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Federal Deposit and Share Insurance: Proposals for Change

William D. Jackson
Specialist in Financial Institutions
Government and Finance Division

Summary

Many Members of Congress are concerned about the federal deposit insurance system. Earlier House-passed legislation and its Senate counterpart sought to change the pricing of insurance, the coverage of accounts, and the financing of the Federal Deposit Insurance Corporation (FDIC). Changes would affect the condition of insured depository institutions, the strength of the insurance funds, and competition among financial institutions. Increasing financial risks, leading some to suggest that deposit insurance may need reform, became evidenced with the collapse of several banks, Enron, WorldCom, etc. The 108th Congress has begun to reexamine the issues raised by prior-Congress measures. H.R. 453, the Municipal Deposit Insurance Protection Act of 2003, would have FDIC insure governmental deposits up to at least $2 million. H.R. 522, the Federal Deposit Insurance Reform Act of 2003, is a broad measure revisiting last year's House-passed measure. It would internally restructure FDIC, change FDIC's pricing of insurance, and increase basic per-account coverage to $130,000 and future inflation. S. 229, the Safe and Fair Deposit Insurance Act of 2003, has markedly similar provisions. The Bush Administration FY 2004 Budget expresses support for deposit reform in similar terms, except for opposing increased coverage of accounts to $130,000. This report analyzes the underlying issues affecting deposit insurance. 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.

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 this insurance. Government has not formally insured foreign office deposits, although very large banks rely upon them. Smaller institutions find deposit insurance, including extra coverage for municipal, joint, trust, and retirement accounts, very valuable.

Pursuant to P.L. 101-73 and P.L. 102-242, the independent agency Federal Deposit Insurance Corporation (FDIC) has two funds. The FDIC's two funds are interest-earning accounts maintained with the U.S. Treasury. Its Bank Insurance Fund (BIF) dates from 1934. Congress intended it and its ancestor the Permanent Insurance Fund to cover commercial bank deposits. BIF members are predominantly commercial and savings banks supervised by FDIC, the Office of the Comptroller of the Currency, or the Federal Reserve. Its Savings Association Insurance Fund (SAIF) is the successor to a failed fund ("Federal Savings and Loan Insurance Corporation") covering savings institution deposits. SAIF members are predominantly thrift institutions supervised by the Office of Thrift Supervision. Many institutions have deposits that the "other" Fund insures because of mergers, 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 $12 billion. Interest on these amounts and income from assessments on covered institutions has long been more than enough to cover FDIC's costs, including of closing failed institutions.

FDIC requires institutions to pay semiannual assessments to reflect their own risk and other factors, and, by statute, must make their premiums reflect the relative sizes 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 the statutorily targeted Designated Reserve Ratio (DRR). When either Fund exceeds that value, then its members do not have to pay assessments into it, unless capital or managerial deficiencies make them 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 rate of up to 23 cents per $100 of insured deposits, large when compared with their profit margins) to fill the fund's shortfall. That would greatly increase the near-zero cost of deposit insurance. Many would prefer to smooth out assessments over time as needed to maintain adequate fund balances. At 1.25%, BIF is just at the so-called cliff point below which assessments are called for, while SAIF is better capitalized at 1.39%.

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 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, beginning in 1985. Their contributions remain assets on the books of the credit unions, representing their investment in NCUSIF. It invests in government obligations, retaining the earnings on them. NCUA may also levy a premium if needed, but has charged only one premium, when three large New England credit unions failed in 1992. It, too, has a reserve ratio of 1.25% of insured deposits with a recent balance of about $5 billion.

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 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 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 theoretically eases the regulation of very large banks, funded mainly by uninsured large deposits, that present systemic risks to the nation's financial system. It is of limited value for the vast majority of smaller institutions whose funding comes mainly from insured deposits, whose financial position Wall Street does not follow closely.

Issues

Ongoing congressional consideration of changes in federal deposit insurance began in February 2000 when the House Banking Subcommittee on Financial Institutions held hearings on problems of depository institutions and FDIC. 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 balances in BIF and SAIF exceed amounts necessary to provide adequate coverage, what should be done with the excess? Would refunds leave FDIC weakened?

—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, the so-called free riders, be assessed premiums to compensate FDIC for resulting increased exposure to payouts and the decrease in fund reserve ratios?

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

We analyze these underlying issues in more depth in CRS Report RL31552.

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. Policymakers have not viewed appropriations as appropriate means of payment, which necessarily would come from covered institutions.

FDIC Recommendations and 107th Congress Activity

At a House Financial Institutions Subcommittee Hearing in May 2001, outgoing FDIC Chairman Tanoue said the agency would like Congress to make statutory improvements. It sought to merge the BIF and SAIF funds. It sought to charge regular premiums based on institutions' risks, whatever the level of the reserve ratio of the fund(s). It suggested adjusting premiums gradually up or down as the health of the fund(s) might change. If it made rebates, the agency would base them on past contributions to building up the fund(s). It suggested indexing the basic account coverage, to keep pace with future inflation, not necessarily boosting 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 the effort forward. 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. Some opposed increasing the dollar amounts of coverage. The Senate Banking Committee held its hearing on deposit insurance reform, August 2, 2001. Regulators repeated their views on public policy issues. Another House hearing explored reforms on October 17. In it, 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 formulas. We compare viewpoints of interest and regulatory groups in CRS Report RL31643; observers expect their ideas and positions to persist in the 108th Congress.

Members introduced several bills in the first session of the 107th Congress, none of which became marked up. They sought to reform pieces of FDIC coverage and operations. Much of their intent carried forward into legislation of the second session.

The House Subcommittee on Financial Institutions and Consumer Credit marked up a package measure: H.R. 3717, the Federal Deposit Insurance Reform Act of 2002, on March 7, 2002. The Financial Services Committee then approved it on April 17 by 52-2. With several more changes, it passed the House by 408-18 on May 22, 2002.

House-passed H.R. 3717 would have done several major things. (1) Create a range of reserve ratios, rather than the DRR minimum of 1.25%. The range could float between 1.15% and 1.40% of covered deposits. (2) Merge BIF with SAIF, into a single Deposit Insurance Fund. (3) Increase basic account protection ("standard maximum deposit insurance amount") to $130,000. (4) Index future basic coverage to inflation every five years. (5) Cover many retirement (IRA and "401(k)") accounts for $260,000, twice the standard maximum deposit insurance amount. (5) Increase coverage of within-state municipal deposits, to a maximum of $2 million. (6) Give banks refunds of premiums should the Deposit Insurance Fund exceed 1.35%, ending their payments now required when the ratio of insured deposits to their fund falls short. (7) Provide FDIC flexibility for: reserving against future losses, recapitalizing the new Fund should it need greater resources, and adjust basic account coverage according to inflation. (8) Give a credit to institutions for assessments based on their insured deposits at the end of 1996, reducing their net assessments. (9) Raise protection at credit unions to match that of banks.

The Senate bill S. 1945, Safe and Fair Deposit Insurance Act of 2002, had generally similar objectives but several differing details. S. 1945 received a hearing in the Senate Banking Committee on April 23, 2002. The Senate Banking Committee also received referral of H.R. 3717. In that venue, both faced resistance to higher coverage of accounts. The Administration and others were concerned that the increase would add to governmental risk without providing much benefit to consumers. The vast majority of depositors currently have fully insured accounts, with lower-than-limit balances or in multiple accounts. Some smaller banks, and at least potentially, retirees, are considered beneficiaries of higher deposit protection. Larger institutions and many government officials oppose any increase since it could be costly: both to the FDIC, and to the banking industry that would have to pay for the increased insurance. Costs to institutions of higher assessments for the higher coverage could amount to $3.5 billion, according to the Office of Management and Budget. We compare major provisions of the two measures of 2002 in CRS Report RL31343 for historical reference.

108th Congress Legislation

Early in the 108th Congress, Members introduced measures that may receive priority treatment. H.R. 522 has identical aims as the deposit insurance legislation that passed the House floor, but that never came up in the Senate. The bill would: merge BIF and SAIF into one Fund; end the 23-cent premium "rate cliff" that occurs when the reserve ratio of insured deposits to premiums held falls beneath 1.25% for more than a year; create a range within which the reserve ratio can float; increase coverage limits for individual accounts to $130,000, index future coverage limits to inflation; double coverage for Individual Retirement Accounts and 401(k)s; and, increase coverage limits for municipal deposits. It would make credit union insurance match bank insurance. This legislation is very similar to S. 229. The more limited H.R. 453 would provide FDIC coverage to municipal (federal, state, local, etc. governmental) bodies of at least $2 million per account. The Bush Administration asked for federal deposit insurance reform, but notably did not endorse increasing coverage levels, in its Fiscal Year 2004 budget. It sought: merging of the two FDIC funds; making a new floating reserve ratio for the merged fund so that it remains adequately capitalized; and requiring all institutions–regardless of capital rating–to pay FDIC for the insurance they receive. The agency, which Congress would grant more discretionary power under the Bush plan, has been prohibited since 1996 from charging premiums to well-capitalized and well-run institutions.

Pending entry of the Schwab securities powerhouse into the banking business adds weight to this legislation. On the other hand, many still oppose increasing how much protection covers accounts. We analyze the coverage issue in CRS Report RL31463.