APPENDIX III - ANALYSIS OF PROPOSALS

TO LIMIT POTENTIAL FDIC LIABILITY

This appendix analyzes three deposit insurance reform proposals which could reduce the FDIC's potential obligations.

A. Limit the insurability of an individual's[1] funds to $100,000 per institution by eliminating ownership categories used for insurability (eg. joint accounts, testamentary accounts).

B. Limit the insurability of an individual's funds to $100,000 across all institutions at any point in time. This proposal could eliminate or maintain ownership categories. If the categories are maintained, each insurable account relationship would be limited to $100,000 across institutions.

C. Limit deposit insurance to a single lifetime entitlement of $100,000 per person. Again, this proposal could maintain or eliminate some ownership categories. Variations on this proposal could involve different time periods (eg. $100,000 of insurance every five years or six months).

Section I of this appendix describes the possible benefits of these proposals. Section II discusses two issues that need to be addressed when considering all three proposals. One is the effect of the possibility that the relevant authorities might elect to handle a truly large bank failure differently from the rules set forth in these proposals. The other issue is the distinction between market discipline and depositor runs. In Section III, the main body of the paper, each of the proposals will be described, its specific administrative requirements discussed, and its unique economic implications considered. The paper ends with a brief summary.

In considering these proposals, it is also assumed that the restrictions will apply across insurance funds, whether FDIC-BIF, FDIC-SAIF, or NCUA. If separate limits apply to deposits at each of these funds, depositors seeking to increase their protection will find ways to create deposit relationships at institutions insured at each fund. This would cause economic distortions as funds flow to institutions based on insurance rules rather than economic advantage.

---

[1] In this paper, the term individual or depositor refers to both persons and business firms holding deposits at insured financial institutions, unless otherwise indicated.

I - Potential Benefits of Proposals

These proposals have a common set of worthwhile goals. To the extent that the proposals would be effective in achieving these goals, the economy and the banking industry would benefit. These goals include:

1. Increased Depositor Discipline.

A larger percentage of bank deposits should become uninsured. Depositors can be expected to exercise more care in selecting a bank in which to deposit their uninsured funds. This heightened depositor scrutiny may make it more difficult for bankers who take excessive risks to generate the funding needed to expand.

2. Reduced Failure Resolution Costs to FDIC.

If a smaller percentage of the total deposits held by banks maintains insurance, it may be possible that the percentage of insured deposits in specific failed banks will also be reduced. If this occurs, more of the losses in those failed banks will be shared by uninsured depositors, and less will be absorbed by the FDIC.

3. Equalization of Treatment Between Depositors at Large and Small Institutions.

If policy makers are able to follow the same set of rules in all failure resolutions, there will be an equal treatment of depositors at institutions of all sizes. This would eliminate any funding advantages that currently exist at banks which are assumed to have greater government protection than their competitors.

II - Concerns Common to Each Proposal

Effects of "Too Big To Fail" Perceptions on Proposals

In order for any of these plans to be effective, the FDIC[2] would have to commit to handling all bank failures in a manner which imposes losses on uninsured depositors. The credibility of such a commitment might be questioned by depositors who believe that the macroeconomic repercussions of major bank failures might motivate those responsible for macroeconomic stability to intervene in support of those institutions.

---

[2] In this paper, FDIC, unless otherwise indicated, will refer to any insuring agency: FDIC-BIF, FDIC-SAIF, NCUA.

To the extent that large banks are perceived by the public as "Too Big To Fail" we would expect a flight of funds to large institutions. This movement of deposits would provide large banks with a lower cost of funds than small banks. This would be caused by distortions stemming from failure resolution policy rather than from a developed advantage in deposit generation. The result would be a sub-optimal allocation of financing across firms in the banking sector. If significant amounts of money are affected, small banks will have to reduce their activities due to a cutoff of funding while large banks would increase activity to accommodate these funds. This change in market shares would also result from a market distortion rather than a developed advantage in credit creation.

The public's perception of the protection afforded to large banks is not without foundation. In the past, public officials who were confronted with major bank failures have opted to act in a way that minimized short term economic disruptions. Officials in different administrations and nations have reacted in similar ways. These proposals do not directly address the concerns which motivated the policy makers to act as they did in the past. If such actions are repeated in the future, we will not have reduced the total potential public liability. Rather, the composition of a portion of the potential liability would have been transferred from deposits at small banks to deposits at large banks.

Depositor Discipline vs. Depositor Runs

These proposals would create a larger pool of deposited funds which is at risk in the event of a bank failure than exists today. Appendix II describes the concerns we have about the effectiveness of depositor discipline and the potential instability that may be introduced into the banking industry by exposing depositors to greater risks. These concerns also apply to the three proposals.

III - Implications for Each Proposal

The above discussion would apply to all three of the proposals. Implications of each specific proposal are discussed below.

PROPOSAL A - ELIMINATE INSURABILITY CATEGORIES

Current regulations establish complex types of ownership categories, each of which is separately insured at a single financial institution. For example, the joint account of a husband and wife is insured separately from individual accounts that they may keep. Furthermore, revocable trusts can be established (by signing the appropriate signature card at the

bank) that are also insured separately - but only if the beneficiary is a spouse, child or grandchild of the trustee. Such trusts established with great-grandchildren, nieces or nephews as beneficiaries do not qualify for separate insurance. Apparently, these regulations have been adopted in response to statutory provisions that suggest insurance be based on ownership capacity. Certain ownership capacities are specified by statute.

An alternative system would mandate that a single tax ID number or social security number be attached to every account to indicate insurability. Regardless of ownership type, only $100,000 (or some other prescribed amount) would be insured for that individual or firm. Such a change would probably have little economic impact. Wealthy depositors (with sufficiently large, qualified families) who currently utilize the system to insure more than $100,000 in a single institution could spread those accounts across several institutions. However, such a change might effect the provision of pass-through insurance that is currently available to certain pension and employee benefit plans.

This proposal could make a payout resolution easier and quicker by streamlining some of the administrative tasks. It would also ease the burden on financial institutions should they be required to maintain and report accurate information about the insurance status of their depositors. This increases the set of institutions for which the FDIC might opt to pay-off insured depositors in the event of failure.

PROPOSAL B - RESTRICTION ON INSURANCE IN MULTIPLE INSTITUTIONS

There are two general ways to design this type of plan. With the first method, depositors designate, in advance of any failure, which specific institutions or accounts are to be insured. An alternative method limits coverage of any individual depositor as multiple failures occur in institutions used by that depositor. The second method would not reduce insured funds as much as the first. Depositors could maintain accounts for the maximum amount at several institutions in the hope that no two of them would go into receivership simultaneously.

Specific procedures that appear necessary to implement each proposal are described below. Each of these systems would involve administrative burdens that are not presently incurred. In addition, there are economic implications to consider with each system.

Method 1.

Description

Individuals must designate in advance which specific accounts in which specific institutions are to be insured. The total of these accounts may not exceed $100,000. Any other deposits at the designated banks or at other banks would not be insured. When an institution is put into receivership, designated deposits would be insured, but all other deposits would not be insured.

Administrative Requirements

There would have to be some controls established that would prevent individuals from intentionally or inadvertently insuring funds in excess of the $100,000 limit. This task is complicated by the dynamic nature of bank deposits. Not only do customers change institutions, depositors may also switch their savings among different accounts within the same institution (eg. from short term CD's to long term CD's or money market accounts), and balances within accounts also vary over time.

Presumably individuals would wish to insure the balances of their checking accounts in order to avoid situations in which checks that are in process are returned by the failed bank. However, these balances fluctuate by considerable amounts throughout a month or year. As investment funds are liquidated or reinvested checking account balances can experience major changes. As salary is deposited, and then spent through the payment period, smaller shifts will occur. An individual who anticipates that his checking account balance would seldom exceed $10,000, might designate the checking account and a $90,000 certificate at another institution as his insured accounts. However, the depositor will be exposed whenever larger amounts of money are flowing through the checking account or there is a delay in the processing of checks he has already written. The insuring agencies would need to have access to records that indicate the pre-designated amount of each account that is insured.

In addition, the designated accounts and amounts at the failed institution would have to be verified against a master file that contained all such designations in all institutions to prevent excess designation by individuals. Penalties would probably need to be established (criminal or civil) for individuals who intentionally over designate in order to increase coverage.

Depositors would have to be allowed to switch designation among institutions. As concern over a specific bank's viability began to spread, depositors with time accounts at that institution would want those funds to be designated (protected) regardless of their deposits at other institutions which may have been previously designated. Whenever a bank failed, FDIC would have to verify that depositors with designated accounts at that institution had not designated other accounts at other institutions in excess of their limit. Because such designations are changing daily, FDIC would need to maintain a database of account designations that is continuously updated.

In order to keep the file current, FDIC would have to receive these changes electronically, rather than on paper. This suggests that banks would become responsible for reporting designated accounts, balances and ownership on a daily basis. However, this could create problems in verifying that the data provided by a bank is consistent with the desires of the customer. FDIC would have to audit the veracity of reported information. All incoming data would have to be compiled daily by the FDIC to verify that individuals have not designated excess funds, and to have accurate information whenever a failure occurs.

Because individuals would be responsible for the accurate designation of their account balances, they would need to have access to the information kept on the master file. However, there are real security and privacy concerns raised by this requirement. FDIC would not be able to verify the identity of any inquirer. However, the potential for fraudulent use of the data released (Bank, account number, balance) is significant. Conceivably, information requests could be channelled through banks, however, depositors may not want a bank to know what other accounts are being held at competing institutions.

Economic Implications

The reporting requirements imposed on the banking industry could be onerous enough to act as a tax. The costs of this burden would be passed on to customers in the form of lower yields on bank deposits and higher loan rates. Maintaining the data base that would run this system would impose heavy costs on the FDIC. These operating costs would be reflected in the insurance premiums assessed to banks.

These burdens could impose deadweight drags on the banking sector and make it less efficient relative to other types of financial intermediaries. To the extent that this occurs, activity would flow away from the banking sector toward other types of financial service providers. This flow would not result

from any economic advantage created by the competing industries. It would be a direct result of the burdens this proposal places on banks.

Method 2.

Description

Accounts at all institutions currently in receivership are combined and analyzed for insurability using a process similar to what currently occurs within a single institution.

Example 1: Joe Jones has $100,000 on deposit at Bank A, Bank B, and Bank C ($300,000 total). If any one of these institutions goes into receivership, Joe's funds would be insured.

Example 2: Same as example 1, but Bank A goes into receivership. After Bank A is taken out of receivership (either through a P&A or payout), Bank B fails. Joe's funds in Bank B would be insured.

Example 3: Bank A goes into receivership. While A is still in receivership, Bank B fails. When we analyze the accounts at Bank B, we see that Joe already has $100,000 in receivership held funds, so the funds in Bank B are not insured.

Example 4: Same as in example 3, but after Bank A is settled, Bank C fails. In this case, analyzing accounts at Bank C indicates that Joe no longer has funds protected in a receivership (the funds in Bank B had lost their protection). Joe's money in Bank C is protected.

Example 5: Same as example 4, but Bank B is settled first. Before Bank A is settled, Bank C fails. Joe still has money protected by FDIC receivership (from Bank A), therefore the money in Bank C is not protected.

Administrative Requirements

At present, the FDIC scrutinizes the ownership arrangements of accounts for insurability only in payout situations. Generally, all depositors are given immediate access to a portion of their funds. In order to avoid over-insuring depositors with more than $100,000 in the institution divided among two or more accounts, the bank's records are carefully scrutinized. After one or two days (in the case of a small institution), the various balances are aggregated by owner and insurability is fully ascertained. The insured balances are paid out at that time. The larger an institution is, the longer this process takes.

Because uninsured as well as insured depositors are kept whole in purchase and assumption resolutions, such record keeping is not presently performed during most bank failures. Using Method 2 to reduce FDIC exposure would require that the record keeping take place in every receivership, even those ultimately resolved through purchase and assumption. Otherwise, when resolving any other contemporaneous failures, FDIC would be unable to identify when it was in situations like examples 3 and 5 above (the only situations in which FDIC coverage would be reduced from current levels). Administrative costs of failure resolution would increase as the intensive record keeping burdens are assumed in all cases.

The lengthy amount of time it takes to accurately sort out and aggregate the ownership of accounts in an institution creates several problems. First, holding failed banks in receivership for longer periods of time may reduce their franchise value.

Additional technical problems might also occur. Returning to the example situations described above, assume that Bank A goes into receivership. Under current practices, a P & A transaction could be arranged after one week. However, two weeks are needed to complete the record keeping required by the new system. Bank B fails during the second week. Is this a case of Example 2 or Example 3? Would depositors accuse the insuring agency of keeping Bank A in prolonged receivership in order to reduce potential liability when another institution failed?

There are also potential inter-agency disputes. If a regional economic downturn threatened the viability of institutions insured by all three funds (FDIC-BIF, FDIC-SAIF, NCUA), each fund would have an incentive to wait until another fund began closing institutions. The first fund to act would become Bank A in the above examples while succeeding funds would become Bank B for many common depositors.

An alternative device which would speed the handling of a failed institution would be to require that banks keep up to date account records on insurability of accounts in a standardized format so that insurance liabilities are rapidly identified during a failure resolution. The records would have to be in an electronic format so that the file from any failed institution could be quickly compared to the files from other institutions in receivership.

Economic Implications

Individuals with more than $100,000 in bank deposits would probably get skittish whenever there was an economic downturn or

threat to the banking sector. Because they would be unsure of the viability of any institution, they would have incentive to move their funds to large banks where there is a "Too Big To Fail" perception. The lack of confidence could also intensify regional economic disturbances. Fearing that the banks in the distressed region were weakened, and more likely to fail than previously, depositors might transfer funds out of that area of the country. If this occurred, it would cause funding problems for the banks and intensify a local credit crunch.

The deposit outflow would become especially strong whenever a bank is put into receivership. Depositors at that bank who have more than $100,000 in the banking system would lose some or all of their protection at other institutions until the failure is resolved. They will have incentives to run, adding instability to the system.

Even depositors whose banks have not yet failed, but who have more than $100,000 in deposits at various institutions would have incentives to panic. Because they would be in a more precarious state after one of their banks closed, they would have incentives to run from any bank that got into trouble.

PROPOSAL C - RESTRICT LIFETIME INSURANCE ELIGIBILITY

Suggestions have also be made that deposit insurance should be a once in a lifetime entitlement. Under such plans, a person would be protected from successive bank failures until the sum of the deposits in past and present failed institutions equalled a cut-off level (eg. $100,000). After that point, the depositor's funds would not be insured. Variations of this proposal could shorten the time period that the individual would be uninsured. For example, every five years an individual would be insured for $100,000. The administrative and economic implications of these plans would be similar.

Administrative Requirements

It would be necessary to maintain records of all depositors at failed institutions and the balances of their accounts. Whenever a failure occurred, the insurability of accounts would have to be determined in the manner described on page 8 above. If the failure is to be resolved through a payout of insured depositors, the accounts records of the institution will have to be compared against the historical file of depositors at failed institutions before final determination of insurability can be made. In the case of a purchase and assumption transaction a rigorous analysis of account records will also have to be undertaken in order to record which depositors have extinguished their insurance benefits.

As explained in the discussion of the previous proposal, the time requirements of completing such an analysis can reduce the franchise value of the failed institution. Such delays could be avoided by imposing requirements on banks that they maintain, in standardized electronic format, timely and detailed tracking of the insurability of depositors accounts.

Special problems arise under these plans in dealing with corporate entities. Presumably insurance entitlement for corporations would be based on tax payer ID numbers. However, what controls would prevent a business from reincorporating in order to obtain a new TIN and thereby renew insurance protection? Also, how would other forms of corporate re-organization (mergers, spin-offs, acquisitions) effect the new entities' insurance entitlement?

Economic Implications

Under this type of plan, depositor behavior would be very similar to behavior without any insurance program. There would be two groups of depositors, those whose insurance benefits have been exhausted and those who still have some or all of their entitlement remaining.

The first class will behave in a manner as destabilizing as if there was no deposit insurance at all. The second class of depositors would also have an incentive to withdraw funds before their institution failed. In a failure, these depositors would keep their money but lose something else of value - insurability. Therefore, the proposal would eliminate the major benefit of a deposit insurance program - stability - while creating formidable administrative burdens on the insurance agency (and probably on the banking industry too).

SUMMARY

Each of the three proposals have worthy goals. These include: increasing depositor discipline; reducing FDIC expenses and; equalizing the treatment of depositors at large and small institutions.

There are issues which need to be considered prior to implementing any of these plans. If depositors in the largest banks continue to be perceived to be immune from loss, the uninsured funds will shift from deposits in small institutions to deposits in large institutions. Should the perception prove to be true, total public liability will have also shifted instead of

being reduced. In addition, to the extent that the proposals might be successful in creating a larger pool of uninsured deposits, instability will be increased in the system. The overall benefits of these plans are uncertain.

On the other hand, the costs will probably be significant in new administrative burdens placed on insuring agencies and probably on the firms within the industry. Economic distortions may occur as funds move to other financial service providers that are not similarly burdened. Additional distortions would be expected to occur as funds within the industry shift to larger institutions.