



# Loss Exposure and the Federal Deposit Insurance Corporation

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## Summary

The Federal Deposit Insurance Corporation (FDIC) was established as an independent government corporation under the authority of the Banking Act of 1933, also known as the Glass-Steagall Act (P.L. 73-66, 48 Stat. 162, 12 U.S.C.), to insure bank deposits. The FDIC is funded through insurance assessments collected from its member depository institutions and held in what is now known as the Deposit Insurance Fund (DIF). The proceeds in the DIF are used to pay depositors if member institutions fail.

Beginning in 2008, the number of bank failures has increased substantially, and the DIF is currently below its statutory minimum requirement. As a result, the FDIC has raised assessments on member depository institutions during a banking downturn, which has drawn attention to a procyclical bias in assessments. The FDIC, therefore, has made efforts to revise deposit insurance assessments to better reflect the total loss exposure to the DIF.

This report begins with an overview of the FDIC, followed by an explanation of the loss exposure and total risk to the DIF. Next, the report discusses issues regarding the setting of deposit insurance premiums and presents changes to the assessment system proposed by the FDIC to address some of the issues. Finally, recent efforts proposed by Congress to support the DIF are discussed. H.R. 2897, the Bank Accountability and Risk Assessment Act of 2009 (Representative Luis Gutierrez et al.); H.R. 4173, the Wall Street Reform and Consumer Protection Act of 2009 (Representative Barney Frank et al.); and S. 3217, the Restoring American Financial Stability Act of 2010 (Senator Christopher Dodd) address modifications to the deposit insurance assessment system. Appendices to this report provide information regarding the FDIC's efforts to support the DIF during the recent period of financial distress, which includes information about the Temporary Liquidity Guarantee Program.

This report will be updated as events warrant.

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## Introduction

The Federal Deposit Insurance Corporation (FDIC) was established as an independent government corporation under the authority of the Banking Act of 1933, also known as the Glass-Steagall Act, to insure bank deposits.<sup>1</sup> The FDIC insures demand deposit (non-interest bearing) accounts, interest bearing checking accounts, savings accounts, and certificates of deposit.<sup>2</sup> The FDIC also insures traditional and Roth Individual Retirement Accounts (IRAs).<sup>3</sup> Bank deposits and IRAs in the same bank for the same individual are insured separately by the FDIC.<sup>4</sup>

When a bank is insolvent or has failed, according to the FDIC, the depositors need not worry about repayment of principal up to the deposit insurance limits. Typically, most depositors have access to their insured funds within one business day after the FDIC closes the bank. With certain deposits, such as 401(k) accounts and retirement accounts, additional time is required to make an insurance determination. The FDIC estimates that this should not be longer than several days. In some situations, depositors may also receive a portion of their uninsured funds, depending on the sale of the failed bank's assets, a process which may take one or two years.<sup>5</sup>

To help discourage runs or panics on banks, Congress has periodically increased the amount of deposit insurance coverage.<sup>6</sup> For example, the Federal Deposit Insurance Reform Act, which was enacted on February 8, 2006, raised the limit on IRA insurance from \$100,000 to \$250,000.<sup>7</sup> The Emergency Economic Stabilization Act of 2008 temporarily raised deposit insurance until December 31, 2009.<sup>8</sup> Under the new 2008 deposit insurance limits, an individual checking account may be covered up to \$250,000 and an IRA may be covered up to \$250,000. An individual having both of these accounts would receive total coverage of up to \$500,000 in a

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<sup>1</sup> P.L. 73-66, 48 Stat. 162, 12 U.S.C. See Christine Bradley, *A Historical Perspective on Deposit Insurance*, Federal Deposit Insurance Corporation, FDIC Banking Review, Washington, DC, December 2000, p. 3, [http://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2\\_1.pdf](http://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_1.pdf).

<sup>2</sup> In addition, the FDIC insures Money Market Deposit Accounts, which are savings accounts that allow a limited number of checks to be written each month, Negotiable Orders of Withdrawal (NOW), and outstanding cashiers' checks. See CRS Report RL33036, *Federal Financial Services Regulatory Consolidation: An Overview*, by Walter W. Eubanks.

<sup>3</sup> The FDIC also insures the following retirement accounts: Keogh retirement accounts for the self-employed, 457 Plan retirement accounts for state government employees, and employer-sponsored defined contribution plan retirement accounts that are self-directed, which are primarily 401(k) accounts and include SIMPLE 401(k) accounts, Simplified Employee Pension (SEP) IRAs, and Savings Incentive Match Plans for Employees (SIMPLE) IRAs. See CRS Report RS21987, *When Financial Businesses Fail: Protection for Account Holders*, by Walter W. Eubanks.

<sup>4</sup> The FDIC does not insure stocks, bonds, mutual funds, money market funds, life insurance policies, annuities, or municipal securities, even if these products were purchased from an insured bank. The FDIC does not insure the contents of safe deposit boxes, losses due to theft or fraud at the bank, losses due to accounting errors, and investments backed by the U.S. government, such as Treasury securities and Savings Bonds. See Federal Deposit Insurance Corporation, *FDIC Consumer News - Spring 2001*, FDIC, Washington, DC, 2001, <http://www.fdic.gov/CONSUMERS/consumer/news/cnspr01/cvrstry.html>.

<sup>5</sup> FDIC, *FDIC Consumer News*, Fall 2008 – Special Edition: Your New, Higher FDIC Insurance Coverage, Washington, DC, 2008, <http://www.fdic.gov/consumers/consumer/news/cnfall08/misconceptions.html>.

<sup>6</sup> On October 14, 2008, the FDIC announced the creation of the Temporary Liquidity Guarantee Program to encourage liquidity in the banking system. See **Appendix B**.

<sup>7</sup> P.L. 109-171, 110 Stat. 9.

<sup>8</sup> P.L. 110-343. See also CRS Report RL34730, *Troubled Asset Relief Program: Legislation and Treasury Implementation*, by Baird Webel and Edward V. Murphy.

single bank. On May 20, 2009, P.L. 111-22 made the increase in deposit insurance effective until December 31, 2013.<sup>9</sup>

To cover losses or costs associated with bank failures, the FDIC collects insurance premiums from member depository institutions and places the monies in the Deposit Insurance Fund (DIF).<sup>10</sup> The designated reserve ratio (DRR), which is the ratio of total funds in the DIF relative to the estimated amount of insured deposits, provides some indication about the adequacy of reserves available to protect depositors and maintain public confidence. The FDIC is required by statute to set the DRR within a range of 1.15% to 1.50%, and the FDIC currently has set the DRR at 1.25%.<sup>11</sup> Should the DIF fall below its statutorily mandated range, the FDIC is then required to devise a restoration plan to recapitalize the fund. A well-capitalized DIF would likely maintain public confidence in the FDIC's ability to protect deposits.

In 2008, the FDIC administered 25 bank failures; 140 banks failed in 2009 according to the FDIC's *Quarterly Banking Report* as of December 31, 2009.<sup>12</sup> In comparison, the FDIC administered no bank failures in 2005 and 2006, and only three bank failures in 2007. The DRR, which was 1.25% at the end of December 2005, was -0.39% as of December 31, 2009. By the end of the fourth quarter 2009, there were also 709 depository institutions on the FDIC's problem list, which suggests that the industry may experience more bank failures. Large losses to the DIF have come from such failures as IndyMac Bank, Downey Savings and Loan, PFF Bank and Trust, Franklin Bank, and First National Bank of Nevada. Consequently, the FDIC has required its member institutions to prepay assessments for 2010, 2011, and 2012 to obtain the funds necessary to repay depositors.<sup>13</sup>

The rest of this report begins with a description of the loss exposure to the DIF, which generally exceeds the dollar amount necessary to protect insured depositors. A discussion follows on issues regarding the pricing of deposit insurance. A summary of changes to the assessment system proposed by the FDIC to address some of the issues is also presented. Finally, recent efforts proposed by Congress to support the DIF are discussed. H.R. 2897, the Bank Accountability and Risk Assessment Act of 2009 (Representative Luis Gutierrez et al.); H.R. 4173, the Wall Street Reform and Consumer Protection Act of 2009 (Representative Barney Frank et al.); and S. 3217, the Restoring American Financial Stability Act of 2010 (Senator Christopher Dodd) address modifications to the deposit insurance assessment system.

## Bank Insolvency and Loss Exposure

Bank assets are the consumer and commercial loans that banks originate and hold in portfolio; bank liabilities are the funds that banks borrow to provide loans to consumers and businesses.

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<sup>9</sup> P.L. 111-22, Section 204.

<sup>10</sup> See <http://www.fdic.gov/news/board/May22no2.pdf>.

<sup>11</sup> See <http://www.fdic.gov/deposit/insurance/initiative/Designated.html> and CRS Report RL34657, *Financial Institution Insolvency: Federal Authority over Fannie Mae, Freddie Mac, and Depository Institutions*, by David H. Carpenter and M. Maureen Murphy.

<sup>12</sup> See <http://www2.fdic.gov/qbp/2009dec/qbp.pdf>. For the FDIC's complete Failed Bank List see <http://www.fdic.gov/bank/individual/failed/banklist.html>. For a brief description of each bank failure see <http://www.fdic.gov/BANK/HISTORICAL/BANK/index.html>.

<sup>13</sup> For more information on recent FDIC actions to replenish the DIF, see **Appendix A**.

Whenever customers make savings or checking deposits into a bank, the bank is essentially borrowing from depositors and using the proceeds to originate loans. A bank typically borrows the funds from its depositors for shorter periods of time with the expectation that its short-term borrowings must be continuously renewed until the longer-term consumer loans are repaid. For example, suppose a bank makes a consumer loan with a duration of two years. Over the life of the consumer loan, the bank may “fund the loan” or borrow cash from depositors in a sequence of quarterly periods (for a total of eight short-term loans) or monthly periods (for a total of 24 short-term loans).

Deposits have traditionally been considered the most stable and inexpensive source of funding for customer loans, in particular for community banks, because depositors typically are the least sensitive to short-term interest rate fluctuations.<sup>14</sup> Banks also fund loans from creditors that are not depositors. They may borrow funds via participation in the federal funds market, using repurchase agreements, obtaining advances (loans) from the Federal Home Loan Bank System (FHLB), and some of the larger banks may issue short-term commercial paper. Although banks frequently refinance their short-term borrowings with depositors and non-deposit creditors, their assets are relatively less liquid. The composition of the short-term liabilities of a financial institution will change more often than the composition of its long-term assets, which means that total amounts of insured deposits are estimates at any point in time and not known with certainty until an institution fails.<sup>15</sup>

If the bank’s activities are unable to generate enough income to repay depositors principal and interest, then the bank becomes insolvent.<sup>16</sup> The FDIC uses a similar definition to determine the solvency of a bank expressed in the form of a ratio. A capital-asset ratio is computed by dividing the bank’s capital by its assets. The FDIC computes a variety of capital-asset ratios, using various accounting methods and asset risk-weighting methods to determine the healthiness of a bank. These are commonly known as the total risk-based capital, tier 1 risk-based capital, tier 1 leverage, and tangible equity ratios. Under-capitalized banks, which typically have capital-asset ratios that are below the FDIC’s minimum thresholds, would be considered insolvent. If a bank lacks sufficient capital, the regulator or chartering authority may shut it down and appoint the FDIC as the receiver.

As the receiver of a failed bank, the FDIC determines the least costly resolution transaction by evaluating possible resolution alternatives and then computing the costs on a net present value basis. The FDIC is required by law to pursue the least-costly transaction to minimize the impact on taxpayers.<sup>17</sup> Typically, the least-costly transaction will involve some form of the purchase and

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<sup>14</sup> The cost to fund bank assets with deposits increases when households shift from holding assets in the form of bank deposits to non-bank investment vehicles, which may offer higher returns, or when deposit insurance premiums increase. For more information on the decline of core deposits and the impact on small banks, see <http://www.kansascityfed.org/banking/bankingpublications/prs01-4.pdf>.

<sup>15</sup> See Andrew M. Davenport, Joseph V. Fellerman, and Lynn Shibut, et al., *An Evaluation of the Denominator of the Reserve Ratio*, Federal Deposit Insurance Corporation, FDIC Staff Study, Washington, DC, February 12, 2007, [http://www.fdic.gov/deposit/insurance/initiative/Denominator\\_Board.pdf](http://www.fdic.gov/deposit/insurance/initiative/Denominator_Board.pdf).

<sup>16</sup> Note that a bank does not have to be insolvent to be illiquid. A bank can hold more of its assets in the form of loans as opposed to cash. If, however, those assets cannot quickly be turned into cash, the bank may face cash flow problems, perhaps if there is an unusual demand for cash by depositors.

<sup>17</sup> See testimony of Mitchell L. Glassman, Director of the Division of Resolutions and Receiverships at the FDIC, at <http://www.fdic.gov/news/news/speeches/chairman/spjan2110.html>.

assumption (P&A) process.<sup>18</sup> A P&A is a resolution transaction in which a healthy institution *purchases* some or all of the assets (outstanding loans) of a failed bank or thrift and assumes some or all of the *liabilities* (deposits).<sup>19</sup> The FDIC seeks bids from qualified institutions for the failed bank's assets.<sup>20</sup> Once the FDIC accepts the bid that is judged to be the least-costly option to the DIF, it then closes the failed bank.

Despite the mandate to pursue the least-costly resolution, the total losses to the DIF generally exceed the costs of reimbursing depositors. For one reason, the composition of a financial institution's liabilities normally changes more often than the composition of its assets as previously discussed, which makes it difficult to know exactly the amount of insured deposits until after the failure has occurred. Furthermore, some of the bank creditors may require repayment ahead of depositors. For example, suppose a bank funded some of its assets with FHLB advances. Upon failure, the FDIC must repay the FHLB advance immediately since advances have priority over depositors (or "super lien" status), and the prepayment fees assessed by the FHLB could be an additional cost to the DIF.<sup>21</sup>

Another reason for the difficulties associated with predicting DIF loss exposure has to do with the additional costs associated with administering a bank failure. The FDIC often provides assistance to or enters into loss sharing agreements with acquirers. This assistance limits the amount of potential losses that may arise from loans transferred to the books of acquiring institutions that could threaten their solvency. Any assets not purchased by an acquirer must be liquidated by the FDIC.<sup>22</sup> Hence, the losses to the DIF are not limited to reimbursement costs of insured depositors. The costs associated with resolving a bank failure also apply.

## FDIC Efforts to Reduce Loss Exposure

The Federal Deposit Insurance Corporation Improvement Act of 1991 granted the FDIC authority to implement a risk-based assessment system, and this was put in place on January 1, 1993.<sup>23</sup> Under a risk-based assessment system, financial institutions that pose more risk to the DIF are assessed higher deposit insurance premiums relative to those that pose lower risks. The Deposit Insurance Funds Act of 1996, however, mandated that institutions that are both well-capitalized

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<sup>18</sup> Although the FDIC has various resolution options and chooses the least costly one, the P&A process is the most frequently used option. See CRS Report RL34657, *Financial Institution Insolvency: Federal Authority over Fannie Mae, Freddie Mac, and Depository Institutions*, by David H. Carpenter and M. Maureen Murphy; Federal Deposit Insurance Corporation, *Managing the Crisis: The FDIC and RTC Experience 1980-1994* (Washington, DC: Federal Deposit Insurance Corporation, 1998) at <http://www.fdic.gov/bank/historical/managing/contents.pdf>; and <http://www.fdic.gov/bank/historical/managing/history1-02.pdf> for more details regarding the resolution process.

<sup>19</sup> See Chapter 3 of the FDIC's *Resolution Handbook* at <http://www.fdic.gov/bank/historical/reshandbook/ch3pas.pdf>.

<sup>20</sup> Qualified institutions are those that obtain approval from their chartering authorities. See <http://www.fdic.gov/buying/financial/index.html> for more information about the qualification process for financial institutions wanting to participate in an FDIC asset sale.

<sup>21</sup> For more information about the FHLB's super lien status, see [http://www.fdic.gov/about/learn/advisorycommittee/fhlb\\_advances.html](http://www.fdic.gov/about/learn/advisorycommittee/fhlb_advances.html), <http://www.fdic.gov/about/learn/advisorycommittee/minutes111903.html>, and CRS Report R41102, *The Federal Home Loan Bank System and Resolution of a Failure*, by N. Eric Weiss and Todd Garvey. For information on the National Depositor Preference Law, which stipulates the priority of payment structure that the FDIC must follow to resolve depository failures, see <http://www.clevelandfed.org/Research/commentary/1994/0215.pdf>.

<sup>22</sup> For information regarding some of the unusual bank assets that the FDIC has had to liquidate after various bank failures, see <http://www.fdic.gov/bank/historical/managing/Chron/1933-79/>.

<sup>23</sup> P.L. 102-242. See [http://www.fdic.gov/deposit/insurance/assessments/rate\\_cases.html](http://www.fdic.gov/deposit/insurance/assessments/rate_cases.html).

and received high examination ratings should *not* be charged premiums when the DIF is at or above the statutorily set DRR.<sup>24</sup> Academic studies argued that this limitation injected a procyclical bias into the pricing of deposit insurance.<sup>25</sup> In other words, the DIF would not be permitted to accumulate reserves in excess of the DRR during financially stable periods; consequently, deposit premiums may increase dramatically during a financial downturn, when it is more difficult for banks to maintain sufficient profitability.

In 2001, FDIC Chair Donna Tanoue testified that this statutory provision resulted in 92% of insured depository institutions in the FDIC's best-risk category not having to pay deposit insurance assessments, which rendered its risk-based premium system ineffective.<sup>26</sup> For this reason, the FDIC requested elimination of the statutory restrictions on its ability to charge risk-based premiums to all institutions even when the DIF level exceeds its statutory requirement. On February 8, 2006, the Federal Deposit Insurance Reform Act of 2005 (the Reform Act) was signed by the President into law, giving the FDIC the authority to charge premiums, after notice and comment rulemaking, based upon the riskiness of the institutions, regardless of the level of the DRR.<sup>27</sup> The FDIC then proposed new risk-based deposit premium assessments on July 16, 2006, and these were approved on November 2, 2006.<sup>28</sup> The FDIC is still unable to collect assessments, however, when the DIF exceeds 1.35% at the end of a calendar year. Given that the Reform Act requires the FDIC to rebate excess assessments in the form of dividends to financial institutions, a procyclical bias in the pricing of deposit assessments still exists.<sup>29</sup>

On April 8, 2010, the FDIC announced proposed revisions to the current system of determining assessments via a Notice of Proposed Rulemaking (NPR) on Assessments.<sup>30</sup> The new system takes a formal risk analysis approach, similar to methodologies used in credit underwriting.<sup>31</sup> This approach attempts to better capture risk at the time the institution assumes the risk and, therefore, to better predict when an institution's risk profile may change. This approach also attempts to reduce procyclical bias. An overview of the proposed assessment system that follows has been abbreviated substantially, but the FDIC provides a complete description in the NPR.

The assessment system would have separate assessment structures for large depository institutions, highly complex institutions, and small depository institutions. A large depository institution would be defined as one having \$10 billion or more in total assets for at least four consecutive quarters. A highly complex institution would be defined as a depository institution with more than \$50 billion in total assets that is fully owned by a parent company with more than

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<sup>24</sup> P.L. 104-208.

<sup>25</sup> See Alan S. Blinder and Robert F. Wescott, *Reform of Deposit Insurance: A Report to the FDIC*, March 20, 2001, available at <http://www.fdic.gov/deposit/insurance/initiative/reform.html>.

<sup>26</sup> See <http://www.house.gov/financialservices/media/pdf/051601ta.pdf>, <http://www.fdic.gov/deposit/insurance/initiative/direcommendations.html#ReCurrent>, and <http://www.frbsf.org/publications/economics/letter/2002/el2002-14.html>.

<sup>27</sup> P.L. 109-171, the Federal Deposit Insurance Reform Act of 2005 (the Reform Act). See <http://www.fdic.gov/deposit/insurance/initiative/index.html> for highlights regarding coverage of the law and a link to the Reform Act.

<sup>28</sup> See <http://www.fdic.gov/news/news/press/2006/pr06070.html> and <http://www.fdic.gov/news/news/press/2006/pr06101.html>.

<sup>29</sup> See <http://www.fdic.gov/deposit/insurance/reform.html#drr>.

<sup>30</sup> See <http://www.fdic.gov/deposit/insurance/new.html>, <http://www.fdic.gov/news/board/april05.pdf>, and <http://www.fdic.gov/news/board/april06.pdf>.

<sup>31</sup> See John W. Straka, "A Shift in the Mortgage Landscape: The 1990s Move to Automated Credit Evaluations," *Journal of Housing Research*, vol. 11, no. 2 (2000), pp. 207-232.



\$500 billion in total assets (or fully owned by one or more intermediate parent companies with more than \$500 billion in assets), or a processing bank and trust company with more than \$10 billion in total assets.<sup>32</sup> Small institutions, which do not fit into the other categories, are assessed separately.

Data for the large depository institutions and the highly complex institutions, which would be collected during examinations, would be evaluated using a scorecard that would use variables from the following categories:<sup>33</sup>

- A weighted average CAMELS rating;<sup>34</sup>
- Variables that represent the ability to withstand a decline in asset holdings or an increase in credit or default risk, such as risk-based capital-to-asset ratios;
- Variables that represent the ability to withstand an increase in liquidity or funding risk, such as the ratio of core deposits to total liabilities;
- A loss severity score that measures the relative magnitude of potential losses to the FDIC, which is computed as a ratio of possible losses to the total domestic deposits, averaged over three quarters.

The scorecards for highly complex institutions will include a market indicator category, which will include a capital asset ratio, specifically the tangible common equity ratio, from the parent company of the institution. After the data have been entered, the scorecard would compute a performance score between 0 and 100 as a weighted average of the first three categories of inputs for the large depository institutions. For the highly complex institutions, the performance score between 0 and 100 would still be a weighted average, but the market indicator category is included for a total of four categories. The loss severity score would also generate a quantitative measure between 0 and 100 for both groups. The performance and the loss severity scores would then be converted to an *initial* base assessment rate. The *final* assessment rate would then be computed by adjusting the initial base assessment rate for holdings of certain long-term unsecured debt, secured liabilities, and brokered deposits. Use of the scorecard allows assessments to vary with the levels of risk taken by institutions each quarter. Consequently, this system may provide incentives to institutions to reduce excessive risks, in particular during economic expansions when loan underwriting standards tend to be relatively more relaxed.

For small depository institutions, a risk-based deposit insurance assessment would still be calculated based upon their CAMELS ratings and capitalization levels. Financial institutions receive a composite CAMELS rating from 1 to 5, with 1 being the most favorable rating of an institution's overall condition and performance. Next, they are assigned capitalization classifications, which are determined by their various leverage ratios: Well capitalized, Adequately capitalized, Undercapitalized, Significantly undercapitalized, and Critically undercapitalized. The institutions can now be grouped into four risk categories:

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<sup>32</sup> For a more precise definition of a highly complex institution, see <http://www.fdic.gov/news/board/april05.pdf>.

<sup>33</sup> A scorecard refers to scoring models and statistical automated methods used to assess the credit risk of individuals or entities based upon various characteristics. For example, the mortgage industry uses scorecards to categorize mortgage applicants into risk groups and set mortgage rates and terms. See John W. Straka, "A Shift in the Mortgage Landscape: The 1990s Move to Automated Credit Evaluations," *Journal of Housing Research*, vol. 11, no. 2 (2000), pp. 207-232.

<sup>34</sup> The CAMELS rating assesses six components: Capital adequacy, Asset quality, Management administration, Earnings, Liquidity, and Sensitivity to market risk. See <http://www.federalreserve.gov/boarddocs/press/general/1996/19961224/default.htm>.

- Risk Category I (Well capitalized and with CAMELS ratings of 1 or 2);
- Risk Category II (Adequately capitalized and with CAMELS ratings of 2 or 3);
- Risk Category III (Undercapitalized with higher CAMELS ratings or currently not undercapitalized with CAMELS ratings of 4 or 5); or
- Risk Category IV (all other undercapitalized institutions).

Under the proposed rule, the final assessment rate for each risk category would be computed using a predetermined initial base assessment rate and adjustments for holdings of unsecured debt, secured liabilities, and brokered deposits.

## Legislative Efforts to Reduce Loss Exposure

On June 16, 2009, H.R. 2897, the Bank Accountability and Risk Assessment Act of 2009 (Representative Luis Gutierrez et al.), was introduced with the stated purpose “to amend the Federal Deposit Insurance Act of 1950 to return a sense of fairness and accountability to the deposit insurance premium assessment process and for other purposes.”<sup>35</sup> H.R. 2897 is particularly interested in the impact that failures of “too-big-to-fail” or systemically important depository institutions would have on the DIF. Given the risk that a failure of one or more of the large financial institutions would overwhelm the DIF, such large entities would be required to pay higher insurance premiums to fully account for the additional risk they pose. This legislation would alter the FDIC’s deposit insurance premium assessment process so that larger institutions would pay additional premiums to better reflect their systemic risks. To achieve the bill objectives, H.R. 2897 proposes a systemic risk premium that certain banks would pay in addition to the premiums calculated based upon the amount of deposits insured. The bill provides criteria for determining which firms are systemically important.<sup>36</sup>

A systemic risk event, however, does not have to be associated with failures of large institutions. Numerous failures of small institutions after a significant economic or financial market downturn can drain the DIF as quickly as a failure of a large bank. For example, small banks may securitize many consumer loans (i.e., mortgages, automobile, and credit card loans) and specialize or retain commercial loans in their portfolios.<sup>37</sup> Given that small banks hold portfolios that consist of very similar types of assets, a sudden rash of defaults by merchants or commercial borrowers during a severe economic downturn could set off a wave of small bank failures. Not only would the DIF be affected by the costs to reimburse depositors, but asset liquidation and disposal may be very costly. Hence, restructuring the deposit assessment base arguably may have less to do with the size of individual institutions and more to do with a realignment to better reflect the costs incurred by the FDIC to resolve bank failures.

Another approach to cover more of the DIF’s total loss exposure may be to expand the assessment base to cover both deposit and non-deposit liabilities. Currently, the deposit assessment base is set

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<sup>35</sup> P.L. 81-797.

<sup>36</sup> For more details about the criteria, see Section 3 of the bill.

<sup>37</sup> See <http://www2.fdic.gov/qbp/2009dec/qbp.pdf>. Note that 56 of the institutions that have over \$1 billion in assets do not meet the definition of a commercial lender, which is met by 4,456 of institutions. The 4,456 institutions are likely to have less than \$10 billion in assets.

to cover the losses associated with protecting depositors and not necessarily to cover the total costs associated with resolving a bank failure. In H.R. 4173, the Wall Street Reform and Consumer Protection Act of 2009 (Representative Barney Frank), the assessment base is defined as the amount of the insured depository institution's average total assets during the assessment period minus the amount of the insured depository institution's average tangible equity during the assessment period. Similarly, S. 3217, the Restoring American Financial Stability Act of 2010 (Senator Christopher Dodd), which has been reported out of the Senate Banking Committee (S.Rept. 111-176), computes the assessment base as the average total consolidated assets of the insured depository institution during the assessment period minus *the sum* of (1) the average tangible equity and (2) the average long-term unsecured debt. In both cases, average assets minus average equity will result in assessments based on the average of all liabilities. The Senate committee version would specifically target short-term liabilities, which is the more popular choice for funding assets.<sup>38</sup>

A broader assessment base would increase the overall funding costs for financial institutions. Under the current assessment structure, banks may select non-deposit short-term funding options to reduce the amount of deposit insurance assessments they would have to pay. With an expanded assessment base, the DIF would collect revenue regardless of the funding strategies pursued. Banks could respond to the higher funding costs in a variety of ways. Banks could make fewer loans and reduce their costs. Banks could charge higher rates and fees to consumers and pass some of the additional funding costs on to consumers. Banks could also take on more risk to try to generate higher returns, which would cover the additional costs. At this point, it is difficult to anticipate the strategies financial institutions would adopt to recoup the additional funding costs.

Another approach to reflect unanticipated loss risks would be to eliminate the procyclical bias in the pricing of deposit insurance, which simultaneously would increase the effectiveness of risk-based pricing when the DIF exceeds the DRR cap. If the FDIC is unable by statute to collect deposit insurance when the DIF reaches its statutory limit, then risk-based pricing would no longer provide a disincentive to discourage imprudent lending behavior. Section 1403 of H.R. 4173 would eliminate procyclical deposit insurance assessments by giving the FDIC sole discretion to suspend or limit the declaration of the payment of dividends to financial institutions. This legislation would allow the FDIC to continue collecting assessments regardless of the DRR. At the time this report was completed, S. 3217 contained no similar provision.

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<sup>38</sup> If long term customer loans were funded at longer term rates, that would reduce profitability. Hence, the subtraction of the average long-term unsecured debt may not have a large impact on the premiums that banks would pay to the FDIC. The costs of the premiums are likely to be less than the costs to fund assets with long-term liabilities.

## **Appendix A. Recent FDIC Actions to Replenish the Deposit Insurance Fund**

The FDIC's risk-based deposit insurance pricing system had been in place for less than two years when the pace of bank failures increased in the latter part of 2008 and into 2009.<sup>39</sup> A chronology of actions taken by the FDIC to replenish the DIF is presented in this appendix.<sup>40</sup>

### **Increase in Deposit Insurance Assessments**

On October 7, 2008, the FDIC announced a plan to restore the DIF by the end of 2013.<sup>41</sup> Under the plan, deposit insurance assessments increased by 7 basis points (or 0.07 percentage points) beginning January 1, 2009. The FDIC announced modifications to its original restoration plan on February 27, 2009.<sup>42</sup> The time horizon deemed necessary to accumulate the DRR level for the DIF was extended to seven years from the initial five.<sup>43</sup>

The FDIC also announced a special assessment fee that was imposed on all banks to help replenish the DIF. The FDIC's response in the event of a banking crisis was consistent with academics' earlier warnings of a procyclical bias injected into the deposit assessment pricing system. The FDIC initially proposed an emergency special assessment of 20 basis points (0.2%) that would be imposed on member banks on June 30, 2009, and collected on September 30, 2009. In the final ruling, however, the FDIC lowered the emergency special assessment to 5 basis points (0.05%).<sup>44</sup>

### **Increase in FDIC Borrowing Authority**

On February 3, 2009, the FDIC asked Congress to increase its line of credit from the U.S. Treasury to \$100 billion from \$30 billion.<sup>45</sup> The increased borrowing authority would be used in case funds from the DIF were not immediately available to meet the demands of rising bank closures.<sup>46</sup> P.L. 111-22 increases the FDIC's borrowing authority from \$30 billion to \$300 billion until December 31, 2010; afterwards, the FDIC will have \$100 billion of borrowing authority from the U.S. Treasury.<sup>47</sup>

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<sup>39</sup> See CRS Report RL34182, *Financial Crisis? The Liquidity Crunch of August 2007*, by Darryl E. Getter et al.

<sup>40</sup> For specific details, see <http://www.fdic.gov/deposit/insurance/new.html>.

<sup>41</sup> See <http://www.fdic.gov/news/news/press/2008/pr08094.html>.

<sup>42</sup> See <http://www.fdic.gov/news/news/press/2009/pr09030.html>.

<sup>43</sup> H.R. 786, Section 2 proposed to extend the restoration period to eight years.

<sup>44</sup> See <http://www.fdic.gov/news/board/May22no2.pdf>, which is a link to the memorandum to the FDIC Board of Directors, and also <http://www.fdic.gov/news/board/May22no1.pdf> for the official announcement the final rule.

<sup>45</sup> See <http://www.fdic.gov/news/news/speeches/archives/2009/spfeb0309.html>.

<sup>46</sup> For more detailed information concerning FDIC authority, see CRS Report RL34657, *Financial Institution Insolvency: Federal Authority over Fannie Mae, Freddie Mac, and Depository Institutions*, by David H. Carpenter and M. Maureen Murphy.

<sup>47</sup> P.L. 111-22, Section 204.

## Prepaid Insurance Assessments

On November 12, 2009, the FDIC approved a final rule that requires its member institutions to prepay deposit insurance assessments covering all of 2010, 2011, and 2012, to be collected on December 30, 2009, along with the regular assessments due for the fourth quarter of 2009.<sup>48</sup> The assessment *rate* would be calculated using the institution's rate as of September 30, 2009, and the rate applied to 2011 and 2012 would be 3 basis points (0.03%) higher. The assessment *base* or amount of deposits would be calculated using the institution's third quarter assessment base, and the base would be estimated to grow at 5% annually through the end of 2012. The FDIC would consider, on a case-by-case basis, requests to be exempted from the prepayment requirement. The FDIC estimates that it would collect \$45 billion in prepaid assessments for the DIF. While the prepayment will improve liquidity for the FDIC, it may not have much impact on the DIF.<sup>49</sup>

The FDIC has other options for reducing its liquidity needs. The FDIC could impose additional special assessments. The FDIC could also exercise its authority to borrow from the U.S. Treasury or the Federal Financing Bank, though these options would still result in higher assessments on member institutions. According to the FDIC, member institutions would repay such borrowings through assessments. Consequently, member institutions will pay either today or in the future to restore the DIF. The prepayment option arguably would be less expensive on the industry than borrowing from the Treasury today and repaying later with additional interest charges.

Restoration of the DIF will be a burden for member institutions. According to the FDIC's *Quarterly Banking Profile* for the second quarter of 2009, bank assets (loans) have declined along with the interest earned from the loans, losses due to loan defaults have increased, and funding bank loans with deposits has increased.<sup>50</sup> This means that banks are currently earning less from lending, yet they must still pay interest on deposits. Higher deposit assessments further reduce bank liquidity during the current period of financial uncertainty, which means that holding deposits has become relatively more expensive for the banking industry, in particular for small banks. If, however, deposits were to decline, insurance costs would still rise under the prepayment option. Prior to the recent increase in bank deposits, bank deposit shares declined over the 1997 through 2007 period.<sup>51</sup> If consumer spending rises or other financial assets such as stock become more attractive alternatives for holding wealth as the economy recovers, bank deposits may again decline. Use of a constant assessment base throughout the first year that increases at 5% annually over the remaining years, when deposits are declining, translates into an increase in the cost of deposit insurance. Should bank deposits increase faster than the estimated 5% annual growth rate over 2011 and 2012, then the costs of deposit insurance would be lower for banks.

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<sup>48</sup> See <http://www.fdic.gov/news/board/2009nov12no4.pdf>.

<sup>49</sup> See <http://www.fdic.gov/news/news/press/2009/pr09203.html>.

<sup>50</sup> See <http://www2.fdic.gov/qbp/2009jun/qbp.pdf>. The report also says that banks profits and capital levels improved given that noninterest income, which includes bank fees, increased.

<sup>51</sup> See Robert B. Avery, Marsha J. Courchane, and Peter Zorn, "The CRA Within A Changing Financial Landscape," paper given at Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act, February 24, 2009, <http://www.frbsf.org/publications/community/cra/index.html>; and James Harvey and Kenneth Spong, *The Decline in Core Deposits: What Can Banks Do?*, Federal Reserve Bank of Kansas City, Financial Industry Perspectives, Kansas City, MO, 2001, <http://www.kansascityfed.org/PUBLICAT/FIP/prs01-4.pdf>.

## Appendix B. Temporary Liquidity Guarantee Program

On October 14, 2008, the FDIC announced the creation of the Temporary Liquidity Guarantee Program (TLGP) to encourage liquidity in the banking system.<sup>52</sup> One component of the program guarantees senior unsecured debt issued by October 31, 2009. (The original June 30, 2009, deadline was extended on March 17, 2009.) Such debt structures include commercial paper, interbank funding debt, promissory notes, and any unsecured portion of secured debt. The guarantee would remain in effect until June 30, 2012, even if the maturity of these obligations extends beyond that date. Also, a surcharge would be imposed on any debt issued on or after April 1, 2009, with a maturity date of one year or more.<sup>53</sup> The Transaction Account Guarantee (TAG) component insures all non-interest-bearing deposit accounts, primarily payroll processing accounts used by businesses, which often exceed the \$250,000 deposit insurance limit.<sup>54</sup>

Financial institutions eligible for participation in the TLGP program include entities insured by the FDIC, bank holding and financial holding companies headquartered in the United States, and savings and loan companies under Section 4(k) of the Bank Holding Company Act of 1956. Although the TLGP is a voluntary program, eligible financial institutions were automatically registered to participate unless they had requested not to be by November 12, 2008. Eligible entities could also opt out of one or both of the program components.

After the first 30 days, institutions that remain in the program pay insurance fees.<sup>55</sup> To insure senior unsecured debt, the FDIC is assessing an annualized fee corresponding to 75 basis points. A 10-basis-point surcharge will be applied for non-interest-bearing deposit accounts above the \$250,000 deposit insurance limit. According to testimony by the FDIC's deputy to the chairman, of 8,300 FDIC-insured institutions, almost 7,000 have opted in to the transaction account guarantee program, and nearly 7,100 banks and thrifts and their holding companies have opted in to the debt guarantee program.<sup>56</sup>

On April 13, 2010, the FDIC adopted a final rule extending the TAG portion of the TLGP for six months through December 31, 2010, with the possibility of extending the program an additional 12 months without further rulemaking.<sup>57</sup>

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<sup>52</sup> See the initial announcement at <http://www.fdic.gov/news/news/press/2008/pr08100.html>. See <http://www.fdic.gov/news/news/press/2008/pr08105.html>, which provides further details of the program.

<sup>53</sup> See <http://www.fdic.gov/news/news/press/2009/pr09041.html>.

<sup>54</sup> Monthly reports on debt issuance under the TLGP program may be found at <http://www.fdic.gov/regulations/resources/tlgp/reports.html>.

<sup>55</sup> The list of institutions requesting not to participate in the TLGP program is available at <http://www.fdic.gov/regulations/resources/TLGP/optout.html>.

<sup>56</sup> John F. Bovenzi, *Statement of John F. Bovenzi, Deputy to the Chairman and Chief Operating Officer, Federal Deposit Insurance Corporation on Promoting Bank Liquidity and Lending Through Deposit Insurance, Hope for Homeowners, and Other Enhancements before the Committee on Financial Services; U.S. House of Representatives*, February 3, 2009, <http://www.fdic.gov/news/news/speeches/archives/2009/spfeb0309.html>.

<sup>57</sup> See <http://www.fdic.gov/news/news/financial/2010/fil10015.html>.

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