industry, and good for the overall economy.

The responsibility of prudently managing the fund and maintaining adequate reserves are taken very seriously by the FDIC—I must reiterate: It is extremely important to depositors, to the industry, and to the financial and economic 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 FDIC's recommendations would retain the essential characteristics of the present system and improve upon them. While Chairman, I will 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 will do so as well.

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 FDIC has put forward some important recommendations for improving our deposit insurance system. We appreciate the Committee's leadership on this issue and look forward to working with each of you to get the job done this year.

PREPARED STATEMENT OF JOHN D. HAWKE, JR.

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

FEBRUARY 26, 2003

Introduction

Chairman Shelby, Senator Sarbanes, and the Members of the Committee, I am pleased to have this opportunity today to present the views of the Office of the Comptroller of the Currency (OCC)* on deposit insurance reform. For almost 70 years, Federal deposit insurance has been one of the cornerstones of our Nation's economic and financial stability. It has relegated bank runs to the history books and helped our country weather the worst banking crisis since the Great Depression without significant adverse macroeconomic effects. Despite this admirable history, there are flaws in our current deposit insurance structure. In fact, efforts to address weaknesses in the system uncovered during the banking and thrift crises of the 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 Federal De-

*Statement required by 12 U.S.C. § 250. The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

posit Insurance Corporation (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.

In summary, the OCC recommends that:

- The FDIC be provided with the authority to implement a risk-based deposit insurance premium system for all banks.
- The current fixed designated reserve ratio (DRR) be replaced with a range to allow the FDIC more flexibility in administering the deposit insurance premium structure over the business cycle.
- Any program of rebates or credits issued when the fund exceeds the upper end of the DRR range take into account the fact that the FDIC and the Federal Reserve already deliver a substantial subsidy to State-chartered banks by absorbing their costs of Federal supervision, and that deposit insurance premiums paid by national banks pay, in part, for the supervision of State-chartered banks.
- The BIF and SAIF be merged.
- Coverage limits on deposits not be increased.

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 parts of deposit insurance reform. While current law mandates that the FDIC charge risk-based insurance premiums, it also prohibits the FDIC from charging premiums to any institution in the 1A category—in general, 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, 91 percent of all insured depository institutions pay nothing for their deposit insurance even though all institutions pose some risk of loss to the FDIC. 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.

A system in which the vast majority of institutions pay 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. The FDIC should be free to set risk-based premiums for all of the insured institutions.

Dampening Procyclicality and Fund Management

Under current law, whenever the reserve ratio of the BIF or SAIF falls below 1.25 percent the FDIC is required either to charge an assessment rate to all banks high enough to bring the fund back to the DRR within 1 year, or if that is not feasible, an assessment rate of at least 23 basis points. This sharp rise in premiums, or "cliff effect," is likely to 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 let the funds build in good times and to draw down slightly in bad times.

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. If a fund falls below the bottom of the range, we believe it would be preferable to allow the FDIC to rebuild the fund gradually to eliminate the 23 basis point "cliff effect." Adoption of a range and elimination of the "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.

If a fund exceeds the upper boundary of the DRR range, the FDIC should be authorized to pay rebates or grant credits against future premiums. While such credits or rebates seem reasonable, there are two principles that should be observed in de-

termining their allocation and use. First, a system of rebates or credits should not undermine the risk-based premium system. Thus, rebates or credits should not be based on an institution's current assessment base. If they were, rebates or credits would lower the marginal cost of insurance. For example, if an institution with a risk-based premium of three basis points received a rebate or credit of two basis points for each dollar of assessable deposits, its true premium would only be one basis point. Another implication of rebates or credits not undermining risk-based premiums is that institutions that paid high insurance premiums in the past 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. Finally, an institution that is faced with a high premium because of high risk should not be allowed to completely offset that premium with credits.

The second principle is that the payment of rebates and credits should take into account the fact that not all insured institutions receive the same services for their deposit insurance dollars. The FDIC uses proceeds from the deposit insurance funds to cover its own costs of supervising State-chartered banks, and it does not pass these costs on to the banks. In 2001, this amounted to an in-kind transfer from the FDIC to State nonmember banks of over $500 million. During this same time, by contrast, national banks paid over $400 million in assessments to the OCC to cover their own costs of supervision.[1] In a regime under which all institutions were paying premiums, national banks should not be required to pay both for their own supervision, and also for a portion of the supervisory costs of their State-chartered competitors. It would be unconscionable for the FDIC to issue credits or rebates to State-chartered banks without first taking into account the subsidy it provides to these banks by absorbing their costs of supervision—a subsidy that is funded in good part by deposit insurance premiums paid by national banks.

Merger of the BIF and the SAIF

One of the most straightforward 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 third quarter of 2002, the reserve ratio of the BIF was 1.25 percent, while that of the SAIF was 1.39 percent. The reserve ratio of a combined fund would have been 1.28 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, the 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.

In addition, a combined fund would insure a larger number of institutions with broader asset diversification than either fund individually. It would also decrease the exposure of the funds—especially the SAIF—to a few large institutions. Industry consolidation has led to increased concentration of insured deposits in a handful of institutions. As of September 30, 2002, the three largest holders of BIF-insured deposits held 15 percent of BIF-insured deposits. The corresponding share for the three largest holders of SAIF-insured deposits was 18 percent. For a combined fund the figure would have been 14 percent. For all these reasons, merger of the two funds would result in a diversification of risks.

Further, there is significant overlap in the types of institutions insured by the two funds. As of September 30, 920 banks and thrifts, or roughly 10 percent of all insured depository institutions, were members of one fund but also held deposits insured by the other fund, and BIF-member institutions held 43 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.

Increasing Coverage Limits

The question of deposit insurance coverage limits is a challenging one, in part because it is easy for depositors to obtain full insurance of deposits in virtually unlimited amounts through multiple accounts. 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. However, there

[1] The Federal Reserve pays for its supervision of State member banks out of funds that would otherwise be remitted to the Treasury. Thus, the taxpayer pays for the supervision of State member banks.

is little evidence to support this contention. Over the 12 months ending September 30, 2002, deposits at commercial banks with under $1 billion in assets grew at a healthy 3.8 percent annual rate, while loan volume actually declined. As a result, loan-to-deposit ratios at such institutions fell from 88 percent to 79 percent.

In addition, 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, however, 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 the larger, more aggressive institutions might use the expanded coverage to offer even more extensive governmentally protected investment vehicles to their wealthy customers. That could cause an even greater shift of deposits away from community banks and increase liquidity pressures.

For many of the same reasons that 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. Increasing the limit on municipal deposits would not provide municipalities with greater protection—they can already secure their deposits—and it is by no means clear that increasing the deposit insurance limit would result in funds flowing into community banks. In addition, an increase in insured coverage could spur riskier lending because banks would no longer be required to collateralize municipal deposits with low-risk securities.

Conclusion

The OCC supports a merger of the BIF and the SAIF and proposals to eliminate the current constraints on deposit insurance premiums. We also 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 believe that any credits or rebates issued when the fund exceeds the upper range of the DRR must first take account of the subsidy that State-chartered banks receive as a result of having the costs of their Federal supervision absorbed by their Federal regulators, and the fact that deposit insurance premiums paid by national banks in effect pay for a large portion of this subsidy.

PREPARED STATEMENT OF JAMES A. GILLERAN

DIRECTOR, OFFICE OF THRIFT SUPERVISION

U.S. DEPARTMENT OF THE TREASURY

FEBRUARY 26, 2003

Introduction

Good morning, Chairman Shelby, Senator Sarbanes, 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)* fully supports 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. A large majority of insured depository institutions continue to be healthy and profitable, which presents us with the best opportunity to improve our deposit insurance system.

Even as the bank and thrift industries have prospered, the reserve ratio for the Bank Insurance Fund (BIF) has steadily declined the last several years. The reserve ratio for the Savings Association Insurance Fund (SAIF) has reversed its own steady decline by increasing three basis points during the second and third quarters of 2002. The decline in the BIF ratio has been fairly dramatic, dropping from 1.40 percent in June 1999 to 1.25 percent as of September 30, 2002. 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.

*Statement required by 12 U.S.C. § 250. The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent the views of the President.

If SAIF remains at or near its current 1.39 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 the 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 affects both funds, regardless of the institution's fund membership. Thus, the funds are already significantly co-dependent, 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 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 September 30, 2002, the largest BIF-insured institution accounted for 9.0 percent of BIF-insured deposits; and the largest SAIF-insured institution held 9.9 percent of SAIF-insured deposits. A fund merger as of September 30, 2002, would have had the largest BIF institution accounting for only 7.7 percent of combined deposits and the largest SAIF member holding only 2.5 percent of combined deposits. Fund merger would moderate concentration risk and reduce pressure for higher premiums.

Premium disparity is another potential problem. 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 even though both funds provide identical deposit insurance coverage. Premium differentials 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 in 1996 demonstrated that premium differentials are destabilizing because institutions shift deposits to the less expensive fund or seek nondeposit funding sources to avoid the cost of the higher premium. Fund merger eliminates this problem.

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. Higher premiums also hamper the ability of all institutions to finance activities that would help to improve the economy. Increasing the FDIC's flexibility to set fund premiums within a target range

[1] As of September 30, 2002, commercial banks held 45 percent of SAIF-insured deposits, with 47 percent of SAIF-insured deposits held by OTS-supervised thrifts. The remaining 8 percent of SAIF-insured deposits were held by FDIC-supervised savings banks.

would reduce insured institutions' exposure to overall economic conditions and to sector 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 and would also address existing inequities in the system attributable to "free riders" that have not contributed to the fund.

DEPOSIT INSURANCE COVERAGE LEVELS

Increasing the Current Coverage Level

While I support the goal of increasing the ability of institutions—particularly small community-based depositories—to attract more deposits, I am not convinced 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 significantly would result in higher 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. I do not see the need for indexing in light of the higher risks and costs involved. There are four factors that frame my view on indexing.

First, current rules governing Federal deposit insurance coverage already 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 relatively few persons holding more than $100,000 in deposits can protect every dollar of savings with the FDIC deposit insurance.

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 through indexing will eventually require higher deposit insurance premiums from insured institutions. While some argue that indexing is an important issue for smaller institutions, I have seen no convincing data supporting the notion that raising deposit coverage levels will benefit smaller institutions. Indexing also 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 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 institutions and their customers should view it negatively.

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 negative 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 insurance reform bill that would: (i) merge the BIF and SAIF and (ii) provide FDIC flexibility to set insurance premiums within a target range. 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.

Thank you for this opportunity to discuss Federal deposit insurance reform. I look forward to working with you, Chairman Shelby, and the Members of the Committee, and appreciate your time and attention to this issue.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR ENZI FROM ALAN GREENSPAN

Q.1. Some of the changes in the recommendations proposed seem like common sense, particularly issues providing more flexibility to the FDIC in setting the reserve ratio and returning the fund to that level. Can you please provide me with a reason why some of these flexibilities weren't included with the legislation when the programs were initially instituted?

When I obtain car insurance, no matter how good a driver I am, I pay for the insurance and the benefits I receive. Why is it that the law provides that some banks, who admittedly may be very well-managed, aren't required to pay for the insurance they receive from the fund?

A.1. The Board agrees that it makes sense to provide more flexibility to the FDIC in setting the reserve ratio or target range and to set risk-based premiums to help return the fund to that level or range. The current statutory requirement that free deposit insurance be provided to well-capitalized and highly rated institutions when the ratio of the FDIC reserves to insured deposits exceeds a predetermined ratio maximizes the subsidy provided to these institutions and is inconsistent with efforts to avoid inducing moral hazard. This free guarantee is of value to institutions even when they are in sound financial condition and when macroeconomic times are good. At the end of the third quarter of last year, 91 percent of banks and thrift institutions were paying no premium. 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 on highly rated banks and thrift institutions. The Board believes that the FDIC should be free to establish risk categories on the basis of any economic variables shown to be related to an institution's risk of failure, and to impose premiums commensurate with that risk. A closer link between insurance premiums and the risk of individual institutions would reduce moral hazard and the distortions in resource allocation that accompany deposit insurance.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SCHUMER FROM ALAN GREENSPAN

Q.1. Mr. Greenspan, as your testimony pointed out, with many of the changes we are discussing, "the devil is in the details." Can you comment on the specific methodologies for evaluating risk that you believe the FDIC should consider employing if it moves to a risk-based premium system? Can you specifically comment on the issue of calculating "systemic" risk given, as I understand it, the still early stages of our understanding of that risk category?

A.1. The Board believes that the FDIC should be free to establish risk categories on the basis of any economic variables shown to be related to an institution's risk of failure, and to impose premiums commensurate with that risk. The best methodologies for assessing risk are constantly changing based on the evolving modeling techniques and the changing economic conditions and financial instru-

ments. As well, the banks may react in unexpected ways to any risk-based premium system, and so the FDIC should have the flexibility to react to any unforeseen consequences.

Systemic risk is indeed difficult to calculate, but the Board does not believe that FDIC premiums should necessarily cover all the risks related to systemic crises and fully eliminate the subsidy in deposit insurance. To eliminate the subsidy in deposit insurance, the FDIC average insurance premium would have to be set high enough to cover fully the very small probabilities of very large losses and to cover 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 systemic risk and is thus subject to a far larger extreme loss in the tail of the probability distributions from which full insurance premiums would have to be calculated. Indeed, pricing deposit insurance risks to fully fund potential losses and cover systemic risk could well require premiums that would discourage most depository institutions from offering broad coverage to their customers. Since the Congress has determined that there should be broad coverage, the subsidy in deposit insurance cannot be *fully* eliminated and the Government has to absorb some of the costs of systemic risk, although we can and we should eliminate as much of the subsidy as we can.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MILLER FROM ALAN GREENSPAN

Q.1. My understanding is that the Congress, in 1978, voted to allow the FDIC to insure IRA and Keogh accounts at the $100,000 level while regular savings did not receive that level of coverage?

First, am I correct about this? Second, can you discuss your position on coverage of particular categories of deposits like retirement savings taking into account this past history?

A.1. First of all, your statement about the 1978 vote is correct. In response to your second question, the Board opposes increases in deposit insurance coverage for any type of deposit at the present time. Raising the coverage limits now would extend the safety net, increase the Government subsidy to depository institutions, expand moral hazard, and reduce the incentive for market discipline without providing any clear public benefit. With respect to retirement accounts, according to the Board's 2001 Survey of Consumer Finances, the current insurance limit is not binding for the vast majority of IRA/Keogh accounts at insured depository institutions. In addition, most households do not exhibit a strong preference for holding their retirement accounts in an insured depository. Again, according to the 2001 Survey of Consumer Finances, households hold slightly less than 22 percent of the value of their IRA/Keogh accounts in an insured institution.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR JOHNSON FROM ALAN GREENSPAN

Q.1. One reform proposal includes a provision that would cap allowable premiums to the most highly rated institutions at one basis point, regardless of economic conditions. Some have argued that such a cap merely shifts the subsidy to a smaller category of finan-

cial institutions, but clearly undermines the fundamental reform proposal. Would you please comment on the one-basis-point cap proposal?

A.1. The Board believes that the FDIC should be allowed to set deposit insurance premiums so as to reflect the risk that a given institution poses to the deposit insurance fund. For even the safest institutions in the best economic environment, it is virtually certain that a premium of one basis point would not be sufficient to cover that risk. As I indicated in my testimony, the Board has concluded "that if a cap on premiums 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 that the market would apply and reduce the associated subsidy in deposit insurance."

Q.2.a. Given that a merged fund would have a ratio of around 1.28 percent, do you believe that a range that extends from 1.25 to 1.5 percent provides the FDIC with sufficient flexibility to address the procyclicality concerns you have expressed?

A.2.a. The Board has no particular numbers in mind for the width of the permissible range for the designated reserve ratio (DRR). A relatively wide range would allow for more stability in premium rates over the economic cycle, an important goal of deposit insurance reform. However, although a range for the DRR is necessary to reduce procyclicality, it is not sufficient. In addition, when the actual reserve ratio (RR) either falls below the DRR or the range's lower limit, or rises above the DRR or the range's upper limit, it is important for the FDIC also to have the flexibility to restore the RR to its proper level in a way that does not cause wide swings in premiums. In particular, both a large premium increase when the economy is weak and a large premium decrease when the economy is strong should be avoided.

Q.2.b. Please tell the Committee specifically what range you believe would best address the procyclicality of the current system, and give a complete explanation of the breadth of the range.

A.2.b. Please see the answer to question (a).

Q.3. Please set forth your thoughts as to whether any new deposit insurance system should include specific triggers or recapitalization schedules should the deposit insurance reserves fall below the floor of the range.

A.3. This is a difficult question, and the answer requires a careful balancing of the need to limit the procyclicality of insurance premiums with the needs to limit taxpayer liability and to mange the insurance fund in a sound manner. On balance, the Board supports some legislative guidance to the FDIC regarding how quickly the insurance fund should be recapitalized. However, for the reasons I discussed in response to question (a), such guidance also should not hard wire rules that would force the FDIC to impose premiums that could seriously impair overall economic activity.

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

Q.1. Some of the changes in the recommendations proposed seem like common sense, particularly issues providing more flexibility to the FDIC in setting the reserve ratio and returning the fund to that level. Can you provide me with a reason why some of these flexibilities weren't included with the legislation when the programs were initially instituted?

A.1. Congress established the current designated reserve ratio (DRR) in 1989 and imposed requirements on the FDIC in 1991 to maintain the DRR. These requirements came in the wake of the collapse of the savings and loan (S&L) deposit insurance fund, the appropriation of significant taxpayer resources to protect insured deposits at failed S&L's, and the temporary depletion of the reserves in the insurance fund for banks. Of paramount importance to the Congress and Executive Branch policymakers at that time was the need to ensure that, going forward, depository institutions themselves, not taxpayers, pay to protect insured deposits at failed institutions. Now that the FDIC's bank and thrift deposit insurance funds are well-managed and have adequate reserves, the Administration believes that this is the right time to act to correct certain structural weaknesses and improve the system's operation.

Q.2. When I obtain car insurance, no matter how good a driver I am, I pay for the insurance and the benefits I receive. Why is it that the law provides that some banks, who admittedly may be very well-managed, aren't required to pay for the insurance they receive from the fund?

A.2. The Federal Deposit Insurance Corporation Improvement Act of 1991 did provide the FDIC with the authority to charge every institution a risk-based premium. Legislation enacted in 1996, however, significantly curtailed this authority by prohibiting the FDIC from charging premiums to well-capitalized and well-rated institutions when the reserve ratio has achieved or exceeded the designated reserve ratio. As a result, over 90 percent of banks and thrifts currently do not pay deposit insurance premiums.

Q.3. I know that most of you oppose raising the coverage limits. However, if you had to choose, which increase would trouble you most—individual, retirement, or municipal.

A.3. The Administration does not support legislation that raises deposit insurance coverage limits in any form, and we urge that Congress avoid such an unneeded and counterproductive diversion from real and necessary reform.

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

Q.1. Mr. Fisher, in your testimony you highlighted what you labeled the "free rider problem," which some might view as a loaded description of the deposit growth in the fund by certain institutions. Is your contention that these banks or thrifts were violating the law in some way or somehow unethically benefiting in ways not mandated by the law?

A.1. Every day that they operate, banks and thrifts benefit from their access to Federal deposit insurance. Yet, under existing law, over 90 percent of banks and thrifts currently do not have to pay deposit insurance premiums. Working within the current deposit insurance rules, some large financial companies have greatly augmented their insured deposits in the past few years by sweeping uninsured funds into their affiliated depository institutions—without having to compensate the insurance funds. Other major financial companies might be expected to do the same in the future. In addition, most of the over 1,100 banks and thrifts chartered after 1996 have never had to pay any deposit insurance premiums. To rectify this "free rider" problem, Congress should remove the current restrictions on FDIC premium setting.

There is nothing illegal or unethical in the current situation. But the current situation is unsound and inequitable as a financial matter.

Q.2. You stated that the reserve ratio would fall below its target level due to adverse economic conditions, but you now seem to be saying it has fallen due to the success of certain institutions in growing deposits. Which is the correct explanation?

A.2. The reserve ratio is the ratio of fund reserves to estimated insured deposits. Higher insurance losses, possibly fueled by adverse economic conditions, could cause fund reserves to decline and thereby lower the reserve ratio. In addition, higher levels of insured deposits may, by definition, reduce the reserve ratio, other factors being equal. Therefore, both adverse economic conditions and higher insured deposit levels could contribute to a decline in the reserve ratio.

Q.3. Finally, I am interested in how you reconcile support for risk-based premiums with your support for on-going assessment credits which, as you explain it, "permit the FDIC to collect payments from institutions more closely in relation to their deposit growth." Are you advocating charging institutions based on the risk they pose to the fund or their success in growing their deposits?

A.3. We believe that insured depository institutions should appropriately compensate the FDIC commensurate with their risk. In order to accomplish this, Congress should remove the current restrictions on FDIC premium-setting. This would also mean that an institution's total payments would rise as its insured deposits rose: For two institutions with the same risk profiles but different levels of deposits, the institution with more deposits should pay more in premiums. Therefore, both risk and deposit levels should affect an institution's total premium payment.

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

Q.1. "Retirement Savings Accounts": My understanding is that the Congress, in 1978, voted to allow the FDIC to insure the IRA and Keogh accounts at the $100,000 level while regular savings did not receive that level of coverage ($40,000 instead). Am I correct?

A.1. Yes. In 1978, Congress increased the IRA and Keogh account coverage limit to $100,000 and then increased the general coverage limit to $100,000 2 years later.

Q.2. Can you discuss your position on the coverage of particular categories of deposits like retirement savings accounts taking into account this past history?

A.2. Examining the Federal Reserve data on retirement (IRA/ Keogh) accounts also shows present maximum deposit insurance coverage to be more than adequate. The median balance across age groups held in IRA/Keogh accounts at insured depository institutions is only $15,000. For the 65 to 69 age group, median household IRA/Keogh deposits total $30,000 ($27,500 for those 70 or over). Furthermore, at little inconvenience, savers with substantial bank deposits including retirees and those with large bank savings for retirement—may place deposits at any number of banks to obtain as much FDIC coverage as desired.

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

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

Q.1. One reform proposal includes a provision that would cap allowable premiums to the most highly rated institutions at one basis point, regardless of economic conditions. Some have argued that such a cap merely shifts the subsidy to a smaller category of financial institutions, but clearly undermines the fundamental reform proposal. Would you please comment on the one-basis-point cap proposal?

A.1. We believe that the one-basis-point cap would needlessly undermine one of the primary goals of reform, namely, restoring the ability of the FDIC to align premiums more closely with risk. The cap would constrain the FDIC in how much revenue it can collect from that risk group, causing it to have to meet its revenue needs primarily from all other risk groups and thereby causing the risk-based rates to diverge from what they should be.

Q.2. In Chairman Greenspan's testimony, he highlights the procyclicality of the current system as one of its major flaws. He advocates that the "suggested target reserve range be widened to reduce the need to change premiums abruptly." In addition, Chairman Greenspan has suggested that "the FDIC be given the latitude to temporarily relax floor or ceiling ratios on the basis of current and anticipated banking conditions and expected needs for resources to resolve failing institutions."

In the Safety Act, we have proposed a range that extends from 1 to 1.5 percent. However, others support a range that begins at 1.2 or 1.25 percent.

Please give complete answers to the following three questions:

(a) Given that a merged fund would have a ratio of around 1.28 percent, do you believe that a range that extends from 1.25 to 1.5 percent provides the FDIC with sufficient flexibility to address the procyclicality concerns you have expressed?

(b) Please tell the Committee specifically what range you believe would best address the procyclicality of the current system, and give a complete explanation for the breadth of the range.

(c) In addition, please set forth your thoughts as to whether any new deposit insurance system should include specific triggers or recapitalization schedules should the deposit insurance reserves fall below the floor of the range.

A.2. Over much of its history, the FDIC insurance fund reserve ratio remained well above the current statutory target, only to drop into deficit conditions by the beginning of the 1990's. It is vital that funds collected in good times be available for times when they will be needed. We believe that a range for the designated reserve ratio (DRR) of 1.20 percent to 1.50 percent would achieve this objective while substantially reducing the procyclical bias of the current system.

As we learned from the deposit insurance experience of the 1980's, flexibility in managing reserves must be tempered by a clear requirement for prudent and timely fund replenishment. The lower the fund's reserves, the greater the probability that a rash of failures could wipe out the fund's net worth. The longer the time that the fund is allowed to operate with significantly inadequate reserves, the greater the risk that taxpayers might once again shoulder the cost of deposit insurance fund losses. Therefore, if the reserve ratio were to fall below the lower bound of the statutory range, the FDIC should restore it to within the statutory range promptly, over a reasonable but limited timeframe. We also support reducing the high minimum premium that would be in effect under current law when the FDIC is under a recapitalization plan.

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

Q.1. Some of the changes in the recommendations proposed seem like common sense, particularly issues providing more flexibility to the FDIC is setting the reserve ratio and returning the fund to that level. Can you provide me with a reason why some of the flexibilities weren't included with the legislation when the programs were initially instituted?

When I obtain car insurance, no matter how good a driver I am, I pay for the insurance and the benefits I receive. Why is it that the law provides that some banks, who admittedly may be very well-managed, aren't required to pay for the insurance they receive from the fund?

A.1. Congress enacted most of the statutory provisions governing fund management in 1991, in FDICIA, at the height of the bank and thrift crisis. At that time, Congress was understandably concerned with protecting the taxpayers and ensuring that the deposit insurance funds were sufficiently capitalized. For this reason, the designated reserve ratio (DRR) was set relatively high (at least 1.25 percent), the FDIC was required to charge high average premiums (23 basis points) if the reserve ratio could not be brought

back up to the DRR within a year, and the FDIC was required to institute risk-based pricing.

The provision prohibiting the FDIC from charging well-managed, well-capitalized institutions for deposit insurance so long as the fund had achieved (and was expected to remain at or above) the DRR was not added until 1996, after the crisis had passed. The 1996 legislation (the Deposit Insurance Funds Act of 1996) required that banks begin sharing the burden of paying FICO bonds, which had been issued in an attempt to recapitalize the FSLIC. By 1996, the Bank Insurance Fund was fully recapitalized and the Funds Act provided for the capitalization of the Savings Association Insurance Fund, so that the pressing need to ensure sufficient revenue for the deposit insurance funds that existed in 1991 had passed.

These pieces of legislation had two unintended effects. One was to create an extremely procyclical bias. The other was to frustrate the mandate in FDICIA to establish a risk-based pricing system for deposit insurance. In retrospect, it appears that, while the mandatory high premium rates during a recapitalization required by FDICIA were probably appropriate for the time—the worst banking crisis in U.S. history—these rates are not appropriate for less extreme downturns that are more likely to occur more often. In addition, other provisions of FDICIA, including prompt corrective action and least-cost resolution, reduced the likelihood of a repeat of the 1980's and 1990's banking crisis. If a crisis were to occur, FDICIA mandated that the entire capital of the banking industry (currently more than $775 billion) would be available to protect the taxpayers.

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

Q.1. Chairman Powell, in past meetings we have had on this subject the point has been made that deposit insurance does not, in many ways, work like a typical insurance fund. Specifically, it has been pointed out that the designated reserve ratio is not based on an actuarial model of potential losses in the system, but rather is based on historical precedent that may or may not be reflective of the true cost of that insurance. Assuming the FDIC is given flexibility to implement a range of reserve ratios, how will you determine what the proper range should be in the absence of typical insurance metrics? What specific data will you rely on, for example, industry profitability, deposit growth, etc.? Using your methodology can you tell us what the correct reserve ratio level for the fund should be today?

A.1. There is no single correct reserve ratio or range that is appropriate for all circumstances. The selection of a reserve ratio or range involves policy trade-offs. For example, while it might be possible to establish a reserve ratio or range that would protect the fund against all losses, it could require a very large fund balance to cover an eventuality with only a small probability of occurring. This would remove funds unnecessarily from the banking system that could otherwise be used to provide additional credit in communities. Therefore, the selection of a reserve ratio or range requires a balancing of policy goals.

Federal Deposit Insurance Corporation staff will be able to give the FDIC Board the ability to make an informed decision about the proper range or target, however, through the use of analytical tools and empirical measurements. Generally, this will entail applying statistical techniques to market data, such as credit ratings and yield spreads, and regulatory data to assess changes in insurance fund exposure. Regulatory data may include such things as the CAMELS ratings (which are bank supervisory ratings), Call Report and Thrift Financial Report data and historical failure rates. The FDIC presently uses this data in several models to predict failure rates and trends in the industry. Ultimately, the goal will be to develop a credit risk modeling approach that quantifies the risk associated with any particular fund size. Because the amount of protection afforded by a particular fund size will vary depending upon risk in individual banks and in the industry, this analysis will be ongoing.

Q.2. You provided some very good reasons for increasing the FDIC's operational flexibility. At the same time, I have some concerns. Since the fund operates so differently from a typical insurance fund, I worry that without tight operating guidelines, political and industry pressures will play a large role in influencing operational decisions. If that happens, and the public sees the FDIC as a political entity, and not an unbiased provider of deposit insurance, the confidence in the FDIC could be undermined to the detriment of the whole system. If you are given greater flexibility, how will you as Chairman ensure that the FDIC avoids this trap?

A.2. You make a good point. In fact, we saw the effects of political and industry pressure on the Federal Savings and Loan Insurance Corporation (FSLIC) during the thrift crisis of the late 1980's. Political and industry pressures are generally greatest during a crisis, and a deposit insurer's ability to withstand these pressures is the least when it is insufficiently funded. For this reason, among others, the FDIC is not opposed in principle to a requirement that it adopt a mandatory recapitalization plan if the reserve ratio falls below a lower bound of 1.0 percent, provided that the recapitalization does not have to occur over too short a period of time. (Too short a recapitalization period would increase the risk of procyclicality and very high premiums.)

However, the type of operational flexibility we seek is the ability to manage the fund and charge risk-based premiums during "normal" times (which we think could reasonably be defined as when the fund is within a range of 1.00 to 1.50 percent). Our experience has been that in these periods, when the FDIC is well-funded and the industry is generally healthy, the FDIC is not overly subject to the types of pressures you are concerned about.

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

Q.1. My understanding is that the Congress, in 1978, voted to allow the FDIC to insure IRA and Keogh accounts at the $100,000 level while regular savings did not receive that level of coverage ($40,000 instead). Am I correct about this? Can you discuss your

position on the coverage of particular categories of deposits like retirement savings accounts taking into account this past history?

A.1. You are correct. As a general matter, I do not favor creating different deposit insurance coverage limits for special categories of deposits. Different coverage limits risk customer confusion and raise the possibility that depositors will unwittingly hold uninsured deposits. The current rules are already sufficiently complex that it is not uncommon for some depositors to find that they are not fully insured when a bank fails, even when they thought that they were fully insured.

However, I believe that a sufficient case has been made for giving retirement accounts a higher coverage limit. Retirement accounts are uniquely important and protecting them is consistent with existing Government policies that encourage saving. It is not unusual for Americans who take full advantage of these incentives to accumulate more than $100,000. An increase in coverage for retirement accounts is consistent with the public policy goals that the Congress has already established. And, as your question mentioned, there is precedent for providing IRA's and Keogh's special insurance treatment.

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

Q.1. One reform proposal includes a provision that would cap allowable premiums to the most highly rated institutions at one basis point, regardless of economic conditions. Some have argued that such a cap merely shifts the subsidy to a smaller category of financial institutions, but clearly undermines the fundamental reform proposal. Would you please comment on the one-basis-point cap proposal?

A.1. Generally speaking, the deposit insurance premiums should reflect risk. In the long-term, the FDIC—or any insurer—must charge for risk to survive. Arbitrary caps, like the one-basis-point cap for the most highly rated institutions, may prevent premiums from reflecting risk. If an arbitrary cap means that one group of insured institutions pays too little for its insurance, others must pay more than their fair share to make up the difference. Thus, an arbitrary cap may force one group of institutions to subsidize another. An arbitrary cap also can increase moral hazard if premiums do not fully reflect risk. Thus—even though a one-basis point premium may be reasonable for a significant number of institutions during normal times—I would prefer not to have the one-basis-point cap mandated by statute.

Q.2. In Chairman Greenspan's testimony, he highlights the procyclicality of the current system as one of its major flaws. He advocates that the "suggested target reserve range be widened to reduce the need to change premiums abruptly." In addition, Chairman Greenspan has suggested that "the FDIC be given the latitude to temporarily relax floor or ceiling ratios on the basis of current and anticipated banking conditions and expected needs for resources to resolve failing institutions."

In the Safety Act, we have proposed a range that extends from 1 to 1.5 percent. However, others support a range that begins at 1.2 or 1.25 percent.

Please give complete answers to the following three questions:

(a) Given that a merged fund would have a ratio of around 1.28 percent, do you believe that a range that extends from 1.25 to 1.5 percent provides the FDIC with sufficient flexibility to address the procyclicality concerns you have expressed?

(b) Please tell the Committee specifically what range you believe would best address the procyclicality of the current system, and give a complete explanation for the breadth of the range.

(c) In addition, please set forth your thoughts as to whether any new deposit insurance system should include specific triggers or recapitalization schedules should the deposit insurance reserves fall below the floor of the range.

A.2. As Chairman Greenspan testified, the narrower the range, the higher the probability of procyclical bias in the system. We suggest a range of 1.00 to 1.50 percent. In our view, a floor of 1.20 or 1.25 percent provides few benefits, and works against steady premiums, revenue neutrality, and risk-based pricing.

Setting the floor at 1.20 percent versus 1.00 percent would have little impact on taxpayer protection. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) requires the FDIC to charge premiums as necessary to maintain adequate insurance funds. This means that the capital of the banking industry serves as a buffer to taxpayers. The industry capital currently exceeds $775 billion, compared to a combined deposit insurance fund of $43 billion.

The floor must be low enough to allow for steady premiums in normal times when the industry is healthy. This is an important goal of deposit insurance reform. With a floor of 1.20 percent, the failure of a single, medium-sized institution could put the fund in the restoration mode and require surcharges. In normal periods when the industry is healthy, the fund could be bouncing in and out of restoration mode with the result of unnecessarily volatile premiums.

The point of deposit insurance reform is not to increase overall assessment revenue from the industry, but to spread the assessment burden more evenly over time and fairly across institutions. This means that the level of the range is important. A 1.20 percent floor is not significantly different from the present 1.25 percent DRR, which is effectively a floor. However, under a reformed system, all institutions will be assessed premiums at all times, even when the fund is above 1.20 percent, while under the current system, only a small minority of institutions are assessed premiums when the fund is above 1.25 percent. Greater revenue under a reformed system means a higher fund level, all else being equal. Credits and rebates can be used to dampen growth of the fund; nevertheless, with a floor of 1.20 percent, the reserve ratio in the future is likely to spend long periods of time well above its recent levels, reflecting a higher overall cost to the industry.

Moreover, a higher range for the reserve ratio could have consequences for risk-based pricing. As the fund grows in good times and the ratio approaches the cap, the deposit insurance system be-

comes self-funding through interest earnings. Credits or other mechanisms must be used to suppress premium income, and this works against the FDIC's ability to maintain an effective risk-based premium system that provides proper incentives. A better approach would be to provide a sufficiently wide range for the reserve ratio such that premium income is necessary on a regular basis, and assessment credits only occasionally dilute the incentives provided by the risk-based premium system.

When the reserve ratio is not below the lower bound, the FDIC should have full flexibility on the timeframe and premiums needed to reach the DRR (if there is one). If the reserve ratio falls below the lower bound, however, the FDIC is not opposed in principle to a requirement that it adopt a mandatory recapitalization plan—the shorter the timeframe for the plan, the greater the risk of procyclicality and very high premiums. Based upon our modeling results, the FDIC would prefer 10 years as the minimum period for a recapitalization plan, in order to avoid needless procyclicality and high premiums. The FDIC would not oppose minimum premiums of five basis points during a recapitalization plan, but would be concerned that higher minimum rates could be unnecessarily procyclical.

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

Q.1. Some of the changes in the recommendations proposed seem like common sense, particularly issues providing more flexibility to the FDIC in setting the reserve ratio and returning the fund to that level. Can you provide me with a reason why some of these flexibilities weren't included with the legislation when the programs were initially instituted?

A.1. At the time the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), was enacted into law, the Bank Insurance Fund (BIF) was insolvent. Given the then recent bankruptcy of the Federal Savings and Loan Insurance Corporation and the large taxpayer cost of cleaning up the S&L crisis, there was a great emphasis put on quickly recapitalizing the BIF. With the benefit of hindsight, it has become clear that there needs to be a greater balance between the desire to quickly replenish the insurance fund and the possible adverse macroeconomic consequences of replenishing the fund too rapidly.

Q.2. When I obtain car insurance, no matter how good a driver I am, I pay for the insurance and the benefits I receive. Why is it that the law provides that some banks, who admittedly may be very well-managed, aren't required to pay for the insurance they receive from the fund?

A.2. The restriction on well-capitalized, well-run institutions paying insurance premiums was not part of the initial risk-based premium system enacted by Congress as part of FDICIA in 1991. It was enacted in 1996 as part of the Deposit Insurance Funds Act. At that time SAIF members were required to pay a 65.7 basis point special assessment to capitalize the SAIF, and BIF members were, for the first time, required to pay part of the interest expense for the FICO bonds—bonds issued to help resolve the savings and loan

crisis. However, even well-managed institutions pose some risk to the deposit insurance fund and derive benefits from deposit insurance, and they should pay for that insurance.

Q.3. I know that most of you oppose raising the coverage limits. However, if you had to choose, which increases would trouble you most—individual, retirement, or municipal?

A.3. The problem with raising the insurance limit is not with depositors. Depositors can already get all the coverage they want simply by splitting up their deposits. However, a higher limit would make it easier for individual banks to garner deposits, regardless of their financial strength, thus increasing moral hazard. This is true regardless of the source of the deposit.

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

Q.1. Mr. Hawke, in your testimony you supported the view expressed by many others that the "cliff effect"—the 23 point assessment by the FDIC to bring the designated reserve ratio back to 1.25 percent—is "likely to hit banks the hardest when they are most vulnerable to earnings pressure." This seems to be contradicted by the current environment where we are seeing strong deposit growth, yet the fund has fallen close to the 1.25 percent floor. Can you comment on this situation?

A.2. While the reserve ratio for the Bank Insurance Fund (BIF) has fallen close to the 1.25 percent floor, this happened during a time when over 90 percent of insured institutions were not paying anything for deposit insurance. Thus, all growth had to be funded out of earnings on the fund after FDIC expenses—including the expenses of supervising State nonmember banks. If the FDIC had been allowed to charge premiums—as is being proposed—the BIF would not be hovering close to the 1.25 designated reserve ratio (DRR).

In addition, the 23 basis point premium is only triggered if the fund is not expected to get back to the DRR within a year. Even if deposit growth were to push the BIF reserve ratio below 1.25, it would do so by only a few basis points, and it would not be necessary to charge 23 basis points, or anything near there, to return the fund to the DRR within a year.

It would require substantial losses for the fund to fall sufficiently below the DRR as to trigger the 23 basis point cliff effect. This is most likely to occur during an economic downturn when banks are most likely to be subject to earning pressures.

Q.2. Can you point to a specific instance or period of time during which the "cliff effect" has weakened the national economy or a regional economy or contributed to the failure of a specific bank?

A.2. Prior to 1989, the FDIC charged a fixed premium of 8.33 cents per $100 of domestic deposits, although until the mid-1980's, rebates lowered the effective premium to about half of that. Starting in 1990 the FDIC raised assessments to 12 cents, then to 19.5 cents for the first half of 1991 and to 23 cents for the second half. The assessment rate remained at this level until 1995, when the reserve ratio of the BIF reached 1.25 percent of insured deposits. Thus, we have had only one experience during which assessments

were at or near the 23 basis point level. The country was in recession in the early 1990's, and there was much talk of a credit crunch. While no one can know for sure, had we had lower deposit insurance premiums and greater credit availability during this period, it might have helped pull the country out of recession earlier.

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

Q.1. My understanding is that the Congress, in 1978, voted to allow the FDIC to insure IRA and Keogh accounts at the $100,000 level while regular savings did not receive that level of coverage ($40,000 instead). Am I correct about this?

A.1. Yes, you are correct.

Q.2. Can you discuss your position on the coverage of particular categories of deposits like retirement savings accounts taking into account this past history?

A.2. The increased coverage level on the IRA and Keogh accounts enacted in 1978, allowed the depositors with retirement savings of $100,000 to escape Regulation Q interest rate ceilings—which did not apply to accounts of $100,000 or more—and still get the benefits of Federal deposit insurance. Regulation Q no longer applies, and Americans who wish to put in excess of $100,000 of retirement savings in insured deposit accounts can easily do so by putting those funds in more than one institution. Thus, unlike 1978, the depositors would not really benefit from an increase in coverage on retirement accounts.

I would oppose raising the coverage limit on retirement accounts for the same reason I oppose raising the coverage limit on any other type of account. A higher limit would make it easier for individual banks to garner deposits, regardless of their financial strength, thus increasing moral hazard.

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

Q.1. One reform proposal includes a provision that would cap allowable premiums to the most highly rated institutions at one basis point, regardless of economic conditions. Some have argued that such a cap merely shifts the subsidy to a smaller category of financial institutions, but clearly undermines the fundamental reform proposal. Would you please comment on the one-basis-point cap proposal?

A.1. Premiums should be based on the risk an institution poses to the insurance fund. There should not be any arbitrary caps on the assessments the FDIC may charge a class of institutions.

Q.2. In Chairman Greenspan's testimony, he highlights the procyclicality of the current system as one of its major flaws. He advocates that the "suggested target reserve range be widened to reduce the need to change premiums abruptly." In addition, Chairman Greenspan has suggested that "the FDIC be given the latitude to temporarily relax floor or ceiling ratios on the basis of current and anticipated banking conditions and expected needs for resources to resolve failing institutions."

In the Safety Act, we have proposed a range that extends from 1 to 1.5 percent. However, others support a range that begins at 1.2 or 1.25 percent.

Please give complete answers to the following three questions:

Q.2.a. Given that a merged fund would have a ratio of around 1.28 percent, do you believe that a range that extends from 1.2 to 1.5 percent provides the FDIC with sufficient flexibility to address the procyclicality concerns you have expressed?

A.2.a. There are a number of elements to addressing the procyclicality of the current deposit insurance system. A range for the reserve ratio is one of them. Other important elements include more flexible insurance pricing including the ability to charge premiums to all institutions based on risk, regardless of the level of the fund, so that the fund can build during good times, and eliminating the mandatory 23 basis point minimum assessment when the fund is not expected to reach the 1.25 designated reserve ratio. Eliminating the 23 basis points mandatory premium combined with the ability to build the fund above the bottom of the range, should give the FDIC the flexibility it needs to address procyclicality.

Q.2.b. Please tell the Committee what range you believe would best address the procyclicality of the current system, and give a complete explanation for the breadth of the range.

A.2.b. The range should depend on overall economic conditions and risks in the banking industry, and is best determined by the FDIC Board through the rulemaking process.

Q.2.c. In addition, please set forth your thoughts as to whether any new deposit insurance system should include specific triggers or recapitalization schedules should the deposit insurance reserves fall below the floor of the range.

A.2.c. I believe it is desirable to have a recapitalization schedule if the fund falls below the bottom of the range. While care should be taken to assure that such a schedule takes into account possible adverse macroeconomic consequences, our experience with the savings and loan crisis teaches us the dangers of not addressing shortfalls in a deposit insurance fund in a timely and comprehensive manner.

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

Q.1. Some of the changes in the recommendations proposed seem like common sense, particularly issues providing more flexibility to the FDIC in setting the reserve ratios and returning the fund to that level. Can you provide me with a reason why some of these flexibilities weren't included with the legislation when the programs were initially instituted?

A.1. We defer to the FDIC for a legislative history on the deposit insurance programs instituted pursuant to the laws affecting the Federal deposit insurance funds.

Q.2. When I obtain car insurance, no matter how good a driver I am, I pay for the insurance and the benefits I receive. Why is it that the law provides that some banks, who admittedly may be

very well-managed, aren't required to pay for the insurance they receive from the fund?

A.2. The Deposit Insurance Funds Act of 1996 provided that once the designated reserve ratio (DRR) was reached, insurance premiums could no longer be collected for well-capitalized institutions (CAMELS rated 1 or 2). Today, 92 percent of institutions pay no insurance premiums. We agree with the other Federal banking agencies and the Treasury Department that risk-based premiums are an important component of deposit insurance reform.

With respect to the specific history of the legislation, we defer to the FDIC.

Q.3. I know that most of you oppose raising the coverage limits. However, if you had to choose, which increase would trouble you most—individual, retirement, or municipal?

A.3. The benefits of increasing coverage are unclear, particularly a significant increase in a category that results in higher costs for insured institutions—whether from increased premiums or costs related to customer notice, signage, forms, and agreements.

With respect to individual accounts, many OTS-regulated institutions have stated that they see no merit to bumping up the current coverage limit, or to index it. In their view, projected increases in insured deposits would not lead to a substantive increase in new accounts. Moreover, as observed by Chairman Greenspan, 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 deposit insurance coverage. For these same reasons, we see little merit in carving out and increasing the current coverage limit for retirement accounts.

We have similar reservations regarding increasing the insurance cap for municipal deposits. The FDIC staff has indicated that providing insurance coverage for municipal deposits could have a significant negative impact on a combined fund's reserve ratio. We cannot support the cost of this increase relative to the potential benefit derived by a small number of institutions from an increase in coverage for municipal deposits.

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

Q.1. My understanding is that the Congress, in 1978, voted to allow the FDIC to insure IRA and Keogh accounts at the $100,000 level while regular savings did not receive that level of coverage ($40,000 instead). Am I correct about this?

Can you discuss your position on the coverage of particular categories of deposits like retirement savings accounts taking into account this past history?

A.1. In 1974, Congress increased deposit insurance coverage from $20,000 to $40,000 generally and to $100,000 for deposits of States and localities. In 1978, coverage was increased to $ 100,000 for IRA and Keogh retirement accounts. Two years later, coverage for all accounts was increased to $100,000 by provisions of the Depository Institutions Deregulation and Monetary Control Act.

While Congress has occasionally carved out special categories for increased deposit insurance coverage in the past, the merits of this

approach under our current system are not convincing. As Chairman Greenspan testified at the hearing, it is currently possible for a family of four to obtain substantially in excess of $1 million in deposit insurance coverage at a single institution. Thus, there does not appear to be a need to increase the cap on retirement savings accounts or any other type of account for individual depositors.

There is also little credible evidence to support the notion that a coverage increase, whether it be across the board or for particular categories of deposits, will increase the ability of the institutions—especially small, community-based institutions—to attract more deposits. It is plausible, however, that raising the deposit coverage cap would actually increase costs for insured institutions by requiring higher premiums and—particularly with respect to indexing—increasing costs related to customer notice, signage, forms, and agreements.

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

Q.1. One reform proposal includes a provision that would cap allowable premiums to the most highly rated institutions at one basis point, regardless of economic conditions. Some have argued that such a cap merely shifts the subsidy to a smaller category of financial institutions, but clearly undermines the fundamental reform proposal. Would you please comment on the one-basis-point cap proposal?

A.1. Providing the FDIC Board with flexibility to levy premiums that correctly reflect the insurance risks posed by insured depository institutions is a critical element of deposit insurance reform. Provisions that limit the FDIC's ability to set premiums undermine the objective of an effective risk-based premium system. A one-basis-point cap on premiums for the most highly rated institutions would subsidize risk-taking behavior by those institutions and thereby weaken the economic incentives important to the health and stability of the deposit insurance system. We oppose a one-basis-point cap on the FDIC's premium-setting authority.

Q.2. In Chairman Greenspan's testimony, he highlights the procyclicality of the current system as one of its major flaws. He advocates that the "suggested target reserve range be widened to reduce the need to change premiums abruptly." In addition, Chairman Greenspan has suggested that "the FDIC be given the latitude to temporarily relax floor or ceiling ratios on the basis of current and anticipated banking conditions and expected needs for resources to resolve failing institutions."

In the Safety Act, we have proposed a range that extends from 1 to 1.5 percent. However, others support a range that begins at 1.2 or 1.25 percent.

Please give complete answers to the following three questions:

Q.2.a. Given that a merged fund would have a ratio of around 1.28 percent, do you believe that a range that extends from 1.25 to 1.5 percent provides the FDIC with sufficient flexibility to address the procyclicality concerns you have expressed?

A.2.a. OTS supports providing the FDIC Board with maximum flexibility to set a reserve ratio within a range that protects the

long-term viability and stability of the deposit insurance funds. The difficulty is in establishing a *floor* that promotes the long-term safety and soundness of the deposit insurance fund while also providing sufficient flexibility to the FDIC Board to address the procyclicality issue. It may be appropriate for the FDIC Board to target a reservation ratio within a range that extends somewhat below 1.25 percent, but we would have concerns with a floor lower than 1.15 percent. Providing the FDIC Board with flexibility to charge premiums commensurate with risk and to build the fund above the bottom of the range are equally important in addressing procyclicality concerns. A more fundamental concern is the safety, soundness, and long-term viability of the fund. We believe that a target reserve ratio range of 1.15 percent to 1.50 percent deposit strikes an appropriate balance among these concerns.

Q.2.b. Please tell the Committee specifically what range you believe would best address the procyclicality of the current system, and give a complete explanation for the breadth of the range.

A.2.b. A reserve ratio target of between 1.15 percent and 1.5 percent of insured deposits provides substantial flexibility to the FDIC Board without unduly jeopardizing the safety and soundness of a combined deposit insurance fund. This range would allow the FDIC to build reserves in anticipation of deposit insurance losses and to absorb losses without triggering premium increases to rebuild the fund during times of stress for insured institutions.

Based on insured deposits as of December 31, 2002, a 35-basis-point range represents a dollar range of $11.86 billion for a merged insurance fund. As of December 31, 2002, a merged deposit insurance fund would have had a reserve ratio of 1.29 percent (with combined reserves of $43.80 billion), which would have exceeded the 1.15 percent target range floor by $4.84 billion, yet still be $7.02 billion below the 1.50 percent ceiling of the target range on that date. Thus, a 1.15 percent to 1.50 percent target range provides flexibility to the FDIC Board with significant parameters in which to set reserves, while maintaining substantial reserve levels even at the bottom of the target range.

Q.2.c. In addition, please set forth your thoughts as to whether any new deposit insurance system should include specific triggers or recapitalization schedules should the deposit insurance system reserves fall below the floor of the range.

A.2.c. Triggers that impose a sharply higher premium in times of stress for insured institutions worsen the procyclicality of the deposit insurance system. Providing the FDIC Board with flexibility to recapitalize the deposit insurance fund within a reasonable timeframe and with a premium lower than that required under current law would help avoid problems associated with procyclicality and reduce the impact on institutions during times of economic stress.

Robert D. Novak

Goodbye, Greenspan?

WASHINGTON—It is difficult to exaggerate the aggravation at the White House over Alan Greenspan's gratuitous shot at President Bush's tax cuts. So angry are the President's advisers that they are willing to consider not reappointing Greenspan next year to a final term as Chairman of the Federal Reserve Board.

The conventional wisdom is that shaky financial markets could not withstand the loss of Dr. Greenspan, exalted in Wall Street as master of the universe. Similar predictions about nonreappointment of past Fed Chairmen Paul Volcker and Arthur Burns proved groundless. With the expiration of Mr. Greenspan's Chairmanship 16 months away, adverse impact on investors could be discounted by early disclosure of the President's intentions.

Greenspan's prestige is so overpowering that hand-wringers will tell Bush that he dare not prevent Greenspan from serving his final 2 years at the Nation's central bank. Still, senior officials privately mention Robert Glenn Hubbard, Chairman of the Council of Economic Advisers, as a possible replacement. A more conventional choice they ponder is William McDonough, the Fed's second-ranking official as New York Federal Reserve Bank President. Furthermore, the White House is in the market for additional names.

The White House and the independent Federal Reserve have been in an effective nonaggression pact for two decades. Since the middle of the Reagan Administration, the White House has said nothing about the Fed's handling of monetary policy. Accordingly, Greenspan could unwisely tighten money in the face of a coming recession with impunity.

In return, Greenspan has assented to any fiscal policy by any President—from Bill Clinton's 1993 tax increase to George W. Bush's 2001 tax cut. In a departure, however, Greenspan's recent testimony to Congress placed him in a clearly adversarial relationship with the President. On February 11, he told the Senate Banking Committee there was no need for the Bush tax cuts and warned of increasing budget deficits.

This was something Bush and his inner circle did not expect or appreciate, and Greenspan's characteristic modification in House testimony February 12, earned him a rebuff from Democrats but not a reprieve from the White House. He had made it harder for Bush to win his major domestic initiative.

Consequently, senior White House aides began to consider the decision the President soon will face. Although only two Fed governors have completed the single 14 year term since it was established in 1936, Greenspan has served on the Board nearly 15 years—6 years filling an expired term and 9 years for a full-term. The 14 years end in 2006, and Greenspan cannot be reappointed. His latest 4 year term as Chairman expires on June 20, 2004. Thus, Bush must decide whether to give Greenspan a fifth term as Chairman, which would be cut short after 2 years.

Given this situation, the White House yearns for a new face at the Fed—such as Glenn Hubbard. The Bush inner circle was not happy about Hubbard's feud with Lawrence Lindsey, then the National Economic Adviser. Nevertheless, Hubbard survived the purge of the Bush economic team, and was dispatched by the White House February 12, to answer Greenspan's claim that the Bush tax cut is "premature." Hubbard, a Harvard Ph.D. Economist who is only 44 years old, would be an articulate young voice at the Fed.

McDonough, who has announced his retirement from the New York Fed effective in July after an unusually long 10 years in charge there, would be a safer pick than Hubbard. A nominal Democrat who admires and supports Bush, he was considered for Secretary of the Treasury late last year. He is a traditional central banker well-respected by the investor community. McDonough is 68 years old, but that is nearly a decade younger than Greenspan, who celebrates his 77th birthday March 6.

"You have been in this position for a long time, some would say too long," Republican Senator Jim Bunning told Greenspan after he criticized the tax cuts. That sentiment is shared at the White House, which wants Hubbard, McDonough, or any Federal Reserve Chairman who will not be a back shooter. The question is whether Bush has the nerve to fire Alan Greenspan and the skill to get away with it.