Order Code RS20724
Updated August 3, 2006

CRS Report for Congress

Received through the CRS Web

Federal Deposit and Share Insurance: Proposals for Change

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Summary

Several Congresses have seen legislation that would change the finances of the Federal Deposit Insurance Corporation (FDIC), the pricing of deposit insurance, and its coverage for customers' accounts. In the 109th Congress, H.R. 1185, the Federal Deposit Insurance Reform Act of 2005, was passed by the House on May 4, 2005. S. 1562, the Safe and Fair Deposit Insurance Act of 2005, a more limited measure, was reported by the Senate Banking Committee on October 18, 2005. Both measures became part of the prolonged budget reconciliation process. On February 8, 2006, the resulting package became P.L.109-171, (120 Stat. 9). The Federal Deposit Insurance Conforming Amendments Act of 2005, P.L. 109-173 (119 Stat. 3601), was enacted on February 15, 2006. Collectively, these laws are referred to as the Reform Act of 2005. The Reform Act increases certain retirement accounts' insurance coverage to $250,000 and sets up adjustments that authorize increasing coverage limits for inflation every five years. The Reform Act also lessens premium volatility for banks, gives premium credits to institutions that paid in funds in past years, gives dividend returns, establishes a risk-based premium system, and merges the two bank and thrift insurance funds into a single Deposit Insurance Fund. This report will be updated as events warrant.

What is Deposit Insurance and How is It Administered?

The full faith and credit of the United States stands behind about $4.0 trillion of insured deposits at banks and savings associations. This insurance guards savers' accounts up to $100,000, providing stability to banks and to the economy. Congress legislated deposit insurance in the 1930s, and modified it in 1989 and 1991 in response to financial crises. All banks and savings associations must carry this insurance. The insurance does not cover deposits held in foreign offices, nor deposits above the legislated ceilings, despite their importance to very large banks. Smaller institutions find deposit insurance, including extra coverage for certain special accounts, very valuable. Observers have universally deemed federally backing essential, as history has shown that guarantees short of the national level are inadequate to prevent panics, runs, and severe economic damage when called upon. The original state funds insuring bank deposits, and most of their descendants, collapsed under pressure, and, while private deposit insurance remains vestigially available, it is not significant.

Pursuant to P.L. 101-73 and P.L. 102-242, the independent agency Federal Deposit Insurance Corporation (FDIC) had two funds. Both funds were interest-earning accounts maintained with the U.S. Treasury. The Bank Insurance Fund (BIF) dates from 1934. Congress intended it and its ancestor the Permanent Insurance Fund to cover commercial bank deposits. BIF members, predominantly commercial and savings banks, were supervised by the FDIC, the Office of the Comptroller of the Currency (OCC), or the Federal Reserve (Fed). The FDIC insures some "industrial loan companies" not otherwise federally regulated. (See CRS Report RL32767, *Industrial Loan Companies/Banks and the Separation of Banking and Commerce: Legislative and Regulatory Perspectives*, by Eric Weiss.) The Savings Association Insurance Fund (SAIF) was the successor to a failed fund (the Federal Savings and Loan Insurance Corporation) covering savings institution deposits. The Office of Thrift Supervision supervised SAIF members, predominantly thrift institutions. Many institutions have deposits that the "other" fund insured because of mergers. Institutions do not "own" either fund. BIF and SAIF balances were on-budget assets of the federal government. Except for the specific institutions covered, BIF and SAIF were essentially identical.

Federal law requires institutions to pay semiannual assessments reflecting their own risk and other factors, and makes premiums reflect the relative sizes of fund reserves. Both funds had target reserve ratios of 1.25% ($1.25 per $100) of insured deposits. That percentage is the statutory Designated Reserve Ratio (DRR). When either fund exceeded that value, its members did not have to pay assessments, unless capital or managerial deficiencies placed them in a risk category below the safest. In the other direction, should either fund fall below its DRR, institutions must pay to fill the fund's shortfall. That would greatly increase the near-zero cost of deposit insurance. Many prefer to smooth out assessments over time as needed to maintain adequate balances, which as **Table 1** shows, have fluctuated markedly since 1990. Since 2003, fund ratios have been trending downward. In the first quarter of 2006, the funds were combined, which resulted in a DRR of 1.23%.

A separate organization has insured accounts at credit unions since 1970: the National Credit Union Share Insurance Fund (NCUSIF). The National Credit Union Administration administers the fund. All federally chartered credit unions must belong to NCUSIF, however, state-chartered ones may elect to join it. Credit unions, owning NCUSIF, have put 1% of their total "shares" (deposits) into NCUSIF, beginning in 1985. Their contributions remain assets of the credit unions. Although it may levy a premium, the NCUA has done so only when three large New England credit unions failed in 1992. The "full faith and credit of the U.S. Government" backs it as well.

Table 1. Financial Position of Bank and Savings Association Insurance Funds, 1990-2005

End of Year	BIF		SAIF	
	Balance (billions)	Reserve Ratio (percent)	Balance (billions)	Reserve Ratio (percent)
1990	$4.0	0.21%	$0.0	0.00%
1991	-7.0	-0.36	0.1	0.01
1992	-0.1	-0.01	0.3	0.04
1993	13.1	0.69	1.2	0.17
1994	21.8	1.15	1.9	0.28
1995	25.5	1.30	3.4	0.47
1996	26.9	1.34	8.9[a]	1.30[a]
1997	28.3	1.38	9.4	1.36
1998	29.6	1.39	9.8	1.39
1999	29.4	1.37	10.3	1.45
2000	31.0	1.35	10.8	1.43
2001	30.4	1.26	10.9	1.36
2002	32.1	1.27	11.7	1.37
2003	33.8	1.32	12.2	1.37
2004	34.8	1.30	12.7	1.34
2005	35.4	1.23	13.0	1.29

Source: Federal Deposit Insurance Corporation.

a. After recapitalization pursuant to the Deposit Insurance Funds Act, P.L. 104-208.

Issues

The contemporary congressional review of deposit insurance began around 2000. Observers began asking questions that persisted for years, as follows:

- Should Congress increase the $100,000 coverage for deposits at banks and savings associations, and shares at credit unions? Should inflation adjustment, perhaps retroactively since 1980, and in future years, "index" FDIC coverage?
- Should Congress insure government and retirement deposits at a greater level?
- What should institutions pay for deposit insurance coverage and associated regulation? Should premiums be smoothed out over time?
- If the balances in BIF and SAIF exceed amounts necessary to provide adequate coverage, what should be done with the excess? Would refunds weaken the FDIC?
- Is no- or very low-cost deposit insurance a subsidy to banks in their competition with nonbank financial firms? Or does it offset costs of bank-only regulations?
- Should BIF merge with SAIF, as P.L. 104-208 planned in 1996?

- Are there better avenues to monitor and restrain risk-taking before it results in FDIC payouts? Are some institutions too-big-to-fail?
- Should rapidly-growing banks who have paid little or no assessments, the so-called free riders, be assessed premiums to compensate for their increased exposure to payouts and decrease in fund reserve ratios?
- What changes affecting FDIC operations might apply to credit unions?

Policy Considerations

Policymakers must weigh many factors. A key issue is how to provide the benefits of deposit insurance without lessening the incentives for managers to engage in prudent operating practices. Owners and managers at covered institutions may take on greater risks, in the expectation of greater rewards, if they know that customers are unlikely to withdraw their insured deposits. Observers call such behavior a "moral hazard." The effectiveness of examination and supervision arrangements thus has an important bearing on risk exposure of the insurance funds. Regulation of banks and savings associations to prevent failure ideally would prevent the FDIC from having to make good on its guarantee. No system is failure-proof, however. In a competitive economy, bad business decisions resulting in closure guide future capital investment away from practices that failed. Banks and savings associations are not exempt from this fact.

Tradeoffs exist among proposals for change. For example, increased account coverage could require greater reserves at BIF and SAIF, making it less likely that the costs of FDIC insurance remain low. Alternatively, should risk increase in financial markets, or the funds' coverage of insured deposits become very thin, institutions might have to pay larger assessments. Competitive equality is an important consideration for different institutions (large versus small, banks and savings associations versus credit unions, for example). Expansion of the federal safety net through the FDIC would have to be funded. Payment would come from institutions; taxpayer funding appears unlikely.

FDIC Recommendations and Congressional Activity

2001. In the 107th Congress, outgoing FDIC Chairman Tanoue said the agency would like Congress to make improvements. It sought to merge the BIF and SAIF funds. It sought to charge regular premiums based on institutions' risks, whatever the level of the reserve ratio of the fund(s). It suggested adjusting premiums gradually up or down as the health of the fund(s) changes. It also suggested indexing the basic account coverage, to keep pace with future inflation.

2002. New FDIC Chairman Powell carried the effort forward. H.R. 3717, the Federal Deposit Insurance Reform Act of 2002, passed the House on May 22, 2002. The House-passed bill would have done several things: (1) Created a range of reserve ratios, rather than the DRR of 1.25%. The range could float between 1.15% and 1.40%. (2) Merged BIF with SAIF, into a single Deposit Insurance Fund. (3) Increased basic account protection to $130,000. (4) Indexed future basic coverage to inflation every five years. (5) Covered many retirement (IRA and "401(k)") accounts for $260,000. (6) Increased coverage of within-state municipal deposits, to a maximum of $2 million. (7) Given banks refunds of premiums should the Deposit Insurance Fund exceed 1.35%, ending their payments now required when the ratio of insured deposits to their fund falls short. (8) Provided FDIC flexibility for reserving against future losses, recapitalizing the new Fund, and adjust basic account coverage according to inflation. (9) Credited institutions for assessments based on their insured deposits at the end of 1996, reducing their net assessments. (10) Raised protection at credit unions to that of banks.

2003. In the 108th Congress, the Oxley-Frank Managers' Amendment to H.R. 522 aimed to do the same things as H.R. 3717 of the prior year. On April 2, 2003, the House approved the bill.

2004. Smaller banks, and at least potentially, retirees, were thought to be the main beneficiaries of higher deposit protection. Yet, the Administration and Fed were concerned that the increase would raise risk without much benefit. (The vast majority of depositors have fully insured accounts.) Larger institutions and many government officials opposed an increase as costly: to the FDIC, and to the industry paying for more insurance. In the Administration's view, more coverage would have lessened depositors' care in monitoring banks, which could lead to costly bank failures. Disagreement over the proposed $130,000 ceiling immobilized legislation (including H.R. 522) in the Senate.

2005. In the 109th Congress, Chairman Powell suggested that a two-tiered safety net might cover differing sizes of banks. The largest institutions might enter a risk pool appropriate for systemic risk protection. Community banks could remain in much the current arrangement. In addition, the Administration's budget for FY2006 proposed that the BIF and SAIF Funds be merged, with the FDIC being allowed to set premiums as user charges for increasing insured deposits or above-average risk. In the second session of the 109th Congress, H.R. 1185, the Federal Deposit Insurance Reform Act of 2005, received approval from the House in May. S. 1562, the Safe and Fair Deposit Insurance Act of 2005, a more limited measure, was approved in Banking Committee markup in October.

2006. The Federal Deposit Insurance Reform and the Safe and Fair Deposit Insurance Acts became part of the prolonged budget reconciliation process. On February 8, 2006, the resulting package became P.L. 109-171 (120 Stat. 9). The Federal Deposit Insurance Conforming Amendments Act of 2005, P.L. 109-173 (119 Stat. 3601), was enacted on February 15, 2006. Collectively, these laws are referred to as the Reform Act. The Reform Act would raise FDIC collections from insured institutions, according to the Congressional Budget Office (CBO). As it appears in the Deficit Reduction Act of 2005, CBO estimated that it would boost net receipt by $2.5 billion over the next 10 years. **Table 2** is a brief summary of the current law and the key provisions of the Reform Act. Since its enactment, the FDIC has merged BIF and SAIF into the DIF, and has issued notices of proposed rulemaking (NPR) and requests for comment on several of the act's provisions, including establishing a risk-based assessment system and the DRR.

In short, the Reform Act takes effect this year; it will merge BIF with SAIF into the new DIF, will allow coverage to be adjusted for inflation, and will insure retirement accounts up to $250,000. It will give banks that paid into the funds in past years credits that can be applied against future premiums. The Reform Act retains the standard coverage ceiling of $100,000 but will index coverage for inflation starting April 1, 2010, effective the following January 1.

Table 2. Current Law and Key Reform Act Provisions

Current Law	Reform Act
BIF and SAIF are the deposit insurance funds for federally insured banks and thrifts.	Merges BIF and SAIF into the new Deposit Insurance Fund.
Standard deposit coverage ceiling is $100,000 with no inflation adjustment.	Increases deposit insurance coverage to $250,000 on retirement accounts, keeping the standard accounts at $100,000, and subsequent inflation adjustments at five-year intervals. FDIC shall determine whether or not to make these adjustments.
Requires the FDIC to keep the funds at or above a minimum level (1.25% of the estimated insured deposits) and to adjust premiums to achieve this target.	Gives the FDIC flexibility in setting minimum assessments for all institutions, including penalties. The FDIC is to consider expenses and income of DIF, capital, and earnings of the institutions in making assessments, repealing special rules relating to minimum assessment and free deposit insurance.
BIF and SAIF fund reserves are both set at 1.25%.	Replaces the fixed designated reserve ratio with a reserve ratio range. The range is 1.15% to 1.5%.
The FDIC uses nine risk categories in a two-step process based on capital grouping and supervisory groupings with zero given to the lowest-risk and five for the highest-risk institutions.	Requires the establishment of a risk-based assessment system. The FDIC must consult with other federal regulators in its development, and insured institutions are required to provide the information for its creation.
BIF may refund part or all of the assessments to lowest-risk members. SAIF has no authority to do so. There is no one-time credit.	Gives the FDIC discretion to pay refunds and dividends, depending on level of the Deposit Insurance Fund. Gives a one-time credit up to 10.5 basis points based on total assessments at year-end 2001.
The FDIC is to increase assessments whenever BIF or SAIF falls below 1.25%. The FDIC has up to 15 years to restore each.	The FDIC is to plan the funds' restoration if the reserve ratio of DIF falls below its minimum. It has up to five years to restore the DRR, or a longer period as the FDIC many determine to be necessary.

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