FEDERAL DEPOSIT INSURANCE REFORM

GARY RICE, LEE A. MEYERSON AND JOHN L. WALKER
SIMPSON THACHER & BARTLETT LLP

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INTRODUCTION

At the direction of Donna Tanoue, then chairman of the Federal Deposit Insurance Corporation (“FDIC”), the FDIC staff prepared and in August 2000 published a “Deposit Insurance Options Paper” in which the staff analyzed the current federal deposit insurance program and discussed ways in which the flaws in the program might be remedied. In April 2001, Chairman Tanoue recommended deposit insurance reform legislation. With the change in administrations and the departure of Chairman Tanoue, it was widely expected that Congress would not address federal deposit insurance reform this year. However, the new FDIC chairman, Donald Powell, has turned out to be an enthusiastic advocate for reform legislation. The legislation now has considerable momentum in both houses of Congress.

On April 17, 2002, the Financial Services Committee of the U.S. House of Representatives approved federal deposit insurance reform legislation by a 52-2 vote. The process is less advanced in the U.S. Senate, but similar reform legislation also is under consideration and appears to enjoy support from many members, including the majority leader and the chairman of the Senate Committee on Banking, Housing and Urban Affairs. In part, the momentum behind the legislation reflects a consensus that this is a propitious time to implement certain policy changes, such as merging the two insurance funds. Another important source of momentum is that smaller depository institutions, through their trade organizations, are attempting to use the reform legislation as a vehicle to increase deposit insurance coverage and thereby (they believe) address their funding problems.

This memorandum discusses those aspects of the federal deposit insurance program that have provided the impetus for reform and the manner in which those matters would be

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2 Federal Deposit Insurance Corporation, “Keeping the Promise: Recommendations for Deposit Insurance Reform” (April 2001) (“Keeping the Promise”).
addressed by H.R. 3717, as approved by the House Financial Services Committee. Any questions concerning this memorandum may be directed to Gary Rice (212/455-7345, grice@stblaw.com), Lee Meyerson (212/455-3675, lmeyerson@stblaw.com) or John L. Walker (212/455-7365, jwalker@stblaw.com).

MERGING THE DEPOSIT INSURANCE FUNDS

The FDIC currently administers two insurance funds, the Bank Insurance Fund and the Savings Association Insurance Fund (the “SAIF”). The SAIF is a product of the savings and loan debacle of the late 1980s and early 1990s. In 1987, after savings and loan insolvencies had used up the Federal Savings and Loan Insurance Corporation fund (“FSLIC”), Congress created the Financing Corporation (“FICO”), which replenished the FSLIC fund by issuing over $8 billion in bonds. The principal of the FICO bonds was covered by $3 billion of zero coupon Treasury bonds purchased with funds taken from the Federal Home Loan Bank system; the interest was to be covered by FSLIC premiums. The proceeds from the FICO bonds, which covered only about 5% of the cost of the savings and loan debacle, were gone by 1989. Congress then resorted to other (primarily taxpayer) sources to fund the cleanup. Congress also closed the FSLIC and replaced it with a new fund, the SAIF, which was to be administered by the FDIC and which was responsible for paying the interest on the FICO bonds. The existing fund administered by the FDIC for banks was renamed the Bank Insurance Fund (the “BIF”). BIF and SAIF are separate funds and they are funded by separate insurance premiums.

Contrary to the expectations of Congress in 1989, SAIF shrank rather than expanded. The fact that SAIF premiums were higher than BIF premiums encouraged newly formed institutions to join the BIF. Also, the FDIC determined that premiums relating to SAIF deposits arising from Oakar and Sasser transactions, which by 1996 constituted 40% of the SAIF, could not be used to pay FICO bond interest payments. With concern growing that the SAIF would not be able to meet interest payments on the FICO bonds, Congress enacted the Deposit Insurance Funds Act of 1996 (the “Funds Act”), which (i) eliminated the BIF/SAIF premium

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3 Within a few days of the introduction of H.R. 3717 by Representative Spencer Bachus, Senator Tim Johnson introduced a similar measure, S. 1945, in the U.S. Senate. This memorandum does not discuss S. 1945, which has not yet been marked up by the Senate Committee on Banking, Housing, and Urban Affairs.


5 In an Oakar transaction, a SAIF member is merged into a BIF member without the payment of exit fees but with the requirement that the acquirer continue to pay SAIF premiums for the acquired deposits. In a Sasser transaction, a savings and loan association that is a SAIF member converts to a bank charter without the payment of exit fees, but continues to have its deposits insured by SAIF.
disparity by requiring a special assessment\(^6\) on SAIF members so that the SAIF immediately reached the required ratio of 1.25% and (ii) required BIF members to pay part of the interest on the FICO bonds. The Funds Act mandated that FICO premiums for BIF and SAIF members, which initially were greater for SAIF members, be equalized by 2000. The Funds Act also provided that the BIF and the SAIF would be merged in 2000 when there were no longer any insured thrifts, the assumption being that once BIF and SAIF achieved the required reserve ratios and had equal insurance and FICO premiums, the thrift charter would be eliminated by financial modernization legislation. However, the financial modernization legislation enacted in 1999, the Gramm-Leach-Bliley Act, retained the thrift charter and as a result the fund merger provisions in the Funds Act never were triggered.

At the time that the FSLIC and FDIC were established, the banking and thrift industries were so distinct that no one would have considered it sensible for the two industries to share a single insurance fund. By the late 1980s industry differences had narrowed, but the banking industry at that time understandably had no appetite for a fund merger that would burden them with the epic cost of resolving the savings and loan debacle.

There no longer appears to be any reason to maintain two deposit insurance funds. The reserve ratios of the two funds are similar and the funds entail similar risks, in part because of the blurring of membership lines: 47% of SAIF deposits are held by commercial banks; a majority of the largest 50 holders of SAIF-insured deposits are banks; and over 800 institutions hold both BIF and SAIF deposits.\(^7\) There are significant disadvantages to maintaining two funds, including additional administrative costs and complexities, which would be exacerbated if premium disparities were to arise again, encouraging depositary institutions to try to shift deposits from one fund to another. Most important, a combined fund would provide greater risk diversification. Combining the funds would ameliorate the greater large firm concentrations that have resulted from industry consolidation, as well as the product and geographic concentrations that continue to exist in the SAIF.\(^8\)

H.R. 3717 would merge the BIF and the SAIF into a single new fund 90 days after enactment of the legislation. There appears to be a consensus in the industry, in Congress and in the regulatory agencies that a single fund makes sense as a policy matter and that this is an opportune time to combine them.

\(^6\) This special assessment turned out to be 65.7 basis points. FDIC, Financial Institution Letter 88-96 (1996).

\(^7\) Options Paper, at page 55.

\(^8\) See Testimony of Gregory A. Baer, Assistant Secretary of the Treasury, before the House Banking Committee Subcommittee on Financial Institutions and Consumer Credit (February 16, 2000).
THE RESERVE RATIO

The current deposit insurance system is pro-cyclical. When the deposit insurance funds are at or above the 1.25% reserve ratio, which can be expected in periods of prosperity, the FDIC is prohibited from assessing premiums against any but the weakest institutions. As of October 2001, 96.3% of the deposits insured by the BIF and 94.5% of the deposits insured by the SAIF were held by institutions that were assessed no deposit insurance premiums. Most depository institutions established after 1996 have never paid insurance premiums.

If the reserve ratio of a deposit insurance fund falls below 1.25%, which is most likely to occur in a recession in which depository institutions are least able to afford greater assessments, the FDIC is require to assess premiums that are not less than 23 basis points. In such a situation the FDIC is also required to establish a schedule of assessments pursuant to which the fund will be restored to a 1.25% reserve ratio within fifteen years.

The pro-cyclical character of the current system could be ameliorated by eliminating the reserve ratio requirement or by requiring that the ratio fall within a very broad range. However, there is a concern that if the reserve ratio is allowed to fall too low, it will make the FDIC reluctant to close institutions that ought to be closed. The FDIC and others concluded that the cost of the savings and loan debacle would have been lower if the FSLIC had had the funds to take over troubled institutions sooner. Many in the banking industry also worry that if the FDIC is permitted to set a relatively high reserve ratio, it will exercise that discretion to make the reserve as large as possible, imposing greater costs on insured institutions than are necessary.

H.R. 3717 would replace the current fixed reserve ratio with a “designated reserve ratio”, to be set not less than once annually by the FDIC within a range from 1.15 to 1.4%. If the FDIC projects that the reserve ratio will fall below the designated reserve ratio within 6 months, or it actually does fall below the designated reserve ratio, the FDIC must establish a fund restoration plan. The plan must provide for restoration of the designated reserve ratio.

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9 When the reserve ratio is met the FDIC may continue to charge premiums only to those institutions that “exhibit financial, operational or compliance weaknesses ranging from moderately severe to unsatisfactory, or are not well capitalized”. 12 U.S.C. §1817(b)(2)(A)(v). Institutions that fall into this category currently hold less than 4% of the deposits insured by BIF and less than 6% of the deposits insured by SAIF.

10 12 U.S.C. §1817(b)(2)(E). This provision appears to require the FDIC to impose a minimum 23 basis point premium as soon as the reserve ratio falls below 1.25%. However, perhaps on the basis of 12 U.S.C. §1817(b)(3)(A)(1), interprets the law to require a 23 basis point premium only if the 1.25% ratio cannot otherwise be restored within one year.

11 This range apparently is modeled on the required reserve ratio for credit union deposit insurance, which has a range of 1.1% to 1.4%.
within 3 years if the reserve ratio has not fallen below, or is not projected to fall below, 1.0%. If
the ratio falls below 1%, then the plan must provide for restoration to that level within 2 years
and must provide for restoration within three years to the designated reserve ratio that was in
effect before the event that triggered the requirement of a plan.

If the reserve ratio were to exceed 1.4%, the FDIC would be required to pay the excess
back to fund members. If the ratio were to exceed 1.35%, the FDIC would be required to pay
half of the excess back to fund members. Any such distributions to members would be based
on past contributions by them and their predecessors to the insurance funds.

H.R. 3717 also would require the FDIC to provide, by regulations to be issued within 270
days of enactment, a one-time credit for depository institutions based on the institution’s share
of the assessment base as of year-end 1996. The FDIC has not charged premiums to any but the
weakest institutions since 1996 and institutions that were organized after that date or that grew
rapidly after that date have paid little or nothing for deposit insurance, while at the same time
adding insured deposits to the assessment base that dilute the reserve ratio.12 The one-time
credit would enable the FDIC to redress the effect of this so-called “free-rider” problem. The
aggregate amount of the one-time credit may not exceed the aggregate amount that would
result from a 12 basis point assessment on the combined BIF and SAIF assessment base as of
year-end 2001. The FDIC would be required to establish such credits, but the decision whether
to allow depository institutions to utilize such credits against assessments would remain within
the FDIC’s discretion. In exercising this discretion, the FDIC is to consider the factors that go
into setting the designated reserve ratio. The FDIC may well decide that the reserve ratio is now
too low for the FDIC to provide a significant credit. The BIF ratio is currently 1.26%.

H.R. 3717 also would authorize the FDIC to establish an on-going credit pool. If the
FDIC decided not to provide for a significant one-time credit because of the need to maintain or
increase the reserve ratio, it could later provide credits that are based on contributions to the
deposit insurance funds prior to 1997, as well as subsequent contributions.

H.R. 3717 would amount to only a modest improvement on the procyclical nature of the
current system. In the current system, although the FDIC cannot assess premiums on most
institutions once the 1.25% reserve ratio is reached, it is not required to rebate amounts in the
fund above that amount that accrue because of fund earnings and premium payments by weak
institutions. The actual reserve ratios under H.R. 3717 may well be less than those that would
be attained under the current system. At the other end of the spectrum, current law requires the
FDIC to charge premiums of at least 23 basis points if the reserve ratio falls below 1.25%, but the

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12 The recent trend of investment banks sweeping idle customer funds into banks and thrifts affiliated
with the investment banks has received considerable attention in the press. One report stated that the
sweep accounts of Merrill Lynch and Salomon Smith Barney alone have resulted in a 4 basis point
drop in the BIF reserve ratio. “Will Brokers’ Sweeps Moves Speed Reform?”, American Banker (May
2, 2002).
FDIC has 15 years to get back to 1.25%. Under H.R. 3717, FDIC could begin charging small premiums once the reserve ratio falls below 1.4%, but if the reserve ratio falls below 1.15%, the FDIC would have only 3 years, rather than 15 years, to get it back to the prior designated reserve ratio (which would be between 1.15% and 1.4%). Thus, in difficult times, H.R. 3717 would be more a “pay-as-you-go” system than the current system. It should be noted that on a strict pay-as-you-go basis, banks would have been assessed insurance premiums of 62 basis points in 1991.13

RISK-BASED INSURANCE PREMIUMS

The Current Risk-Based Assessment System

The so-called “moral hazard” created by deposit insurance exists because insured depositors are indifferent to the level of risk incurred by the depository institutions in which they deposit their funds. One way to reduce the moral hazard of deposit insurance is to require depository institutions to maintain adequate capital and to ensure that, in the event of insolvency, only insured depositors receive the benefit of FDIC funds. The most excessive risk taking in the savings and loan debacle appears to have occurred at savings and loans that were allowed to operate without capital (because the FSLIC did not have the funds to close them). Although capital adequacy requirements and depositor preference legislation reduce FDIC losses by serving as a form of deductible, the presence of outside investors will act as a brake on excessive risk-taking only to the extent that the information available to outside investors enables them to evaluate such risk. The FDIC’s analysis of bank and thrift failures indicates that “off-site” analysis of financial information (as compared to analysis by on-site examiners) is not very useful in predicting future insolvency. The FDIC concluded: “five years before their failure, banks that would subsequently fail [during 1980-1994, when 1600 banks failed] differed little from banks that would survive in terms of equity-to-asset ratios and other measures of current condition.”14 Although a high loans-to-assets ratio was the risk factor with the strongest statistical relationship to incidence of failure five years later, only a fraction of the banks with such ratios actually failed. Failure occurred not because a bank made a large volume of loans, but because it did so “by relaxing credit standards, entering markets where management lacks expertise . . . or if loan growth strains the bank’s internal control systems or back-office operations.”15

Another way to reduce the moral hazard of deposit insurance is for the FDIC to charge insurance premiums that correlate with the risks incurred by depository institutions. The Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”) required the FDIC

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13 Options Paper, at page 5.
14 History of the Eighties, at page 31.
15 Id.
to establish a risk-based assessment system. FDICIA specifically required that the risk-based system take into account risks attributable to “different categories and concentrations of assets” and “different categories and concentrations of liabilities, both insured and uninsured, contingent and noncontingent”, as well as other factors the FDIC determined to be relevant.\(^{16}\) FDICIA also authorized the FDIC to establish different risk-based systems for large and small depository institutions.

However, the risk-based system adopted by the FDIC in 1993 consisted of a simple matrix of three capital categories and three supervisory categories (based on examination ratings). Nearly 90\% of all insured institutions fell into the two lowest risk categories.\(^{17}\) The risk premiums for the two lowest categories were 23 and 26 basis points, respectively, while the risk premium for the riskiest category was only 31 points.\(^{18}\) The FDIC did not believe it possessed sufficient information at the time to establish more refined risk categories; it also appears to have been concerned that if premiums were closely correlated with risk, the weakest institutions would not be able to bear the weight of the premiums that would be imposed on them.

Congress further diluted the risk-based aspect of the assessment system a few years later. At year-end 1996, both the BIF and the SAIF met the mandatory reserve ratio of 1.25\% and, under a provision added by the Funds Act, the FDIC is prohibited from assessing premiums against depository institutions that are well capitalized and have a satisfactory examination rating as long as the reserve ratio is 1.25\% or better. The FDIC currently is not permitted to assess premiums on institutions that account for 96.3\% of BIF-insured deposits and 94.5\% of SAIF-insured deposits. Institutions that were formed after 1996 or that experienced most of their growth since then, have paid little or no insurance premiums. In other words, FDIC insurance assessments are not risk-based to any significant extent.\(^{19}\)

\(^{16}\) 12 U.S.C. §1817(b)(1)(C)(i). Congress had rejected a Bush Administration proposal for risk-based assessments under which premiums would have been determined by capital categories.

\(^{17}\) These categories generally included institutions that were at least adequately capitalized and had a CAMELS examination rating of 1 or 2.


\(^{19}\) In 2000 the FDIC began screening institutions in the low risk supervisory subgroup for unusually rapid growth, high concentrations, high loan portfolio yield and rapid changes in business mix. After a discussion between the FDIC and a flagged institution’s regulator, the FDIC may increase the institution’s insurance premiums. However, this process appears to be aimed at only extreme cases: only six institutions were flagged in the first semiannual period in which the screens were in place. FDIC, FIL 7-2000 (Feb. 4, 2000).
Amendments Proposed by H.R. 3717

H.R. 3717 would leave in place the provisions added by FDICIA that provide the FDIC with broad discretion to design a risk-based assessment system. H.R. 3717 also would facilitate improvements in the current risk-based assessment system by removing the prohibition on assessing any but the weakest institutions when the reserve ratio equals or exceeds the designated reserve ratio. H.R. 3717 would also grant explicit authority to the FDIC to impose special assessments on rapidly growing institutions.

However, the benefits of these changes for a risk-based system are diminished by other provisions (discussed above) that require the FDIC to rebate (based on an institution’s prior contributions rather than the risk it poses to the fund) any amounts in the fund that exceeds the 1.4% reserve ratio. This hard 1.4% cap was not included in the FDIC recommendations and it impedes the implementation of a risk-based system.

Refining the Risk-Based Assessment System

The FDIC’s reform recommendations included a discussion of options for more closely correlating premiums and risk. Implementation of these revisions to the risk-based assessment system would not require legislation. Although the FDIC did not recommend adoption of any particular revision, the discussion of various options indicates that the FDIC believes that the assessment system should be more risk-based and that it now has sufficient information to move in that direction.

None of the options under discussion involves greater reliance on capital measures. Capital is a lagging indicator of problems. The FDIC’s most costly bank failures in recent years have occurred rather abruptly among institutions that had consistently reported strong earnings and capital. In these cases, an examination or another event ultimately revealed that reported earnings had been artificial and overstated while asset values had been inflated unrealistically. Examination ratings have proven to be a more reliable indicator of future problems. One option discussed in the FDIC recommendations is to refine the supervisory

20 The FDIC recommended that depository institutions always be charged some premium for deposit insurance and that, if the reserve ratio exceeded 1.35%, the FDIC be required to rebate only 30% of the excess. Keeping the Promise, at page 12.

21 For this reason, the prompt corrective action legislation (“PCA”) included in FDICIA has proven to be of little use in preventing bank failures. Regulators generally impose enforcement actions on banks experiencing financial difficulties long before the capital of the institution is depleted to the point at which PCA triggers enforcement actions. History of the Eighties, at page 55.

22 Options Paper, at page 17.

23 History of the Eighties, at page 56.
Currently one supervisory subgroup includes all depository institutions with a CAMELS composite rating of 1 or 2, which includes approximately 95% of all depository institutions. The FDIC could place only institutions with a CAMELS 1 composite rating in the top supervisory subgroup, or it could assign institutions to a number of subgroups based on the ratings for the components that go into the CAMELS composite rating, some of which more closely correlate with bank failures than the composite rating.

The FDIC also discussed a scoring system that would take into account CAMELS ratings, capital, and a variety of other measures such as net income and the level of nonperforming loans. In the example provided by the FDIC, the CAMELS rating would count for up to 50 points out of 100; capital would count for no more than 14 points.

Based on prior experience, it would make sense for examination ratings to play a more important role in the risk-based assessment system. Examiners have more information available to them than anyone other than bank management, and they typically bring years of experience to the task. However, the judgment of examiners is obviously imperfect, and, even if correct, severe judgments will often not be reflected in the examination rating of an apparently healthy bank. The FDIC’s analysis of bank failures in the 1980-1994 period concluded that a major cause for the failures was that banks that assumed excessive risks were “insufficiently restrained by supervisory authorities.” Examiners reported that “as long as the banks were profitable, it was difficult to persuade bank managements or their own superiors in the regulatory agencies that problems could lie ahead.” It was hard to distinguish risky behavior from “acceptable risk/return trade-offs, innovation, and other appropriate activity, or to modify the behavior of banks while they were . . . still apparently healthy.” This is not just an historical problem. Superior Bank FSB failed in July 2001 due to excessive concentrations in residual assets related to subprime lending and flawed valuations of such assets. According to the FDIC, the OTS identified some of these problems as early as 1993, but it continued to rely

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24 Keeping the Promise, at page 9.

25 The FDIC states that it does not rely on examination ratings alone in assigning depository institutions to supervisory groups, but that subgroup A “generally corresponds” to CAMELS 1 and 2, subgroup B generally corresponds to CAMELS 3 and subgroup C generally corresponds to CAMELS 4 or 5. The CAMELS composite rating is derived from individual ratings for capital adequacy, asset quality, management, earnings, liquidity and sensitivity to market risk.

26 Keeping the Promise, at pages 9-11.

27 History of the Eighties, at page 4.

28 Id., at page 40.

29 Id., at page 84.
upon representations by management of Superior and by its outsider auditors that Superior’s valuation of its residual assets was correct.\textsuperscript{30}

Examiners are also less adept at analyzing the future effect on a bank of developments that occur outside the bank. The preconditions for the increased number of bank failures in the 1980-1994 period were established by “broad national forces—economic, financial, legislative, and regulatory”, which left banks vulnerable to a “series of severe regional and sectoral recessions”.\textsuperscript{31}

Another risk-based refinement, which was not discussed by the FDIC but was included in a prior staff study,\textsuperscript{32} would be to assess the risk of small and large institutions differently, as FDICIA expressly authorized the FDIC to do. For example, large complex banks are assigned ratings for a variety of risk-management factors and banks with the same CAMELS rating can have substantial differences in these risk management ratings. The FDIC could incorporate these ratings into the risk assessment process for large banks. Also, in the case of large banks it may be possible to incorporate into the risk assessment process changes in the prices of their publicly traded securities.\textsuperscript{33}

\textit{Assessment for Lifeline Accounts}

FDICIA provided for reduced insurance assessments (one-half the normal rate) for deposits held in transaction accounts that permitted basic transactions to be conducted and that charged low fees and required a low minimum balance. However, this provision was subject to Congress appropriating the funds necessary to make up the lost assessment revenue, which Congress never did.\textsuperscript{34} H.R. 3717 would strike the requirement that conditions the provision on Congressional appropriations. This aspect of H.R. 3717 was hotly contested in the House Financial Services Committee, with small banks supporting it and large banks opposed. The provision is strongly opposed by Sen. Phil Gramm who argues that deposit insurance should not be tied to social policy.

\textsuperscript{30} BNA Banking Daily, “Senate Hearing, Reports on Superior Blame Bank, Accountants, Regulators” (Feb. 8, 2002).

\textsuperscript{31} History of the Eighties, at page 4.

\textsuperscript{32} Options Paper, at page 13.

\textsuperscript{33} Options Paper, at pages 10, 20.

\textsuperscript{34} 12 U.S.C. §1834(c).
THE LEVEL OF DEPOSIT INSURANCE COVERAGE

H.R. 3717

The deposits of a depositor at an FDIC insured institution are insured up to $100,000 (the “standard deposit insurance amount”). In addition to this amount, the depositor is separately insured for deposits placed in other capacities and in certain types of accounts. For example, the depositor is insured for up to $100,000 for funds in a individual retirement account at the same bank. These limits are separate for each bank in which the depositor places funds.

The FDIC’s recommendations for deposit insurance reform included a recommendation that Congress index for inflation the “standard deposit insurance amount” and that Congress increase the separate $100,000 coverage for individual retirement accounts. Smaller depository institutions, which have found it increasingly difficult to raise sufficient deposits, advocate, in addition to the changes recommended by the FDIC, an increase in the standard coverage amount and an increase in coverage for municipal deposits. These changes are generally opposed by large banking organizations.

H.R. 3717 would increase the standard deposit insurance amount to $130,000 from $100,000 and adjust this amount for inflation every 5 years. H.R. 3717 would also provide double the standard amount for retirement accounts and provide coverage for in-state municipal deposits equal to the lesser of (i) $5 million and (ii) the sum of the standard deposit insurance amount and 80% of the deposit above that amount.

Analysis of the Increased Coverage Issue

The purpose of federal deposit insurance is to enhance financial stability by mitigating the risk that the failure of some banks will undermine confidence in other banks and lead to large scale withdrawals of deposits from the banking system. Deposit insurance coverage was initially set at $5,000, which is equal to about $60,000 today. It was later increased to $40,000 and, in 1980, to the current level of $100,000.

The rationale for the increase to $100,000 had nothing to do with financial stability. At the time, depository institutions were struggling to raise funds amid high inflation and legal restrictions on the amount of interest they could pay. The interest rate restrictions did not apply

35 H.R. 3717 would incorporate the “standard deposit insurance amount” term into 12 U.S.C. §3104, which currently restricts uninsured branches of non-U.S. banks from accepting deposits of less than $100,000. Although such branches do not rely on retail deposits, incorporating a term that will change every five years will increase modestly the compliance burden of such branches.
to deposits of $100,000 or greater and raising the insurance limit to $100,000 enabled banks to offer a fully-insured deposit that bore a market interest rate. 36

It is difficult to make a case for increasing the coverage limit based on financial stability. A 1998 Federal Reserve survey indicated that 98 percent of households with deposits were fully insured (either because their deposits were less than $100,000 or because they made deposits in multiple banks), 37 which suggests that an increase in insurance coverage is unnecessary to avert bank runs. At least in the near term, even indexing the funds would not appear to enhance financial stability. The FDIC’s argument for increasing insurance for retirement accounts is that $100,000 is a relatively modest amount for such accounts today, and no purpose is served by requiring depositors to achieve full insurance by holding retirement accounts in multiple institutions.

Small depository institutions appear to support an increase in deposit insurance coverage for two reasons. First, trends in “household wealth accumulation, a declining savings rate, the availability of higher yielding investment alternatives, and demographic shifts are making it increasingly challenging for commercial banks to attract deposits.” 38 Second, the increase will not impose a significant cost on such institutions. Most deposits of small banks are already insured and, all else being equal, an increase in the coverage amount will not increase their insurance costs except to the extent that it also results in an increase in the deposits they gather. By contrast, a substantial portion of large bank deposits are uninsured, which suggests that an increase in coverage may not result in an increase in their deposits but would immediately bring a large amount of previously uninsured deposits into the assessment base. If premiums are re-instituted, as appears likely, large banks’ insurance costs will increase. In fact, the increase in the assessment base would accelerate the re-institution of premiums because it would enlarge the assessment base and thereby reduce the reserve ratio.

36 Testimony of Chairman Greenspan before the U.S. Senate Committee on Banking, Housing and Urban Affairs (April 23, 2002).

37 Options Paper, at page 39.

38 Options Paper, at page 43. The difficulties of community banks in raising deposits has led them to rely more heavily on Federal Home Loan Bank (“FHLB”) advances. FHLB advances to thrifts grew from 8.2 percent of liabilities in 1980 to 19.1 percent today. This trend may ultimately increase the cost to the FDIC of insolvencies because the high-quality assets that secure those advances would not be available to the FDIC. Id. Similarly, increasing insurance for municipal deposits will reduce administrative burdens for small banks because they would not need to collateralize these deposits, which “entails continuous reporting to each public entity, and management of the assets serving as collateral, and associated administrative expenses.” Id. at page 46. However, if such banks are not required to provide high-quality collateral, they will likely invest the funds in riskier assets, thereby potentially increasing the risk to the FDIC.
The Federal Reserve opposes an increase in insurance coverage on the grounds that it is unlikely to enhance financial stability, will impose costs on large banks, and may not result in any increase in deposits at small banks. The Federal Reserve also believes that an increase in coverage would reduce the incentive for market discipline and expand moral hazard. It seems unlikely that the increase under discussion would affect market discipline: depositors at that level are incapable of ascertaining the true condition of a bank and, since they can place deposits in multiple banks, have no incentive to do so. With regard to moral hazard, the FDIC has pointed out that if insurance premiums were truly risk-based, “raising or lowering the coverage limit would not have a major impact on systemic risk.” Of course, at the moment, insurance premiums are not truly risk-based.

Nevertheless, it currently appears that, as a result of political dynamics and other factors, an increase in deposit insurance coverage is likely to be approved by Congress.

39 Id., at page 35.