TESTIMONY OF

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ON

DEPOSIT INSURANCE PROVIDED FOR "457 PLAN" DEPOSITS

BEFORE THE

SUBCOMMITTEE ON GENERAL OVERSIGHT AND INVESTIGATIONS
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

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Good morning, Mr. Chairman and members of the Subcommittee. My name is Roger A. Hood. I am an Assistant General Counsel with the Federal Deposit Insurance Corporation in Washington, D.C.. I am pleased to testify this morning, on behalf of the FDIC, concerning the deposit insurance provided for "457 Plan" deposits in FDIC-insured institutions. For the record, I should clarify that when we say a "457 Plan" we mean a deferred compensation plan established for the benefit of employees of a state government, local government or tax-exempt organization, that qualifies under section 457 of the Internal Revenue Code.

The FDIC recently adopted comprehensive amendments to its deposit insurance regulations. Those amendments were adopted, in part, to comply with section 402(c) of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"). Section 402(c) required the FDIC to adopt uniform deposit insurance regulations so that the insurance provided for deposits in banks, insured by the Bank Insurance Fund ("BIF"), would be the same as the insurance provided for deposits in savings institutions, insured by the Savings Association Insurance Fund ("SAIF").

Section 402(c) also mandated that, in promulgating such uniform regulations, the FDIC take into account the regulations, principles and interpretations for deposit insurance coverage utilized by the former Federal Savings and Loan Insurance Corporation ("FSLIC"). In addition, the FDIC was directed to

consider all relevant factors necessary to promote safety and soundness, depositor confidence, and the stability of deposits in insured depository institutions.

After considering all of the necessary factors, the FDIC's Board of Directors adopted the uniform deposit insurance regulations on April 30, 1990. Those regulations became effective, for the most part, on July 29, 1990. Section 330.12(e) of the regulations governs 457 Plan deposits. Under section 330.12(e), all 457 Plan deposits will be aggregated, added to any other deposits of like kind maintained by the same official custodian of a public unit (or any deposits maintained by the same tax exempt organization) at the same insured institution, and the total will be insured up to $100,000.

Section 330.12(e) follows an FDIC staff interpretation under the previous regulations and thus represents no change in the manner in which such deposits in FDIC-insured banks have traditionally been insured. The regulation is, however, contrary to the manner in which 457 Plan deposits in savings and loan associations previously insured by the FSLIC ("S&Ls") had been insured. Since 1982, such deposits in S&Ls have been afforded pass-through insurance coverage (insurance coverage on a per-participant basis) pursuant to a FSLIC regulation. The difference in

insurance coverage has been quite substantial; a 457 Plan deposit in an S&L could be insured for several million dollars while a 457 Plan deposit in an FDIC insured bank could only be insured for up to $100,000.

The FDIC has long recognized pass-through insurance for deposits of private sector deferred compensation plans qualifying under section 401(k) of the Internal Revenue Code and most public and private pension plans, because such plans involve the transfer of funds by the employer to a trustee. The trustee holds title to, and administers, those funds for the exclusive benefit of the employee/beneficiaries. The insurance for such deposits is similar to that afforded deposits of other irrevocable trusts where ownership of the funds is transferred from the settlor or trustor to a trustee who is considered to be holding the funds in a separate trust capacity as to each beneficiary. The trustee is separately insured up to the maximum amount of $100,000 in each such trust capacity.

FDIC Prior Staff Interpretation on 457 Plan Deposits

Prior to the adoption of the uniform regulations there was no specific provision on 457 Plan deposits in the FDIC's deposit insurance regulations. However, the FDIC staff interpretation noted above -- which had been in existence for more than a decade -- stated that deposit accounts maintained by a "457 Plan" with an insured bank were not entitled to pass-through insurance coverage (insurance coverage on a per-participant basis). The

interpretation was based on the fact that, under section 457 of the Internal Revenue Code, 457 Plan funds are required to "remain (until made available to the participant or other beneficiary) solely the property and rights of the employer (without being restricted to the provision of benefits under the plan). . . subject only to the claims of the employer's general creditors." [emphasis added] This provision enables the employer (i.e., the state government, local government or non-profit organization) to utilize 457 Plan funds for its own purposes and makes those funds subject to the claims of the employer's creditors. The employer, rather than the employees, is the sole owner of the funds until they are distributed.

Accordingly, the FDIC staff has maintained that the employees (the participants) do not have any ownership interests in the funds upon which insurance coverage could be based. Thus, the funds cannot be insured on a pass-through basis under current law.

FSLIC and NCUA Positions on 457 Plan Deposits

Prior to 1982, both the FSLIC and the NCUA staffs maintained the same position as the FDIC staff with respect to 457 Plan deposits. Neither agency had a specific regulation which mentioned deferred compensation plan deposits, although informal discussions with staff members from both agencies in 1980 confirmed that their interpretations were the same as the FDIC staff interpretation. In other words, prior to 1982, all three

insurers maintained that under their respective regulations (which did not specifically mention deferred compensation plans), 457 Plan accounts were not insured on a per-participant basis.

On March 5, 1982, the Federal Home Loan Bank Board, as operating head of the FSLIC, proposed amendments to its regulations to provide that the interest of each participant in a deferred compensation plan (including a 457 Plan) would be insured up to $100,000. The FHLBB received 514 comments on the proposal. According to the FHLBB, only one commenter (an individual) objected to the proposal "apparently on the mistaken belief that such action would require a large and immediate outlay of taxpayers' funds."

The FSLIC's final regulations were adopted on May 6, 1982 and published in the Federal Register on May 14, 1982. In adopting the final regulations, the FHLBB recognized that "the funds in a deferred compensation plan typically remain the sole property of the employer." Nevertheless, the FHLBB decided to insure the accounts of such plans on a per-participant basis because the FHLBB concluded that "there is no substantive difference between the interest of a participant in a deferred compensation plan and the interest of a beneficiary in a trusteed employee benefit plan."

The NCUA issued a final rule amending its regulations, effective July 12, 1982, to provide insurance coverage for deferred

compensation plan accounts in the amount of up to $100,000 per-participant. The final rule was published in the Federal Register on July 14, 1982. In the preamble to the final rule, the NCUA recognized that "the funds in a deferred compensation plan usually remain the sole property of the employer." The NCUA further recognized that "if the employer becomes insolvent ... the funds would become depleted and would no longer be available to the employee." The NCUA concluded, nonetheless, that "the differences between [the interest of a participant in] a deferred compensation plan and the interest of a beneficiary in a trusteed employee benefit plan are not significant." On that basis, the NCUA adopted its final rule providing insurance coverage to each individual participant in a deferred compensation plan.

FDIC's Proposed Regulation and Summary of Comment Letters

Our proposed uniform regulations indicated that the FDIC was contemplating formal adoption of the existing staff position on 457 Plan deposits. The FDIC received in excess of 3,750 letters in response to the proposed uniform regulations. More than 90 percent of the comment letters addressed the proposed rule affecting 457 Plan deposits. The vast majority of those were opposed. Many government units (including state and local governments and political subdivisions thereof), government employee organizations, savings and loan associations, trade organizations and numerous individuals objected to the FDIC's proposed regulation because it provided for substantially less insurance coverage than was previously provided by the FSLIC.

Most commenters advocated the adoption of the FSLIC's rule, which insured 457 Plan deposits in S&Ls on a per-participant basis. The most frequent arguments were:

(1) deposit insurance was an important factor in the 457 Plan participant's decision to participate in the deferred compensation plan and it would be unfair to eliminate that insurance at this juncture;

(2) elimination of per-participant insurance coverage would have a serious effect on the participant's retirement plans and financial security;

(3) adoption of the proposed rule discriminates against state and local government employees who participate in 457 Plans, when compared with private sector employees in 401(k) plans which have pass-through insurance coverage; and

(4) the FDIC's proposal is in direct conflict with President Bush's efforts to encourage citizens to save more money.

Moreover, objections were expressed regarding the FDIC's literal reading of the Internal Revenue Code for determining "ownership" of deposits in 457 Plan accounts. Some commenters suggested that practical and public policy reasons exist for recognizing that such funds "constructively" belong to the employees (participants) and thus should be insured on a per-participant basis, like other types of employee benefit plan accounts. Other objections emphasized the potential disintermediation of funds out of S&Ls. Numerous commenters urged the FDIC to adopt some type of "grandfather" provision for the benefit of those adversely affected by the new rule.

Public Hearing on the Proposed 457 Plan Rule

In view of the volume of comment letters received and the FDIC's desire for further information on various aspects of 457 Plan deposits -- including the size of the market affected and the ownership rights of various parties in such deposits -- the FDIC's Board of Directors authorized, and the staff held, a public hearing on March 14, 1990. Twelve witnesses testified. They represented various state and municipal organizations, labor unions, savings and loans associations, and banks.

All but one of the witnesses (the IRS representative) testified in opposition to the proposed rule. The witnesses' testimony raised primarily public policy arguments, rather than legal arguments. They asserted that the public policy issues are very significant and have some legal basis in FIRREA's mandate to consider "all relevant factors necessary to promote safety and soundness, depositor confidence, and the stability of deposits in insured depository institutions." The major public policy arguments include:

(1) the proposed rule would eliminate the only safe haven for public employees to invest their 457 Plan funds and, thus, would discourage public employees from saving for their retirement or cause investment in higher risk instruments;

(2) 457 Plan accounts provide a very stable source of funding and liquidity for certain savings and loan institutions and the proposed rule could eliminate that stable source of

funding or cause liquidity constraints by effectively requiring collateralization of existing Plan deposits;

(3) the proposed rule would cause a massive outflow of funds from numerous savings and loan institutions which might cause certain institutions to become insolvent and thus add to the inventory of the Resolution Trust Corporation ("RTC");

(4) there are no valid public policy reasons for treating 457 Plans differently from other deferred compensation plans;

(5) the proposed rule is inconsistent with President Bush's recent initiatives which would encourage greater saving by the public (e.g., the President's proposal to establish "Family Savings Accounts").

Many of the witnesses acknowledged that 457 Plan funds are legally owned by the employer. However, they argued that the funds are constructively held for the benefit of the employees. To support the "constructive trust" theory, the witnesses made several points. Among them were that the employee earns the funds, controls the deferral of income, directs the investment of the funds, and benefits from any gains and suffers from any losses resulting from those investments. In addition, the witnesses indicated that most employers maintain separate deposit accounts for each employee, do not commingle 457 Plan funds with other employer funds, and would not utilize 457 Plan funds for purposes other than to pay the deferred compensation.

The IRS representative was the only witness who did not oppose the proposed rule. His testimony was based on legal, rather than public policy, grounds. He contended that FSLIC's rule (which insured 457 Plan accounts on a per-participant basis) was based on a misunderstanding of section 457. He asserted that, under section 457 of the Internal Revenue Code, 457 Plan assets cannot be set aside for the benefit of the employees without producing immediate taxation of the employees. The employer must retain control over the deferred amounts and cannot be required to use them to pay the deferred compensation. Therefore, he asserted that 457 Plans are much different from trusteed employee benefit plans (such as 401(k) Plans) and that the employees' ownership interests are not at all alike. He concluded that FSLIC was wrong in drawing an analogy between those plans for purposes of justifying their rule.

Several witnesses at the hearing indicated that the size of the 457 Plan market is not specifically ascertainable. Most agreed, however, that approximately $4-5 billion is currently invested in savings deposits nationwide under 457 Plans. Of that amount, approximately $2.2 billion is deposited with Great Western Financial Corporation, Beverly Hills, California.

Final Rule on 457 Plan Deposits

The FDIC staff carefully reviewed the comment letters and the testimony presented at the public hearing. That review resulted in no change in the staff's legal analysis that existing law

precluded the FDIC from providing pass-through insurance for 457 Plan deposits. As noted above, testimony by a representative of the IRS supported the staff's legal interpretation of the language in section 457 of the Internal Revenue Code. Section 3(m)(1) of the Federal Deposit Insurance Act requires the FDIC to aggregate, for insurance purposes, all deposits held in the same "right and capacity." The phrase "right and capacity" relates to the manner in which funds are legally owned. Since the employee benefit plans under discussion are created to qualify under section 457 of the Internal Revenue Code, the FDIC must assume that qualified plans are structured to provide ownership interests as required by that section of the tax code. As noted above, the statutory mandate of section 457 is clear: the assets of the plans must be owned by the employer (i.e., the state government, local government, or non-profit organization) that sponsors the plans.

However, the FDIC was mindful of FIRREA's mandate that, in promulgating the uniform regulations, the FDIC must consider all relevant factors necessary to promote safety and soundness, depositor confidence, and the stability of deposits in insured institutions. This requirement, and the testimony presented at the public hearing, suggested that the FDIC should not adopt a final rule which would result in an immediate outflow of funds from those S&Ls that maintain 457 Plan accounts. The FDIC believed that adopting the rule as proposed but including a lengthy "grandfather" period for deposits of existing 457 Plans

would address the legal constraints as well as the policy concerns.

The "grandfather" period was structured as follows. As required by FIRREA, the final regulations were effective on July 29, 1990 -- 90 days from the date the regulations were promulgated in final form. During that 90-day period, deposit insurance continued to be provided on a per-participant basis (for both existing and new participants) for accounts in S&Ls previously insured by the FSLIC.

For 18 months following the effective date of the insurance regulations, or the earliest maturity date of any time deposit thereafter, deposits of existing 457 Plans in S&Ls will continue to be covered on a per-participant or pass-through basis. Thus, for participants in 457 Plans existing on the effective date, any account balances, any new money deposited and any interest earned within 21 months following adoption of these rules (up until January 29, 1992) will continue to be insured on a pass-through basis until January 29, 1992, or, in the case of a time deposit, the first maturity date thereafter. However, any funds deposited by a 457 Plan established after July 29, 1990 will not be insured on a pass-through basis.

Any new money deposited after January 29, 1992 will not be insured on a pass-through basis. Any 457 Plan time deposits that mature prior to January 29, 1992 and that are renewed on the same

terms and conditions will continue to be insured on a pass-through basis until January 29, 1992 or the first maturity date thereafter. Any rollovers subsequent to January 29, 1992 will no longer be insured on a pass-through basis.

The FDIC believes this extended "grandfather" period is warranted given the consequences if most of the $4-5 billion dollars in 457 Plan deposits had become uninsured after only 90 days. The extended "grandfather" period permits ample time for plan participants and participating S&Ls to adjust to the new rules. In addition, to the extent that there are compelling public policy reasons to provide pass-through insurance for 457 Plan deposits, the extended "grandfather" period provides Congress with sufficient time to enact legislation to address the issue.

Proposed Legislation

The FDIC does not believe that it has the authority unilaterally to provide pass-through insurance for 457 Plan deposits under the existing statutory provisions. In our judgement, some action by Congress is required for the FDIC to be able to change the insurance rules that apply to 457 Plan deposits.

If Congress decides to amend the law so as to provide pass-through insurance for 457 Plan deposits, the FDIC respectfully requests that the amendment be carefully crafted so as to leave no doubt as to Congress' intent. Some of the bills that have been drafted to provide pass-through insurance for 457 Plan

deposits fall short of achieving their stated purpose. If Congress desires to provide pass-through insurance for 457 Plan accounts, we believe it should enact a statutory provision that specifically extends deposit insurance to 457 Plans based on the respective values of each participating employee's deferred compensation up to the maximum amount of $100,000 per employee. In our judgment, H.R. 5008 would effect that result.

Incorporating the amendments into section 11(a)(3) of the Federal Deposit Insurance Act, however, may have an undesired effect. Section 11(a)(3) extends separate deposit insurance only to time and savings deposits of Keogh Plans and IRAs. By amending Section 11(a)(3), this restriction also would apply to 457 Plans, thus, the amendment would not extend pass-through coverage to 457 Plan demand deposits. Demand deposits often are used by 457 Plans to make disbursements of funds to employees under the Plan. Since the bill would recognize each employee's imputed interest in a Plan's time or savings deposit, it should do the same for demand deposits. A stand alone provision under Section 11 providing for insurance coverage of all eligible deposits of 457 Plans would better achieve the legislative intent of H.R. 5008.

Conclusion

As was stated in our February, 1990, Report to Congress (entitled "Findings and Recommendations Concerning 'Pass-Through' Deposit Insurance"), the FDIC believes that there are no economic or

policy reasons why 457 Plan deposits should not be afforded the same pass-through insurance coverage that is provided for the deposits of most other trusteed employee benefit plans. However, it has been a longstanding legal staff opinion that section 457 denies plan participants any ownership interests in the funds of such plans upon which insurance coverage could be based. As we concluded in our Report to Congress, if Congress were to amend the Internal Revenue Code, or to enact some other statutory provision, to provide that 457 plan participants have ownership interests in the funds of such plans, a basis would exist for extending insurance coverage to plan participants.

I want to emphasize, however, that the FDIC is not advocating that Congress change the law to provide per-participant insurance coverage for 457 Plan deposits. Nor are we recommending against such a change in the law. We believe this is a fundamental policy decision that Congress must make.