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# Federal Deposit and Share Insurance: Proposals for Change

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## Summary

Legislators, regulators, interest groups and academics are examining many proposals for changes in the federal deposit insurance system for banks and savings associations and the share insurance program for credit unions. In the 107th Congress, measures seek to change the pricing of insurance, how much coverage should exist for customers' accounts, and operations of the insuring agency. Changes could affect the financial condition of insured institutions, the financial strength of the insurance funds, and competitive equality among participating institutions, making deposit insurance reform a complex issue. Signs of increasing risk, leading some to suggest that deposit insurance generally may need reform, have become dramatized with the collapse of several banks, shrinking the Bank Insurance Fund of the FDIC. One measure, H.R. 3717, has passed the House overwhelmingly, while a Senate measure, S. 1945, has received a hearing. CRS will update this report as warranted. See the Electronic Briefing Book on banking and financial services [http://www.congress.gov/brbk/html/ebfin1.shtml] for more information on financial services issues, and CRS Report RL31343 for specific bill comparisons.

## What is Deposit Insurance and How is It Administered?

The full faith and credit of the United States stands behind more than $3 trillion of insured deposits at banks and savings associations. This insurance guards savers' accounts up to $100,000, providing stability to banks and to the economy. Congress legislated deposit insurance in the 1930s, modifying it in 1989 and 1991 in response to financial crises. Congress now requires all banks and savings associations to carry federal insurance. FDIC has not formally insured amounts greater than the limits set by law, nor foreign office deposits, although very large banks rely upon them. Smaller institutions find deposit insurance very valuable, in contrast.

Pursuant to P.L. 101-73 and P.L. 102-242, the independent agency Federal Deposit Insurance Corporation (FDIC) provides federal deposit insurance through two funds. The FDIC's two funds are accounts maintained with the U.S. Treasury that the agency may call upon in case of need. Both earn interest income for FDIC. The Bank Insurance Fund (BIF) dates from 1934. Congress intended it and its ancestor the Permanent Insurance Fund to cover commercial bank deposits. The Savings Association Insurance Fund (SAIF) is the successor to a failed fund ("Federal Savings and Loan Insurance Corporation") covering savings institution deposits. Many institutions have deposits that the "other" Fund insures, because of mergers and other corporate developments, thus complicating FDIC administration and financing.

Institutions do not "own" either Fund. BIF and SAIF balances are on-budget assets of the government. BIF's balance is $31 billion and SAIF's balance is $11 billion. Interest on these amounts has long been more than enough to cover FDIC's operations, including the costs of closing failed institutions.

FDIC may require banks and savings associations to pay semiannual assessments to reflect their own risk and, by statute, must make their premiums reflect the size of BIF and SAIF. Both Funds have target ratios of 1.25% ($1.25 per $100) of their balance against insured deposits. That percentage is a statutorily targeted Designated Reserve Ratio (DRR). The resulting DRR carries large consequences. If either Fund exceeds that value, then its members do not have to pay assessments into it, unless low capital or managerial deficiencies make them individually risky. Institutions regard fund balances much above than 1.25% as "excess deposit insurance" which FDIC should refund to them. Institutions argue that, in the general spirit of tax cuts, institutions that paid into the respective Fund should get back their "surplus." In the other direction, should either Fund fall below its DRR, institutions must pay (at a general rate of up to 23 cents per $100 of insured deposits) to fill the fund's shortfall. That jump would greatly increase the near-zero cost of federal insurance, which is a necessity for doing business. Many prefer to smooth out assessments over time as needed to maintain adequate fund balances. FDIC is considering whether to charge BIF-insured banks for their insurance. At 1.26%, BIF is hanging just above the so-called cliff point below which assessments are called for by law; while SAIF is better capitalized at 1.38% (both as of June 30, 2002.)

A separate organization insures "share" accounts at credit unions: the National Credit Union Share Insurance Fund (NCUSIF). Congress created NCUSIF in 1970. The National Credit Union Administration (NCUA) administers it. While all federally chartered credit unions must belong to NCUSIF, state-chartered ones may or may not choose to join it. Federally insured credit unions fund NCUSIF differently than BIF and SAIF. Credit unions, owning NCUSIF, put 1% of their total "shares" (deposits) into NCUSIF. Their contributions remain assets on the books of the credit unions, representing their investment in NCUSIF. NCUSIF invests in government obligations, retaining the earnings on them. NCUA may also levy a premium if needed. It has met its target ratio of 1.30% of insured deposits without charging for its insurance as a rule.

## Background: The Purpose and Problem of Deposit Insurance

The purpose of deposit insurance is twofold: it is, first, to protect depositors against risks they cannot control, and, second, to enhance economic stability. In exchange for these benefits, however, the insurance also entails some hazards for the government.

**Purpose.** Deposit insurance, as provided by the government, makes deposits safe by assuring depositors that they can get their money even if their bank fails. It protects the depositors from a sudden and unforeseen loss of wealth. It also protects the economy against sudden contractions due to a loss of liquidity in the banking system.

The current federal deposit insurance program commenced during the Depression years, in response to just such a loss of liquidity. When some banks failed, depositors who were not first in line to withdraw their money lost much or all of their balances. Depositors in other banks, fearing further failures, "ran" to withdraw funds from their own, otherwise-healthy banks while cash was still on hand.

Even a sound bank cannot withstand a run. Deposits are used to make loans which banks cannot immediately call in to pay off depositors. If an entity with deep pockets cannot stem the run, more banks fail through contagion. The overall effect is to shrink the money supply, curtail lending for business and other economic activity, and thus to contract the economy.

Deposit insurance stops such contractions, so that bank runs have not occurred on the national level since its inception. They have occurred locally, when federal deposit insurance was absent, with effects ranging from inconvenience to genuine hardship. Taxpayers of affected states eventually bore much of the burden of cleaning up after failures of institutions insured by state instrumentalities.

**The Problem of Moral Hazard.** A problem for policymakers is the tradeoff between protection and the loss of market discipline in financial institutions that comes from the insurance. Observers know it in the industry as "moral hazard." That is, depositors have no reason to be concerned about the risks a bank takes with their funds since government insurance protects them. Banks, knowing that depositors have no reason to care, have a financial incentive to take on greater risks than they otherwise might, in the expectation of earning greater returns. Bankers retain profits from risky investments. Catastrophic losses fall on government should the investments mostly fail.

If a deep-pocket insurer has not insured depositors, they and other bank creditors have every reason to monitor a bank's riskiness. If they perceive that their funds are not well handled, they may require higher interest rates on their monies to compensate for the extra risk. That brings down the returns from risky investments for a bank and, therefore, discourages risk-taking. The behavior of uninsured, but presumingly knowledgeable, depositors gives regulators another way of monitoring the complex activities of banks and of protecting against serious systemwide problems. Such monitoring facilitates the regulation of very large banks, funded mainly by uninsured large deposits, that present systemic risks to the nation's financial system.

## Issues

The 106th Congress saw a resurgence of interest in examining various issues surrounding federal deposit insurance. Legislators, regulators, interest groups, and academics examined a growing list of complex questions.

Congressional consideration of possible changes in federal deposit and share insurance began in February 2000 when the House Banking Subcommittee on Financial Institutions held hearings on FDIC-related problems of depository institutions, and on a possible merger of BIF and SAIF. Interest was evident in asking:

—Should Congress increase the $100,000 coverage for deposits at banks and savings associations, and shares at credit unions? Should inflation, perhaps retroactively since 1980, and in future years, be used to "index" FDIC coverage to preserve the purchasing power of deposits?

—Should FDIC insure deposits of municipalities at a greater level?

—Should FDIC insure retirement and pension accounts at a greater level?

—What should institutions pay for deposit insurance coverage and associated regulation? Should premiums be smoothed out over time?

—If the fund balances in BIF and SAIF exceed the amounts necessary to provide adequate coverage, what should be done with the excess? Would refunds leave FDIC in weakened condition?

—Is free or low-cost deposit insurance an unwarranted subsidy to banks in their competition with nonbank financial firms? Or does it offset costs of complying with bank-only regulations?

—Should Congress merge BIF with SAIF, as a 1996 statute planned?

—Are there better avenues to monitor and restrain risk-taking before it results in FDIC payouts? Must large institutions be deemed too-big-to-fail: posing such systemic risk to the economy that America must prop them up rather than close them?

—Should rapidly-growing banks, who have paid little or no assessments, be assessed premiums to compensate FDIC for its increased exposure to payouts and the downward change in fund reserve ratios?

—What changes affecting FDIC operations might apply to credit unions?

## Policy Considerations

Policymakers must weigh many factors in considering possible changes. A key issue is how to provide the benefits of deposit insurance without lessening the incentives for the managements of banks, savings associations, and credit unions to engage in prudent operating practices. Owners and managers at covered institutions may take on greater risks, in the expectation of greater rewards, if they know that customers are unlikely to withdraw their deposits, as described above. The effectiveness of examination and supervision arrangements thus has an important bearing on the exposure of the insurance funds. Regulation of banks and savings associations to prevent failure ideally would prevent FDIC from having to make good on its guarantee. Government can make no system failure-proof, however. In a competitive economy, bad business decisions resulting in closure guide future capital investment away from practices that failed. Banks and savings associations are not exempt from this truth.

Tradeoffs exist among proposals for change. For example, increased account coverage at banks and savings associations could require more reserves at BIF and SAIF, making it less likely that the costs of FDIC insurance remain low. Alternatively, should risk increase in financial markets, or the Funds' coverage of insured deposits become very thin, institutions might have to make larger payments. Competitive equality is an important consideration for different institutions (large versus small, banks and savings associations versus credit unions, for example). Any expansion of the federal safety net through FDIC has to be paid for, and appropriations are not viewed as appropriate means of payment, which necessarily would come from covered institutions.

## FDIC Recommendations and Congressional Activity

At a House Financial Institutions Subcommittee Hearing in May 2001, outgoing FDIC Chairman Tanoue said the agency would like the 107th Congress to make statutory improvements to its practices, policies, and structure. It seeks to merge the BIF and SAIF funds. It would like to charge regular premiums based on institutions' risks, whatever the level of the reserve ratio of the fund(s). It seeks to adjust premiums gradually up or down as the health of the fund(s) might change. If it makes rebates, the agency would base them on past contributions to building up the fund(s). It seeks to index the basic account coverage, to keep pace with future inflation, not necessarily to sharply boost standard minimum account coverage to $130,000. The agency believed that its recommendations would produce a stronger, more properly priced, less volatile, system of deposit insurance.

Current FDIC Chairman Powell carried forward much of the FDIC's reform effort. Regulators and Administration officials endorsed many of FDIC's recommendations at a House Financial Services Subcommittee hearing, July 26, 2001. They approved of merging the two Funds, charging premiums to all institutions, and replacing the DRR and associated premium pricing with a more flexible approach giving FDIC greater discretion. They disagreed somewhat over the FDIC's proposal to index coverage to inflation, and some opposed increasing the basic dollar amount coverage per account.

The next day saw closure of the undercapitalized $2.3 billion Superior Bank. With that collapse as backdrop, the Senate Banking Committee held its hearing on deposit insurance reform, August 2, 2001. Regulators repeated their views on public policy issues. Superiors' closure added momentum to legislation to merge BIF with SAIF and to strengthen supervision of institutions, perhaps giving FDIC a larger role.

Another House hearing explored reforms on October 17. In it, FDIC Chairman Powell expressed support for merging the two funds, indexing future account coverage to inflation, raising coverage for retirement accounts, and changing the pricing of FDIC insurance to reflect risks rather than through statutory formulas.

## Legislation

### Bills of 2001.

H.R. 557, Deposit Insurance Fairness and Economic Opportunity Act, would provide payments for, and to, insured institutions if FDIC funds accumulate excess amounts. S.128, Meeting America's Investment Needs in Small Towns Act of 2001, would make periodic cost of living adjustments to basic insurance of $100,000. The measure would retroactively start adjustments as of 1980, increasing coverage to about $200,000 per account, and would make future adjustments for inflation every 3 years. S. 227, Municipal Deposit Protection Act of 2001, would provide full FDIC coverage to within-state deposits of governmental bodies. H.R. 746 is similar to S. 128. H.R. 1293, Deposit Insurance Stabilization Act, would merge the BIF and SAIF insurance funds, and would also permit FDIC to impose fees on institutions if their activities cut the deposit insurance fund(s) below the DRR of $1.25. It would repeal the automatic assessment of 23 cents per $100 that FDIC must charge when the insurance funds(s) become undercapitalized. H.R. 1355, Deposit Insurance Funds Merger Act of 2001, would similarly merge BIF and

SAIF into one fund. The House version of the Municipal Deposit Insurance Protection Act of 2001, H.R. 1899, would fully insure deposits of within-state municipal depositors up to the total equity capital of banks holding them.

### Bills of 2002.

In 2002, further legislation of a comprehensive nature came onto the congressional agenda. H.R. 3717, the Federal Deposit Insurance Reform Act of 2002, was marked up by the House Subcommittee on Financial Institutions and Consumer Credit on March 7, 2002. It was then further approved by the House Financial Services Committee on April 17 with a 52-2 favorable report. With several changes made to increase its appeal, H.R. 3717 passed the House by 408-18 under a suspension of rules, May 22, 2002.

H.R. 3717 would now do several basic things. (1) It would create a range of reserve ratios, rather than the existing Designated Reserve Ratio minimum of 1.25%. (2) It would merge BIF with SAIF, into a single Deposit Insurance Fund. (3) It would increase standard account protection to $130,000. (4) It would index future basic coverage to inflation every 5 years. (5) It would double coverage of many retirement (IRA and "401(k)") accounts, that is, to $260,000. (6) It would increase insurance coverage of municipal deposits. (7) It would give parity in account coverage to federally insured credit unions. (8) It would allow FDIC to charge a small premium to institutions that do not currently pay premiums. S. 1945, the Safe and Fair Deposit Insurance Act of 2002, has generally similar objectives but somewhat different details for several aspects of proposed reform. The House-passed H.R. 3717 now largely resembles its Senate counterpart. S. 1945 received a hearing in the Senate Banking Committee on April 23, 2002. CRS Report RL31343 compares provisions of the two measures.

Administration and some bank resistance remains to increasing standard coverage per account to $130,000 and retirement accounts to twice as much with consequent public and private-sector costs and risks; while other portions of FDIC-related bills are less contentious. Safety of wealth in light of unsettled securities markets, an increasingly aging population, and the implosion of retirement savings plans of Enron and other entities have raised important risk concerns for congressional consideration. Competitive considerations remain important. Industry groups are far from united in their views on desirability of reforms: some providers seek to avoid having to pay for changes in the ways FDIC does business and, especially, for increasing its formal protection on accounts.

For further discussion, see; CRS Report RL31343, *Deposit Insurance Reform: Comparison of H.R. 3717* and *S. 1945, 107th Congress*; CRS Report RL31463, *Deposit Insurance: Raising the Coverage Limit*; and, CRS Report RL31552, *Deposit Insurance: the Government's Role and Its Implications for Funding*.