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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, the Federal Deposit Insurance Reform Act of 2005 and the Federal Deposit Insurance Conforming Amendments Act of 2005, P.L. 109-173 (119 Stat. 3601), were enacted on February 15, 2006. Collectively, these laws are referred to as the Reform Act of 2005. In the 110th Congress, the FDIC has been implementing the provisions of the Act. The Act sets the maximum deposit insurance coverage and sets up adjustments that authorize increasing coverage limits for inflation every five years. However, due to current financial crisis and evidence of public lack of confidence in the financial system, the Emergency Economic Stabilization Act (EESA) of 2008, increased the standard deposit insurance coverage from $100,000 to $250,000 and maintained retirement accounts' insurance coverage at $250,000. On December 17, 2008, because of rising bank failures, the FDIC board of directors approved the final rule for implementing a restoration plan to restore the designated reserve ratio to its minimum level by increasing assessments as mandated by the Reform Act of 2005. The proposed rules will take effect on January 1, 2009.

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 $8.6 trillion of insured deposits at banks and savings associations. This insurance guards savers' accounts up to $250,000, providing stability to banks and to the economy. Congress legislated deposit insurance in the 1930s, and modified it a dozen times in response mainly 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 federal 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 N. 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 2007, the funds were combined, which resulted in a DRR of 1.20%. In November 2006, the FDIC board suggested that it expects DRR will reach 1.25% in mid-2009.

A separate organization has insured accounts at credit unions since 1970: the National Credit Union Share Insurance Fund (NCUSIF). The National Credit Union Administration (NCUA) 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. EESA also increased the standard credit union deposit insurance coverage to $250,000 and maintained the maximum retirement accounts' insurance coverage at $250,000.

Table 1. Financial Position of Bank and Savings Association Insurance Funds, 1990-2007

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
		The Deposit Insurance Fund Balance (billions)	Reserve Ratio (Percent)	
2005 (End of Year)		48.59	1.25	
2006 (End of Year)		50.17	1.21	
2007 (End of Year)		52.41	1.22	

Source: Federal Deposit Insurance Corporation.

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

Issues

Leading up to the passage of the FDIC Reform Act of 2005, there was a contemporary congressional review of deposit insurance that began around 2000. Observers began asking questions that persisted for years, as follows:

- What should institutions pay for deposit insurance coverage and associated regulation? Should premiums be smoothed out over time?
- If the balances in BIF and NCUSIF 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?
- Are there better avenues to monitor and restrain risk-taking before it results in FDIC and NCUSIF payouts? Are some institutions too-big-to-fail?
- Should rapidly growing banks that 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 NCUSIF, making it less likely that the costs of deposit insurance would 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 and NUCSIF would have to be funded. Payment would come from institutions; taxpayer funding could appears unlikely.

FDIC Recommendations and Congressional Activity

2005

In the 109th Congress, Chairman Don 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 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 on May 9, 2006. 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 regulatory environment before the reform act 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.

2007

On September 11, 2007, the FDIC asked for comments on an Advance Notice of Proposed Rulemaking (ANPR) to establish a system for providing rebates to insured financial institutions in the event that the DIF reaches the upper limit of the reserve ratio. The Reform Act, which allows the FDIC to manage DIF within the range of 1.15% and 1.5%, must refund the excess payments in the form of dividends to depository institutions that support DIF. If the fund reaches 1.5%, all the excess must be refunded. One part of the ANPR requires that the system take into account a bank's assessment base at the end of 1996, which is a proxy for the assessments paid by institutions to recapitalize the fund following the deposit insurance crisis of the 1980s and the early 1990s. The FDIC named this the "fund balance method, which would tend to befit older institutions. The second part's "payment method" would take into account only the premiums paid over a prior period that is designated by the board rather than all eligible premiums. This second approach tends to put new institutions on an equal basis with older institutions more quickly.

Other regulatory and legislative developments concerning the FDIC include the FDIC board approving a two-year pilot project to test banks' and consumers' receptivity to small-dollar lending programs, which would compete against the unfair, deceptive, and expensive credit terms offered by payday lending organizations. Legislatively, the House of Representative reported out H.R. 3526 that would give the FDIC, Office of the Comptroller of the Currency the power to write rules to identify and prohibit unfair or deceptive practices. In addition, the House of Representatives approved H.R. 2547 to ban the misrepresentation of financial products as having the protection of federal deposit insurance if they do not have such coverage.

2008

On March 14, 2008, as mandated by the Reform Act of 2005, the FDIC board of directors approved the rule for calculating a payment of dividends to insured institutions if and when the DIF reserve ratio exceeds 1.35%. The banking industry seems to be less concerned about getting back the additional premiums it paid in, preferring the FDIC not to allow the reserve ratio to exceed 1.35%. The FDIC board argued that the methods it approved are simple, transparent and do not require constant FDIC intervention and decision-making, which is similar to what the industry advocated.

However, the increased number of bank failures (twenty five so far in 2008), including IndyMac, currently under FDIC's receivership, and the largest depository institution failure in the United States' history – Washington Mutual Bank (WaMu) with assets totaling $307 billion, which was merged with JPMorgan Chase Bank – shifted the FDIC's focus from paying out premium refunds in the form of dividends to restoring the rapidly disappearing Deposit Insurance fund. In addition, the FDIC expects a higher rate of bank failures in the next few years. As mentioned above, the reserve ratio of the Deposit Insurance Fund is mandated in the FDIC Reform Act of 2005 to be between $1.15 and $1.50 per $100.00 of insured deposits. The DIF declined from $1.19 as of March 30, 2008 to $1.01 as of June 30 and 76 cents as of September 30, 2008, and FDIC's staffers project that the ratio would fall to 60 cents in 2009. The Reform Act requires the FDIC to establish and implement a Restoration Plan to restore the reserve ratio to at least the $1.15 per $100.00 within five years.

The FDIC published a Restoration Plan (see 73 FR 61598) on October 7, 2008 through a notice of proposed rulemaking (NPR). The rulemaking proposed that effective January 1, 2009, the current assessment rate would increase uniformly by 7 basis points for the first quarter of 2009. Effective April 1, 2009, the rulemaking proposed to alter the way that the FDIC risk-based assessment system differentiates across various risks and sets new deposit insurance premiums assessment rates. It also postponed other technical changes to the risk-based assessment system. On December 17, 2008, the FDIC issued its final rule only for the first part of the NPR. It will raise the current assessment for the first 2009 assessment period by a uniform 7 basis points. The FDIC postponed the final rule on the risk-based assessment until the early part of 2009 to be effective in the second assessment period, starting April 1, 2009. The banking industry expressed disappointment in the magnitude of the assessments and that the FDIC implemented them cross-the-board. Many analysts have argued that the assessments are procyclical, because they are being raised at a time when the banks are least able to pay them due to declining profits, and arguably, this further reduce the banks' ability to increase lending during a recession.

Table 2. Key Reform Act Provisions

Reform Act

- Merges BIF and SAIF into the new Deposit Insurance Fund.
- 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.
- 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.
- Replaces the fixed designated reserve ratio with a reserve ratio range. The range is 1.15% to 1.5%.
- 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.
- 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 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 may determine to be necessary.

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