

TESTIMONY OF

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CHAIRMAN  
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ON

H.R. 5590, BANK ACCOUNT SAFETY AND SOUNDNESS ACT

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS  
SUPERVISION, REGULATION AND INSURANCE  
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS  
UNITED STATES HOUSE OF REPRESENTATIVES

10:00 A.M.  
SEPTEMBER 27, 1990  
ROOM 2128, RAYBURN HOUSE OFFICE BUILDING

Good Morning, Mr. Chairman and members of the Subcommittee. We are pleased to have the opportunity to testify on your proposed Bank Account Safety and Soundness Act (H.R. 5590).

The Bank Insurance Fund (BIF) is under considerable stress as a result of the increased number of bank failures over the past several years. A number of extraordinary events, such as a substantial downturn in the economy or the failure of several large banks, could further deplete the insurance fund. Recent reports by the General Accounting Office and the Congressional Budget Office generally support this conclusion. Planning for such a contingency is important to ensure the continued viability of the deposit insurance fund, as well as the banking industry.

The Federal Deposit Insurance Corporation Board has recommended an increase in deposit insurance premiums. We also favor the various legislative proposals that would remove the limits currently imposed on our flexibility to increase insurance premiums. However, increasing the funding for the deposit insurance system alone is not the answer -- whether done by providing flexibility to increase premiums or through changes in the mechanism used to fund the system. Without significant changes, the deposit insurance system could become so costly that the funding needed to support it would threaten the viability of the banking industry.

Fundamental reform of the deposit insurance system is needed. Any proposed changes to the funding mechanism -- such as

that contained in H.R. 5590 -- should be taken up as an integral part of deposit insurance reform. Further, if there are to be lasting improvements in the deposit insurance system, structural problems in the banking industry also must be addressed. The purpose of deposit insurance reforms should not be to hold together an antiquated industry. Such comprehensive reform is the subject of the FIRREA-mandated study being conducted by the Department of Treasury with the assistance of the FDIC and other banking regulators.

#### H.R. 5590

The proposed method of recapitalization of the bank deposit insurance fund proposed in H.R. 5590 would provide capital to the FDIC in the form of deposits amounting to one percent of total bank deposits. Although this bill addresses only the BIF, any major changes should apply also to the Savings Association Insurance Fund.

The concept of a deposit insurance system funded by deposits from member institutions is not new. In fact, under the Banking Act of 1933, the method of funding the permanent deposit insurance system was for banks to subscribe to the capital stock of the FDIC. This mechanism was eliminated in the Banking Act of 1935.

The National Credit Union Share Insurance Fund (NCUSIF) model resembles the original method for funding the FDIC. The NCUSIF, which had sustained substantial losses in the late 1970's

and early 1980's, was recapitalized through member deposits as a result of legislation approved by Congress in 1984.

One of the important issues raised by this form of assessing insured banks is the accounting treatment afforded the deposits from member banks. Although GAAP accounting treatment would be determined by the accounting profession, there are a couple of possible options from a regulatory perspective.

One option is to permit banks to carry these deposits as assets on their books. This arrangement would be equivalent to banks making an equity investment in the FDIC. Should the deposit insurance fund incur liabilities that jeopardize the value of the deposits, bank equity would be reduced accordingly.

One advantage of this method of accounting for such deposits is that it would have a relatively small impact on banks in the short run. In addition, it would result in a more accurate and immediate reflection of deposit insurance losses on the books of the banking industry. Shifting fund losses directly to banks would create additional incentives for self-policing by the industry. This should serve to discourage activities that could jeopardize banks' investment in the insurance fund.

This accounting treatment, however, could have implications for the FDIC's ability to control the deposit insurance fund. It is possible that the FDIC could face a situation like that experienced by the Federal Savings and Loan Insurance Corporation in 1987. Although the FSLIC fund was declared insolvent,

Congress later directed the recapitalized FSLIC to rebate the funds deposited in FSLIC's secondary reserves to the thrift member institutions, thereby shifting liability from the thrift industry to taxpayers. In other words, there may be more uncertainty as to the resources of the insurance fund if the assessments were considered to be assets of the banking institutions.

Alternatively, if bank funds on deposit with the FDIC were excluded from the bank regulatory balance sheet and did not count as bank assets, these deposits would be treated as an expense similar to the current treatment of deposit insurance premiums. In this circumstance, the increase in the BIF balance would result in an immediate equivalent reduction in bank capital.

The major difference between this treatment and the current use of deposit insurance premiums is the timing of the bank contribution. H.R. 5590 would require banks to provide one dollar per \$100 of assets. If this obligation were due all at once, banks would be subject to a large one-time loss and may have difficulty restoring capital levels.

The impact of a one-time assessment on bank capital can be demonstrated by observing the current capitalization of banks. As Table 1 shows, of the 12,516 banks for which capital data are available, 311 banks currently have adjusted capital levels below four percent, the minimum capital requirement for most banks. A one percent assessment would drive 28 additional banks into insolvency, and 241 banks currently meeting the four percent

capital requirement would become capital deficient. The cost of the assessment, approximately \$25 billion, exceeds total bank earnings for 1989 -- which were 15.7 billion. This indicates that the industry may not be able to cover this cost during a one-year period through retained earnings, even if all dividends were suspended.

TABLE 1  
COMMERCIAL BANK CAPITAL RATIOS BEFORE SPECIAL ASSESSMENTS

ASSETS			
	Number	Total (\$000)	Percent Assets
EQUITY CAPITAL			
< 0%	35	1,485	0.00
0% to 1%	28	1,514	0.00
1% to 2%	48	18,698	0.06
2% to 3%	72	8,473	0.25
3% to 4%	128	117,038	3.48
4% to 5%	241	890,504	26.49
5% to 6%	769	660,232	19.64
≥ 6%	11,181	1,663,214	49.48

If banks treated the deposits as expenses, it would be difficult to distinguish the proposed recapitalization from the financing that would result from higher insurance premiums under the existing system. The impact on bank balance sheets would be

identical: banks would need to raise additional capital to offset this expense, and the deposit insurance fund would be recapitalized in both cases.

The primary difference between H.R. 5590 and the current program is that the proposed system would require a fixed, one percent deposit up front (but subject to lower future costs), whereas the current system of assessing insurance premiums provides a more gradual adjustment of the fund towards the desired level. The advantage of allocating these costs over a longer time horizon is that most banks could meet expenses through retained earnings without a substantial decrement in capital. However, should current restrictions on insurance premiums be removed, the FDIC could impose assessments up front as well. In that case, H.R. 5590 actually would reduce FDIC flexibility.

A one-time recapitalization of the fund is bound to create some turmoil in the banking industry. This might be minimized if the fund were recapitalized over several years. Further thought is needed to determine whether this method of recapitalization would have any advantages over using insurance premiums to fund BIF, assuming that the FDIC is given the flexibility now being proposed to increase premiums.

Recapitalization, however, is only one of the banking and deposit insurance reforms that Congress must address. The Treasury study is expected to provide guidance on how to proceed with these reforms. As stated earlier, we do not believe that a

revamping of the system should be undertaken immediately.  
Instead, the issue of recapitalization should be included in  
those proposals considered next year when deposit insurance and  
banking industry reform are considered.

We would be pleased to respond to any questions.