

CRS Report for Congress

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Federal Deposit and Share Insurance: Proposals for Change

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

Summary

Many Members of Congress are concerned about the costs and benefits of the current deposit insurance system. Legislators, regulators, interest groups and academics started today's ongoing examination of proposals for changes 2000. Resulting legislation has sought to change the pricing of insurance, how much coverage should exist for customers' accounts, and financing the insuring Federal Deposit Insurance Corporation (FDIC). Changes could 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 end of several banks, Enron, WorldCom, etc. The 108th Congress has reexamined these issues. H.R. 522, the Federal Deposit Insurance Reform Act of 2003, is a broad measure revisiting last year's House-passed measure. It would restructure FDIC, change FDIC's pricing of insurance, and increase basic per-account coverage to \$130,000 and for future inflation. It incorporates H.R. 453, for greater insurance of municipal deposits, as well. H.R. 522 passed the House on April 2, 2003, by a vote of 411 to 11. S. 229, the Safe and Fair Deposit Insurance Act of 2003, has similar provisions. S. 913 addresses how government could compensate banks for past premium payments. The Senate Banking Committee has also received draft legislation, written by the bank regulatory agencies to replace H.R. 522. The Administration supports deposit insurance reform in very similar terms, but opposes raising coverage of accounts of \$130,000. 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 on financial services issues.

What is Deposit Insurance and How is It Administered?

The full faith and credit of the United States stands behind \$3.4 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 \$33 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 reflecting their own risk and other factors, and, by statute, must make 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 statutory 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 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. BIF's ratio stood at 1.29 % and SAIF's at 1.38%, as of June 30, 2003.

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. While it may levy a premium, it has charged only one, when three large New England credit unions failed in 1992. NCUSIF, too, has a targeted reserve ratio: 1.30% of insured deposits, based on a recent balance of almost \$6 billion. Likewise, the "full faith and credit of the U.S. Government" backs it.

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 questions that are posed even today:

- 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 P.L. 104-208 planned in 1996?
 - 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. A key issue is how to provide the benefits of deposit insurance without lessening the incentives for managers 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. Observers call such behavior “a moral hazard.” 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. Payment 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 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. Current FDIC Chairman Powell carried the effort forward. The Subcommittee on Financial Institutions and Consumer Credit marked up H.R. 3717, the Federal Deposit Insurance Reform Act of 2002, on March 7. The Financial Services Committee approved it on April 17. With several changes, it passed the House by 408-18 on May 22, 2002.

The House-passed bill 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.

Senate bill S. 1945, Safe and Fair Deposit Insurance Act of 2002, had similar objectives but differing details. S. 1945 received a hearing in the Senate Banking Committee on April 23, 2002. The Senate Banking Committee also received H.R. 3717. In that venue, both faced resistance to higher coverage of accounts. (We compare major provisions of these two measures in CRS Report RL31343 for historical reference. We also compare viewpoints of interest and regulatory groups in CRS Report RL31463, because they persisted into the 108th Congress).

108th Congress Legislation

H.R. 522, introduced by Representative Bachus, noted below, is very similar to S. 229, introduced by Senator Johnson. Both mirror the bills noted above from the 107th Congress. H.R. 453, introduced by Representative Gillmor, would provide FDIC coverage to municipal (federal, state, local, etc.) governmental bodies up to \$2 million per account or lesser coinsured amounts. The Administration did not endorse increasing

coverage 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 insurance. 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, leaving only 9% to 10% of depositories paying insurance premiums. Banks controlled by Citigroup and Merrill Lynch have required FDIC to protect them in large amounts, yet have paid little or no premiums.

Specifically, the Oxley-Frank Managers' Amendment of H.R. 522, the Federal Deposit Insurance Reform Act of 2003, passed the Financial Services Committee by voice vote March 13, 2003. This bill would:

- merge the two Funds into the new Deposit Insurance Fund
- create a range of 1.15% to 1.40% within which FDIC can set the reserve ratio
 - require minimum assessments for all institutions
 - give FDIC flexibility in setting assessments
 - provide for dividends if the new Fund exceeded 1.35%, and credits for institutions insured in 1996
 - increase coverage limits for individual accounts to \$130,000
 - index future coverage limits to inflation
 - double coverage limits for certain types of retirement accounts and 401(k)s
 - increase coverage for instate municipal deposits up to the lesser of \$2 million or \$130,000 per account plus 80% greater than \$130,000 (as in H.R. 453),
 - increase credit union share insurance to conform to FDIC coverage, and,
 - require studies of deposit and share insurance and related matters.

The Committee adopted an amendment of Representative Gonzalez requiring FDIC to survey use of depository institutions by people without bank accounts. Dissent about increasing coverage was evident. (We analyze that issue in CRS Report RL31463.)

On April 2, 2003, the House approved the bill by 411-11 vote. It passed with general support from banking groups, with reservations about features that some believe protect deposit insurance against potential abuses. Industry advocates praised its merger of FDIC's two Funds. It would end the DRR of \$1.25 for every \$100 in insured deposits. H.R. 522 would shift the ratio to a floating reserve range that could give regulatory flexibility in making adjustments. H.R. 522 would require FDIC to provide certain banks and thrifts with one-time credits against future assessments, based on their payments to BIF or SAIF before 1997. It would increase account coverage from the current \$100,000 to \$130,000, indexing future coverage for inflation. That aspect generated opposition from Federal Reserve Board Chairman Greenspan and Senate Banking Committee Chairman Shelby. Similarly, the Congressional Budget Office recently reported that boosting the general coverage limit to \$130,000, combined with indexing to inflation, would dramatically increase FDIC's liability for future failures. Thus, \$1.9 billion of increased spending (including some by the credit unions' NCUSIF) to resolve failures could occur over the next ten years. Members defeated an amendment of Representatives Ose and Maloney to remove that coverage increase.

More specifically focusing on FDIC premiums, Senator Santorum introduced S. 913 on April 11. It would return "excess amounts" in FDIC to financial institutions according to the historical basis of their contributions to the funds.

The next day, major bank regulatory agencies released consensus draft language for deposit insurance reform legislation. Agencies favor having all depository institutions pay regular insurance premiums, and they favor no increase in coverage for each account. The draft reflects desires of the Treasury Department, Fed, FDIC, Office of Thrift Supervision, and OCC. Their consensus responds to request from Senate Banking Committee Chairman Shelby. Their draft provides for a merger of the two FDIC Funds, and flexible management of fund reserves within a range. The agencies recommend imposing moderate, regular premiums on all institutions. FDIC could set the new DRR within a range between 1.15% and 1.50%, with a restoration schedule should the ratio fall below. Their plan would provide assessment credits and rebates for institutions that have paid into their fund in the past. The agencies' draft calls for "transition" credits of nine basis points (nine cents per \$100) of the combined BIF and SAIF assessment base as of Dec. 31. Total transition credits would be about \$4.4 billion. Insured banks or their successors existing before Dec. 31, 1996, which paid premiums before that date would be eligible for some of that total. Their system would further allow for assessment credits if the reserve ratio rises above the DRR or 1.25%. The amount each qualifying institution would receive would depend on several factors, including the ratio of its assessment base as of Dec. 31, 1996, to the aggregate assessment for all institutions that were eligible as of that date. FDIC could also offer cash rebates instead of any additional assessment credits that they would otherwise have received. The draft does not increase coverage for accounts, or for indexation of coverage for inflation.

Senate take-up of a deposit insurance measure reportedly would require agreement of Banking Committee Members that no increase of coverage to \$130,000 would be in the bill. Analysts generally view other financial legislation as must-pass initiatives of higher priority for the panel. Thus, many observers treat deposit insurance legislation as a second-session matter.