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# Deposit Insurance: The Bank Insurance Fund

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## Summary

The prosperity of the banking and thrift industries in recent years has spurred the Federal Deposit Insurance Corporation (FDIC) to propose reforming the system of deposit protection. Deterioration in the economy during the 2001 recession added to the impetus for reform. Two bills in the 107th Congress — H.R. 3717 and S. 1945 — have emerged as the primary vehicles to execute those and other proposed reforms. Both bills include controversial provisions to change the way in which the Bank Insurance Fund (BIF) operates and is funded.

In analyzing the proposals for changes to BIF, the report considers relevant history. Federal deposit insurance for commercial and savings banks in the United States was initiated in 1934 by the Federal Deposit Insurance Corporation (FDIC). The FDIC fund, as it was initially called, grew steadily for 50 years — through the nation's recovery from the Great Depression, the economy's conversion to a war footing during World War II and its readjustment to "Cold-War" conditions in the 1950s and 1960s. Benefitting from this period of recovery, followed by a time of relative bank stability, the fund had grown to over $18 billion by the mid 1980s.

The economy began to develop maladjustments during the 1970s, however. They, together with supervisory inadequacies, led to a very large number of costly bank failures in the mid- and late-1980s and early-1990s that adversely affected the FDIC fund. The then statutory requirement to charge banks a flat rate premium for each dollar of their domestic deposits — moderated by rebates when the fund was considered to be well-capitalized — meant that the fund balance would change with the condition of the banking industry. Consequently, when the condition of the banking industry deteriorated, the fund's $18 billion in reserves was quickly dissipated. The fund became illiquid by the end of the 1980s and was insolvent by 1991.

That experience led to a large number of legislative changes. Many of the changes made during the early 1990s — prompt corrective action, least cost resolution, risk-adjusted premiums, limiting the adoption of "too big to fail" policies, depositor preference — were intended to protect the Bank Insurance Fund (BIF), as it was renamed in 1989, from severe losses in the future. Other changes — increased insurance premiums and a switch from fixed premiums to a fixed target for the fund — were meant to protect the taxpayer from having to come to BIF's rescue.

Certain of these changes now present problems for funding and operating BIF and have led to the current proposals for changing the current arrangements. This report concludes by describing BIF's current condition as good, but seeing its outlook for the near future as depending on the future, possibly uncertain, path for the economy.

This report may be updated to reflect new developments.

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For further information, please contact Barbara Miles at 202-707-7804.

# Deposit Insurance: The Bank Insurance Fund

## Background

Currently, customer deposits in commercial and savings banks are insured by the Bank Insurance Fund (BIF), which is operated by the Federal Deposit Insurance Corporation (FDIC). Initially, the fund for commercial and savings banks was called the Federal Deposit Insurance Fund, formed in 1934, was renamed by the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) of 1989.[1] The Bank Insurance Fund has successfully insured bank deposits in the United States since 1934. No federally insured depositor has ever lost his/her insured funds.

Taking the opportunity offered by the then unusual prosperity in the banking industry and consequent well-capitalized insurance funds, the FDIC issued a paper discussing options for reforming the systems of deposit protection for banks and thrifts in mid-2000,[2] and issued specific proposals for reform in spring 2001.[3] These proposals included provisions that would change the funding arrangements for the BIF. The House Subcommittee on Financial Institutions and Consumer Credit held hearings on the FDIC proposals on July 26, 2001 at which the Treasury Department and Federal Reserve, among others, testified.[4] The Senate Subcommittee on Financial Institutions held hearings on deposit insurance reform in August 2001. On October 17, 2001, the then-new FDIC Chairman, Donald E. Powell, presented the FDIC's proposals formally to Congress.[5]

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[1] The United States has three systems of deposit protection that have served the nation well (with the notable exception of a period in the 1980s) since they were created. Most thrifts are covered by the Savings Association Insurance Fund (SAIF), which is the successor to an earlier system that also was created in the 1930s, but failed in the late 1980s. Coverage at credit unions is offered by the National Credit Union Association's Share Insurance Fund (NCUSIF), which was formed in 1970.

[2] See Federal Deposit Insurance Corporation, *Deposit Insurance Options Paper*, Aug. 2000, available at [http://www.fdic.gov].

[3] See Federal Deposit Insurance Corporation, *Keeping the Promise: Recommendations for Deposit Insurance Reform*, April 2001, available at [http://www.fdic.gov].

[4] The Treasury's position was given in greater detail by Sheila C. Bair, Assistant Secretary for Financial Institutions at the Treasury Department, at hearings held by the House Subcommittee on Financial Institutions and Consumer Credit on July 26, 2001. Federal Reserve Governor Laurence H. Meyer gave the Federal Reserve's position at this hearing. FDIC Chairman Donald E. Powell testified before the subcommittee on Oct. 17, 2001.

[5] See [http://www.fdic.gov/news/speeches/archives/2001/sp17octo1.html].

A number of bills adopted one or more of the FDIC's proposals, but by March 2002, two bills (H.R. 3717 and S. 1945) had emerged as potentially the principal vehicles for deposit insurance reform.[6] The two bills incorporate three major proposals — to merge the BIF and SAIF funds, increase the upper limit on deposit insurance coverage, and alter some of the FDIC's funding arrangements for BIF and SAIF. The House Subcommittee on Financial Institutions and Credit marked up H.R. 3717 on March 7, 2002 and the House Committee on Financial Services marked up the bill on April 17, 2002. The House passed the bill under suspension of the rules and referred it to the Senate for consideration. The Senate Banking Committee then held hearings on S. 1945 on April 23, 2002.

This report focuses on issues related to BIF's funding of deposit insurance for commercial and savings banks in the United States. It first provides some history of the Bank Insurance Fund and then examines its current condition and funding arrangements. In doing so, it discusses proposals for, and arguments for and against, changing these arrangements. Finally the report considers the outlook for BIF in the near term.

# A Brief History of Federal Deposit Insurance

## Starting the System[7]

Economic and social disruption caused by bank failures were a recurring problem in the United States during the 19th and early 20th centuries. As a result, a number of states separately experimented during this period with systems of deposit protection for their banks. The states' deposit insurance systems were initiated in two waves (1829 through 1858 and 1907 through 1917) but all of the systems had ceased to function by 1930.[8]

While 150 proposals for federal deposit protection were made between 1886 and the establishment of the FDIC in 1933, there was strong opposition within Congress and from the different administrations. Consequently, it was not until the nadir of the Great Depression of the 1930s that the Federal Government finally became involved. In the interim, the number of bank failures had risen by a factor of 10 in the 1920s, so that an average of 600 banks failed each year between 1921

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[6] See CRS Report RS20724, *Federal Deposit and Share Insurance: Proposals for Change*, by William D. Jackson and CRS Report RL31343, *Deposit Insurance reform: Comparison of H.R. 3717 and S. 1945, 107th Congress*, by Gillian Garcia and William D. Jackson.

[7] This section draws heavily on *A Brief History of Deposit Insurance In the United States* (Washington, Federal Deposit Insurance Corporation, 1998), which can be found at [http://www.fdic.gov/bank/histprical/brief/brhist.pdf].

[8] Five states (New York, Vermont, Michigan, Ohio, and Iowa) enacted systems of depositor protection in the first wave from 1829 through 1858, but all had failed by 1866. Eight mostly agricultural states west of the Mississippi (Kansas, Mississippi, Nebraska, Oklahoma, North and South Dakota, Texas, and Washington) enacted systems in the second wave between 1907 and 1917. All had ceased to operate by 1930.

and 1929. The situation deteriorated further in the four years from 1930 through 1933 when over 9,000 banks failed. Finally, the wave of failures culminated in the early months of 1933 when more than four thousand banks faced massive deposit withdrawals and were closed, never to reopen. Depositors suffered significant losses from these bank failures.[9] The resulting damage to public confidence in the country's banking system was severe.

The situation had became so intractable that the newly inaugurated President, Franklin D. Roosevelt, imposed a week-long bank holiday in early March 1933 and then signed legislation that aimed to improve the financial climate, restore public confidence, and stimulate economic growth. The legislative measures included the installation of a system of deposit insurance. Despite misgivings by the President, the Secretary of the Treasury, the Chairman of the Senate Banking Committee, some other Members of Congress, and also segments of the banking industry, public opinion strongly favored deposit protection and prevailed upon Congress to provide it.

Protection for the depositors of the United States' commercial and savings banks was enacted in the Banking Act of June 1933. Coverage (up to $2,500) became effective on January 1, 1934, but was raised to $5,000 six months later.[10] The Act stipulated that a temporary fund should be created by January 1, 1934. It was replaced by a permanent fund on July 1, 1935. The measure was an immediate success in restoring confidence in the banking system; consequently, only nine banks failed in 1934 and deposits in the banking system rose by 22%.

All banks that were members of the Federal Reserve System (which includes all national banks) were required to become members. Other banks were authorized to join upon certification of their solvency by their respective state supervisory agency and after examination by, and with the approval of, the FDIC. The Temporary Deposit Insurance Fund opened with 13,201 members, which represented 12,987 or 90% of all commercial banks and 214 or 36% of mutual savings banks.

## Early Financial Arrangements

The initial capital needed to establish the FDIC was provided by the Treasury Department, the Federal Reserve Banks and member institutions.[11] By the end of 1934, the fund amounted to $292 million or 0.73% of all domestic deposits and 1.61% of the estimated value of insured deposits.

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[9] For further information, see *A Monetary History of the United States, 1867-1960* by Milton Friedman and Anna Schwartz (Princeton, New Jersey: National Bureau of Economic Research, 1963).

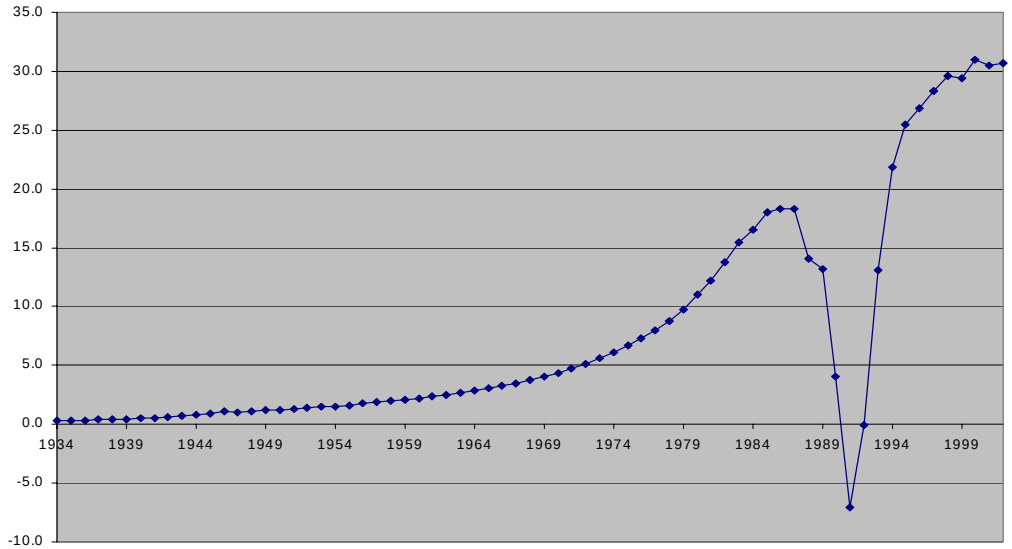
[10] Coverage was increased on five more occasions. The last increase (to $100,000) occurred in 1980.

[11] The Treasury Department provided $150 million. The 12 Federal Reserve Banks contributed one half of each bank's surplus on January 1, 1933. Member banks were assessed at 0.5% of their insurable deposits. One half of this amount was payable immediately and the remainder at the call of the FDIC.

As the banking industry recovered from the Great Depression during the remainder of the 1930s, the FDIC handled 370 (mostly small banks) failures during the period 1934 through 1941. Fewer than 10 banks failed each year from 1943 through 1975. These failures were mostly small banks and FDIC outlays were correspondingly modest. Consequently, as shown in Figure 1, the fund balance grew steadily during these years.

**Figure 1**

**Bank Insurance Fund: 1934 through March 2002 ($billions)**

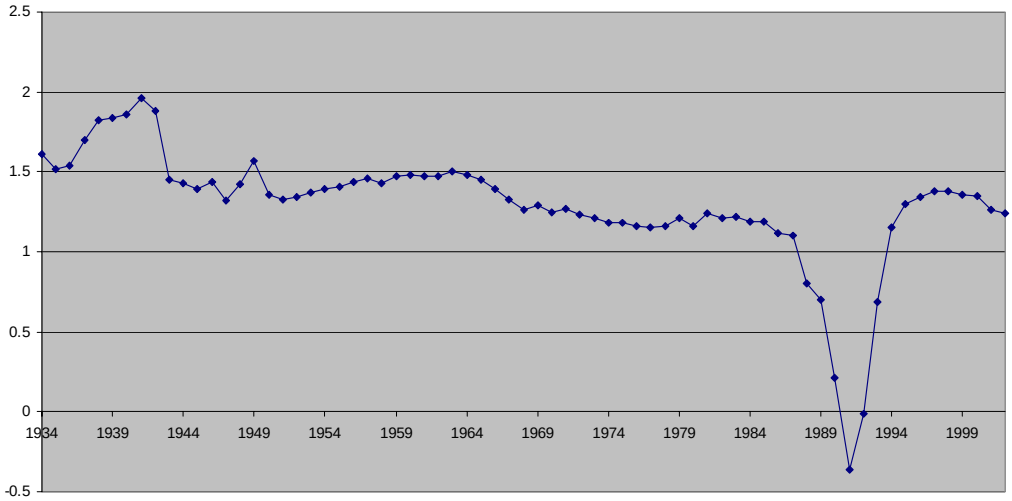



**Sources:** Generated from data in the *FDIC 2000 Annual Report*, which can be found at [http://www.fdic.gov.about/strategic/report/2000AnnualReport/BIF.html] and updated with data from the *FDIC Quarterly Banking Profile* for the First Quarter of 2002, which can be found at [http://www2.fdic.gov/fdic/qbp/2002mar/qbpcom.html].

Although the fund balance grew during this recovery period, insured deposits grew more rapidly than FDIC net income. Consequently, the ratio of fund reserves to insured deposits had declined to 1.25% by the end of 1970 and it stayed there until the mid-1980s. This decline is shown in Figure 2, which portrays the fund's reserve ratio from 1934 through 2000.

**Figure 2**

## The BIF as a Percentage of Estimated Insured Deposits: End 1934 through March 2002




**Sources:** Generated from data in the *FDIC 2000 Annual Report*, which can be found at [http://www.fdic.gov.about/strategic/report/2000AnnualReport/BIF.html] and updated with data from the *FDIC Quarterly Banking Profile* for the First Quarter of 2002, which can be found at [http://www2.fdic.gov/fdic/qbp/2002mar/qbpcom.html].

The Federal Deposit Insurance Fund, as it was then called, prospered during the post-war period, and the banking industry helped the U.S. economy to recover and transition from World War II. This was a period of stability in the banking industry that lasted into the 1970s. At this juncture, problems began to develop and they culminated in the severe problems of the 1980s and early 1990s.

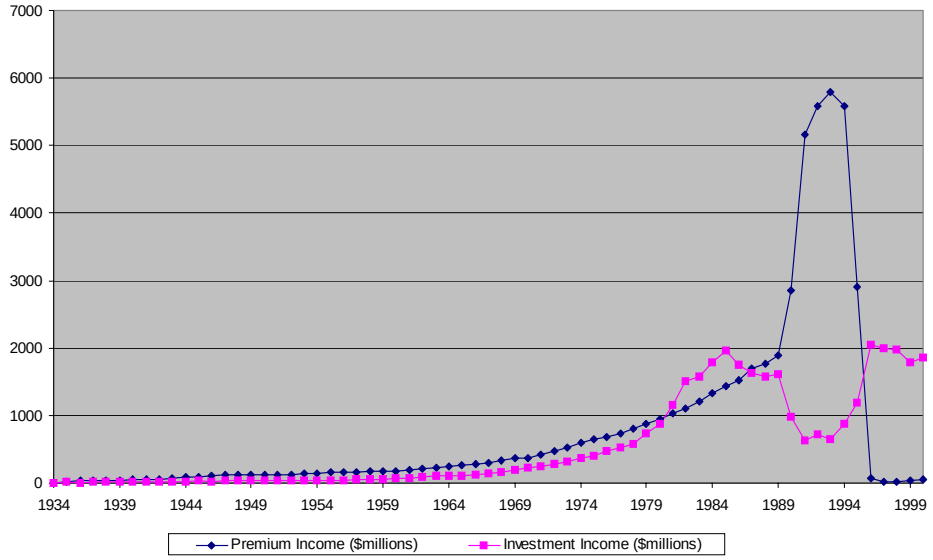
## Factors Determining the Bank Insurance Fund Ratio over Time

The factors determining two important numbers need to be considered. The first number is the numerator (BIF's actual value) and the second number is the denominator in the ratio (the estimated total value of insured deposits). BIF's actual value at any point in time equals its value at the end of the previous year plus the funds's subsequent net income for the period. Net income, of course, equals the difference between BIF receipts and its outlays.

**BIF's Receipts.** BIF derives its receipts (its gross income) from two primary sources: (1) interest plus gains or losses realized on its investments in a portfolio of specially designated Treasury securities, and (2) premium assessments. The contributions made to BIF's net income by these different components has, since the late 1970s, varied greatly over time, as is shown in Figure 3.

**Figure 3**

**BIF Premium and Investment Income: 1934 through 2000**




**Source:** The figure was generated from data in in the *FDIC 2000 Annual Report*, available at [http://www.fdic.gov/about/strategic/report/AnnualReport/pg94.html].

Figure 3 shows BIF's gross income from premium assessments and investments from 1934 through 2000. Assessments rose almost monotonically from inception until 1990, when the FDIC raised the premium rate and its dependence on assessments escalated. BIF depended crucially on premium income during the early 1990s. BIF' income from investments had risen fairly regularly as the fund balance grew until the late 1970s. At that point, interest income increased sharply as interest rates rose in early 1980s. BIF's heavy disbursements on failed banks had depleted the fund balance by the end of the 1980s, however, so that BIF's investment income plummeted and remained low until the fund was recapitalized in 1995. In contrast, by the end of the century, income from investments was BIF's primary source of income.

That the composition of BIF's total income has varied markedly over the past 12-year period is demonstrated in Table 1. In 1989, before the effects of the banking crisis depleted the BIF, premiums and investments contributed relatively equally to BIF receipts. By 1993, with a depleted fund, BIF became heavily dependent on

premium income to compensate depositors in failed banks and rebuild the fund. By 2000, the recapitalized fund needed little in premium income and relied almost entirely on investment income to meet its expenses.

## Table 1. Contributions of Premiums and Investments to BIF Income

| Year | Premium Assessments | Investments | Total |
|---|---|---|---|
| 1989 | 53.9% | 46.1% | 100.0% |
| 1993 | 89.9% | 10.1% | 100.0% |
| 2000 | 2.4% | 97.6% | 100.0% |

**Source:** The data for the table were calculated the *FDIC 2000 Annual Report,* available at [http://www.fdic.gov/about/strategic/report/AnnualReport/pg94.html].

**BIF's Investment Portfolio.** BIF's funds are invested safely — in specially issued U.S. Treasury securities that are not marketable. As is shown in Table 2, the maturity of these securities ranged in 2002 from over three months to 10 years. At the end of 2000, three-quarters of the $29.3 billion in such securities were intended to be held to maturity, the remainder would be available for sale, if needed. (BIF holds no securities for trading.) One eighth (that is, 12.5%) of the total portfolio was invested in securities with maturities of less than one year, 45% in securities with maturities between one and five years, and the remaining 42% were held in securities with maturities of between five and 10 years.

## Table 2. Distribution of BIF Investments by Maturity

| Maturity | Held to Maturity | | Available for Sale | | Total |
|---|---|---|---|---|---|
| | Yield at purchase | Portfolio Share | Yield at purchase | Portfolio Share | Both as % of Total |
| < one year | 5.7% | 13.6% | 5.6% | 10.6% | 12.9% |
| 1-3 years | 6.2% | 27.3% | 6.4% | 18.1% | 24.9% |
| 3-5 years | 6.6% | 22.7% | 6.3% | 13.2% | 20.3% |
| 5-10 years | 5.6% | 36.4% | 4.8% | 58.5% | 41.8% |
| **Total** | | $22.0 billion | | $7.3 billion | $2.3 billion |

**Source:** The *FDIC 2000 Annual Report*, pages 9 and 10, available at [http://www.fdic.gov/about/strategic/report/2000AnnualReport/BIF.html].

**BIF Outlays.** BIF incurs expenses for (1) making provision for losses incurred in resolving failed banks, (2) salaries and other administrative and operating expenses, and (3) interest paid on any funds it has borrowed. The second and third items are rather mundane. Administrative expenses have grown fairly consistently in dollar value from year to year and in 2000 constituted virtually all of BIF expenses. The agency hired a large number of additional staff during the nation's banking problems. Despite subsequent retrenchment, BIF's administrative costs have continued to increase consistently, raising questions why administrative expenses did not decrease in the late 1990s. H.R. 3717, consequently, would require the FDIC and the U.S. General Accounting Office (GAO) to study the FDIC's organizational structure and operational efficiency.

Interest expense has typically been negligible, except during the period from 1981 through 1997, when the fund had borrowed heavily. The composition of BIF expenses for selected years is shown in Table 3.

## Table 3. The Changing Composition of BIF Expenses

| Year | Provisions | Administration | Interest | Total |
|---|---|---|---|---|
| 1978 | 24.5% | 69.4% | 6.1% | 100.0% |
| 1983 | 69.6% | 14.0% | 16.4% | 100.0% |
| 1988 | 83.0% | 3.0% | 14.1% | 100.1%* |
| 1991 | 92.3% | 1.6% | 6.4% | 100.2%* |
| 2000 | -23.7% | 119.8% | 3.9% | 100.0% |

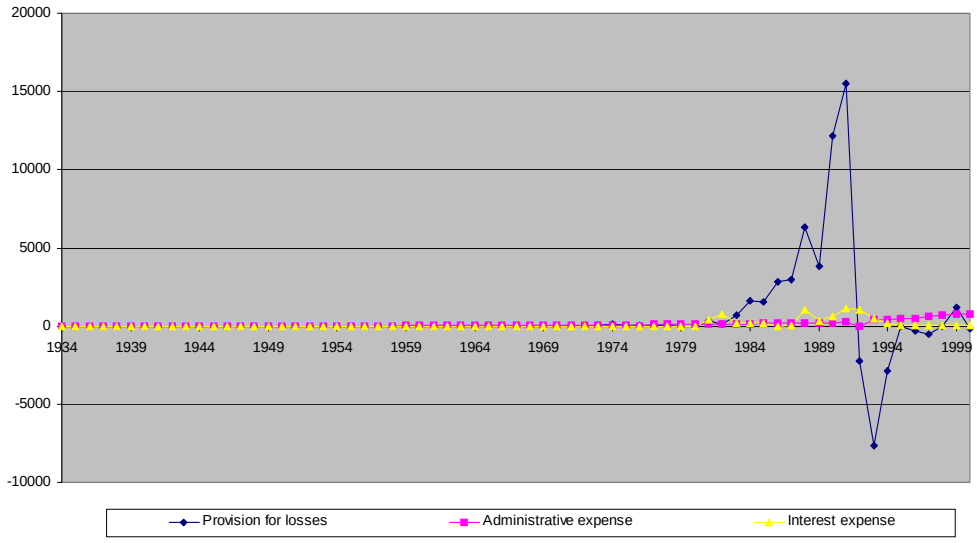
**Source:** The *FDIC 2000 Annual Report*, which is available at [http://www.fdic.gov/about/strategic/report/2000AnnualReport/pg94.html].
* percentages do not sum to 100% because of approximations in rounding.

Figure 4 shows the time path of BIF's provisioning, administrative, and interest expenses since 1934. While BIF's interest and administrative expenses behave in expected ways, provisioning for losses presents a much more interesting series. Outlays on this item rose sharply during the country's banking problems of the 1980s and early 1990s, but then became negative. A negative number means that the FDIC had previously made more provisions than it needed and was subsequently able to reverse them. It appeared that BIF over-provisioned in the late 80s and early 90s and reversed the surplus provisions between 1992 and 1998. This experience has led some in the banking industry to claim that the FDIC, together with its U.S. General Accounting Office auditor, have been too pessimistic about the losses that BIF may incur and have over-provisioned in recent years. H.R. 3717, therefore, would require the FDIC and GAO to study BIF's reserving methodology and the loss accounting for the period January 1992 through December 2002.

**BIF's Implications for the U.S. Budget.** Although the BIF has been self-financed for most of its history, its income and expenditure are included in the United States Budget. They are accounted for as program financing for a "public enterprise fund." As such, BIF is not subject to the potentially politically contentious budget-authorization process. Nevertheless, BIF receipts tend to reduce the deficit and its outlays increase it.[12] In addition, the BIF balance serves to finance the national debt, as measured.

**Figure 4**

**BIF Outlays: 1934 through 2000 ($millions)**



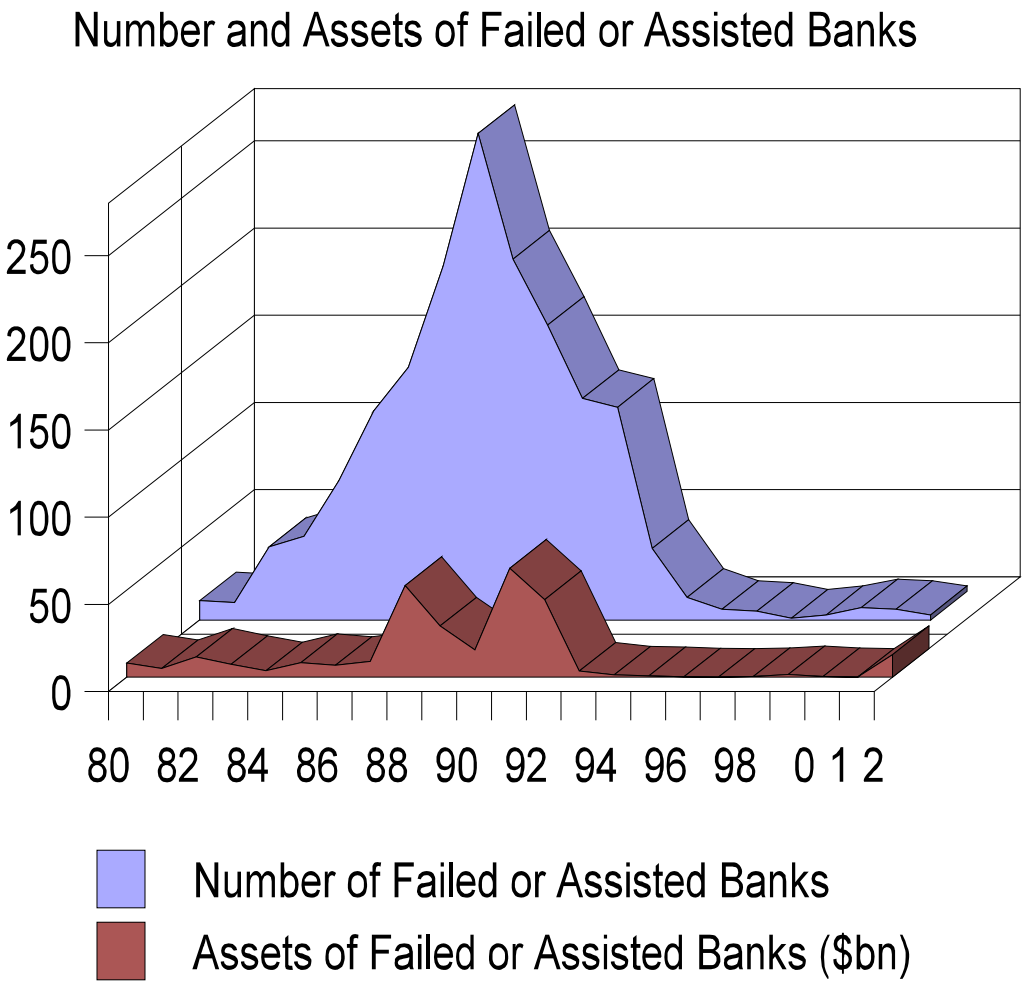

**Source:** The data for the table were calculated from the *FDIC 2000 Annual Report*, available at [http://www.fdic.gov/about/strategic/report/AnnualReport/pg94.html].

[12] See the *Appendix to the Budget of the United States Government for Fiscal Year 2003* (Washington, U.S. Government Printing Office, 2002), pp. 1122-1123.

## The Problems of the 1980s and Early 1990s

After its initial year of operation, the FDIC enjoyed positive net income every subsequent year until 1988, when it experienced its first loss since the Great Depression. As a result of its earlier net earnings, the fund had risen to $18.3 billion by the end of 1987. However, during the 1970s and 1980s, problems had developed in the banking industry. These problems resulted in a large number of failures during the 1980s and early 1990s, as shown in Figure 5. Some of the failed banks (for example, Continental Illinois National Bank, First Republic National Bank, and Bank of New England) were relatively large in size so the resulting losses to the fund during the 1980s and early 1990s were so substantial that the fund became illiquid in the late 1980s and then technically insolvent in 1991. (See Figure 1 above.)

**Figure 5**




**Source:** Data for the figure were taken from *FDIC Historical Trends*, which can be found at [http://www.fdic.gov/bank/statistical/stats/2001dec/fdic.pdf].

# Congressional Measures to Avoid a Recurrence of the Problems of the 80s and Early 90s

Congress and the Administration during the late 1980s and early 1990s became determined to prevent a recurrence of the problems that led to the proliferation of bank failures and the insolvency of the BIF. Thus, they made a number of legislative changes that required the FDIC to amend some of its operational procedures. These measures are discussed below.

## The FDIC's Authority to Borrow Was Increased

The first legislative amendment resulted in an increase in the FDIC's ability to borrow. When a bank fails, the FDIC makes rapid disbursements to reimburse depositors and these disbursements can be large. The agency expects to recover a large proportion of its outlays later. Nevertheless, as shown in Table 2 above, BIF investments range up to 10 years in maturity and they are not marketable. Consequently, the FDIC may need to borrow to increase its liquidity in the interim and cover its need for "working capital." In the Omnibus Budget Reconciliation Act (OBRA) of 1990 the FDIC was authorized to borrow working capital from the Federal Financing Bank. At the end of 1991 and 1992, BIF had outstanding loans of roughly $10 billion from the Federal Financing Bank. It had repaid these loans in full by the end of 1993 from the funds it had recovered by selling the assets of the banks that had failed, as required by statute. This borrowing provision remains in effect in 2002.

This borrowing authority was designed to cover a situation where the BIF was solvent but illiquid, so that the Federal Financing Bank could be sure of repayment. By 1991, however, BIF's situation had worsened considerably — it was technically insolvent. Consequently, there was a need to enable the FDIC to borrow from the Treasury in order to cover its losses and honor the government's guarantee of the repayment of insured deposits. Under the FDIC Improvement Act (FDICIA) of December 1991, the FDIC's ability to borrow from the Treasury was raised from $5 billion to $30 billion. FDICIA required the BIF to repay its borrowing and recapitalize a depleted BIF by increasing the premiums charged to banks for their insurance coverage. This borrowing option continues to be available in 2002.

Both H.R. 3717 and S. 1945 include provisions that extend the privilege, already available to SAIF, to borrow from the Federal Home Loan Banks. Some analysts assert that borrowing from the Home Loan Banks could prove a more expensive option than borrowing from the Treasury.

## Prompt Corrective Action Was Required

Congress considered that bank and thrift supervisors had not acted sufficiently aggressively during the 1980s to remedy the problems that had developed in the banking and thrift industries. FDICIA therefore established a menu of increasingly stringent mandatory " prompt corrective actions" (PCA) that supervisors should take as the condition of a bank or thrift deteriorated. FDICIA divided institutions into five groups according to the adequacy of their capital: (1) well-capitalized, (2) adequately

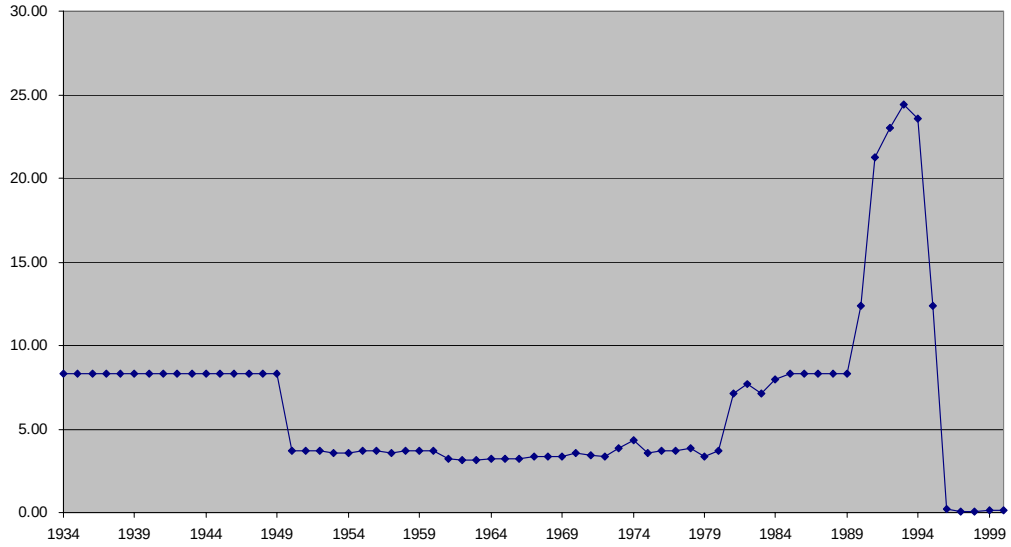
capitalized, (3) under-capitalized, (4) severely under-capitalized, and (5) critically undercapitalized. Institutions were judged to be critically under-capitalized when their leverage ratio (the ratio of their tangible capital to total assets) fell below 2%. At this juncture, either the chartering agency or the FDIC was required to close the institution, unless its capital deficiency was corrected within 90 days.[13] The intent of closing the bank before it became insolvent was to reduce the losses incurred by the FDIC in compensating the depositors of a failed bank. FDICIA's prompt corrective action provisions continue in effect during 2002.

## BIF Premiums Were Raised

Until the 1990s, the premiums charged to banks for their insurance coverage had been relatively modest, at 8.33 basis points or less.[14] By statute, premiums were levied on each dollar of domestic deposits at a flat rate. Following their initial contribution in 1933 to capitalize the fund, by statue, member banks paid 1/12 of one percent (or 8.33 basis points) of their total domestic deposits until 1950.[15]

**Figure 6**

**BIF Premiums in Basis Points**
**1934 - 2000**




**Source:** The figure was generated from data in the *FDIC 2000 Annual Report,* available at [http://www.fdic.gov/about/strategic/report/AnnualReport/pg94.html].

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[13] National banks are chartered by the Office of the Comptroller of the Currency and State banks are chartered by their State.

[14] A basis point is 1/100 of 1%. For example, 25 basis points constitute 1/4 of 1%.

[15] CRS Report 97-723, *Bank and Thrift Insurance Premiums: The Record from 1934 to 2001,* by Barbara Miles, discusses premiums in greater detail.

By 1950 the fund had become regarded as well-capitalized and this enabled the FDIC to make rebates to member institutions. The rebates reduced the effective premium rate to 3.7 basis points or less until 1980. The effective premium rate was raised again to 8.33 basis points between 1985 and 1989, when no rebates were made. Thereafter, using new authority provided to it under FDICIA, the FDIC raised premiums annually until they reached 24.4 basis points in 1993, at a time when the BIF was incurring heavy losses, and subsequently was repaying the funds it had borrowed and rebuilding the fund. The fund had been recapitalized by May 1995, and this enabled the FDIC to reduce premiums in 1996. The time path of effective premiums is shown in Figure 6 above.

## The FDIC Was Required to Charge Premiums Adjusted for a Bank's Risk

Initially the FDIC was required by statute to charge premiums to its member institutions at a flat rate. FDICIA subsequently mandated the FDIC to adjust its premium structure according to the risk that each bank posed to the fund. As a result, the FDIC began to risk-adjust its premium charges in 1993. To set differentiated rates, it divided banks into nine groups in a 3x3 matrix that ranked banks from one to three according to the adequacy of their capital ratios and from A to C according to their supervisory ratings. A bank's supervisory rating is based on its CAMELS assessment that results from its typically annual on-site inspection.[16] Banks with supervisory ratings one or two are placed into group A; banks rated three are located in group B; and banks rated four or five are relegated to group C. Thus, the best banks fall into group 1A and the worst into group 3C. The percentage distribution of BIF members by capital adequacy and supervisory rating is shown in Table 4.

### Table 4. BIF Assessment Rate Schedules and Their Distribution March 31, 2002

| Capital Group | Supervisory Risk Subgroup | | |
|---|---|---|---|
| | A | B | C |
| Rate paid by well-capitalized banks<br>% of institutions falling in the subgroup | 0<br>90.6% | 3<br>6.3% | 17<br>1.3% |
| Rate paid by adequately capitalized banks<br>% of institutions falling in the subgroup | 3<br>0.6% | 10<br>0.5% | 24<br>0.5% |
| Rate paid by under-capitalized banks<br>% of institutions falling in the subgroup | 10<br>0.0% | 24<br>0.0% | 27<br>0.2% |

**Source:** *FDIC Quarterly Banking Profile*, First Quarter 2002, which can be found at [http://www2.fdic.gov/bank/statistical/stats/2002mar/fdic.pdf].

[16] The acronym CAMELS stands for the supervisor's assessment of the bank's capital adequacy, asset quality, managerial competence, earnings, liquidity, and sensitivity to market risk.

Initially in 1993, the FDIC charged rates that ranged between 23 and 31 basis points. When BIF regained its target level, the agency reduced premiums, however, so that they will range from zero to 27 basis points during 2002. The rates charged to banks falling in each subgroup are shown in Table 4. By the first quarter of 2002, over 90% of member institutions fell into the 1A category that paid no premiums whatsoever for their coverage.[17] As a result, the effective average rate charged for deposit insurance coverage across all institutions was less than one basis point (only 0.20 basis points, to be precise) in 2001, as was shown in Figure 6 above.[18]

**Perceived Problems with the Current Pricing Arrangements.** The FDIC's ability to charge banks premiums that reflect their risk is, in fact, constrained by a post-FDICIA legislative requirement that precludes its ability to charge positive rates to the best-rated banks when the fund exceeds its designated reserve ratio (DRR) of 1.25%.[19] Although FDIC research has shown that the risk of loss to the fund varies significantly between banks rated CAMELS 1 and those rated CAMELS 2,[20] current arrangements do not allow for such a distinction when the FDIC sets premiums. In addition, over 900 institutions, newly chartered since 1996 and rated 1A, have never paid any premiums for their insurance. Moreover, banks that grow fast and are rated 1A benefit from free insurance, possibly at the expense of their slower-growing competitors.

The FDIC would like to change the current arrangements and has made proposals to enable it to differentiate more extensively and more precisely among risks. It could do so simply by differentiating between banks rated CAMELS 1 and those rated CAMELS 2, but it had initially been reluctant to do so, because CAMELS ratings, having an eighteen-month cycle, can frequently be out-dated. Instead, it has suggested using a statistical model that distinguishes among banks according to their examination ratings, several financial ratios, and (for larger banks) their market signals, such their stock prices and interest premiums. Such a model would be similar to the credit-scoring models that are used by banks that offer credit to consumers.[21]

The Deposit Insurance Funds Act of 1996 codified the FDIC's originally voluntary decision to classify CAMELS 1 and 2 banks together as having a strong

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[17] See *The FDIC Quarterly Banking Profile* for First Quarter 2002, which can be found at [http://www2.fdic.gov/bank/statistical/stats/2002mar/fdic.pdf].

[18] See the memorandum of May 2, 2002 from Arthur J. Murton to the FDIC Board of Directors on "BIF Assessment Rates for the Second Semiannual Assessment Period of 2002." This document can be found at [http://www.fdic.gov/deposit/insurance/risk/index.html].

[19] See the Deposit Insurance Funds Act of 1996.

[20] See *FDIC Deposit Insurance Options Paper* (2000).

[21] This and FDIC's other pricing proposals are discussed more extensively in (1) *Deposit Insurance Options Paper* (Washington, FDIC, August 2000), (2) *Keeping the Promise: Recommendations for Reform* (Washington, FDIC, April 2001), and (3) *Analyzing Policy Options for Deposit Insurance Reform* by Oliver, Wyman & Company (Washington, FDIC, July 2000).

supervisory rating. As a result, the FDIC now considers that it is prohibited from distinguishing between CAMELS 1- and 2-rated institutions for the purposes of determining premiums. Thus, it appears that the FDIC would need congressional approval to implement a more finely calibrated system of pricing risk. The two bills, H.R. 3717 and S. 1945, give the FDIC Board some greater discretion to set premiums. The House bill, however, would require the FDIC not to charge premiums in excess of one basis point (exclusive of rebates or credits) to institutions in the lowest-risk category. Although this offers the FDIC greater flexibility than in the past, some analysts question whether it is enough.

***Rebates and Credits.*** H.R. 3717 and S. 1945 both make provisions that would give the FDIC greater authority to provide premium rebates or credits and to base such refunds or credits on past contributions to the fund, rather than current assessments. Thus, newly chartered banks would not receive rebates or credits and fast-growing institutions would benefit relatively less than their slower-growing competitors.

## The FDIC Was Required to Adopt Resolution Methods Least Costly to the BIF

Until 1991, the FDIC could choose any method of resolution that was less costly than liquidating the bank. (In a liquidation, the FDIC pays off its depositors and sells the bank's assets. This is typically the most expensive form of resolution.) Using this latitude, from the 1960s onwards, the FDIC routinely protected all depositors — even uninsured depositors — from loss, by transferring all of the failed bank's deposits to another bank that was willing to acquire them. FDICIA required the FDIC to adopt the *least costly of all methods* available for resolving the bank. This requirement, which is still in effect in 2002, may well involve imposing losses on uninsured depositors in order to conserve BIF resources.

## Limiting the Application of "Too Big To Fail"

From 1950 until FDICIA, the FDIC had the authority to provide financial assistance to a large troubled bank to keep it open. It could provide such "open bank assistance" when it judged that closing the bank would have systemically adverse effects on the banking system and public confidence in it. Although it had applied this "too big to fail" policy only twice, Congress was concerned that FDIC latitude could be abused, was unfair to smaller institutions, and could prove costly to the BIF.[22] Consequently, FDICIA restricted the FDIC's authority to provide open-bank assistance. The statute requires that the FDIC Board, the Federal Reserve Board, and the Secretary of the Treasury, in consultation with the President, must agree that the closure of an insured bank would have systemically adverse effects. Any loss to the insurance fund, incurred in such assistance, must be recouped through a special assessment on member banks. By mid-2002, the FDIC had not invoked this provision, which is still operative.

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[22] The FDIC provided open-bank assistance to First Pennsylvania Bank in 1980 and to Continental Illinois National Bank in 1984.

## Depositor Preference

Until 1993, federal and state laws sometimes set different priorities for claimants over the assets of a failed bank and this impeded FDIC efforts to enforce its claim against the failed institutions' assets that it held in receivership. The Omnibus Budget Reconciliation Act (OBRA) of 1993, therefore, set national priorities over a failed institution's assets. This order of priority is (1) administrative expenses of the receiver; (2) secured claims, (3) the claims of all depositors holding domestic deposits, and including the rights of the FDIC, standing in line in the depositors' position; (4) the claims of general creditors, including foreign depositors; (5) claims of subordinated debt holders; and (6) residual rights of shareholders. The depositor preference provision, still in effect in 2002, was expected to reduce the cost of resolving failed banks, increase the amount the BIF recovers from the assets of failed banks, and conserve BIF resources.

## The Impact of These Measures

In light of these legislative improvements in the risk environment that it faced, FDIC staff calculated in 1995 that the fund would need an average assessment of only between four and five basis points in order for it to maintain a long-run balance between income and expenses, assuming that the insured deposit base did not grow fast enough to dilute the ratio.[23]

## The Size of the Insurance Fund: The Designated Reserve Ratio

Figure 2 above suggests that the BIF has fluctuated near a level near 1.25% of insured deposits for much of its history. Consequently, legislation in 1980 set 1.25% as the mid-point of the range in which fund was to be maintained. If the ratio exceeded 1.40%, the FDIC was required to make refunds. If the ratio fell below 1.10%, the FDIC had to call for additional assessments.

The Deposit Insurance Funds Act of 1996 eliminated this range and set the Designated Reserve Ratio (DRR) for BIF (and also for SAIF) at 1.25%. That is, the FDIC is required to keep the BIF fund at or above a level that represents 1.25% of estimated insured deposits. While the FDIC Board has the authority to raise the DRR above 1.25% if it foresees a significant risk of loss to the fund, it has not yet done so. Rather, it aims to set assessment rates to maintain the reserve ratio near the DRR. The Board can increase assessments up to five basis points at any one time. Forty-five days notice must be given for any increase in assessments. Larger increases require the Board to solicit public comment.

If the actual ratio falls below the DRR and remains there for more than one year, statute requires the FDIC to raise assessment rates to 23 basis points until the fund recovers. In addition, the FDIC must also set a schedule for recapitalizing the fund within 15 years. When the fund falls below 1.25%, as it did at the end of the first

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[23] See Murton (2002).

quarter of 2002, the FDIC has a year — which it interprets as two semiannual assessment periods — to bring the fund back to target, before it needs to charge the relatively high rate of 23 basis points. On the other hand, if BIF exceeds the DRR, there is a statutory provision for the FDIC to rebate surplus funds by reducing the assessment rate of best-rated banks, but, as is discussed in the next section, the FDIC has been unable to use this provision.

**Perceived Problems with a Rigid DRR.** H.R. 3717 and S. 1945 seek to redress three problems perceived in the present arrangements. The first problem involves the rigidity in the DRR that can force the FDIC to raise deposit insurance premiums when the fund ratio declines below 1.25%. The premium increase would occur at a time when the banking industry is experiencing problems. It is argued that one of the benefits from maintaining a fund is that it builds up resources during good times and depletes them when the need arises. That is, one of the rationales for maintaining a fund is to give the FDIC flexibility that avoids imposing additional costs on the banking industry when the economy and the industry are weak and can least afford higher insurance deposit premiums. The two bills seek to replace the rigid DRR with a range that would provide the FDIC with a constrained amount of flexibility to vary premiums.

The second problem is that current law requires the FDIC to raise premiums to a high level of 23 basis points if the BIF does not return to 1.25% within one year. The two House and Senate deposit insurance reform bills give the FDIC greater flexibility to set rates when it needs to restore the BIF to within designated range.

The third problem involves constraints on the FDIC's ability to make rebates or give premium credits when the fund balance is in excess of needs. Statute requires that the FDIC give rebates only to the best banks and only by deducing their current premium contributions to the fund. As the1A banks have not paid assessments since 1995, the FDIC has been unable to make refunds. For example, it could not act even when it had a large surplus in 1998, when the reserve ratio stood at 1.37% or when the fund reached its peak of 1.41% early in 1999.

H.R. 3717 and S. 1945 would enable the FDIC to give rebates or credits to sound banks and they would base the rebates on contributions to the fund made prior to the end of 1996. This provision would reward those banks that had paid premiums in the past and not give benefits to newly chartered banks that have not paid premiums and not unduly benefit older-established banks that have grown rapidly in recent years.

## BIF's Financial Situation in Mid-2002

The FDIC releases data about the BIF's financial condition in its annual report. Unfortunately, the latest annual report that is available is for 2000, so information about the more recent financial results have to be derived from a variety of FDIC publications and news releases. Data available after the end of the first quarter of

2002 showed that the BIF ratio had declined to 1.24% — below the DRR.[24] This situation requires a response from the FDIC Board.

The FDIC Board meets twice a year to set assessment rates — in May and November. The rates set at these meetings go into effect the following July 1 or January 1 after allowing 45 days' notice to the industry and the public. When the Board last met in May 2002, data for the first quarter of 2002 were not yet available. Consequently, the Board relied on end-of-2001 data, which showed BIF at 1.26% — above the DRR. The Board consequently decided not to change rates from the existing schedule of 0 to 27 basis points. Given the subsequent decline in BIF to 1.24%, the FDIC might well decide to raise rates in 2003 at its mid-November meeting.

## Reasons for the Decline in the BIF Ratio

The decline in the BIF ratio below its DRR of 1.25% foretells an increase in bank premiums. Naturally, this is of considerable concern to all segments of the banking industry. Consequently, it is necessary to examine the reasons for the BIF ratio's decline. The reasons are five-fold and include (1) a decline in BIF's investment income, (2) an increase in outlays for failed banks, (3) an increase in provisions for future expected failures, (4) an increase in insured deposits arising, for example, from inflows into banks from the securities markets and (5) an improved method of estimating insured deposits.

**Less Interest Income.** Since the end of 2000, interest rates in the economy have declined sharply, as the Federal Reserve has sought to combat the 2001 recession and the economic discouragement of the 9/11 terrorist attack. Consequently, FDIC investment income can be expected to have declined, so that BIF's total revenues may have risen less subsequently than in 2000. In fact, because most BIF investments were made when interest rates were higher, FDIC staff project only a slight fall in interest income — to approximately $1,655 million in 2002 as compared to $1,861 million in 2000.

**More Outlays for Failed Banks.** Six BIF-insured banks with $378 million in assets failed in 2000. While only 3 banks failed (with $54 million in assets) in 2001, six banks (with $2.14 billion in assets) failed in the first three months of 2002. That is, the effects of the recession in 2001were being felt as increased failures and increased resolution activity and outlays by the BIF.

**Additional Provisions for Future Failures.** The FDIC, acknowledging that the effects of a recession usually continue to be felt by the banking industry and its insurer well into the recovery, set aside a large $1.3 billion in additional reserves for expected future losses at the end of 2001.

The FDIC's loss, on average, in resolving failed banks varies with the size of the institution and the quality of its assets. The loss has ranged from 12% of assets for smaller banks with assets between $1 billion and $5 billion to 8% for larger banks

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[24] See Murton (2002, pp. 8-9).

with more than $5 billion in assets. Assuming an average rate of 10% over all banks, additional reserves of $1.3 billion implies that the FDIC sees approximately an additional $13 billion in failed bank assets on its near-term horizon. The FDIC itself has given a range for failed bank assets over the two-year period 2002-2003 as between $1 billion and $35 billion.

Figure 4 above shows that the FDIC put aside more reserves than it needed in the mid 1990s. While the loss reserve was small, as in most recent years, this tendency to over-provision was not a cause for great concern. However, as mentioned above, the FDIC made a relatively large provision at the end of 2001, and the issue of over-provisioning became more pressing. Under generally accepted accounting principles, FDIC and its GAO auditor make provisions for losses that are "probable and estimable." But such estimates can be inaccurate, especially when economic conditions are volatile. FDIC staff calculate that the BIF ratio would rise by one basis point for every $240 million in loss reserves that are reversed — and conversely the ratio would fall if losses are understated.[25] Thus, this $1.3 billion additional provision can be expected to have reduced BIF's actual reserve ratio by five basis points. Because of the importance of the provisioning procedure, the House bill requires the FDIC and the GAO to study the FDIC's methodology for setting loss reserves.

**Whether to Count Provisions Back into the Fund Balance.** The banking industry's concerns about over-provisioning led to a proposed House amendment to H.R. 3717 that would require the FDIC to include the provisions it set aside for future losses in the fund, instead of treating them as an expense. Including provisions for future losses would increase the value of the fund and reduce the need for the FDIC to raise assessments in order to maintain the fund at its 1.25 designated level. The amendment was not accepted on the grounds that it would violate generally accepted accounting practices and Members of Congress were sensitive to issues of "phony accounting" after the Enron, WorldCom, and other accounting scandals.

**Increases in Insured Deposits.** Insured bank deposits shrank between 1991 and 1994, but grew between 1.1% and 4% from 1995 through 1999. But they grew by 7% in 2000, and 4.7% ($109 billion) in 2001. FDIC staff estimate that a $19 billion increase in insured deposits reduces BIF's actual reserve ratio by one basis point.[26] Consequently, other things being equal, the increase in insured deposits in 2001 reduced BIF's actual reserve ratio by 6 basis points. FDIC staff estimated in May 2002 insured deposit growth at between 2% and 6% for 2002. However, this estimate may prove to be conservative given the public's current disenchantment with the stock markets. Additional inflows to insured deposits would further depress BIF's reserve ratio and add to the pressure on the FDIC Board to increase insurance assessments.

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[25] See Murton (2002, p. 12).

[26] See Murton (2002).

**Improved Estimates of Insured Deposits.**[27] In the first quarter of 2002 alone, BIF-insured deposits grew by 3.1% or $75 billion. That increase alone lowered BIF's reserve ratio by four basis points. Nearly two-thirds of the growth in insured deposits was due to a reporting change. Prior to 2002, the FDIC's method of estimating the value of insured deposits was imprecise.

Until March 2002, institutions were required to provide the value of their domestic deposits each quarter, but submitting estimates of their insured or uninsured deposits was voluntary and few banks did so. The FDIC did require an institution to report the number of its accounts with balances over $100,000 and the combined value of deposits in these accounts. In the absence of an estimate by an institution, the FDIC assessed the value of the bank's uninsured deposits as the total value of its domestic deposits in excess of $100,000 less the number of its deposit accounts times $100,000. The FDIC then summed the estimates of individual banks' uninsured deposits to provide a nationwide estimate and calculated the total value of insured deposits by subtracting the estimated value of uninsured deposits from total domestic deposits.

The FDIC saw three problems with this approximate method of estimation. First, it looked at the separate accounts of individuals, rather than the aggregated value of each individual's deposits at any institution. In this way, it tended to overestimate the value of insured accounts. Second, it ignored the fact that large accounts that had multiple owners would be entitled to more than $100,000 in coverage. Third, it ignored the additional, "pass-through," coverage for accounts held by groups of beneficiaries (for example, members of a pension fund). These last two omissions tended to understate the value of insured deposits.

Beginning in March 2002, the FDIC summed the value of uninsured deposits submitted by member institutions and calculated insured deposits by subtracting estimated uninsured deposits from total domestic deposits. The new data showed that the procedure used before 2002 had, in fact, underestimated the value of insured deposits. Thus, the FDIC had overestimated BIF's actual reserve ratio.

## The Outlook for BIF in the Near Term

During an economic recovery problems tend to continue to plague the banking industry and its insurer. The reason is that credit problems lag the economic cycle. Consequently, even if the U.S. economy's first quarter recovery were to continue through 2002, BIF outlays for resolving failed banks might be expected to continue to rise.

Furthermore, there is uncertainty about the strength and durability of the economic recovery. The continuing decline in the stock markets, corporate scandals, increasing unemployment, the decline in the dollar's exchange rate, international

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[27] The change in estimation methods is discussed in greater detail in *For Your Information: Better Deposit Data Show BIF Below Target*, available at [http://www.fdic.gov/bank/analytical/fyi/061202fyi.html].

political uncertainty, concerns about continuing terrorism, an unprecedentedly large trade deficit, unusually high consumer debt, and a decline in consumer confidence all gave cause for concern during the summer of 2002. Moreover, the effects on their bank creditors of the large corporate bankruptcies of Enron, Global Crossing, KMart, WorldCom, and others have yet to be felt.[28] The FDIC itself has expressed concern over the health of some banks that focus especially on sub-prime lending. The FDIC has already added to BIF's reserves to cover the losses it expects from this source.

In short, the outlook for the banking industry, which has been experiencing record profits during recent quarters, and the Bank Insurance Fund depends on the future course of economic events. If economic recovery continues, the outlook is good. If the recovery falters, the outlook may become more problematic.

[28] See CRS Report RS21188, *Enron's Banking Relationships and Congressional Repeal of Statutes Separating Bank Lending from Investment Banking*, by William D. Jackson.