STATEMENT OF
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FEDERAL DEPOSIT INSURANCE CORPORATION
on
DEPOSIT INSURANCE REFORM
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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 one 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 1980s. However, these provisions, intended as protections, could cause unintended problems. During a period of heightened insurance losses, both the economy in general and depository institutions in particular are more likely to be distressed. High premiums at such a point in the business cycle would be pro-cyclical and 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 pro-cyclicality 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 just one example, since the mid-1980s, 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 pro-cyclical 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 Congress to develop parameters for an appropriate range for the fund ratio. The FDIC also will work with Congress 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 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 1990s 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 yearend 1996. For example, an institution that held one percent of the industry assessment base in 1996 would get one 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 fast-growing institutions would pay increasingly larger premiums as they gather 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 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 reiterate: it is extremely important to depositors, 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 1980s and 1990s 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 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.

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.

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