Policy Analysis
No. 432 April 16, 2002

FDIC Reform
Don't Put Taxpayers Back at Risk

by George G. Kaufman

Executive Summary

Enacted at the depth of a banking crisis, the Federal Deposit Insurance Corporation Improvement Act of 1991 effectively turned the deposit insurance system into a privately funded, albeit still mandatory and government-managed, system. In the 10 years since the FDICIA's enactment, the new system has worked reasonably well to preserve the safety and soundness of the banking system and to protect taxpayers from funding losses to the Federal Deposit Insurance Corporation fund, for which banks are now responsible. Nevertheless, the FDIC has recently encouraged a reexamination of the current structure of the deposit insurance system to improve its performance.

Some of the changes proposed by the FDIC may actually return the system to one in which the taxpayer is again at greater risk for funding bank losses. Chief among those changes is a measure, included in a number of bills now pending in Congress, that would allow the FDIC greater flexibility in the way it charges insurance premiums on banks. In particular, it would alleviate the requirement to increase premiums as harshly and rapidly when losses drive the fund below the designated 1.25 percent reserve-to-insured-deposits ratio to replenish the fund within one year. But that would increase the likelihood of the fund going and staying negative and increase the probability of putting the taxpayer back on the hook.

A second proposed change would increase the maximum coverage of $100,000 per account. That is likely to encourage some depositors to become less concerned about the financial health of their banks and banks to take on more risks, which would increase the chances of bank losses and failures.

Last, the FDIC would like to see insurance premiums reflect the riskiness of insured banks. Although it sounds good in theory, this is one task that bank regulators are ill-equipped to perform, because the appropriate risk also depends on the risks imposed by the regulators themselves when they fail to act in a consistent and efficient manner in resolving troubled banks.

An implicit government guarantee of banks will remain as long as the deposit insurance system is government operated. For that reason, to reduce that guarantee, insured banks should at least be given a greater voice in the management of the FDIC.

Many of the proposed changes would diminish market discipline and encourage regulatory forbearance. Their adoption could inadvertently lead to a reversion to the pre-1991 system of almost unlimited taxpayer liability.

George G. Kaufman is John Smith Professor of Banking and Finance, Loyola University, Chicago, and cochair of the Shadow Financial Regulatory Committee.

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Introduction

In August 2000 the Federal Deposit Insurance Corporation issued a lengthy paper titled *Deposit Insurance Options Paper*,[1] which was intended to encourage public dialogue on possible reforms in the deposit insurance system. That paper was followed by another study, *Keeping the Promise: Recommendations for Deposit Insurance Reform*,[2] which presented the FDIC's recommended changes. Largely as a result of those two papers, Congress recently began hearings to consider changes in the current structure of the deposit insurance system in the United States.[3]

In this paper, I review the past and current structures of deposit insurance in the United States and analyze the more important changes proposed in the FDIC papers and in the subsequent bills introduced in Congress. Those changes deal mostly with three aspects of the structure: how to fund insurance losses, the pricing of risk in insurance premiums, and setting account coverage ceilings.

Federal government–sponsored deposit insurance was introduced in the United States in 1933, during the depth of the banking crisis that accompanied the Great Depression of the 1930s. The United States was the second country to adopt national deposit insurance, after Czechoslovakia. Between 1929 and 1933, the number of commercial banks in the United States declined by more than 10,000—from more than 25,000 to fewer than 15,000—mostly because of failure. In addition, there were widespread failures among savings and loan (S&L) associations, mutual savings banks, and other financial institutions. Public confidence in the ability of banks and thrift institutions to repay their deposits in full and on time was low, and runs from deposits into currency were widespread. The FDIC was established as part of the omnibus Banking (Glass-Steagall) Act of 1933 to offer full insurance on small bank deposits and partial insurance on larger deposits.[4] Since then, many major and minor changes have been made in the insurance system.[5]

Most recently, the Federal Deposit Insurance Corporation Improvement Act of 1991 introduced major changes in the system. Like the earlier Banking Act, the FDICIA was enacted at the depth of a banking crisis, this time the crisis of the late 1980s and early 1990s. By the end of that crisis, some 1,500 commercial banks, which represented more than 10 percent of the banking industry at the start of the crisis, and some 1,200 S&Ls, or 25 percent of all the S&Ls in the country, had failed.[6] The costs of the S&L failures exceeded the reserves of the then federal insurer of those institutions, the Federal Savings and Loan Insurance Corporation, by some $125 billion to $150 billion.[7] That cost represented the difference between the par value of the insured and other protected deposits and the lower market value of the assets at failed institutions and was paid by the federal government—that is, by the U.S. taxpayer. Although the cost of the simultaneous bank failures came close to depleting the FDIC's reserves, it did not, and the FDIC did not require any taxpayer funding.

Since then, the banking industry has recovered strongly and few banks or thrift institutions have failed. Partially as a result, both bankers and the general public have become less concerned about deposit insurance and less familiar with its features, particularly those newly introduced by the FDICIA. This paper is in part intended to help increase awareness of both the current structure of deposit insurance and the pros and cons of some of the more important proposals for change raised in the FDIC options paper and elsewhere.[8]

The Current Structure

The post-FDICIA deposit insurance system is basically a privately funded, government-managed system. The government's liability through an implicit guarantee to pay at par at least all insured deposit claims and possibly some or all uninsured deposit claims is greatly

diminished from what it was in the pre-FDICIA era, during which the perceived government guarantee was of paramount importance. That change stems from the way in which losses to the FDIC (which now insures both banks and S&Ls) are now funded.

The Fund

Prior to the enactment of the FDICIA, the deposit insurance fund was financed through a fixed premium on banks of 8.33 basis points measured as a percentage of total domestic deposits, regardless of the riskiness of banks' assets or the size of the insurance fund, although rebates were provided when the FDIC considered the size of the fund to be appropriate. The FDIC was allowed to build up the fund in anticipation of losses and, most important, was not required to increase premiums in the event of losses to the fund. The flat premiums encouraged banks to engage in riskier behavior than they would otherwise, and the discretion the FDIC enjoyed meant that the implicit government guarantee was almost unlimited, as was the potential taxpayer liability.

The post-FDICIA structure dramatically reduces the number and amount of deposits that are likely to be protected by the FDIC in the case of bank failures. The FDICIA requires the FDIC to charge insured banks premiums to build up a fund equivalent effectively to no more and no less than 1.25 percent of insured deposits and to maintain it at that ratio.[9] If, thereafter, the fund falls below that ratio, either because of losses resulting from the protection of insured depositors at insolvent insured banks or from operating costs, the FDIC is required to increase premiums to bring the ratio back to the minimum percentage within one year or to impose very high premiums the next year. In addition to revenues from premiums, the FDIC receives income from investing the monies in the fund in U.S. Treasury securities.

Two further changes in the statutes have affected both the size and potential uses of the insurance fund. In 1993, the Depositor Preference Act subordinated deposits at foreign branches of U.S. banks (on which insurance premiums are not assessed) and funds at domestic branches of insured banks from nonsecured nondeposit sources, such as Federal Reserve funds purchases and bond and note sales, to both deposits at domestic branches and the FDIC. Thus, bank losses in excess of the amount of the bank's equity capital are charged to those claimants before they are charged to other depositors at domestic branches or the FDIC.[10] From the FDIC's point of view, those subordinated claims serve as capital that buffers it from losses. In 1996, the Deposit Insurance Funds Act effectively prohibited the FDIC from assessing premiums when the fund is above 1.25 percent, except on "risky" banks—that is, banks that are not classified both "well-capitalized" according to the prompt corrective action (PCA) criteria adopted by bank regulators under the FDICIA (see Table 1) and that do not have what is called a CAMELS rating (Capital, Assets, Management, Earnings, Liquidity, and [Market] Sensitivity)[11] of 1 or 2, the two highest examination ratings given by the federal bank regulators on a scale of 1 to 5 (and which are therefore not in the top left corner cell in Table 3).

Those changes effectively converted the 1.25 percent reserve ratio into a "hard target" that could not be either exceeded or fallen short of. The FDIC may not raise premiums in anticipation of future losses for which it does not reserve—for example the next cyclical downturn—and must raise premiums to finance, within one year, any losses that diminish the fund below the 1.25 percent target or increase the average premium on all banks to a minimum of 23 basis points until that target is regained. Thus, the fund is basically only a bookkeeping account. It cannot be used to provide liquidity, except when the fund is above its designated value from earnings on investments and premiums on risky banks and to finance temporary shortfalls in anticipation of revenues from required increased premiums. Indeed, for most purposes, except for financing the buildup, temporary use to finance losses, and generating earnings from investments, it does not mat-

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Table 1
Capital Adequacy Levels (percent)

	Total Risk-Based Capital*		Tier 1 Risk-Based Capital*		Tier 1 Leverage		Tangible Equity
Well capitalized	≥10	and	≥6	and	≥5		–
Adequately capitalized	≥8	and	≥4	and	≥4		–
Undercapitalized	>6	and	>3	and	>3		–
Significantly undercapitalized	<6	or	<3	or	<3	and	>2
Critically undercapitalized	–		–		–		≤2

*As percentage of risk-weighted assets.

ter much what the target value of the fund is—it could be 1 percent or 10 percent with the same effect. Once premium payments are made into the fund, they are effectively frozen and belong neither to the banks nor to the FDIC but effectively to the U.S. Treasury in whose securities they are permanently invested. This greatly changes the nature of the fund from what it was before the enactment of both the FDICIA and DIFA, when it could be built up in anticipation of losses and be used to pay as much of the FDIC's insurance and operating losses as possible without raising premiums. When the fund was exhausted, the implicit government guarantee was expected to kick in.

Requiring the FDIC to increase premiums to fund its losses greatly reduces the need for any additional government guarantee of deposits.

The change in the nature of the fund not only significantly altered the financing of any FDIC losses but also affected the extent of any implicit government guarantee of and liability for deposits at failed banks and thrifts. Because the fund can never be effectively built up or drawn down from the target ratio for very long, most future losses are paid on a pay-as-you-go basis through premiums assessed on surviving banks after losses to the FDIC from bank failures have occurred. This is referred to as "ex post settling-up."[12] Before those changes, premiums were assessed primarily in anticipation of losses and the fund could serve as a buffer that permitted the FDIC to delay increasing premiums until a more opportune time. Of course, if the ex ante premiums were insufficient to keep the fund from declining too close to zero for comfort, premiums could be collected ex post. That was done to rebuild the fund in the early 1990s. Even after the FDICIA (but before the DIFA), premiums could be assessed against anticipated losses to increase the fund above the minimum 1.25 percent and any "excess funds" could be used to moderate and/or delay premium increases when losses occurred. Since 1997, when the DIFA was implemented, all premiums have been effectively determined ex post.

Requiring the FDIC to increase premiums to fund its losses greatly reduces the need for any additional government guarantee of deposits. For such a guarantee to come into play, the entire capital resources of the banking industry must first be exhausted so that the banks cannot pay the required premiums. In other words, the capital of the entire banking system now theoretically stands between the government and insured depositors. That is, the banking system has almost unlimited liability for FDIC losses.[13] However, though there is no explicit federal government guarantee of any deposits in the statutes, either before the changes of the 1990s or now, it is highly unlikely that the government would not protect at least all insured deposits at failed banks should the

resources of the banking system become exhausted. Thus, an implicit guarantee appears to remain, though vastly scaled down from before 1991.

The FDICIA also permits the FDIC to borrow up to $30 billion from the Treasury Department, for working capital, if losses exceed the amount of the fund before offsetting revenues from the required increased premiums are received, but only if the secretary of the treasury determines that the FDIC will be able to repay the amortized principal on the loan, as well as pay the interest, from assessments on insured institutions within an agreed-upon time period.

Premiums

From 1934, when the FDIC was established, until 1993, premiums were a flat across-the-board percentage of a bank's total domestic deposits. Table 2 shows the history of assessment rates for commercial banks. The first premium column shows the rate or rates assessed in each year. From 1934 through 1989, the premium was a fixed 8.33 basis points for all banks.[14] The second premium column shows the effective or average assessment rate actually paid, which is computed by dividing the premium (assessment) revenues by the appropriate deposit base for the period. Before 1985, the effective rates were at times lower than those assessed for the year and reflect rebates paid (assessment credits) by the FDIC to all the banks because of the small size of the losses from the few failures experienced. Those rebates were also flat across the board.

Starting in 1993, the FDICIA required the FDIC to charge premiums to insured institutions based on the "probability that the deposit insurance fund will incur a loss with respect to the institution."[15] In response, the FDIC developed a three-by-three risk matrix to sort banks into one of nine risk cells. The three rows of the matrix incorporate the capital-to-asset classifications specified in the prompt corrective action provisions in the FDICIA. Row 1 includes all "well-capitalized," row 2 all "adequately capitalized," and row 3 all "undercapitalized" banks. The three columns incorporate the supervisory CAMELS ratings based on bank examinations by the regulatory agencies. Column A includes banks rated 1 and 2, column B banks with a 3 rating, and column C banks rated 4 or 5, the lowest categories. The higher and further to the left the risk cell, the lower the premium assessed. Thus, using the matrix, different banks may be assessed different rates according to their risk classification.

The FDICIA required the FDIC to establish the risk-based premiums in such a way that, until the target 1.25 percent reserve ratio was achieved, the average rate would be no lower than the flat 23-basis-points rate in existence at the end of 1991. Thereafter, it could set the premium structure subject to the constraint that the average rate would prevent the fund from dropping below the minimum 1.25 percent reserve ratio for more than one year. If the reserve ratio remained below 1.25 percent for more than one year, the minimum average premium would need to be returned to 23 basis points. Currently, almost all banks are classified in the lowest risk cell, so only a few banks may be assessed premiums under DIFA. As a result, in 1993 and 1994 the effective assessment rate was higher than the premium rate for the less risky banks but lower than the rate for the riskiest banks and exceeded 23 basis points. After the FDIC reached the target 1.25 percent ratio, the effective rate dropped quickly because only the riskiest banks were assessed premiums. The low effective rates since 1996 reflect both the significant improvement in the financial health of the banking industry and the impact of DIFA, which prohibited the FDIC from assessing premiums on banks that are both well capitalized and receive CAMELS ratings of 1 or 2 and are thus ranked in the least risky cell. Currently fewer than 10 percent of all banks are assessed premiums.[16]

Table 3 shows the end-of-year premium assessments, by risk cell, on commercial banks from 1993 to 2000. Also shown are the number of banks and the assessable deposit base in each cell.

The banking system has almost unlimited liability for FDIC losses.

Table 2
FDIC Insurance Premiums, 1934–2000 (basis points)

	Premiums Assessed				Premiums Assessed		
	Range of Rates		Effective		Range of Rates		Effective
Year	High	Low	Rate	Year	High	Low	Rate
2000	27.00	0.00	0.14	1966	8.33		3.23
1999	27.00	0.00	0.11	1965	8.33		3.23
1998	27.00	0.00	0.08	1964	8.33		3.23
1997	27.00	0.00	0.08	1963	8.33		3.13
1996	27.00	0.00	0.24	1962	8.33		3.13
1995	31.00	4.00*	12.40	1961	8.33		3.23
1994	31.00	23.00	23.60	1960	8.33		3.70
1993	31.00	23.00	24.40				
				1959	8.33		3.70
1992	23.00		23.00	1958	8.33		3.70
1991	23.00		21.25	1957	8.33		3.57
1990	12.00		12.00	1956	8.33		3.70
1989	8.33		8.33	1955	8.33		3.70
1988	8.33		8.33	1954	8.33		3.57
1987	8.33		8.33	1953	8.33		3.57
1986	8.33		8.33	1952	8.33		3.70
1985	8.33		8.33	1951	8.33		3.70
1984	8.33		8.00	1950	8.33		3.70
1983	8.33		7.14	1949	8.33		8.33
1982	8.33		7.69	1948	8.33		8.33
1981	8.33		7.14	1947	8.33		8.33
1980	8.33		3.70	1946	8.33		8.33
1979	8.33		3.33	1945	8.33		8.33
1978	8.33		3.85	1944	8.33		8.33
1977	8.33		3.70	1943	8.33		8.33
1976	8.33		3.70	1942	8.33		8.33
1975	8.33		3.57	1941	8.33		8.33
1974	8.33		4.35	1940	8.33		8.33
1973	8.33		3.85	1939	8.33		8.33
1972	8.33		3.33	1938	8.33		8.33
1971	8.33		3.45	1937	8.33		8.33
1970	8.33		3.57	1936	8.33		8.33
1969	8.33		3.33	1935	8.33		8.33
1968	8.33		3.33	1934	8.33		8.33
1967	8.33		3.33				

Source: Federal Deposit Insurance Corporation, *Annual Report* (various years).
*Effective June 1, 1995

Table 3
End-of-Year Insurance Premiums for Commerical Banks by Capital Category and Supervisory Risk Group, 1993–2001

Capital Category	Supervisory Risk Group Group A	Group B	Group C
	1993		
1. Well capitalized			
Premium (Basis Points)	23	26	29
# Institutions	9,595	1,112	288
Assessable Deposit Base ($billions)	1,923.7	330.1	72.3
2. Adequately capitalized			
Premium (Basis Points)	26	29	30
# Institutions	59	48	112
Assessable Deposit Base ($billions)	58.5	9.1	20.3
3. Undercapitalized			
Premium (Basis Points)	29	30	31
# Institutions	3	4	66
Assessable Deposit Base ($billions)	0.3	0.9	11.6
	1994		
1. Well capitalized			
Premium (Basis Points)	23	26	29
# Institutions	9,820	634	168
Assessable Deposit Base ($billions)	2,153.3	133.8	20.9
2. Adequately capitalized			
Premium (Basis Points)	26	29	30
# Institutions	79	29	47
Assessable Deposit Base ($billions)	45.9	4.5	5.7
3. Undercapitalized			
Premium (Basis Points)	29	30	31
# Institutions	2	1	34
Assessable Deposit Base ($billions)	0.1	–	3.6
	1995		
1. Well capitalized			
Premium (Basis Points)	4	7	21
# Institutions	1,553	138	25
Assessable Deposit Base ($billions)	2,388.9	42.5	8.7
2. Adequately capitalized			
Premium (Basis Points)	7	14	28
# Institutions	25	31	26
Assessable Deposit Base ($billions)	29.6	2.9	3.4
3. Undercapitalized			
Premium (Basis Points)	14	28	31
# Institutions	0	0	10
Assessable Deposit Base ($billions)	0.2	–	1.6

continued

Table 3—*continued*

Capital Category	Supervisory Risk Group Group A	Group B	Group C
	1996		
1. Well capitalized			
Premium (Basis Points)	0	3	17
# Institutions	9,538	368	59
Assessable Deposit Base ($billions)	2,591.0	27.7	2.2
2. Adequately capitalized			
Premium (Basis Points)	3	10	24
# Institutions	73	19	17
Assessable Deposit Base ($billions)	17.1	1.1	1.3
3. Undercapitalized			
Premium (Basis Points)	10	24	27
# Institutions	6	1	18
Assessable Deposit Base ($billions)	–	0.4	0.8
	1997		
1. Well capitalized			
Premium (Basis Points)	0	3	17
# Institutions	9,160	275	37
Assessable Deposit Base ($billions)	2,741.1	17.1	1.8
2. Adequately capitalized			
Premium (Basis Points)	3	10	24
# Institutions	96	17	12
Assessable Deposit Base ($billions)	15.7	1.9	1.1
3. Undercapitalized			
Premium (Basis Points)	10	24	27
# Institutions	2	2	14
Assessable Deposit Base ($billions)	–	–	0.4
	1998		
1. Well capitalized			
Premium (Basis Points)	0	3	17
# Institutions	8,602	261	36
Assessable Deposit Base ($billions)	2,931.7	40.7	2.0
2. Adequately capitalized			
Premium (Basis Points)	3	10	24
# Institutions	111	14	14
Assessable Deposit Base ($billions)	17.7	1.4	1.7
3. Undercapitalized			
Premium (Basis Points)	10	24	27
# Institutions	5	2	11
Assessable Deposit Base ($billions)	0.4	0.2	0.5

Capital Category	Supervisory Risk Group Group A	Group B	Group C
	1999		
1. Well capitalized			
Premium (Basis Points)	0	3	17
# Institutions	8,291	329	50
Assessable Deposit Base ($billions)	2,946.5	52.7	2.5
2. Adequately capitalized			
Premium (Basis Points)	3	10	24
# Institutions	150	12	10
Assessable Deposit Base ($billions)	34.2	0.8	1.1
3. Undercapitalized			
Premium (Basis Points)	10	24	27
# Institutions	2	0	8
Assessable Deposit Base ($billions)	0.3	–	0.3
	2000		
1. Well capitalized			
Premium (Basis Points)	0	3	17
# Institutions	7,965	383	55
Assessable Deposit Base ($billions)	3,230.1	58.7	6.5
2. Adequately capitalized			
Premium (Basis Points)	3	10	24
# Institutions	157	15	7
Assessable Deposit Base ($billions)	26.9	3.0	0.6
3. Undercapitalized			
Premium (Basis Points)	10	24	27
# Institutions	3	2	4
Assessable Deposit Base ($billions)	0.5	0.2	0.1
	*2001**		
1. Well capitalized			
Premium (Basis Points)	0	3	17
# Institutions	7,766	393	63
Assessable Deposit Base ($billions)	3,351.2	67.1	20.8
2. Adequately capitalized			
Premium (Basis Points)	3	10	24
# Institutions	–	19	12
Assessable Deposit Base ($billions)	30.4	1.4	2.0
3. Undercapitalized			
Premium (Basis Points)	10	24	27
# Institutions	3	1	10
Assessable Deposit Base ($billions)	0.3	–	2.4

Note: Supervisory Risk Group A = CAMELS 1 and 2, Supervisory Risk Group B = CAMELS 3, and Supervisory Risk Group C = CAMELS 4 and 5.
*As of September 30.

The government's liability for losses to uninsured depositors and other creditors in "too-big-to-fail" banks appears to be greatly diminished from what it was in the pre-FDICIA era.

Too Big to Fail

In addition to its liability for losses to insured depositors, the government's liability for losses to uninsured depositors and other creditors in "too-big-to-fail" (TBTF) banks also appears to be greatly diminished from what it was in the pre-FDICIA era. In the United States, TBTF does not mean that the government will bail out all stakeholders of big insolvent banks to keep them in operation. Rather, TBTF tends to mean either that a bank is too big to permit losses to de jure uninsured depositors and possibly other creditors but not to its shareholders when a bank fails, or that a bank is too big to liquidate quickly. In the latter case, legal failure (i.e., a bank's being officially declared in insolvency by its primary regulator) may be temporarily delayed or the bank is failed but effectively transferred to the FDIC, which may temporarily operate it as a bridge bank to minimize fire-sale losses.[17]

Since the mid-1980s, the major exception to that policy has been the Continental Illinois National Bank, which, along with its parent bank holding company, was temporarily propped up by a government-sponsored recapitalization scheme in 1984. Continental Illinois was not legally failed and existing shareholders were not wiped out when it was reorganized, although the FDIC received a controlling ownership stake and changed the bank's senior management. When the bank failed to recover, the old shareholders were effectively wiped out and the FDIC eventually sold the bank to Bank of America. Since then, resolved banks and bank holding companies have been legally failed, and shareholders have been removed or, if the bank was resolved with some positive equity value remaining, reimbursed only the value of their ownership interest at the time of resolution.

In the United States, the resolution process for insolvent banks and thrifts differs significantly from that for other corporations. Unlike other corporations and even bank holding companies, commercial banks and S&Ls are failed by their primary chartering regulator and resolved by the FDIC according to bank statutes and not by courts according to the regular corporate bankruptcy statutes.

The basic rationale underlying TBTF is the fear that losses to some or all de jure uninsured depositors and possibly other claimants at major banks could ignite doubts about the financial health of other banks and start runs that trigger uncertainty or require speedy unwinding of complex positions, both of which are likely to result in fire-sale losses and disrupt financial markets. Those effects in turn could spread beyond the financial sector and also adversely impact the macroeconomy and result in losses in output and increases in unemployment. When most de jure uninsured claimants at failed banks were effectively protected before the FDICIA, any loss incurred from the shortfall of the pro rata market value of the insolvent bank's assets from the par value of the protected claims was effectively transferred from the claimant to the FDIC and paid out of the FDIC fund. Losses from TBTF were not distinguished in the fund from losses from protecting de jure insured depositors. If the TBTF losses threatened to exceed the size of the fund, the FDIC could increase premiums, but was not required to do so. Rather, it was widely perceived that the government—that is, taxpayers—would be liable for any amounts required in excess of the value of the fund.

The FDICIA changed the ground rules. It prohibited the FDIC from protecting de jure uninsured bank claimants in insolvencies either partially or in full, if doing so would increase resolution costs. It provided, however, an exemption to least-cost resolution in instances of potential systemic risk in which the failure to protect uninsured claimants "would have serious adverse effects on economic conditions or financial stability; and any action or assistance under this subparagraph would avoid or mitigate such adverse effect."[18] But invoking that exemption is not easy. It requires a written recommendation of two-thirds of both the Board of Directors of the FDIC and the Board of Governors of the Federal Reserve System and approval by the

secretary of the treasury in consultation with the president. Upon approval, written notice and a description of the basis for the determination must be provided by the treasury secretary to the Banking Committees of both the House and Senate. In addition, the General Accounting Office must report to Congress on the basis for the determination, in compliance with the legislation, and the effects.

If the assistance results in a loss to the FDIC, that body must recover the amount "expeditiously" through an emergency special assessment on all banks based on their total assets less capital. Again, this involves ex post settling-up. There is no lasting FDIC fund that can be used to finance those losses and, unless there is a change in the law, any implicit government guarantee and liability would come into play only after the banking system's capital is fully exhausted and the banks cannot meet the special assessment. Combined with the increases in premiums required to fund losses from protecting insured depositors, the requirement to fund losses from protecting uninsured depositors effectively makes all FDIC losses the liability of banks and reduces sharply any government subsidy to deposit insurance that may have existed before. However, cross-subsidies among banks are likely to continue to exist.

Because of these barriers to its use, it is likely that regulators will be considerably more hesitant to invoke TBTF or, more accurately now, the systemic risk exemption (SRE) than before the FDICIA and that large banks will be less supportive of such assistance, knowing that they will likely be paying fully for any deposit protection for their competitors.[19] Indeed, since 1992, the FDIC has never invoked the SRE and has protected uninsured depositors only in the few resolutions in which doing so was not expected to increase the cost of the resolution to the FDIC.[20] In large measure, however, this reflects the fact that no major money center banks have been on the brink of insolvency in this period. Thus, the status of TBTF or SRE remains to be fully tested.

Last, the prompt corrective action provisions of the FDICIA also reduce the need for invoking the systemic risk exemption. Those provisions require bank supervisors to become progressively more familiar with troubled banks as their capital positions deteriorate through the undercapitalized zones. As a result, regulators should have time to plan and prepare for resolving the institutions in an orderly fashion before they reach the 2 percent equity-to-asset ratio closure rule. That would include the sale of large banks in total or in parts and the unwinding of complex positions to avoid sudden actions that would result in large fire-sale losses and disrupt financial markets. If a bank can be resolved in an orderly fashion, then as Federal Reserve Board chairman Alan Greenspan has noted, there is little need to "protect non-guaranteed deposits from loss"[21] and "the potential for greater market discipline at large institutions is substantial."[22]

The status of "too big to fail" remains to be fully tested.

Current Issues

The changes introduced by the FDICIA have not left the deposit insurance structure without controversy, particularly with respect to funding losses, tying premiums to risk, charging all insured institutions premiums, and account coverage. In *Keeping the Promise*, the FDIC makes the following recommendations: (1) the hard reserve target of 1.25 percent of insured deposits should be modified to allow some premium smoothing and allow the fund to absorb some losses (i.e., to switch to a system that allows funding some losses on an ex ante basis); (2) rebates should be permitted and based on past contributions to the fund; (3) the FDIC should be allowed to charge risk-based premiums at all times and on all institutions; (4) the deposit insurance coverage level should be indexed to maintain its real value; and (5) the Bank Insurance Fund and the Savings Association Insurance Fund should be merged.[23]

Funding of Insurance Losses

Insurance firms can fund their operating

costs and losses by building up a fund through premium assessments on insurees in anticipation of future losses (ex ante funding), by assessing the insurees after any loss and financing the loss immediately through borrowings (ex post settling-up), or a combination of the two. Private insurance firms generally prefer accruing a reserve fund before losses occur to build credibility in their ability to pay the losses expeditiously. However, it is unlikely that they can anticipate correctly all losses, particularly major losses from natural causes such as earthquakes, floods, and hurricanes. Thus, when unanticipated losses diminish the fund to unacceptably low levels or exhaust it altogether, insurers will try to increase premiums in the future on current policyholders to pay for the past losses and engage in partial ex post settling-up. For example, the unusually stormy weather in the first half of 2001 caused unusually severe damage to residential structures and forced many home insurers to schedule large hikes in insurance premiums for 2002. In addition, the magnitude of the damage from the events of September 11 has caused sharp increases in the cost of terrorism insurance.[24]

By contrast, federal government–supported insurers are generally perceived to have access to the government "printing press" or large-scale general tax revenues and thus are not in as much need of ex ante funding for credibility. For that reason, the decision on whether to fund losses to the FDIC ex ante or ex post rests on three other factors: the ability to predict losses accurately, fairness, and the desirability of smoothing premium payments by insured banks over time.

The FDIC's risk exposure contains both bank risk and regulatory risk.

As noted earlier, losses to the FDIC and other creditors occur only if an insured institution is not resolved until after its effective capital (claims subordinated to the FDIC) turns negative, so that part of the losses must be charged against its deposits and other nonsubordinated claims. Because the regulatory agencies have the authority and, since the FDICIA, the obligation to resolve insolvencies before an institution's book value equity becomes negative, if not before, the FDIC's loss is not necessarily determined only by the riskiness of the bank but also by the ability and political will of the regulatory agencies to enforce the positive equity "closure" rule and, failing that, the extent to which the FDIC is willing to impose losses on uninsured depositors and other creditors.[25] Thus, the magnitude, if not the probability, of the loss, if any, is to a large extent endogenous and, except in instances of sudden major fraud, directly under the control of the FDIC and its sibling regulatory agencies through their PCA and closure policies. The FDIC's risk exposure contains both bank risk and regulatory risk. As a result, risk pricing for deposit insurance differs significantly from risk pricing for most other types of insurance, in which the riskiness of the insured is more closely related to the potential loss to the insurer.

Ex ante funding requires the FDIC to predict at what capital levels it and its sibling agencies will resolve undercapitalized institutions. That may not be easy. If the FDIC overestimates its ability and will to resolve institutions quickly, it will undercharge premiums and will have to supplement them with ex post premiums later, as occurred before the crisis of the 1980s. Alternatively, if it underestimates its ability and will, it will overcharge premiums and build up a surplus fund, if permitted to do so. Moreover, because currently banks eventually bear any losses to the FDIC fund, the FDIC has less incentive to resolve insolvencies promptly, except when insured banks are likely to balk at paying high premiums and to exert political pressure to reduce the premiums or to introduce rebates. Thus, getting the premium revenues right in advance is difficult and subject to political constraints, whereas in ex post funding the losses have already occurred and are known with certainty in the aggregate and thus are subject to little, if any, dispute. The issue then becomes how to distribute the cost of those losses among the individual institutions.

Ex post funding of losses from protecting insured and, at times, uninsured depositors in failed banks requires the collection of assessments from surviving institutions only. Thus

the "innocent" are paying for the sins of the "guilty." That raises questions of both fairness and discipline. In ex ante structures, insurees that are perceived to make a larger contribution to potential future losses will generally pay higher premiums now and fund a larger part of their own expected losses. In addition, if institutions that are perceived to be more risky and thus more likely to contribute to losses know that they will have to pay higher premiums in ex ante structures, they will act more cautiously and become less risky. By contrast, in ex post structures, in which, if institutions fail and generate losses to the fund, they will not have paid any premiums at all to finance the loss and would have had less incentive to reduce their risk taking. That is, by reducing market discipline, ex post premiums may exacerbate moral hazard behavior that ex ante premiums may mitigate. However, members of the insurance pool could impose at least some degree of discipline if, knowing that failures would increase premiums for all surviving banks, they monitored each other and exerted pressure both on each other to avoid excessive risk taking and on the insurer to subject riskier pool members to greater monitoring, regulation, and covenants. But that is more difficult to do successfully the larger and more diverse are the members of the pool.

The U.S. Shadow Financial Regulatory Committee, a group of independent banking experts, has recently recommended that it might be desirable in the current ex post settling-up structure to consider dividing all insured banks into smaller and more homogenous pools—say according to their primary regulator.[26] That would enhance both interbank monitoring and discipline. In addition, competition among the pools on the basis of premiums could also be expected to increase the incentives of regulators to intensify pressure on pool members to limit their losses in order to lower premiums. Recent World Bank studies on a large sample of countries conclude that, if deposit insurance premiums are ex post and funding is provided by private banks rather than the government, market discipline is greater and the banking system less fragile.[27] Thus, a change to ex ante funding, even if it is partial as the FDIC has proposed, would be undesirable because it would encourage regulatory forbearance and reduce market discipline.

Pricing Risk

It is also possible to scale ex post premiums according to the risk that particular insurees will cause future losses, even if the revenues collected are used to pay for past losses caused by others. As noted earlier, however, implementing efficient risk-based insurance premiums is not easy in either ex ante or ex post structures. The premiums assessed need to reflect both the probability of insolvency and the loss to the FDIC, if there is an insolvency. The former is largely a function of the bank (private risk) and the latter a function of the bank's primary federal agency. But the intensity of supervision also affects the probability of bank failure, so that it is not solely a private risk. Thus, actual losses to the FDIC from an insolvency are to a considerable degree a function of the regulatory agencies' ability and will to resolve institutions expeditiously (regulatory risk). This suggests that, for the premium structure to be credible, the FDIC must not only predict its fellow agencies' closure behavior, but it must also act to validate it.

Moreover, assigning premiums to accurately reflect individual bank risk is difficult. Banks assume a wide variety of on– and off–balance-sheet risks, including credit, interest rate, market, foreign exchange, liquidity, operational, regulatory, and fraud risk. Neither those risks nor their subcomponents are additive. Indeed, through diversification, the individual risks may offset each other partially or totally and reduce a bank's overall risk. Thus, basing risk premiums on individual activities in the asset and liability portfolio as a whole is likely to be inaccurate and incentive incompatible.[28]

If regulators do not set risk premiums the same way as the market does, which is difficult, banks will engage in arbitrage both within and among the classifications and shift

Basing risk premiums on individual activities in the asset and liability portfolio as a whole is likely to be inaccurate and incentive incompatible.

assets from overpriced to underpriced activities. If so, the premium revenues collected may not necessarily compensate the FDIC for actual losses. Regulators have also been known to measure risk and assign premiums on the basis of political considerations rather than potential losses in order to allocate credit to favored sectors or parties. Thus, regulator-determined, non-market-based, risk-sensitive premiums are as likely to distort efficiency and fairness as they are to promote those goals.[29]

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Premium Smoothing

Although ex post premiums are easier to assess to collect the correct amount of aggregate losses, they will likely be higher when most banks are performing poorly and are thus less likely to be able to afford higher premiums. That is, the higher premiums are likely to hit the banks the hardest when they are down. By contrast, ex ante premiums may be smoothed over time through an appropriate use of a reserve fund. Premiums may be set higher than otherwise when banks are performing well to build up the fund and lower than otherwise when banks are performing poorly. The fund then would not be replenished as it pays the losses, which are likely to be greater in those periods of poor performance, until it runs down to some minimum value.

But, as noted earlier, premiums on almost all types of privately provided insurance tend to vary procyclically, increasing when or shortly after the insurance company experiences large, unexpected losses that deplete the reserve fund and decreasing when losses are low and profitability high. Even with the ex ante premium structure that was in place before the FDICIA, FDIC premiums effectively varied procyclically. Although the premiums were nominally constant at 1/12 of 1 percent of domestic deposits (8.33 basis points), large rebates were paid to insured banks throughout most of the the profitable post–World War II period until the late 1980s, when sharp increases in losses led the FDIC to raise premiums. In any case, some smoothing of premiums through time may be desirable.

Modifying the single-value hard target would be one possible way to achieve partial smoothing of premiums. As aggregate deposits in the banking system grow through time, either because of an increase in the demand for real (constant dollar) deposits or because of inflation, the hard 1.25 percent target may require banks to pay additional premiums to maintain the target value of the reserve ratio. But those additional premiums cannot be used to fund meaningful future losses. Such losses require higher premiums afterwards to restore the ratio to its target value. The higher premiums from deposit growth only effectively represent a continuous tax on the banking industry. On the other hand, because the FDIC earns income from investing the monies in the fund, eliminating the reserve fund reduces the FDIC's income and may require higher premiums. Changing from a single-value hard percentage target to an equivalent semihard or two-value (floor and cap) dollar-amount or soft target still large enough to generate sufficient income to fund annual operating expenses would not require higher premiums due to deposit growth.[30] Introducing a hard-value upper cap as well as a floor would permit the FDIC to build up a reserve above the minimum that could be used to pay for losses without increasing premiums until the floor amount is hit. Thus, the fund can fluctuate between the lower dollar floor and the higher dollar ceiling, both of which can be indexed to grow through time. Such an arrangement would permit some premium smoothing without threatening the mandatory and timely increases in premiums that make the structure privately funded and protect the taxpayers.

Concern has also been expressed that the requirement that the FDIC increase premiums whenever the designated reserve ratio declines below 1.25 percent—or, if it is changed, whatever the new floor target is—to return the ratio to that level within one year or raise the average premium to 23 basis points until the minimum ratio is achieved is too strong a medicine and would only rein-

force the existing procyclicality in the loan pattern of banks. Both FDIC chairman Donald Powell and Laurence Meyer, until recently a member of the Board of Governors of the Federal Reserve System, have testified in Congress in favor of giving the FDIC greater discretion in determining the speed at which the reserve ratio needs to be returned to its minimum level.[31] That would be undesirable for two reasons. First, the longer premiums are not increased to return the reserve ratio to its minimum, the more likely the fund is to go into deficit and the taxpayer again to become liable. Second, the threat of a premium increase to 23 basis points serves to encourage the banks to pressure the FDIC to resolve insolvencies more quickly and efficiently in line with the spirit as well as the letter of least-cost resolution and reduce the need to impose this penalty. The recent costly failures serve to underscore the need for such pressure on the FDIC.[32] Reducing or eliminating this ex ante incentive for the banks is likely to increase FDIC losses and again increase the likelihood of putting the taxpayer at risk.

Fairness Relative to New Entrants

In ex post systems without hard targets, newly insured banks chartered after a loss to the FDIC are likely to pay premiums for past losses to which they have not contributed. But because premiums are currently zero for banks classified as well capitalized and well managed, under the hard target most new banks, which tend to be so classified under current regulations, do not pay any premiums at all, even if they represent a high risk for future losses, until future losses occur. Then, if they fail, they will have paid no premiums at all. This system, which is viewed as unfair, is of current importance because there are a number of newly chartered banks that are large and growing rapidly. Those banks were chartered by large securities firms, such as Merrill Lynch and Morgan Stanley Dean Witter, which then transferred large amounts of funds accumulated in their noninsured money market funds to insured accounts at their banks.[33] If those banks are not classified as risky, they pay no premiums. Moreover, to the extent that these transfers increase aggregate insured deposits meaningfully, they may cause the reserve ratio to decline below the target ratio and trigger dollar premium increases on all banks, including those that may have experienced no or only moderate deposit growth. The FDIC can partially solve this perceived fairness problem by including a rapid growth variable in its formula for assigning CAMELS ratings and have the fast growers pay, at least, for the premium necessitated by their deposit growth within the framework of ex post risk-based premiums.[34] Thus, these new banks would pay for a larger proportion, if not all, of any fund shortfall that they may have created.

Coverage Amount

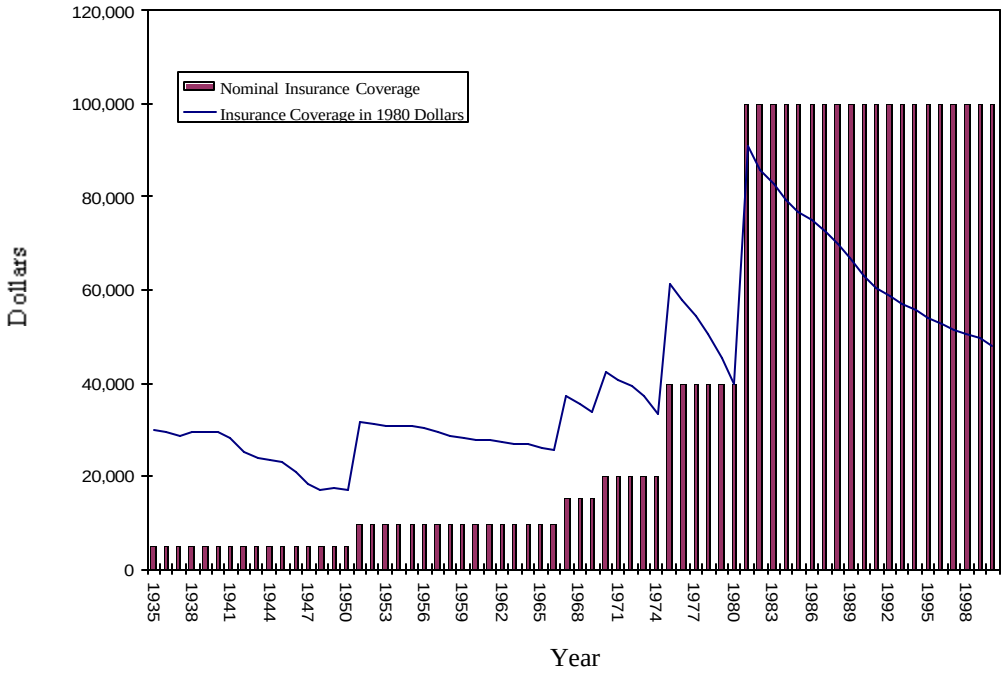
As noted earlier, since 1980 deposit insurance has applied to the first $100,000 of qualifying deposit accounts at insured banks and thrift institutions. Previously, the insurance ceiling had been increased in six steps, from the initial $2,500 per account adopted in 1933 to $100,000 in 1980.[35] The reasons for the increases have varied through time, as have the reasons for the new ceiling selected, but, for the most part, they have been motivated by inflation, which has decreased the constant dollar value of the coverage. For example, the increases in 1950, 1974, and 1980 occurred when the real value of the coverage had declined to near the levels it was before the previous increase in coverage (see Figure 1).

In each instance, the amount of the increase was more than what was necessary to reestablish the previous constant dollar ceilings. Thus, although in 2001 the constant dollar coverage in 1980 dollars was more than 50 percent below the newly increased level in 1980, it was still slightly higher than its level before that increase and higher than at any time before that with the exception of the mid-1970s.

Currently, some 98 percent of all deposit accounts are fully insured and insured deposits represent about 70 percent of total domestic deposits. That is lower than the peak of 78 per-

The longer premiums are not increased to return the reserve ratio to its minimum, the more likely the fund is to go into deficit and the taxpayer again to become liable.

Figure 1
Real Value of Coverage



Source: Federal Deposit Insurance Corporation, *Deposit Insurance Options Paper*, Washington, August 2000, p. 36.

The higher the account coverage, the fewer depositors at risk, and the smaller the amount of deposits at risk, the weaker will be market discipline on insured banks.

cent in 1991, about the same as in 1980, immediately after the increase to $100,000, and higher than at any time before that.

As discussed earlier, the higher the account coverage, the fewer depositors at risk, and the smaller the amount of deposits at risk, the weaker will be market discipline on insured banks. Concern over market discipline has often been a consideration for policymakers in establishing the ceiling. It was the reason that the initial coverage was limited to $2,500, a reasonably small amount even in those days (although it included nearly 97 percent of all bank depositors at national banks).[36] However, concern over market discipline appears to have been of less importance in 1980, when the ceiling was increased by 150 percent from $40,000 to $100,000. This likely reflected a combination of an almost complete lack of concern with market discipline after some 40 years of a heavily regulated environment in which bank failures were few and the overriding fear at the time was continued substantial deposit withdrawals from thrift institutions (and thus the mortgage market), both because of disintermediation caused by below-market ceilings on their deposit rates and because of financial difficulties caused by rapidly rising market interest rates. Concern about the ability of small banks to retain deposits also appears to have partially motivated almost all increases in coverage.

Current arguments for increases in the coverage ceiling center on both the reduced real value of the coverage—as noted, almost back to the 1980 level—and preventing an outflow from smaller to larger banks, which are perceived to be protected by TBTF. Arguments against an increase focus on a number of factors, including the following: that it would lead to a likely reduction in market discipline; that even with the decline in real value, the real value of the ceiling is still higher than it has been through most of FDIC history; that the average deposit balance is only somewhere

near one-tenth of the current ceiling; that a historically relatively large percentage of total domestic deposits is fully insured; that fully guaranteed Treasury securities are readily available to depositors with deposits near the current ceiling; and that many depositors with deposits below the ceiling already use noninsured but highly liquid and low-credit-risk private institutions, such as money market funds. In addition, an increase in the amount of insured deposits (even without an increase in total deposits) would increase the denominator of the 1.25 percent FDIC reserve ratio target and is likely to require an increase in dollar premiums to return the ratio to its target value.[37]

It appears that little aggregate economic welfare would be gained by increasing the existing coverage ceiling and that something may be lost by decreasing the breadth and intensity of market discipline. Both small and large depositors would be relatively unaffected by increasing the existing ceiling. Medium-size depositors, who would be most affected, appear to be aware of both the risk exposures of their banks and the risks of alternative uninsured investment opportunities and thus would not be greatly harmed by maintaining the current ceiling. Smaller banks may be more successful in retaining deposits by emphasizing the barriers to TBTF that exist under the current insurance structure and their own generally higher capital ratios than by reinforcing the perception that TBTF remains as before 1992, which would help to transform perception into reality to their own long-term disadvantage.

Moreover, because banks now effectively pay for all the losses to the FDIC from protecting insured depositors at failed banks, it is uncertain whether small banks as a whole will benefit from an increase in coverage, particularly if risk-based premiums assess them a high rate in part because resolution losses on small banks tend to be relatively larger. In addition, because the potential for any government funding or subsidy to finance such losses has been greatly reduced, if not eliminated altogether, the issue of raising the account coverage is of considerably smaller public policy interest than before. It is largely a matter for the banks to settle how much coverage they like to offer.

Management

Although banks now effectively fund the FDIC, that organization is still totally government managed. The separation of liability for losses from the management of the fund weakens the incentive to reduce losses and minimize premiums charged. The poor behavior of the FDIC and other bank regulators during the U.S. banking crises of the 1980s and early 1990s (and in a number of instances since), when they delayed both the imposition and enforcement of sanctions on financially troubled institutions and the resolution of economically insolvent institutions, resulted in large losses to the insurance fund. The explanation for such poor management is simple: It was not their money at stake. Regulators, who are charged with maintaining bank safety, are often reluctant to draw public attention to bank failures, which may be viewed as a black mark on their records; they are also subject to intense political pressure from various groups and stakeholders that are less concerned about the magnitude of potential losses than about their own welfare. Indeed, some groups may even gain from delayed sanctions and resolution through, say, obtaining loans or employment at troubled institutions that they might not otherwise have obtained. In sum, regulators have often been poor agents for the healthy, premium-paying institutions.

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The solution to this skewed incentive structure is to give the insurees a greater voice in management of the FDIC through, say, electing all the directors who appoint management subject to specified oversight by the federal government or through electing a majority of directors and sharing management of the FDIC with the government.[38] Increasing the role of the insurees in managing the FDIC may also improve the agency's incentives both to charge more market-based insurance premiums and, consistent with the

spirit as well as the letter of FDICIA, to discipline poorly performing banks on a more timely and effective basis, including more timely resolution of insolvencies.

On the other hand, bank control of the FDIC may introduce a number of problems. Because the deposit insurer needs to examine banks and be fully aware of their financial condition for the purposes of both imposing discipline and assessing risk-based premiums, the confidentiality of information obtained from individual banks might be endangered or provided to competitors. As a result, insurees might become reluctant to provide necessary but sensitive information. In addition, banks might divide into coalitions—for example, large vs. small banks, city vs. rural banks—for the purposes of using the FDIC's regulatory authority to promote protectionist and anti-competitive purposes. Such practices may include active discouragement of new bank entry and harsh treatment of those that do succeed in obtaining a charter, overly rapid resolution of troubled banks to reduce the number of competing banks, and the setting of premiums on the basis of anti-competitive or short-term profitability considerations rather than market-mimicking criteria. Nevertheless, increasing the participation of insured banks in the management of the FDIC deserves serious consideration.[39]

Increasing the participation of insured banks in the management of the FDIC deserves serious consideration.

Conclusion

Federal government–sponsored deposit insurance has had a checkered record in the United States. On the positive side, it has almost eliminated depositor runs on banks, which can have particularly adverse effects on financial markets and the economy. On the negative side, by reducing depositor concern about the financial health of their banks and thereby the threat of runs, deposit insurance has encouraged both excessive risk taking by banks and poor behavior by bank regulators in sanctioning troubled institutions and resolving insolvent ones. The net effect has been broad dissatisfaction with the structure of the insurance system. As a result, there have been numerous calls for reform.

In 1991 the Federal Deposit Insurance Corporation Improvement Act made a number of fundamental changes in deposit insurance and smaller changes were introduced later by the Depositor Preference Act in 1993 and the Deposit Insurance Funds Act in 1996. The structure of FDIC insurance now differs significantly from that prior to 1991. Most important, although it is not widely recognized, the deposit insurance system is now nearly totally privately financed, albeit government managed. A designated reserve-to-insured deposit ratio of 1.25 percent effectively must be maintained by the FDIC at all times. If losses from protecting insured depositors in bank failures reduce the ratio below 1.25 percent, premiums on insured banks are required to be raised to recoup the losses within a short period of time. Likewise, any losses to the FDIC from protecting uninsured creditors at insolvent banks to prevent the possibility of systemic risk must be paid for by a special assessment on all banks. Thus, any implicit government backup guarantee would not come into play until all the capital resources of the banking system are exhausted and the premiums cannot be paid. That is highly unlikely to occur in the United States even in severe crises. It did not happen in the 1930s or the 1980s. If the current insurance structure had been in effect in the 1980s, it is unlikely that taxpayers would have been called on to fund the deficit of the Federal Savings and Loan Insurance Corporation to nearly the extent they did.

The FDIC has recently encouraged a reexamination of the current structure of deposit insurance, including both the changes that have been introduced and provisions that were not changed, and Congress has initiated hearings. In particular, the FDIC is most concerned that only a small number of banks—the riskiest banks—currently pay premiums into the fund as the reserve ratio stands above the designated 1.25 percent value and that the account coverage has not been increased from $100,000 since 1980. It would prefer a struc-

ture of ex ante premiums assessed on all insured institutions according to their risk, a reserve ratio that could be varied within limits both to pay for losses from failures and to smooth premiums on banks over their financial cycle so that they are not assessed the highest premiums when they are financially distressed, and a higher maximum insured account limit.

This paper argues as follows:

- To minimize any implicit backup guarantee from the federal government, FDIC losses from protecting both insured and, if the systemic risk exemption is invoked, uninsured depositors should be funded through required rapid assessment increases although possibly with some greater flexibility in the reserve ratio. In short, the new system of rapid ex post settling-up by the banks for all is preferable to ex ante funding without required rapid assessment increases to finance losses beyond the floor reserve ratio.
- Bcause all losses are effectively funded by the insured banks and not the government, issues of account coverage, including TBTF, are not as important a public policy concern as before 1991. Nevertheless, increased account coverage at this time is likely to do more harm than good in terms of enhancing financial stability.
- Efficient risk-scaled insurance premiums are difficult to implement in practice, as banking regulators are ill-equipped to measure individual bank risk accurately. Furthermore, any losses to the FDIC depend not only on the private risk imposed by the banks but also on the regulatory risk imposed by the FDIC itself in resolving insolvencies in an inconsistent and inefficient manner;
- Although many institutions may not pay premiums now, they would if and when losses from failure increased in the future; so the perceived "fairness problem" is not very serious.
- The procyclical nature of the current structure of insurance premiums is consistent with the way markets work and is not entirely undesirable, although some premium smoothing may be warranted.
- Insured banks should be given greater voice in the management of the FDIC.

The current structure of deposit insurance, though in need of some fine-tuning, is vastly superior to that before 1991, which contributed significantly to the onset and the magnitude of the banking crisis of the 1980s. The current structure should not be changed substantially without careful consideration of all the implications, particularly those that deliberately or inadvertently increase the liability of taxpayers for FDIC losses.

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Notes

The author is indebted to Larry Mote of the Office of the Comptroller of the Currency, Robert Bliss of the Federal Reserve Bank of Chicago, Robert Eisenbeis of the Federal Reserve Bank of Atlanta, and Douglas Evanoff of the Federal Reserve Bank of Chicago for helpful comments on an earlier draft; to James McFayden of the FDIC for providing data on premium assessments; and to Veronica Maman and Ivan Bravo of Loyola University for research assistance.

1. Federal Deposit Insurance Corporation, *Deposit Insurance Options Paper*, Washington, August 2000.

2. Federal Deposit Insurance Corporation, *Keeping the Promise: Recommendations for Deposit Insurance Reform*, Washington, April 2001.

3. As of March 2002, there were eight bills introduced in Congress to modify deposit insurance in one way or another. Most deal with increasing the ceiling on insurance coverage in general or only for municipal government deposits.

4. More detailed histories of deposit insurance may be found in Federal Deposit Insurance Corporation, *Annual Report*, 1950, Washington, 1951; and Federal Deposit Insurance Corporation, *A Brief History of Deposit Insurance in the United States*, Washington, September 1998.

5. Indeed, the permanent plan enacted in the Banking Act of 1933, which was intended to replace a temporary emergency plan enacted at

the same time, was itself superseded first in 1934 by an act that extended the temporary plan and then by the Banking Act of 1935 before it even had a chance to go into effect.

6. See George G. Kaufman, "The U.S. Banking Debacle of the 1990s: Overview and Lessons," *Financier*, May 1995, pp. 9–26.

7. See Timothy Curry and Lynn Shibut, "The Cost of the Savings and Loan Crisis: Truth and Consequences," *FDIC Banking Review* 13, no. 2 (2000): 26–35.

8. Because federal government–provided and supervised deposit insurance of some type is currently a political reality in all countries, either explicitly or implicitly, the paper does not consider the pros and cons of removing such insurance in favor of a completely private structure. For the case against mandatory insurance, see, for instance, Joseph Pomykala, "Financial Deregulation," in *The Cato Handbook for Congress*, ed. E. Crane and D. Boaz (Washington: Cato Institute, 2001), pp. 257–70. For an analysis of how a voluntary system works in practice, see Thorsten Beck, "Deposit Insurance as Private Club: The Case of Germany," Working Paper, World Bank, Washington, June 2000.

9. The 1.25 percent designated reserve ratio was chosen apparently because it was the approximate average reserve ratio maintained by the FDIC throughout its history until the 1980s.

10. See George G. Kaufman, "The New Depositor Preference Act," *Managerial Finance* 23, no. 11 (1997): 56–63.

11. Regulators rate banks on each of the five areas on a scale of one to five, with one being the best and five being the worst. A composite rating is then derived from the ratings in the five areas to produce the CAMELs rating.

12. A number of deposit insurance funds in other countries, including those in the United Kingdom and France, are funded by ex post assessments. See Patricia Jackson, "Deposit Protection and Bank Failures in the United Kingdom," *Financial Stability Review*, Autumn 1996, pp. 38–43. See also Asli Demirguc-Kunt and Enrica Detragiache, "Does Deposit Insurance Increase Bank Stability? An Empirical Investigation," Working Paper, World Bank, Washington, April 2000; and Asli Demirguc-Kunt and Harry Huizinga, "Market Discipline and Financial Safety Net Design," Working Paper, World Bank, Washington, April 2000.

13. The original permanent deposit insurance plan enacted by Congress in 1933 and scheduled to go into effect on July 1, 1934, and then postponed until July 1, 1935, also called for unlimited premium assessments on insured banks based on their total deposits. Banker opposition to this unlimited liability and regulatory agency, particularly FDIC, fear that few state non–Federal Reserve member banks, who were not required to be insured, would either not join the insurance system or withdraw from voluntary participation if there was unlimited liability caused Congress to rescind the permanent plan in 1935 before it ever went into effect and replace it with a structure of limited premiums and liability. In 1935, more than half of all insured banks, albeit mostly smaller banks, were voluntarily insured. See Christine M. Bradley, "An Historical Perspective on Deposit Insurance Coverage," *FDIC Banking Review* 13 no. 2 (2000): 1–25; and Bert Ely, "Banks Do Not Receive a Federal Safety Net Subsidy," in *Refuting the Federal Safety Net "Subsidy" Argument* (Washington: Financial Services Roundtable, September 1999).

14. It is believed that a premium rate of 8.3 basis points would have covered all but severe depression losses from the Civil War through 1933 had deposit insurance been in effect. See Carter Golembe, "Reflections on Deposit Insurance Reform," *Golembe Reports* 8 (2000).

15. See Federal Deposit Insurance Corporation Improvement Act, Sec. 302 (c) i.

16. See Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, Third Quarter 2001, p. 19.

17. See Alan Greenspan, "Question and Answer Session Following the Keynote Address," in *The Changing Financial Industry Structure and Regulation* (Chicago: Federal Reserve Bank of Chicago, May 2000); and George G. Kaufman, "Are Some Banks Too Large To Fail? Myth and Reality," *Contemporary Policy Issues*, October 1990, pp. 1–14.

18. Federal Deposit Insurance Corporation Improvement Act, Sec. 141 (G) i.

19. See Frederic S. Mishkin, "Comment on Systemic Risk," in *Research in Financial Services*, ed. George G. Kaufman (Greenwich: JAI Press, 1995), vol. 7, pp. 31–45.

20. See George J. Benston and George G. Kaufman, "FDICIA after Five Years," *Journal of Economic Perspectives*, Summer 1997, pp. 139–158; George J. Benston and George G. Kaufman, "Deposit Insurance Reform and the FDIC Improvement Act: The Experience to Date," in Economic Perspectives (Chicago: Federal Reserve Bank of Chicago, Second Quarter 1998), pp. 2–20; and Laurence H. Meyer, "Controlling the Safety Net," Board of Governors of the Federal Reserve System, May 10, 2001.

21. See Greenspan, "Question and Answer Session."

22. See Alan Greenspan, "Remarks at 37th Annual Conference on Bank Structure and Competition," Board of Governors of the Federal Reserve System, May 10, 2001.

23. Congress established the Savings Association Insurance Fund in 1989 to replace the insolvent Federal Savings and Loan Insurance Corporation and placed it under the FDIC. At the same time, the commercial bank fund was renamed the Bank Insurance Fund. The FDIC administers both funds. There is little disagreement today about whether the funds should be merged or not—they should—and the issue is not considered in this paper. Any disagreement is more on the technical aspects of the actual merger.

24. See Pallavi Gogie, "Homeowners, Brace Yourselves," *Business Week*, September 17, 2001, p. 48.

25. See Benston and Kaufman, "FDICIA after Five Years."

26. See U.S. Shadow Financial Regulatory Committee, "Deposit Insurance Reform Options," Statement no. 165, American Enterprise Institute, December 4, 2000. There is evidence that strong interbank monitoring occurs in the private German deposit insurance system for private banks, which includes only some 300 banks. See Beck, "Deposit Insurance as Private Club."

27. See Demirguc-Kunt and Detragiache, "Does Deposit Insurance Increase Bank Stability?" Demirguc-Kunt and Huizinga, "Market Discipline and Financial Safety Net Design"; and Asli Demirguc-Kunt and Edward J. Kane, "Deposit Insurance around the Globe: Where Does It Work?" Working Paper, World Bank, July 2001.

28. A more detailed critique of measuring bank risk in this way appears in U.S. Shadow Financial Regulatory Committee, "Reforming Bank Capital Regulation," Statement no. 160, Washington, March 2, 2000.

29. To reduce these problems, a number of analysts have recently suggested requiring at least the large insured institutions to issue unsecured subordinated debt that would trade on financial markets at interest rates that incorporate investors' perceptions of the risk of loss. The spread of these rates over those of default-free Treasury securities of like maturity would be useful information for the FDIC to incorporate in its pricing of premiums. See ibid.

30. See Shadow Financial Regulatory Committee, "Deposit Insurance Reform Options."

31. See Laurence H. Meyer, "Federal Deposit Insurance Reform," Board of Governors of the Federal Reserve System, July 26, 2001; and Donald E. Powell, chairman, Federal Deposit Insurance Corporation, Testimony on Deposit Insurance Reform before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services, October 17, 2001.

32. See Rob Blackwell, "In Focus: Suddenly, 'Premiums for All' Not Just Academic," *American Banker*, February 11, 2002, p. 1.

33. Salomon Smith Barney reported that it transferred some $17 billion of customer balances from its money market funds to insured accounts at its affiliated Citibanks in the first quarter of 2001. Merrill Lynch reported a similar transfer of $11 billion to its banks and a transfer of $60 billion over the past year. Although large, these transfers are exceeded by increases in insured deposits of more than $100 billion at community banks in the fourth quarter of 2000. See Rob Blackwell, "Merrill, Solly Put $28 B into Insured Accounts," *American Banker*, April 19, 2001, p 1.

34. Pending bill H.R. 1293, the Deposit Insurance Stabilization Act, would permit the FDIC to assess an additional fee on rapidly growing institutions.

35. Higher limits at times applied to state and local government, IRA, and Keogh accounts. At present, all are subject to the $100,000 ceiling, although demand deposits of municipal governments in banks in their home state at times qualify for an additional $100,000 coverage. See Bradley, "A Historical Perspective on Deposit Insurance Coverage."

36. This ceiling was apparently chosen because it was the maximum amount that could be deposited with the then government-operated postal savings system, which was a competitor to the banks and thus fully guaranteed. See ibid.

37. See Mark J. Flannery, "Increasing Deposit Insurance Coverage," Report prepared for the American Bankers Association, December 2000.

38. The German deposit insurance system for private banks is managed only by the bank owners and has no public supervision. See Beck.

39. These issues are discussed at greater length in George G. Kaufman and Peter J. Wallison, "The New Safety Net," *Regulation*, Summer 2001, pp. 28–35.

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