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CRS Report for Congress

When Financial Businesses Fail: Protection for Account Holders

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Summary

Lawmakers have long recognized the importance of protecting some forms of financial savings from risk. Such vehicles clearly include deposits in banks and thrift institutions and credit union "shares." Remedial and other safety net features also cover insurance contracts, certain securities accounts, and even defined-benefit pensions. Questions over how to fund and guarantee Social Security, along with the troubles of the Pension Benefit Guaranty Corporation, have renewed interest in these arrangements. This report portrays the salient features and legislation of account protection provided by the Federal Deposit Insurance Corporation, the National Credit Union Share Insurance Fund, state insurance guaranty funds, the Securities Investor Protection Corporation, the Pension Benefit Guaranty Corporation, and a discussion of the FDIC's Temporary Liquidity Guarantee Program that extends unlimited temporary deposit guarantees to certain depositors and debt held in insured depository institutions. It ends with a discussion of monoline insurance companies. Overall, it provides resources for further analysis of each protective arrangement and will be updated as appropriate.

Analysis

Analysts and lawmakers view many financial businesses as having an important role in the U.S. economy, receiving protection for their individual account holders against loss, should the firms fail. Such protections exist both to protect the individuals from risks they probably could not discern for themselves, and to protect the economy against the effects of financial panics if failures occur. Panics, the attendant collapses of wealth, and severe consequences for the economy occurred before Congress created federal deposit insurance in 1934. Until the enactment of the Emergency Economic Stabilization Act (EESA) of 2008, government policy protected customers of depository institutions — banks, thrift institutions, and credit unions — in full for accounts up to $100,00 and up to $250,000 for retirement accounts. But the enactment of EESA on September 23, 2008 immediately raised the maximum deposit insurance to $250,000, leaving retirement accounts at $250,000 until December 31, 2009. Other institutions such as insurance companies, securities broker/dealers, and many pension funds receive government or government-sponsored guarantees on specified accounts.

This report provides a side-by-side summary of the major features of financial institutions' customer protection systems, reflecting safety-net provisions legislated over time, usually in reaction to specific collapses. Besides these explicit guarantees, regulatory bodies can attempt the rescue of failing financial enterprises, using many tools authorized by laws and regulations and often acting in the background. Such tools include liquidity lending, arranging memoranda of understanding, issuing cease and desist orders against risky practices, and arranging mergers of weak entities into stronger institutions. If the entire financial economy seems threatened by pending collapse of either a sizeable financial institution that is "too large to fail," or many financial businesses collectively, the Federal Reserve (Fed) can step in as the lender of last resort to avert serious adverse consequences for the economy (e.g., use of the Fed's liberal bank liquidity policy immediately after the 911 attacks, and currently the subprime meltdown led to failures of institutions once believed to be too large to fail — Bear Stearns, Fannie Mae, Freddie Mac and AIG, all of which were or are being assisted by the federal government). Moreover, Congress may have to provide emergency funding when parts of the federal safety net are under severe pressure. The cleanup of the savings and loan industry in the 1980s and early 1990s, for example, required appropriated funds plus a new deposit insurance fund and regulator. A more recent example is the Emergency Economic Stabilization Act of 2008 that provided $700 billion to purchase distressed assets such as mortgage-backed securities and to make direct capital investments in troubled financial institutions.

An important conceptual distinction between support structures is who ultimately pays for the protection. Lawmakers originally created federal deposit insurance in a "user fee" model of insurance, in which the government owned and operated each insurance system and charged member banks for its use. Following the banking failures of the late 20th century, legislation moved deposit protection part way toward an alternative "mutual" model, in which the burden of financing the system falls more clearly on the banking industry. Mutual institutions are owned by their customers, such as saving associations' depositors and insurance companies' policyholders. As a result, some analysts now claim that the banking industry "owns" the deposit insurance funds in mutual mode. In reality, the federal government still owns and operates them. That is so because in all depository institution cases, the ultimate guarantor is the economic power of the federal government. History has shown that deposit guarantees short of the federal level have universally been inadequate to prevent panics, runs, and severe economic damage when called upon.[1] Industry-sponsored and state-level programs have contained the collapses of their covered entities only if the damages have been small. Credit union share insurance, in contrast, more nearly follows the mutual model. Likewise, state insurance company guaranty and federally-sponsored securities investor protection arrangements follow the mutual model. The troubled pension benefit arrangement, however, remains in user fee mode.

The following tabulation lists the major elements and components of these safety nets. **Table 1** outlines the support structures for accounts at depository institutions. **Table 2** does the same for the nondepository supports. Readers may obtain further analysis of each system via the websites of the administering agencies noted.

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[1] CRS Report RL31552, *Deposit Insurance: The Government's Role and Its Implications for Funding*, by Gillian Garcia, William Jackson, and Barbara Miles.

Table 1. Comparing Account Protection: Depository Institutions

Feature	Bank Deposits	Thrift Institution Deposits	Credit Union Shares
Statutory Authority	Federal Deposit Insurance Act	Same	Federal Credit Union Act (Amendment)
Original Date/ Major Modification	1933/1991/2005/ 2008	1934/1989/1991/2005/ 2008	1970/2005/2008
Citations to Authority and Operations	64 Stat. 873; 12 U.S.C. 1811 ff. P.L 110-343, Sec.346A	Same	84 Stat. 994; 12 U.S.C. 1781 ff; P.L. 110-343, Sec. 346A
Administrator	Independent agency: Federal Deposit Insurance Corporation's Deposit Insurance Fund.	Independent agency: Federal Deposit Insurance Corporation's Deposit Insurance Fund.	Independent agency: National Credit Union Administration manages National Credit Union Share Insurance Fund.
Funding	Banks pay assessments on deposits to maintain fund balance: currently zero for all but riskiest firms.	Same	All federal and electing states may pay assessments; none recently. Contribution of 1% of credit union "shares" required.
Federal Budgetary Status	Part of consolidated federal budget.	Same	Members own off-budget fund.
Federal Government Backstop	Unlimited line of credit with U.S. Treasury until 12/31/09; "full faith and credit of the United States."	Same	$100 million line of credit with U.S. Treasury; "full faith and credit of the United States."
Risk-based Assessment	Yes: cents more per $100 of covered deposits.	Same	No
Tax Deduction for Assessment	Yes: Business expense deduction for taxes.	Same	None usually since credit unions are exempt from federal and most state taxes.
Product Line Differentiation	None	None	None
Coverage Limit	$250,000 per account and no limit for certain account.	Same	$250,000 for standard share account.

Source: Congressional Research Service, The Library of Congress.

Table 2. Comparing Account Protection: Nondepository Institutions

Feature	Insurance Policies	Securities Accounts	Pension Accounts
Statutory Authority	State laws; McCarran-Ferguson Act (59 Stat. 33, 1945) removed most federal industry involvement.	Securities Investor Protection Act of 1970	Employee Retirement Income Security Act of 1974; Consolidated Appropriations Act, 2001; Deficit Reduction Act of 2005.
Original Date/ Major Modification	Various.	1970	1974/1994/2000/2005
Citations to Authority and Operations	State laws.	84 Stat. 1636; 15 U.S.C. 78aaa ff.	88 Stat. 829; 29 U.S.C. 1001 ff.
Administrator	Multi state administrators and non-profit associations of licensed insurers; coordinated via National Association of Insurance Commissioners and National Conference of Insurance Legislators.	Non-governmental membership corporation, funded by member securities broker-dealers: Securities Investor Protection Corporation.	"Self-supporting" federal government corporation: Pension Benefit Guaranty Corporation.
Funding	Licensed direct insurers pay after actual insolvency; no funds(s) generally exist.	Assessments on members for "reserve" fund advancing payments to claimants: flat $150 yearly per firm. Corporation may levy revenue-based assessment, as in 1989 — 1995.	Employers pay annual premium per participant: $30 minimum in single-employer/$8.00 flat in multi-employer plans.
Federal Budgetary Status	Not applicable.	Not a budgetary account.	On-budget.
Federal Government Backstop	None, except for a program of terrorism reinsurance.	May borrow $1 billion from U.S. Treasury Department through Securities and Exchange Commission; *lacks* "full faith and credit" backup.	Borrowing or appropriation has not covered fund deficits; *lacks* "full faith and credit" backup.

Feature	Insurance Policies	Securities Accounts	Pension Accounts
Risk-based Assessment	No.	No.	Yes: Underfunded single-employer plans pay extra $9/1,000 on unfunded vested benefits, varying with interest rates
Tax Deduction of Assessment	Yes: Life insurers in 45 states and property-liability insurers in 20 may deduct assessments from premium taxes; business expense deduction for federal and state taxes.	Essentially not applicable, although business expense tax deduction is nominally available.	Yes: Employers' business expense deduction for federal and state taxes.
Product Line Differentiation	Insurers are assessed by market share in particular types of insurance.	None.	Program for single-employer plans; another for multi-employer plans.
Coverage Limit	Coverage limits vary by state	Stocks, bonds, and cash registered to holders in closed broker/dealers; $500,000 of which $100,000 may be cash; not protected against changing market values.	Varies. Single-employer plan basic benefits to $51,750 annually for retirees starting at age 65, adjusted for age and inflation. Multi-employer plan formula is 100% of first $11 of monthly benefits per year of service plus 75% of the next $33 of such benefits, not adjusted.

Source: Congressional Research Service, The Library of Congress.

FDIC Temporary Liquidity Guarantee (TLG) Program

On October 23, 2008, in the midst of the current financial crisis, the Federal Deposit Insurance Corporation announced its Temporary Liquidity Guarantee program to help unfreeze the U.S. short term credit markets. At the time, financial institutions were not lending to each other, especially in the commercial paper market, which was almost completely frozen. The two-part program temporarily guarantees all new senior unsecured debt and fully guarantees funds in certain non-interest bearing accounts at FDIC-insured institutions issued between October 14, 2008 and June 30, 2009 with guarantees expiring no later than June 30, 2012. The FDIC expects these guarantees would restore the necessary confidence for investors to begin investing in obligations of depository institutions. Evidence suggests that these shot-term markets are slowly returning to normal after the TLG program was implemented.

The second part of the FDIC's TLG program is to guarantee 100% of non-interest-bearing transaction accounts held in insured depository institutions until December 31,

2009. This addresses the concern that many small business accounts, such as payroll accounts, frequently exceed the current maximum deposit insurance limit of $250,000. The TLG program is being paid for by additional fees placed on depository institutions that use these guarantees, not taxpayers.[2]

Financial Guarantors (Monoline Insurance Companies)

Financial guarantors are insurance companies that insure the credit quality of securities that banks, securities firms, insurance companies, among others hold as assets. Even though state insurance regulators have sole authority to supervise them[3], financial guarantors' safety and soundness may have a critical impact on the safety and soundness of all financial businesses including federal regulated banks.[4] The failure of one or more financial guarantors could possible bring about other financial business failures because credit rated securities backed by guarantors' insurance on, for example, a national bank's books would be downgraded, requiring the banks to add capital. If the bank is unable to acquire the necessary capital, the bank could suffer losses or even fail due to the falling prices of its insured assets, which might no longer cover its liabilities, including deposits.

Financial guarantors provide insurance against credit defaults of securities. Specifically, they focus on insuring the timely payment of principal and interest on securities, including municipal bonds, asset-backed securities and collateralized debt obligations (CDOs). The guarantors' insurance raises the credit rating of the underlying securities, which in turn lowers the interest costs to the issuer and makes the securities more attractive to a wider range of investors. The nine New York monoline insurance companies insure $2.5 trillion of domestic and international debt. An increasing part of this debt was CDOs backed by subprime residential mortgage-backed securities. Such debt led to losses for these monoline companies because these securities were being sold at substantial discounts. The growing possibility of more losses caused the rating agencies to lower the treble A ratings of several of these financial insurance companies. The treble A credit rating is required for the guarantors to offer treble A credit ratings on securities issuers offer. Because some guarantors were downgraded, the securities they insured are being downgraded as well, which means that banks, securities firms, and insurance companies, among others holding these downgraded assets must increase their capital as the price of these assets falls. New York state insurance regulators and the U.S. Treasury are seeking ways to help these financial guarantors get recapitalized.

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[2] Thecla Fabian, "FDIC Board Approves Formal Notice of Temporary Liquidity Guarantee Program," *BNA Banking Report,* October 27, 2008, p. 714, and FDIC website at [http://www.fdic.gov/news/news/press/2008/pr081105.html].

[3] While New York state supervises financial guarantors, it's insurance guaranty funds do not cover monoline insurance companies.

[4] See the testimony of Patrick M. Parkinson, Deputy Director, Division of Research and Statistics of the Board of Governors of the Federal Reserve System, before U.S. House of Representative, the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, February 14, 2008. [http://www.federalreserve.gov/newsevents/testimony/parkinson20080214a.htm].