Statement of
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on
Regulatory Burden Relief
Subcommittee on Financial Institutions and Consumer Credit
Committee on Banking and Financial Services
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Chairwoman Roukema, Ranking Member Vento, and members of the Subcommittee, I appreciate the opportunity to present the views of the Federal Deposit Insurance Corporation (FDIC) on proposed legislation to provide regulatory burden relief. The FDIC has long shared the Subcommittee's commitment to eliminating unnecessary regulatory burden by removing inconsistent, outmoded, and duplicative regulatory requirements. Indeed, since we began a systematic and ongoing review of regulations and written statements of policy as directed under the Riegle Community Development and Regulatory Improvement Act of 1994, the FDIC has rescinded or revised over two-thirds of its regulations and policy statements.

Illustrative of our continuous efforts in this area are two recent rule changes that significantly streamline application requirements in several areas and eliminate them entirely in others. The first, which became effective in October 1998, amends the FDIC's regulations governing applications, notice and request procedures, and delegations of authority. The final rule provides qualifying well-capitalized and well-managed insured depository institutions and their holding companies expedited processing procedures for several major types of filings, including deposit insurance, branching, and mergers. Currently, over 90 percent of insured depository institutions qualify for such expedited processing. The final rule also centralizes substantially all the filing procedures found throughout the FDIC's regulations within a single rule for ease of reference.

In December 1998, the FDIC Board also approved revisions to its regulations governing the activities and investments of insured state banks and savings associations. Under the new rule, a well-capitalized and well-managed state-chartered bank could, in lieu of an application, simply notify the FDIC of its intention to engage in activities that are permissible under state law and their chartering authority, but not permissible for national banks. Absent an FDIC objection within 30 days, the bank could make the investment, provided it did so through a subsidiary, subject to certain firewalls and limits on the amount of investment. The final rule also consolidates all related regulations into a single section for ease of reference.

Although the FDIC and the other banking regulators have continued to strive toward more efficient regulation and procedures, some potential improvements are outside the regulators' purview and must be addressed through legislation. To that end, this Subcommittee is to be commended for its efforts on H.R. 4364, The Depository Institution Regulatory Streamlining Act of 1998, which was passed by the full House last October. The FDIC supported many of the provisions in that legislation and so we applaud the recent introduction by Chairman Roukema of H.R. 1585, The Depository Institution Regulatory Streamlining Act of 1999. However, as before, we do have some concerns about the legislation, especially in regard to several issues that relate directly to the role of the FDIC as deposit insurer. My initial comments will speak to issues related to deposit insurance, including an additional initiative that we believe should be part of any new bill. Following that, I will discuss issues that affect the FDIC as a bank supervisor and receiver of failed institutions.

DEPOSIT INSURANCE FUNDS ISSUES

The Deposit Insurance Funds

To begin, the FDIC would like to reiterate its support for the provision in H.R. 1585 that would eliminate the Savings Association Insurance Fund (SAIF) Special Reserve. The Special Reserve was created by the Deposit Insurance Funds Act of 1996 (the Funds Act). Under the Funds Act, the FDIC was required to establish, on January 1, 1999, a Special Reserve comprised of SAIF funds above the dollar amount required to meet the 1.25 percent Designated Reserve Ratio (DRR). On the basis of year-end 1998 data, $978 million was segregated into the Special Reserve, lowering the SAIF reserve ratio from 1.39 percent to 1.25 percent. The final amount of the SAIF Special Reserve remains subject to adjustment, pending a completed audit by the U.S. General Accounting Office.

Since the Special Reserve can only be drawn upon if the reserve ratio of the SAIF is less than 50 percent of the DRR and is expected to remain so for four consecutive quarters, the existence of the Special Reserve could potentially result in an assessment rate disparity between the Bank Insurance Fund (BIF) and the SAIF — recreating the very same circumstances the Funds Act – which levied a $4.5 billion special assessment on SAIF-assessable deposits – was intended to eliminate. As a result of the Special Reserve, unanticipated failures of banks and savings associations, or faster-than-expected growth in insured deposits, could cause the reserve ratio of the SAIF to drop below the DRR. Any drop in the SAIF reserve ratio below the DRR likely would precede the reserve ratio of the BIF falling below 1.25 percent, because the SAIF would be starting at a lower reserve ratio. When a fund's reserve ratio drops below the DRR, the FDIC is required to increase deposit insurance assessments to restore the fund's reserve ratio to the DRR, unless the reserve ratio is expected to be restored to the DRR within a year. Thus, the FDIC most likely would be required to raise SAIF assessments before instituting a comparable increase in BIF rates, recreating a rate disparity between the two funds. This disparity in assessment rates could occur even though the actual amount of funds available to support the SAIF, which would include the Special Reserve, might exceed the amount of funds necessary to meet the DRR.

Differences in deposit insurance assessment rates among institutions should reflect differences in risk posed to the insurance funds, not artificial distinctions, such as those that existed before the passage of the Funds Act. Higher assessment rates for SAIF-insured deposits resulted in the shifting of deposits from the SAIF to the BIF and other inefficiencies that were detrimental to virtually all parties. Such market distortions have an economic cost as institutions devote resources to countering artificial statutory distinctions. Thus, the FDIC strongly endorses the elimination of the Special Reserve.

Merger of the Funds

Although the Depository Institution Regulatory Streamlining Act of 1999 contains language that eliminates the Special Reserve, it does not address another important issue — the existence of two separate deposit insurance funds — and the inefficiencies and safety-and-soundness concerns associated with maintaining two separate funds. The arguments for a merger of the BIF and the SAIF are persuasive, and implementation would be neither complicated or difficult. Given the current condition of the industry and of the funds, there is no better time than now to remove this statutory relic of a bygone era.

The FDIC was established in 1933 to primarily insure commercial banks, while the Federal Savings and Loan Insurance Corporation (FSLIC) was established in 1934 to insure savings-and-loan associations (S&Ls). Throughout its history, however, the FDIC has also insured some savings institutions, notably state-chartered savings banks. The savings-and-loan crisis of the 1980s and the insolvency of the FSLIC led to the establishment of the SAIF in 1989. At the same time, the FDIC fund was renamed the BIF, and both funds were placed under FDIC management.

Although the name Savings Association Insurance Fund connotes a fund that insures savings associations, the name has actually become somewhat of a misnomer. When it was first established, virtually all SAIF-insured deposits were held by SAIF-member thrifts. However, over the last decade, this has changed dramatically. As of December 31, 1998, commercial banks and BIF-member savings banks held 36.4 percent and 3.6 percent, respectively, of all deposits insured by the SAIF. Indeed, two of the five largest holders of SAIF-insured deposits are First Union National Bank and NationsBank N.A. Despite its name, the SAIF has become a true hybrid fund.

If the only problem with having two insurance funds is that one is misnamed, there would be little reason to merge the funds. However, there are substantive reasons why the two funds should be merged. First, the BIF and the SAIF provide an identical product – deposit insurance. Yet, as long as there are two deposit insurance funds whose assessment rates are determined independently, the prospect of a premium differential exists. When an identical product is offered at two different prices, consumers – in this case, banks and thrifts that pay deposit insurance assessments –

naturally gravitate to the lower price. This phenomenon was observed before the passage of the Funds Act when some SAIF-insured institutions successfully shifted deposits to BIF insurance, despite moratoriums, entrance and exit fees, and outright bans on deposit shifting. Although the Funds Act led to the elimination of the disparity in deposit insurance assessment rates that then existed between the BIF and the SAIF, a merged fund would guarantee that such a disparity would not recur in the future. It would have a single assessment rate schedule whose rates would be set solely on the basis of the risks that institutions pose to the single fund. The prospect of different prices for identical deposit insurance coverage would be eliminated.

Second, a merger of the funds would help mitigate the increased concentrations of risk facing both the SAIF and the BIF. Since its inception, the SAIF has insured depositors at far fewer, and more geographically concentrated institutions than the BIF has insured. Consequently, the SAIF has faced greater long-term structural risks and has been subject to proportionately greater losses from the failure of a single member. Although interstate merger activity may have reduced the geographic concentration of SAIF deposits somewhat, recent merger activity has increased the relative size of the largest members of either fund. As of midyear 1990, the three largest holders of SAIF-insured deposits held 8.7 percent of these deposits, and the three largest holders of BIF-insured deposits held 5 percent of these deposits. As of December 31, 1998, that figure was 16.5 percent for the SAIF and 11.5 percent for the BIF. In a combined insurance fund, the three largest institutions would hold only 10.5 percent of insured deposits.

Finally, a merger of the funds would result in lower administrative and record-keeping costs to the FDIC and to the approximately 900 institutions that hold both BIF- and SAIF-insured deposits (Oakar deposits) that must be tracked and assessed separately. Although these costs may not be large in absolute dollars, they represent wasted funds.

In summary, the BIF and the SAIF both are now fully capitalized. They have identical assessment rate schedules; and the member institutions of both funds are generally healthy and profitable. Upon elimination of the SAIF Special Reserve, the reserve ratio of the SAIF would be restored to reflect its true level, and the BIF and the SAIF would have comparable reserve ratios. In fact, absent the Special Reserve, the SAIF reserve ratio would be slightly higher than the BIF's. Under the circumstances, a merger of the two funds would not result in a material dilution of either fund, and would strengthen the deposit insurance system. This is an excellent time to merge the funds and eliminate a weakness in the federal deposit insurance system. It would be unfortunate if the Congress, while streamlining bank regulation, left the anachronism of two deposit insurance funds in place.

BANK SUPERVISION AND RECEIVERSHIP ISSUES

Codification of a Federal Examination Privilege

Currently, no federal statutory privilege protects confidential information provided by banks to their banking regulators. Recently, a federal court held that banks waive their attorney-client and work-product privileges when they disclose information to banking regulators. As a result, an increasing number of banks are reluctant to share confidential information with their banking regulators. The FDIC strongly supports the provisions in H.R. 1585 which would provide that banks do not waive existing privileges when they respond to examiners' requests (Title V). These provisions would help preserve the cooperative, non-adversarial exchange of information between supervised institutions and their examiners that is critical to the examination process.

The FDIC also strongly supports the provisions in the bill that codify the bank examination privilege, extend the privilege to cover information collected by examiners and allow the federal banking regulators to prescribe regulations to control access to confidential supervisory information. Reports of examination contain examiner analysis of the bank's condition and operations, that, among other things, includes critical analysis of classified loans, financial information on borrowers, and candid analysis of management. The banking agencies have received thousands of subpoenas from litigants seeking access to reports of examination and other confidential supervisory information. Protecting such information is important to prevent the "chilling effect" on both banks and examiners that would result if litigants could routinely obtain such records. Banks need to know that the information they provide to their supervisors will be maintained in the strictest confidence, and examiners need to know that the sanctity and integrity of the examination process will be preserved.

Some federal courts, and a few state statutes, recognize a bank examination privilege that protects bank examiners' analyses under certain circumstances, but recent court decisions have eroded this privilege. Codifying the privilege would ensure uniformity in the handling of supervisory banking information. The legislation provides that litigants must seek supervisory information solely from banking regulators (rather than forcing the banks to produce their copies of the reports) and first request the information through regulatory procedures before seeking to compel its production in court. These provisions will help the banking agencies maintain control over sensitive supervisory and other confidential financial information and will relieve the courts of the burden of addressing all such requests.

Interest on Demand Deposits

The FDIC supports the provisions of H.R. 1585 that would permit banks to pay interest on demand deposits (§102). The prohibition against paying interest on demand deposits is antiquated and no longer serves a useful purpose.

In the 1930s, Congress provided for interest-rate ceilings on time and savings deposits and enacted the current prohibition against banks' paying interest on demand deposits. At the time, two principal arguments were made for controlling the cost of deposits. The first was that deposit competition had the potential to destabilize the banking system.

The second was that money-center banks would draw deposits from rural communities and divert funds from productive agrarian uses to stock speculation.

Whatever validity these arguments may have had then, they have little today. Congress has removed all the Depression-era bank price controls except the prohibition on paying interest on demand deposits. Removing the last of these controls should not threaten the stability of the banking system. First, banks should be able to manage additional costs that might result from this legislative change. Some banks already provide nonpecuniary compensation to businesses for demand deposits through "free" or discounted services or lower interest rates on loans for which they hold compensating demand deposit balances. Banks that begin paying interest on their commercial demand deposits may charge explicitly for services they now provide free or at a discount. Banks and their customers now spend time and money circumventing the prohibition against the payment of interest on demand deposits by, for instance, setting up interest-bearing sweep accounts. Eliminating the prohibition should reduce or eliminate these expenses.

Second, not all demand deposit accounts will necessarily pay interest. Many consumers, for a variety of reasons, presently choose to hold non-interest-bearing demand deposits rather than interest-bearing NOW accounts. Instead of receiving interest, customers with these accounts may receive other benefits, such as returned canceled checks, lower minimum-balance requirements, lower service charges, including lower per check charges, or a package of other banking services.

Further, banks already pay interest on demand-like deposits without threatening the stability of the banking system. Interest-bearing sweep accounts, for example, function as demand deposits for businesses. Interest-bearing NOW accounts function much like demand deposits for consumers, nonprofit groups, and governmental units.

Finally, you asked for our view on the effective date of October 1, 2004, for the repeal of the restriction on paying interest on business checking accounts. As discussed above, interest-bearing sweep accounts already function as demand deposits for businesses. Because the payment of interest on these accounts has not raised safety-and-soundness concerns, we see no reason to delay until 2004 the repeal of the restriction on paying interest on business checking accounts. However, a delay until 2001 would be appropriate so as not to interfere with the millennium date change.

Call Report Simplification

The FDIC also supports the intent of H.R. 1585 to achieve Call Report simplification (§302). However, in accordance with Section 307 of the Riegle Community Development and Regulatory Improvement Act of 1994, the banking agencies have already made significant progress along the lines included in the draft bill. For example, all insured depository institutions now file Call Reports electronically. The FDIC has made all major categories of Call Report information available to the public electronically via its Web site. Also, under the auspices of the Federal Financial

Institutions Examination Council (FFIEC), the banking agencies are developing a simplified, less burdensome "core report" that would be filed by banks, bank holding companies and savings associations in place of their existing regulatory reports after the year 2000.

It is worth noting that changes in the industry continuously affect the information that bank regulators need. For example, banks and thrifts, including those with multi-state operations, report financial results on the basis of their main office location, regardless of the locations of their branches and customers. With more and larger institutions operating on an interstate basis, bank Call Reports and Thrift Financial Reports fail to give regulators an accurate picture of where loans are actually being made. Thus, regulators are finding it much more difficult to identify regional lending patterns, diminishing their ability to assess geographic concentrations in interstate bank portfolios. Although changes to the Call Report can be burdensome for banks, some adjustments may be necessary to allow bank regulators to gather the information that we need to do our jobs effectively. The banking agencies will continue to work together through the FFIEC to ensure that any necessary changes are minimized.

Judicial Review of Conservatorship and Receivership Appointments

The FDIC is also supportive of the provision in Section 304 that would shorten the time period during which the appointment of the FDIC as conservator or receiver of a failed insured depository institution can be challenged. Current law permits judicial review of the FDIC’s appointment for as long as six years in certain cases. Although we support a reasonable period of time for judicial review, the process of resolving failed institutions should not be compromised by the possibility of a challenge to the FDIC’s appointment as conservator or receiver, several years after the designation.

Interest on Claims in Receiverships

Section 308 of H.R. 1585 would clarify our authority to promulgate a regulation that establishes: (1) the post-insolvency interest rate that a receiver will apply to allowed claims in a surplus receivership estate after the receiver’s appointment, and (2) the payment priority of this post-insolvency interest. The FDIC fully supports this provision.

After paying the principal amount of all claims against the receivership estate of a failed insured depository institution, other than the claims of equity holders, a receiver may have funds remaining to pay post-insolvency interest on the non-equity claims. Neither the Federal Deposit Insurance Act (FDIA), the National Bank Act, nor the statutes of most states address the interest rate that should be applied after a receiver’s appointment. Also, these statutes generally do not address the priority in which the receiver should pay this interest. State statutes that do address post-insolvency interest vary greatly, resulting in disparate treatment of receivership creditors from state to state.

In the past few years, an increasing number of FDIC-administered receiverships have had sufficient assets to make some post-insolvency interest distributions. This trend may continue because the prompt corrective action requirements of the FDIA can result in institutions being placed in receivership before their capital is depleted. Institutions closed because of a liquidity crisis -- rather than because they are balance-sheet insolvent -- may also have sufficient assets to pay post-insolvency interest.

A uniform interest rate and distribution priority for all receiverships would benefit the receiver, receivership creditors, and equity holders. The receiver would apply the uniform rules, creditors would be able to calculate the interest, and equity holders would be able to anticipate what surplus may be available for distribution after the payment of post-insolvency interest. A federal regulation would also treat similarly situated creditors in bank failures equally by eliminating existing discrepancies in distributions on the basis of an institution's location.

Deposit Brokers

Section 29A of the FDIA prohibits a deposit broker from soliciting or placing any deposits with insured depository institutions unless the deposit broker has notified the FDIC in writing that it is a deposit broker. The FDIC supports Section 309 of H.R. 1585, which repeals the notification requirement. The notification requirement serves little useful supervisory purpose and may actually confuse consumers.

Although a deposit broker must notify the FDIC that it is in the business of deposit brokerage, the FDIC cannot reject a notice and has no, nor does it want, explicit enforcement powers over deposit brokers generally. Deposit brokers, however, frequently state that they are "registered" with the FDIC. These statements can easily deceive consumers, who have come to associate the FDIC with the safety of their funds.

From the institution's perspective, the FDIC can and does obtain sufficient information on brokered deposits through on-site examinations and off-site surveillance. During safety-and-soundness examinations, the FDIC thoroughly reviews liquidity and funding sources, including brokered deposits, for every institution it supervises. In addition, banks must report brokered deposits on Call Reports submitted to the regulatory agencies. The FDIC also closely monitors deposit growth. The FDIC and the other bank regulatory agencies can curtail the use of brokered deposits effectively when necessary, through formal and informal enforcement actions, including informal agreements, prompt corrective action and cease-and-desist orders.

OTHER ISSUES

In the Committee's letter of invitation, we were asked to respond to several additional issues addressed in H.R. 1585. First, you asked us to comment on whether the Federal Reserve should pay interest on reserves maintained at the Federal Reserve Banks. The FDIC supports the direct payment of interest on Federal Reserve balances to depository institutions and believes that the payment of interest does not present any safety-and-soundness concerns.

In March 1995, the Board of Governors of the Federal Reserve submitted to the Congress a study of the effect of the payment of interest on reserves, as required by Section 329 of the Community Development Banking Act. The study was prepared in consultation with the FDIC and the National Credit Union Administration, and examined the effect of paying interest on "sterile reserves," or required reserve balances. The role of required reserves for the conduct of monetary policy and the economic consequences of a so-called "reserve tax" – the imputed earnings or foregone interest on the portion of required reserve balances that depository institutions would not have held in the form of non-earning deposits with the Federal Reserve Banks in the absence of reserve requirements – were discussed.

The study noted that depository institutions, in response to the reserve tax and the prohibition on paying interest on demand deposits, have offered products such as sweep accounts that avoid reserve requirements. To the extent that substitutes for reservable deposits can be found, depository institutions can reduce their costs and be more competitive when issuing deposits and making loans. That is, the reserve tax creates an incentive for depositories to engineer products and legal structures that circumvent the tax. Because these activities are not costless, the reserve tax creates economic inefficiencies and leads to the misallocation of resources. The study concluded that paying a market rate of interest on required reserves directly to depository institutions would eliminate the reserve tax and remove the competitive disadvantage that reserve requirements place on depository institutions relative to their non-depository competitors.

You asked us also to comment on Sections 222 and 223 of H.R. 1585, which would grant regulatory relief for limited-purpose banks, known as CEBA banks. These amendments would expand the permissible activities of such nonbank banks and modify related divestiture provisions. For example, Section 223 would allow nonbank banks to offer credit-card accounts for business purposes. While Sections 222 and 223 do not raise safety and soundness concerns and the FDIC does not oppose them, we would observe , however, that they would only benefit a limited subset of financial-services providers.

CONCLUSION

The FDIC commends and supports the Subcommittee’s continued efforts to reduce unnecessary burden on insured depository institutions without compromising safety and soundness or consumer protection. We continually strive for more efficiency in the regulatory process and are pleased to work with the Subcommittee in accomplishing this goal.

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