BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date December 20, 1949

To Governor Eccles

Subject:

From Mr. Morrill

Dear Governor Eccles:

You will find attached a copy of a draft of a report to the Board on the questions of increasing deposit insurance coverage and reducing the assessments. The Board this morning decided to devote a session on Thursday, December 29, 1949 to a review of this memorandum for the purpose of determining what position the Board should take. With this in view, I was asked to bring the memorandum to your attention for the purpose of getting any comments that you might have to make before the meeting. While the whole memorandum is well worth reading, the main points are covered in the first 6-1/2 pages of the attached pamphlet. The rest of the pamphlet is explanatory.

I would greatly appreciate it if you could let Mr. Carpenter know before Thursday, December 29, what you would like to say to the Board about it, as I expect to be away from the office this coming week.

C. M.

Enclosure

File

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date December 20, 1949

To Mr. Eccles

Subject:

From Mr. Sherman

This is a reminder of the understanding at the meeting of the Board this morning that a special meeting of the Board would be held at 10:30 a.m. on Thursday, December 29, 1949, for the purpose of considering and determining the Board's position on the question of deposit insurance coverage and assessments.

In this connection, there is attached a copy of the revised draft of the staff memorandum in which there have been incorporated several of the suggestions made by the Presidents of the Federal Reserve Banks and the Federal Advisory Council. It was understood that between now and December 29 the members of the Board would re-read the memorandum as a background for the discussion at the meeting of the Board.

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Attachment

MEMORANDUM

October 13, 1949

To: Board of Governors

From: Senior Staff

Staff suggestions for deposit insurance reforms.

Submitted herewith is a comprehensive study of the Government's deposit insurance program, prepared by the Banking Section of the Division of Research and Statistics in response to the Board's action, taken on March 11, 1949, requesting such a study. The study was circulated in preliminary draft to members of the Board's senior staff for criticism and comment. The present and final draft is a revision based on the many suggestions received from senior staff members.

A major question to which the study is directed is whether the present benefits of insurance--i.e., level of insurance coverage--can and should be increased at this time. The senior staff concurs in the conclusion reached in the study that the answer is in the affirmative. Staff viewpoints differ on how far public policy should go in raising present insurance coverage. There is a consensus, however, that the Board could properly favor an increase in deposit coverage to at least $10,000 considering the sharp increase in the general price level, the average level of income, and bank deposits since prewar years. The coverage might reasonably be as high as $25,000 in view of these changes and at the same time recognize the conflicting arguments for limited and full (or substantially full) coverage of deposits.

Another major question with which the study is concerned is whether the present assessment burden on banks can safely be modified at this stage. The senior staff also concurs with the conclusion reached that the answer to this question is in the affirmative. Of the several alternatives for effecting such moderation, the senior staff favors the statutory formula suggested by the study which would relate the rate of assessment to average loss experience over the previous ten-year period, and be geared to maintain a maximum reserve fund of about 3 per cent of total deposits, less cash assets and Government securities, of insured banks. This formula would allow the fund to decline in periods of banking difficulty without a sharp rise in assessment rates, leaving the rebuilding of the fund at higher assessment rates to more prosperous periods. A formula along such lines would be reasonably consistent with the one suggested by the American Bankers Association, but would not have the rigidity and pro-cyclical effect of that organization's proposals.

An alternative regarded favorably by some staff members is a discretionary authority for the bank supervisory authorities to vary the assessment rate within prescribed limits according to certain statutory criteria. This alternative raises difficult problems of administrative responsibility and does not seem likely to receive support from the banking community.

A technical revision in the method of calculating the assessment base that has merit and, in the staff's opinion, should be strongly favored by the Board is to make consistent the definitions of deposits for insurance and for reserve and call report purposes. The procedures for calculating the deposit base for each bank could be simplified by using deposits as reported for selected dates instead of the daily average of deposits now used.

The study considers possible changes in the assessment base that effect some reduction in the assessment burden on insured banks. The staff concurs that such methods are a circuitous means of accomplishing the end of a moderation of the assessment burden; generally speaking, they are not favored.

Attachment.

MOVING AVERAGE FORMULA FOR INSURANCE

ASSESSMENT RATE

The Formula

Assessment rate set to yield assessment receipts to FDIC equal to

the average of recorded losses over preceding 10 years.

Provided that:

(1) The assessment rate shall not exceed 1/12 of 1 per cent, or be less than 1/50 of 1 per cent of the assessment base (total deposits).

(2) Except that when the reserve fund of the Corporation is greater than 3 per cent of total deposits, less cash assets and U. S. Government securities, of insured banks, the minimum assessment rate is 1/100 of 1 per cent.

The formula is geared to maintaining the reserve fund over the long run at about 3 per cent of the total volume of deposits, less cash assets and U. S. Government securities, of insured banks.

Illustrative Computation for 1950

Assessment rate set to yield $750,000, the estimated average of losses 1940-1949.

Since the insurance reserve fund is not at present larger than 3 per cent of total deposits, less cash assets and U. S. Government securities, of insured banks, (1.2 billion dollars as compared with about 50 billion dollars) the minimum rate of 1/50 of 1 per cent would apply and the Corporation's assessment receipts would be $30 million.

This sum plus the excess of investment income over Corporation expenses would be applied towards building up the insurance reserve fund to the 3 per cent relationship with total deposits, less cash assets and U. S. Government securities, of insured banks.

Confidential

October 13, 1949

ASSESSMENTS AND COVERAGE FOR DEPOSIT INSURANCE

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CONFIDENTIAL

ASSESSMENTS AND COVERAGE FOR DEPOSIT INSURANCE

Summary of Conclusions

After 15 years of operations, the FDIC has accumulated from assessment receipts and other earnings an insurance fund of more than one billion dollars. With this huge reserve fund increasing rapidly (and considering the drawing fund of 3 billion dollars which the Corporation has with the Treasury), it is appropriate to reexamine the whole matter of public policy with regard to deposit insurance.

The basic question is whether, for all practical purposes, the existing reserve fund for deposit insurance is now large enough. The answer indicated in this study is that the fund is now approaching such a size.

Three further questions therefore need consideration: first, whether the present benefits of the insurance should be increased; secondly, should a revised assessment formula be established that would moderate the assessment burden on insured banks; and thirdly, could both of these steps be taken at this time. The conclusions of this study with respect to these questions are in the affirmative and are set forth below:

Increase in deposit coverage. At present deposit insurance is extended on all deposit accounts but with a maximum coverage for individual accounts of $5,000. With this coverage, about half of the total dollar amount of bank deposits are insured; in small banks where the accounts tend to be small, the proportion of deposits insured is relatively high; in large banks, where most of the large deposits are held, the proportion of deposits insured is relatively small.

The principal objection to an extension of deposit insurance coverage is based on the belief that the watchfulness of large depositors helps to promote sound banking practices. It is felt by some observers that any substantial increase in coverage, especially to full deposit coverage, would result in an inevitable encroachment by supervisory authorities on bank management responsibilities.

On the other hand, the weight of argument is in favor of some increase in the coverage of deposit insurance. Added coverage may help in achieving more fully both of the major objectives of deposit insurance--protection of the individual depositor and promotion of stability in the economy as a whole through protection of the money supply and maintenance of public confidence in banks. The sharp increase in the general price level, average level of incomes, and bank deposits since prewar has made the existing coverage less adequate than it was 15 years ago. Expanded coverage would also prove of advantage to smaller banks in getting and retaining larger deposit accounts and further would correct in part the unevenness of the insurance burden relative to statutory coverage as it is presently distributed among large and small banks.

As the FDIC currently functions, great emphasis is placed on keeping "trouble" banks in active operation through reorganization and mergers rather than allowing them to be closed and paying off promptly just the insured depositors. This method of operation has been found to be cheaper to the FDIC and has the great advantage of protecting communities against the depressing effects of bank failures. If the present fund is adequate to support an operating procedure of this kind at current levels of insurance coverage, there is no reason for thinking that it would be less adequate at higher levels of coverage.

Moderation of the assessment burden. If the deposit insurance reserve is not to be increased indefinitely without regard for probable adequacy, the present scheme of insurance assessment must be revised at an early stage. Some reduction in the assessment burden could be effected by permitting deductions from the assessment base for vault cash and reserves against deposits, and perhaps for other riskless assets such as short-term Government securities. A combination of such allowances, at the present assessment rate, would reduce premium payments about 40 billion dollars. This approach, however, to the problem of moderating the assessment burden on insured banks is a circuitous way of accomplishing what might better be done directly.

The burden on banks of the insurance assessment could be moderated in direct fashion by lowering, at least for extended periods, the assessment rate. One proposal, supported by banker groups, would provide for the establishment of a statutory formula for an automatic scale of assessments, based on the previous year's losses, to range from a nominal assessment up to 1/12 of 1 per cent. This plan, however, would have a pro-cyclical impact on banks in that it would provide for raising rates sharply in periods of banking difficulties and dropping rates rapidly as conditions became favorable.

It would be preferable to moderate the assessment burden through some alternative formula which would minimize the pro-cyclical effect by providing for an automatically varied premium rate under a statutory formula allowing the fund to decline in periods of banking difficulty without a sharp rise in assessment rates, and leaving the rebuilding of the fund to a more gradual process. The present level of the fund would be maintained over the long run, but the formula would not place banks under additional strain in periods of banking difficulties by raising premium rates abruptly. A formula along these lines would be entirely feasible. For this purpose, the rate of assessment could be related to average loss experience over the previous 10-year period. Either the reserves of more than 1,100 million dollars that have now been accumulated could be considered a maximum, or provision might be made for tying the maximum size of the fund to the volume of deposits to allow automatically for any future substantial growth in deposits.

Still another way of making provision for lowering the present assessment burden would be to give to the Corporation authority, after consultation with other agencies such as the Federal Reserve Board and the Secretary of the Treasury, to vary the assessment rate within statutory limits. It is doubtful, however, whether such an arrangement would offer any important advantages as against the formula proposed.

Whatever action may be taken to moderate the assessments burden on insured banks, there is a need for technical changes to simplify the procedures for computation of the assessment base such as use of deposits as of selected dates instead of the daily average of deposits, and to make consistent the definitions of terms used in determining the volume of deposits for insurance assessment purposes and for reserve and call report purposes.

Timing of above reforms. The above reforms in deposit insurance program--an increase in coverage and provision for easing the assessment burden on banks--are sometimes considered as mutually exclusive alternatives. The conclusion of this study, however, is that both major steps could be taken concurrently, and that early legislative action for this purpose would be appropriate.

ASSESSMENTS AND COVERAGE FOR DEPOSIT INSURANCE

Since the establishment of a national system of deposit insurance, there have been numerous suggestions for its amendment, some reaching the status of bills before the Congress. In general these proposals fall into two groups: those favoring an increase in the amount of deposits insured, and those favoring decreases in the base or rate of assessment. Some proposals incorporate elements of both groups--larger deposit coverage with a reduction in the assessment rate and/or base.

Renewed interest in the whole subject of deposit insurance has been stimulated by the size of the insurance fund and the rate at which it has been increasing in recent years. It has been possible for the Federal Deposit Insurance Corporation to build the insurance fund to more than 1,100 million dollars, while repaying the 289 million dollars contribution to capital made originally by the Treasury and the Federal Reserve Banks. Currently (at present deposit levels) assessments are adding more than 100 million dollars a year to the fund. Interest from invested funds and other income more than pays for operational costs and current losses. In 1947, 38 million dollars was added to the fund from this source alone.

The powers granted to the Corporation permit loans on and purchase of assets for the purpose of amalgamating distressed banks with stronger banks. These powers have provided the Corporation with a very effective alternate procedure for dealing with banks in difficulty. This alternate procedure has resulted in much smaller losses than would have come from outright liquidation proceedings and consequently required less recourse to the insurance funds.

Interest of the Federal Reserve System in Deposit Insurance

As the agent primarily responsible for monetary stability, the Federal Reserve System is vitally interested in the functioning of an insurance program which has as its primary objective the removal of one of the prime causes of monetary instability. Deposit insurance is potentially one of the more important reforms directed to greater monetary stability by the banking legislation of the 1930's. In essence, these banking reforms aimed at preventing a repetition of the wholesale destruction of the money supply that occurred between 1929-33. To that end the Board of Governors among other things was authorized to vary reserve requirements within certain limits, and to prescribe margin requirements on listed stocks, the Federal Reserve Banks were authorized to grant credit on any sound bank asset, and provisions for the issuance of Federal Reserve notes were liberalized. It will be noted, however, that these changes in System powers, while providing the necessary elasticity in the banking system to cope with adverse conditions, deal only indirectly with one of the causal factors which in the past have greatly aggravated cyclical developments, namely panic conditions among depositors. Deposit insurance is the instrument set up to prevent that considerable part of a liquidating process which is due to the panic withdrawal of funds by the general public.

System interest in possible changes in deposit insurance arises also from another feature of the deposit insurance plan. Under the existing arrangement, member banks pay a disproportionate share of the insurance cost. The assessment base is total deposits less cash items in process of collection and each bank pays roughly in proportion to the amount of its total deposits, regardless of how much of these deposits are covered by insurance. Since insurance coverage is limited to amounts of $5,000 or less and the large accounts are in larger banks, it is generally true that the larger the bank the smaller the proportion of its deposits covered. Member banks have about 85 per cent of the total assessment on commercial banks for deposit insurance. Yet member banks tend to run larger in size than nonmember banks with the result that only about 37 per cent of member bank deposits are covered as compared with about 72 per cent for nonmember insured banks.

This study explores the three basic elements of deposit insurance--coverage of insurance, assessment base, and rate of assessment--in order to make available pertinent information and consideration that should be taken into account in working out basic changes in the present arrangements.

The Need for Deposit Insurance

The economic importance of deposit insurance stems from the fact that liabilities of banks are essentially demand liabilities to the public and that these liabilities constitute the country's principal means of payment, i.e., check money. All too often in our history panic shifting of funds from one bank to another and eventually panic withdrawals of funds by the public from the banking system have forced the banks to liquidate assets at most unfavorable times. Distress calling of loans and forced liquidation of securities by banks and bank borrowers have led to widespread bank suspensions and to a drastic destruction of the principal part of the money supply--bank deposits.

Deposit insurance is useful in correcting these unfortunate periodic experiences from two major closely related viewpoints--that of the individual and that of the nation. From the individuals' standpoint, deposit insurance provides protection, within limits, against the banking hazards of deposit ownership. But the major virtue of deposit insurance is for the nation as a whole. By assuring the public, individuals and businesses alike, that their cash in the form of bank deposits is insured up to a prescribed maximum, a major cause of instability in the nation's money supply is removed. Preservation of public confidence in the banks makes for stability in the level of bank deposits and for stability in the economy as a whole.

Background of Present Law

Federal insurance of bank deposits grew out of the widespread bank failures of the 1920's and early 1930's. The Federal Deposit Insurance Corporation was established by the Banking Act of 1933, with amendments by the Banking Act of 1935.

There was little experience and information on which to base a scheme to insure bank depositors against loss. Rates of assessment, the assessment base, and insurance coverage all had to be determined more by current judgment than on the basis of actuarial experience. In fact, such experience as was available---various state deposit insurance funds--was so unfortunate that had it been used, insurance rates might well have been prohibitive.

In recommending the present rates and base, the FDIC had some data on annual rates of loss to depositors for the period beginning 1863. As eventually revised, covering the period 1863-1940, these data show that annual losses to depositors from bank suspensions ranged from less than 0.01 per cent of all deposits in operating banks to slightly more than 2 per cent. It is estimated that about two-thirds of the total losses to depositors in closed banks over the 76 years occurred in 12 particular years, 1873, 1875-78, 1884, 1891, 1893, and 1930-33. About half of the total loss was in the 1930-33 period.

Present assessment rate

The statutory assessment rate was set as follows: Total losses to depositors in closed or suspended commercial banks for the period 1863-1933 were estimated at about 2.7 billion dollars, excluding assessments of about 500 million dollars from bank stockholders (actual loss about 2.2 billion dollars), or an average annual rate of 1/5 of 1 per cent of deposits in operating banks. Deposit balances not exceeding $5,000 were estimated to have accounted for approximately three-fourths of these losses. The annual average rate of assessment necessary to have covered losses on these deposit balances would have been about 1/7 of 1 per cent of total deposits (less cash collection items) in operating banks. It was assumed that banking reforms would eliminate repetition of the so-called crisis years mentioned earlier in which losses to depositors were heavy. Losses in the non-crisis years were 1/12 of 1 per cent for all deposits in active banks. The rate then is the equivalent of closed bank losses against all deposits in the non-crisis years.

Present assessment base

The statutory assessment base selected for Federal insurance of deposits was total deposits plus trust funds less cash items in the process of collection. This base was selected despite the fact that many banks would have essentially full coverage out of the common fund whereas others, mainly the larger banks, a large proportion of whose deposits would represent large accounts, would have a considerably smaller proportion of their deposits insured. It was thought that the indirect benefits from deposit insurance for larger banks fully justified their more than proportionate assessment contribution.

Limitation of insurance to deposits of $5,000 and under

The limitation of Federal deposit insurance to bank deposits of $5,000 and under was frankly designed to insure "the mass of depositors with small accounts". With this limitation on coverage, about 98 per cent of depositors were fully insured. As a result of the increase in the average size of deposits in recent years, the proportion has fallen slightly to about 96 per cent at present.

Merger vs. receivership procedure

There are two procedures by which the Corporation may protect the deposit holders of insured banks in financial difficulty. One is an advance or purchase of certain assets by the Corporation to facilitate assumption of the deposit liabilities of a weak or insolvent bank by another bank in the same or nearby community. The other is to act as receiver for an insolvent bank, paying off insured deposits. The merger method has been much more widely used in recent years. This method is clearly superior on several counts: ordinary business has not been disrupted by an interruption of banking services; all depositors have been protected; depositor losses to be met by the Corporation have been less severe; and undesirable repercussions on neighboring banks and communities have been held to a minimum.

The Record - 1934-47

Bank suspensions as well as bank deposit losses have been small since Federal insurance of deposits was established. Over the period of more than 13 years, 1934-47, only 404 banks have required assistance. As is shown in Table 1, 245 were placed in receivership and 159 were merged with other banks. Losses to the Corporation in these operations were about 26 million dollars. Actual losses to depositors were less than 2 million dollars for the entire period.

Precisely how much influence deposit insurance has had in this excellent record and how much must be credited to other factors cannot be determined. The entire period of the Corporation's existence except for a part of the years 1937-38 was one of rapidly expanding bank credit, generally rising prices, and expanding business activity. The violent bank upheaval of the early 1930's undoubtedly removed from business most banks not structurally sound or economically necessary, resulted in a drastic housecleaning of many banks which survived, and provided a good deal of hard-won experience for individual bankers. Bank supervision has also improved greatly as a result of the experience in the 1930's. Financial developments, too, particularly the enormous and continuous growth of the public debt over the period to 1946 and the stabilization of the Government security market by the Federal Reserve System have permitted banks to acquire a larger proportion of liquid assets than was the case in earlier years.

Is the Present Insurance Fund Large Enough?

No one can say exactly what the size of the FDIC surplus fund should be if it is to be fully adequate to meet any contingency. It is not feasible to apply rigorous actuarial principles to bank deposit insurance to determine precisely the size of the insurance reserve fund that is needed. Historically losses to depositors through bank closings have been concentrated in particular periods of economic upheaval. These losses could not have been forecast either as to timing or amount. On the basis of the generally recognized principle that most bank assets are sound, assuming integrity of management, losses to depositors or to an insurance fund should be low providing there is time and opportunity to liquidate the bank assets in an orderly fashion. Under such conditions, an insurance fund of the present size should be more than adequate to take care of ultimate losses.

When public loss of confidence in banks becomes a major factor, however, a larger fund is needed in order to pay off depositors and hold assets until conditions are proper for their liquidation, and for this reason the FDIC now has a drawing fund available from the Treasury of 3 billion dollars and authority to issue debentures to the public and borrow from the R.F.C. If confidence is fully undermined, then no reasonable fund would be large enough to meet liquidation problems arising from panic withdrawals of deposits. But provision for ultimate liquidity of deposits is basically not properly the task of an insurance fund; it is the responsibility of the central bank--i.e., the Federal Reserve System. Under the legislation of the 'thirties, the System is in a greatly strengthened position to discharge that task.

Table 1

Amount of Deposits and Losses in Insured Banks
Placed in Receivership or Merged with the
Financial Aid of the Corporation, 1934-1947

Item	Total	Banks placed in receivership	Banks merged with financial aid of FDIC
Number of banks	404	245	159
Amount of deposits	$512,223,000	$109,603,000	$402,620,000
Estimated loss by depositors	1,865,000	1,865,000	--
Estimated loss to FDIC	26,014,000	14,619,000	11,395,000

Source -- Annual Report of Federal Deposit Insurance Corporation for 1947, p. 14.

At present the insurance fund is very large and is growing rapidly. At the end of 1948 it was about 1,100 million dollars, an amount approximately equal to the total reported losses of all depositors in the 1930-33 period. Assessments paid by all insured banks are currently about 120 million dollars a year, as is shown in Table 2. Of particular interest is the very large current income from investments. Almost a quarter of a billion dollars has been added to the insurance fund from this source. This sum is almost three times the total expenses of the Corporation since its beginning, and almost eight times the deposit insurance losses and expenditures since 1935. Moreover, while the Corporation's expenses have tended to remain relatively constant, income from investments has tended to increase at a rapid rate. The investment income, of course, is in addition to assessments.

The fund was set up for paying off ultimate losses of bank deposits to depositors in amounts of $5,000 or less. Actually the Corporation has two functions and uses the fund in both. First, it is a liquidating or merger agency and secondly, it is the insurance agency which absorbs losses arising out of its liquidating activity. As a liquidating agency, it acts as a receiver, pays off insured depositors as fast as claims can be proved, and attempts to realize on assets of liquidated banks. It is, however, only the difference between the realized value of the assets and the amount paid to meet depositors' claims that needs to be absorbed in its insurance function.

The liquidating function requires the availability to the FDIC of a large amount of money. Bank assets cannot be liquidated overnight; indeed, public policy might and probably would require that such assets should be held for gradual liquidation, particularly in the event of wide-scale suspensions. It was to meet this need that the FDIC was given a 3 billion dollar drawing fund at the United States Treasury and authority to issue debentures to the public and to borrow from the R.F.C. On the other hand, the size of the fund needed for the insurance function --and this is the fund that should be provided out of assessments and investment income--is related only to the losses (over and above those covered by bank capital) that would be sustained in the final liquidation of assets.

Those who believe that the insurance fund is not now large enough have called attention principally to the decline in the ratio of bank capital to bank assets, to a recent increase in sub-standard assets, and to the danger of rising losses from defalcation by bank employees. The decline in the ratio of bank capital to bank assets has been substantial. During the 'twenties and in the middle 'thirties, member bank capital averaged between 11 and 14 per cent of total member bank assets. After 1938, and particularly during the early war years (1939-1943) this ratio declined sharply to about 6 per cent, and since 1944 has risen slightly to 7 per cent as of April 1949. Most of the asset expansion since 1938, however, has been due to larger bank holdings of U. S. Government securities which are free of credit risk. The ratio for member

Table 2

Income and Expenses of the Federal Deposit Insurance Corporation Since Beginning Operations

(In millions of dollars)

Year	Income			Expenses			Net income added to surplus
	Total	Deposit insurance assessments	Investment and other income	Total	Deposit insurance losses and expenses	Administrative expenses	
1933-1948	$1,148.7	$904.3	$244.4	$82.8	$25.9	$57.0	$1,065.9
1948	146.8	119.2	27.6	5.7	.4	5.3	141.2
1947	157.7	114.4	43.3	5.7	.2	5.5	152.0
1946	130.9	107.1	23.8	4.6	.1	4.5	126.3
1945	121.2	93.7	27.5	4.0	.1	3.9	117.2
1944	99.5	80.9	18.6	3.9	.1	3.8	95.6
1943	86.7	70.0	16.7	4.5	.2	4.3	82.2
1942	69.4	56.5	12.9	4.4	.5	3.9	65.0
1941	62.0	51.4	10.6	4.4	.7	3.7	57.6
1940	55.9	46.2	9.7	8.5	4.9	3.6	47.4
1939	51.2	40.7	10.5	11.7	8.3	3.4	39.5
1938	47.8	38.3	9.5	5.5	2.5	3.0	42.3
1937	48.1	38.8	9.3	6.2	3.5	2.7	41.9
1936	43.8	35.6	8.2	5.1	2.6	2.5	38.7
1935	20.7	11.5	9.2	5.5	2.8	2.7	15.2
1933-34	7.0	--	7.0	4.4	.3	4.1	2.6

Source -- Annual Report of the Federal Deposit Insurance Corporation for 1947, p. 28 and FDIC Report to Insured Banks, December 31, 1948.

banks of capital to "risk assets" is currently considerably higher than in the 'twenties, although below the level of the 'thirties and war years, both periods when bank lending operations were abnormally curtailed. In 1947 and 1948, banks added to their capital at about the same rate as they increased their "risk assets," and so the ratio of capital to "risk assets" has remained about unchanged.

Available statistical evidence does not indicate that any significant deterioration in the quality of bank assets has occurred in recent years. According to an FDIC report to insured banks, dated February 23, 1949, there has been a steady improvement in the quality of bank assets over the past 15 years. In 1948 the volume of sub-standard assets was only about 1/2 of 1 per cent of total assets, slightly more than two years ago but very much less than in 1939, when they comprised 5 per cent of total bank assets. Further evidence of a significant quality improvement in bank assets since 1933 is given in Table 3. United States Government securities now represent about 40 per cent of total assets of insured banks as compared with 8 per cent in 1929, and 28 per cent in 1939. This is true despite a record breaking increase in loans in the past several years. Loans as a whole have decreased in relative importance from about 55 per cent in 1929 to about 28 per cent in 1948 of bank assets.

What the table cannot show is improvement in risk quality of the loan portfolio. For example, although real-estate loans represent almost identical proportions of total assets in 1948 and in 1929, provisions for amortization plus the fact that much of the real-estate loan portfolio is guaranteed by Federal agencies put these loans in a much improved risk category. Moreover, improved risk quality applies in varying degrees to other categories of the loan portfolio.

Defalcations were an important or controlling factor in the difficulties of 5 (and perhaps 6) of the total of 7 banks whose depositors the Corporation was called upon to protect in 1945, 1946, and 1947. The problems that arose were related to the fact that fidelity protection was not in keeping with the risks and responsibilities involved. While defalcations have been an important cause with the very few banks that have experienced difficulties recently, they can scarcely be considered of large enough general importance to place the present deposit insurance fund in jeopardy. In any event, the remedy is greater bank fidelity coverage, not a larger deposit insurance fund.

Can the assessment rate safely be cut?

In view of the size of the insurance fund at the present time, the answer to this question is believed to be in the affirmative. The question of what kind of a formula might be used to effect such a cut is considered in following sections.

Table 3

Assets of Insured Banks for Selected Years

Percentage Distribution

	1920 1/	1929 1/	1933 1/	1939	1947	1948
Total assets	100.0	100.0	100.0	100.0	100.0	100.0
Loans	58.1	54.4	37.9	26.7	24.6	27.6
For purchasing securities	14.7	21.1	13.6	2.6	1.3	1.5
Real estate	2.8	6.6	7.0	6.6	6.1	6.7
Business				9.3	11.8	12.4
Agricultural	40.6	26.7	17.3	1.7	1.0	1.8
Other				6.5	4.4	5.2
Investments	17.9	20.3	36.7	35.5	50.2	46.2
U. S. Government securities	8.4	8.0	21.5	24.7	44.5	40.3
Other securities	9.5	12.3	15.2	10.8	5.7	5.9
Cash assets	18.6	19.0	19.1	34.7	24.2	25.0
Reserves with Federal Reserve Banks	5.5	4.9	7.9	18.4	11.7	13.4
Cash in vault	1.8	1.2	1.4	1.7	1.4	1.3
Balance with other banks	5.4	4.8	6.5	11.6	6.4	5.9
Cash items in process of collection	5.9	8.1	3.3	3.0	4.7	4.4
Other assets	5.4	6.3	6.3	3.1	1.0	1.2

1/ Percentages refer to member bank data only.

Can the insurance coverage be increased?

Some discussions of the status of deposit insurance have been predicated on the assumption that either the assessment might be cut or the coverage of deposit insurance could be increased. These two courses of action, however, are not necessarily mutually exclusive. In a following section it is suggested that extension of the coverage of deposit insurance might strengthen rather than weaken the adequacy of the present fund by increasing public confidence in banks. Further, it is not true as a practical matter that the insurance liabilities of the FDIC would be much if any increased by an increase in coverage, say to $10,000 or even to $25,000. The Corporation now in fact tends to protect all deposits through its merger procedure described in a preceding section.

Proposals Relating to Insurance Coverage

With respect to deposit insurance coverage, three types of proposals have been made. First, there are those who hold that the present coverage is adequate and that there should be no change. Secondly, it has been suggested that all deposits should be insured. Thirdly, bills now pending in Congress would double or triple the coverage of deposit insurance. The advantages and disadvantages of these alternatives are discussed below.

No change in coverage

Arguments for no change in deposit insurance coverage generally fall into one of the following three broad categories:

1. The fund is not large enough to meet the potential liabilities arising out of increased coverage.

2. In an independent unit banking system such as ours, it would not be advisable to increase insurance coverage because the policing influence that large depositors exert for the promotion of sound banking practices would be removed and the role of the bank supervisory authorities would be correspondingly expanded.

3. The banking legislation of the 'thirties corrected the deficiencies in the banking system which gave rise to large deposit losses and depositor panic and in consequence no insurance at all is really needed. Thus, no increase in insurance coverage is required.

The question whether the fund is large enough now to support increased coverage was discussed in a previous section, with the answer in the affirmative.

The second objection to a change in coverage of deposit insurance is in part based on the feeling that such extension would result in placing a "premium on bad banking". That is to say, if full deposit insurance coverage were in effect, it would tend to lift the influence that watchful, large depositors may have over the loan and investment and other policies of bankers. Even if deposit insurance were increased to some amount greater than $5,000 but less than full coverage, a smaller group of individuals than now would be concerned with the safety of their deposits and consequently with the solvency of their banks.

It is difficult to evaluate in specific terms the extent of this kind of influence. Undoubtedly, bankers are restrained, in many cases, from going heavily into certain types of credit in part by the knowledge that some large depositors are following closely the bank's lending and investing policies and may withdraw their funds if disturbed by a movement of the bank into more risky assets. "Conservative banking", under full or substantially increased coverage might no longer be a competitive asset in competition among banks for accounts of large depositors. Competition might rather be intensified in the service fields. It is conceivable that service competition might prove so costly as to influence banks into much riskier credit policies. With a significant expansion in deposit coverage it is therefore argued that the scale of bank supervision would need to be materially enlarged.

Lastly, extension of deposit insurance is sometimes opposed on the grounds that it is not needed because the banking reforms during and since the mid-1930's, legislative and otherwise, have largely corrected weaknesses in the banking system which engendered depositor loss and depositor panic in the past. Two fundamental reforms in banking practice illustrate specifically lessons learned from the experiences in the last depression which have been used to strengthen the banking system against future difficulties. An agreement between bank supervisory agencies in 1938 represents a change in the concept of appraising bank assets from a basis of liquidating value to a going concern basis of value. For example, high-grade bonds are valued at the lower of book or amortized cost and loans are classified only on the basis of some question in regard to payment. Under this arrangement bank supervision should help to prevent forced liquidation of assets rather than contribute to such liquidation. A second major improvement in banking practice has been the growing tendency under the prodding of supervisory authorities in establishment of adequate reserves against losses. This trend was greatly stimulated by the recent ruling of the Bureau of Internal Revenue (Mimeograph 6209) under which banks are permitted to establish such reserves out of income for tax purposes. The authority given to the Federal Reserve to lend on any sound bank asset is also cited as a measure that vastly increases the capacity of the banking system to meet demands for funds made on it. It is one point of view that because of these banking reforms deposit insurance is no longer needed. However, the existing insurance plan is generally recognized as being a part of the warp and woof of our present day banking and elimination is not usually recommended by those holding this view. But neither is expansion considered necessary or desirable.1/

Full deposit insurance coverage

The case for full deposit insurance coverage rests basically on the thesis that the primary function of deposit insurance is to preserve stability in the money supply and thus to contribute to general economic stability, and that the lessons of past financial crises show that extension of insurance to cover all deposits is essential to the full accomplishment of those objectives. With respect to this thesis, the following points are made, which are developed in subsequent paragraphs:

1. More than half of the dollar amount of all individual and business depositors are in noninsured accounts. Large rather than small depositors historically have exerted the main pressure on banks' liquidity positions.

2. Many deposits of more than $5,000 are small business balances, loss of which would result in economic distress to individuals and the community.

3. Substantially full deposit coverage already is provided in actual practice, although the stabilizing value of this is not taken full advantage of.

4. Although reforms in banking and in the economy as a whole, supplemented by experience joined in the last depression, reduce the probability of another prolonged major depression, and the quality of bank assets and banking practices in general appear to be much better than in any previous period of modern banking experience, full coverage of deposit insurance is a needed extension in the banking field to round out the necessary precautionary measures.

Subsidiary arguments for full deposit insurance coverage are made on grounds of equity as among large and small banks and as among large and small depositors.

Federal Reserve surveys of ownership of demand deposits indicate that about two-thirds of demand deposits held by businesses and individuals are in balances of $10,000 or more. More than half are in

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1/ A somewhat different interpretation of the inter-relationship between deposit insurance and the banking reforms of the 1930's is given in the following section.

balances of $25,000 or more. Unfortunately, there are no current estimates of balances of $5,000 or less but it seems probable that as much as 75 per cent of all private demand deposits are in accounts in excess of $5,000. Reinforcing this evidence that the bulk of demand deposits are in the large accounts is the FDIC's most recent (1945) survey. According to this survey only 28.7 billion dollars of the 71.8 billion dollars (about 40 per cent) of demand deposits were insured as compared with 25.2 billion dollars of 28.1 billion (about 90 per cent) of time and savings deposits.

If the contention that lack of confidence in periods of economic adversity induces extensive withdrawals of funds and forced liquidation of assets with consequent destructions of bank deposits is valid, then lack of confidence of large depositors could bring about deposit declines of sufficient magnitude to force widespread liquidation of bank assets even if insured depositors held their funds in banks intact. In the 1930-33 recession, according to the findings of a study by the staff of the Board of Governors of the Federal Reserve System, deposit withdrawals by large rather than small depositors appeared to have exerted the main pressure on banks' liquidity positions.

The study covered a large sample of banks with deposits of from 1 to 40 million dollars (about half of the total amount of deposits in closed banks in this period were in banks of such size). It was found that a presuspension decrease in deposits of 70 per cent took place in the balances of demand deposit accounts of $100,000 and over. Although demand accounts of $25,000 and over accounted for only 28 per cent of total demand accounts on the date from which deposit losses were measured, reductions in the balances of accounts of this size accounted for 43 per cent of the total reduction in demand accounts.

It was further observed that the magnitude of the percentage decrease in balances tended to decline successively with each smaller-size deposit class. Reducations in the balances at the lower limit--accounts less than $500--were about 6 per cent.

Finally, the most important factor in explaining differences in the instability of deposit balances in times of stress was found to be the size of account. Other factors, it appeared, such as type of deposit (demand or time), residence of holder (local or non-local), or type of holder (business or personal), seemed to be of comparatively minor importance.

One of the arguments for not moving to full deposit insurance coverage given in a previous section is that such a step would remove the influence which uninsured depositors may now have in enforcing good banking practices. On the other hand, it may be pointed out that the restraint exercised by large depositors is not the only factor tending to enforce good banking practices. Apart from those restraints from the law and bank supervision, bank stockholders, especially large stockholders, whose equity in the bank is in the front line to meet losses under full, partial, or no deposit coverage, can be expected to exercise some vigilance over their investments. In both instances, however, it is possible that both depositor and stockholder influence may be relatively weak in a period of boom activity when bank credit is expanding rapidly, and relatively strong (although not necessarily favorable when the same person is a large borrower) in periods of downturn when the outlook is unfavorable and bankers are already on guard against anything but the soundest of ventures. Indeed the strengthening of such influence at the peak and during the downturn of the cycle while "good business" for those concerned for the individual bank has had harmful effects on the economy as a whole.

In summary, the contention is that the usefulness of deposit insurance both in maintaining confidence and in maintaining the quantity of the circulating medium may be significantly limited by the present restricted coverage. In other words, while there may be serious risks of encouraging widespread loose banking by relieving the banks of a large part of their concern over the stability of deposits, there are also serious risks for the banking system in leaving the large depositor as the source of main liquidation pressure in times of great financial strain. It may be true that the burdens of bank supervisory agencies would increase significantly with a rise to full deposit coverage. Some would say that the supervisory role would need to expand so much that it would tend to encroach significantly on the field of management.

Another argument that is advanced for the extension of deposit insurance is that over the period of its existence substantially full coverage of all depositors has in fact been provided without, however, the effects of such coverage being widely understood and appreciated. Since its inauguration the Corporation has either acted as receiver for, or caused to be merged with other banks, 404 banks with total deposits of 512 million dollars. Losses on uninsured deposits included in this amount have totaled less than 2 million dollars. This means that liquidation of assets of these banks by the Corporation either through the receivership route or by merger has resulted in practically full coverage of deposits irrespective of size.

It may be noted that this experience probably does not cover adequately the larger banks of the country. On that point, however, it is extremely unlikely that the large banks holding the bulk of large deposits would be permitted to close in view of the drastic experience of the mid-1930's. In effect then, large depositors in these banks enjoy 100 per cent coverage without the economy gaining the stabilizing effect which would result from official recognition of that fact.

Still a third argument is that small business needs the protection of full deposit coverage. It is quite probable that the accounts of many small businesses run over $5,000 and particularly so after the significant increase in the general price level. The Federal Reserve survey of demand deposits shows that over 52 per cent of noncorporate, i.e., small business, accounts are in the $10,000 and under class. Losses in this type of deposit might result in even greater economic distress to the community through unemployment, etc., than would result from loss of deposits to individual small-deposit holders. In addition, small business failures involve a great social loss to the nation.

Another case for extending the deposit coverage has been made by arguing that such extension is a desirable complement to the banking and monetary reforms of the mid-1930's. Legislative reforms were made to deal with the shiftability (liquidity) of bank assets, of which liberalized provisions for extension of Federal Reserve Bank credit through lending or open market operations and for the issue of currency are the most pertinent. Bank supervisory practices have been modified and strengthened in a way that should remove some unstabilizing factors that were important in past periods of financial crisis. These positive actions provide elasticity in the credit structure and give some assurance that the public may hold its cash balance either in deposits or in currency with equal assurance as to its availability. Increased coverage of deposits by insurance is said to be needed to put this particular banking reform on a par with these other measures for financial stability.

The matter of equity as among large and small banks is also advanced as a subsidiary argument for extending insurance coverage to all deposits. Banks holding large deposit accounts pay full assessment on these accounts whereas only a small fraction of the funds are insured. On the other hand, those banks having primarily small accounts are insured practically up to the total volume of deposits on which they are paying assessment. For example, member banks, which tend to have most of the large accounts, hold about 85 per cent of commercial bank deposits and pay about 85 per cent of the total assessment paid by commercial banks for deposit insurance. But only 37 per cent of member bank deposits are covered by insurance. Nonmember insured commercial banks, holding about 15 per cent of total deposits and paying about 15 per cent of the annual assessment, have 72 per cent of their deposits covered by insurance.

The equity problem as among banks is not necessarily as sharp as the foregoing statistics might indicate. It can be said that as a practical matter the larger banks are fully insured now, both in consequence of the FDIC merger policy and because it is unlikely in view of past experience that the larger banks would be permitted to fail as a matter of public policy.

Related to the equity problem is the disadvantage resulting from limited deposit coverage suffered by country banks in competing with larger banks in neighboring urban centers. Many large business concerns with branch operations in country areas as well as medium-sized and large local industries prefer now to keep minimum balances in local banks. The reason for this is said to be that larger well established banks have a competitive advantage over local banks only because of their size. This particular competitive advantage would probably be lessened if deposit coverage were increased or if all deposits were covered.

Another subsidiary argument advanced for increased or full coverage has to do with the inconvenience created for some depositors by limited insurance coverage. Depositors with cash holdings of over $5,000 and who desire the protection of full deposit coverage (because of the historically greater risk of holding deposits in small banks) are seriously inconvenienced by the necessity of dividing their accounts among several banks, some of which may be many miles away. Needless to add, the smaller banks feel that they are discriminated against by a limited insurance coverage which induces depositors to divide deposits between banks.

Extension of limited deposit coverage

The case for increasing deposit insurance coverage to some amount larger than $5,000, say to $10,000 or to $25,000, rests on much the same grounds as those discussed for full coverage. In addition, however, an extension of deposit insurance can be justified on the basis of the significant rise in the general price level and the increase in the amount of deposits in the hands of the public over the 14 years since the inauguration of deposit insurance in its present form. The wholesale price index has more than doubled since 1935 while deposits have risen fourfold. The number of depositors fully covered has declined from over 98 per cent of all deposit accounts to about 96 per cent. Probably there is a substantial number of accounts that are completely covered only because depositors, perhaps at considerable inconvenience, have split their accounts.

Most of the arguments made against full coverage do not apply with as much force to an extension of limited coverage. In particular, such extension would not remove the "healthy" influence large depositors are said to have on the quality of bank practices.

Proposals for Changes in Assessment Rate and Base

Most suggestions to lower or suspend the rate on, or change the base for, deposit insurance stem from the fact that the present fund is probably of adequate size and that investment income from it alone is currently more than adequate to meet current losses and expenses. Modification or reform of the insurance system is also proposed on grounds of equity--most proposals aim in the general direction of giving relief to the larger banks where a relatively small proportion of deposits is insured under the present law in relation to assessments paid.

Relief to insured banks through possible changes in the assessment base

There are several methods by which the present assessment base could be reduced so as to relieve insured banks of some part of their current insurance assessment. There is, however, only one method by which the present system can be made proportional--namely, that banks be assessed only on those deposits that are fully insured. If the present limit in coverage were kept, this method would reduce total assessments by more than 55 per cent. Most of the decrease in assessment resulting from adoption of a rigidly proportional base would, of course, rebound to the benefit of those banks holding the larger accounts.

A valid although not necessarily compelling objection to such a step, however, is the proposition mentioned in an earlier section to the effect that all deposits at the larger banks are under official protection since it is unlikely that the banks holding the larger deposits would be permitted to fail as a matter of public policy.

There are other adjustments that have been suggested to reduce assessments by narrowing the assessment base for banks in general. One method would permit bank holdings of U. S. Government securities to be used as a deduction from the assessment base. To the extent that banks hold Government securities an equal amount of deposits may be said to be backed by riskless, liquid assets--a form of insurance. It is estimated that with such an assessment base member banks would be paying about the same proportion of assessments as under that now used. In some respects, however, this method leaves much to be desired. One effect of this method would be raise the effective interest yield to banks on Government securities in accordance with the assessment rate authorized, at present by 1/12 of 1 per cent. Placing an added, fixed premium on Government securities and thus encouraging banks to acquire and hold them, might prove undesirable particularly at times when monetary and debt management authorities would be using their influence in an opposite direction. However, if the deductible securities were confined to bills, certificates and notes, some advantage might result in that some banks might be less disposed to shift from short-term to longer-term securities in certain periods in order to profit from higher yields and capital gains.

Another method sometimes suggested is to permit deductions from the assessment base equal to the amount of bank reserves and vault cash holdings. Bank reserves and cash in effect perform an insurance function in their own right. Member banks would profit by about 20 million dollars a year at present deposit levels if this assessment base were used. As in the preceding method, however, member banks would pay about as large a proportion of total assessments as under the present rate.

Another possible way to reduce the assessment burden via a smaller assessment base would be by deducting from the base the amount of public funds on deposit. These deposits usually require pledges of Government securities and in this manner tend to have already the status of insured deposits. Member bank assessments would be reduced by about 6 million dollars under this procedure. 1/

1/ The question as to whether interbank deposits should be included in the assessment base and whether these deposits should be insured is relevant here. For purposes of this discussion interbank deposits have tentatively been taken to be in the same category as other deposits, just as they are under the present insurance law.

An assessment base could be developed which would incorporate features of proposals mentioned above. From the present base of total deposits less cash items (the latter deducted to avoid double counting of deposits) two additional deductions might be permitted.

(1) Vault cash and reserves--presumably they cover deposits of an equal amount, dollar for dollar, and no liquidating problem is involved.

(2) Short-term Government securities.

Table 4 shows the estimated effect of such a change in base on the assessment income of the Corporation in 1948. Note that it would provide an income to the FDIC of 78 million dollars (assuming no change in the assessment rate) over and above the net income from investments, or roughly equal to three times the total deposit insurance losses met by the Corporation since 1935.

This assessment base would thus cut the present deposit insurance charges to member banks by about one-third. It would reduce the charges to both member and nonmember banks by about the same percentage. It appears that almost any feasible scheme for changing the base and/or the rate would have little effect in reducing the disproportionately large share of the assessment now carried by member banks in relation to coverage. Presumably, however, member banks would be interested in an absolute reduction in their dollar assessments even if it did not reduce the proportion of the total assessment that they pay.

There is one general and telling objection to the "narrowed assessment base" approach to the problem of relieving banks of some part of their present assessment burden, namely, that the method is a circuitous way of arriving at a goal better attained more directly. Furthermore, this approach tends to complicate rather than to simplify deposit insurance mechanics. If reform of the existing deposit insurance program is desirable it would seem much better to accomplish it by means that eliminate rather than enlarge the program's technical complications.

Redefinition of the Assessment Base

Even if there is no basic change made in the assessment base to effect a reduction in the insurance burden on banks, it has been argued that an effort ought to be made to simplify the assessment procedures and definitions. For computation of the deposit base, deposits for some selected dates could be used instead of a daily average of deposits as at present. The assessment base could be left for definition by the FDIC (in consultation with the other Federal bank supervisory agencies) in such a manner that deposits for call report purposes, for reserve purposes, and for assessment purposes would be identical, and

Table 4

Insurance Assessments under Present Plan and With Credit Given for Cash, Cash Reserves and Bills, Certificates, and Notes
December 31, 1948

(In millions of dollars)

	All insured commercial banks	Member banks	Central Res. City		Reserve city banks	Country banks
			New York City	Chicago		
Deposits for assessment purposes	133,900	114,800	22,100	5,900	42,700	44,100
Rate times base (assessment)	112	96	18	5	36	37
Deposits less reserves, vault cash, and bills, certificates, and notes	93,300	79,500	14,200	3,900	29,100	32,300
Rate times base (assessment)	78	66	12	3	24	27
Reduction in assessment	34	30	6	2	12	10
Percentage reduction	30%	31%	33%	40%	33%	27%

that the definitions of cash items allowable as deductions from deposits for both reserve and assessment purposes would be identical. At present an effort apparently is made to define deposits for assessment purposes in a manner consistent with deposits insured, disregarding the limitation on the amount insured. For this reason trust funds in the trust department are included in the assessment base by the statute itself, even though such funds are not treated as deposits for reserve purposes nor for the purposes of the call report. Drafts drawn on correspondent banks are, by ruling of the Corporation, regarded as deposits for assessment purposes, though not for reserve or call report purposes. It would be helpful if the items involved in the base formula were defined in such a way that they could be identified with corresponding items in the call report, as is now done in the case of reports submitted for reserve purposes. This would simplify preparation of reports for assessment purposes, as well as the auditing of such reports by the FDIC. The definitions probably ought not, however, be written into the law in precise terms; rather, the FDIC ought to be empowered to define deposits and the various deduction items authorized by law in a manner consistent with reserve reports or call reports.

Relief for insured banks by possible changes in the assessment rate

The present rate of 1/12 of 1 per cent could, of course, be lowered by Congressional action to any given rate with a proportional reduction in the assessment burden on insured banks. Action to cut the rate by three-fourths (to 1/48 of 1 per cent) would yield on the present base an annual income of over 25 million dollars, which is about equal to total losses paid by the Corporation in the past 13 years. If the insurance reserve fund were gradually drawn down to what was considered a dangerously low level at this rate, an increase could be made later on the basis of Congressional review and determination.

A proposal has been advanced for moderating the assessment burden by gearing the assessment rate automatically and inversely to the size of the insurance fund. That is to say, the rate would decrease after the fund had reached a given (the present) level and would increase after the fund had fallen below a given level. This proposal has one important disadvantage--it is pro-cyclical in effect. The fund would only be reduced by virtue of the fact that a number of banks are in difficulty. If this situation were sufficiently widespread to reduce significantly the insurance fund, this would be the best evidence that there was underway a nation-wide pressure on bank liquidity. To raise rates under these circumstances would add a further demand on bank liquidity and would aggravate rather than relieve the situation. By the same logic the fact that the fund was increasing in some period probably would reflect a high level of economic activity in the country with characteristic increased profits to most businesses including banks. These are the circumstances when banks could best afford to pay a higher assessment and to rebuild the fund.

Another proposal for moderating the assessment burden which involves an automaticity almost identical with the foregoing provides for varying the rate in accordance with the loss experience of the previous year and allows for an annual increase in the fund of 25 million dollars from assessments and income from investments. Income from investments which has been running about 25 million dollars would, of course, be considered before the assessment requirement would be computed. The proposal recommends that the assessment rate be allowed to vary from a minimum of 1/96 of 1 per cent to a maximum of 1/12 of 1 per cent of the present deposit base. The proposal actually only spells out in more detail the suggestion for an assessment rate varying inversely with the size of the fund. Like the other, it would have a pro-cyclical effect.

Relief to banks from the present burden of assessment could be made through an automatic statutory formula for regulating the assessment rate that would not be subject to these objections, or at least not with the same force. A moving average of insurance losses over a period, say ten years, could be used as the basis of automatic rate adjustment. Some pro-cyclical effect would still remain but its amount would be greatly moderated. Table 5 illustrates the point. Deposit losses roughly comparable to those experienced in 1930 and after are assumed to occur over the 15-year period 1950 through 1964. Note that, during the period of large deposit losses, the maximum permissible assessment under the previous year loss formula would be required from banks at the very time the banking system is undergoing the greatest liquidity difficulties.

Under the moving average method, however, two years of heavy losses would be taken with no increase in assessment and the rise thereafter in the rate would be small. Indeed, under the conditions assumed, in only one year during the cycle would the rate go as high as 1/12 (.08) of 1 per cent. Rebuilding of the fund would be more concentrated in years of small loss experience, when banks are best able to do so. In dollar amounts, during the four years of large deposit losses banks would have been assessed 346 million dollars under the previous year loss method as compared with 120 million under the moving average method. It will be noted, however, that despite the smaller initial increases in assessments the integrity of the fund would be maintained over the years by the moving average method just as with the previous loss method, providing of course that average loss rates under both plans over a long period of time do not exceed the maximum assessment rate.

It is probably desirable to make automatic provisions for expanding the maximum size of the fund should deposits increase. Provision for accomplishing this may easily be written into the assessment formula. Under any of the above automatic plans, of course, statutory limitation of the maximum assessment rate would help to limit the procyclical effect.

Table 5

Illustration of Alternate Methods of
Computing Assessment for Deposit Insurance
for Insured Commercial Banks

(In millions of dollars)

Year	Losses assumed 1/	Assessment as computed by formula based on: Losses of preceding year 2/		Average losses of preceding 10 years 3/	
		Dollar amount	Per cent of total deposits 4/	Dollar amount	Per cent of total deposits 4/
1950	150	13	.010	13	.010
1951	300	111	.083	13	.010
1952	150	111	.083	40	.030
1953	350	111	.083	54	.040
1954	10	111	.083	107	.080
1955	5	111	.083	94	.070
1956	5	111	.083	94	.070
1957	5	111	.083	94	.070
1958	5	111	.083	94	.070
1959	5	13	.010	94	.070
1960	5	13	.010	94	.070
1961	5	13	.010	67	.050
1962	5	13	.010	40	.030
1963	5	13	.010	27	.020
1964	5	13	.010	13	.010

1/ Assumptions based on loss experience of 1930 and after.
2/ Formula suggested by certain banker groups, except that provision for yearly increase in reserve fund of 25 million dollars is not made.
3/ Formula suggested in this memorandum.
4/ For purposes of simple computation, the deposit base assumed unchanged over the years.

A minimum assessment is usually suggested for any plan of flexible rates because it is believed that the insurance should not be free if for no other than psychological reasons. This minimum assessment rate is generally put at some very nominal rate, say 1/50 or 1/100 of 1 per cent. However, it may be that an assessment of such small proportions (at 1/100 of 1 per cent, only 13 million dollars for all participating banks under conditions assumed in Table 5) might prove unduly irritating to banks without compensating benefit. On grounds of equity as among banks newly insured banks should be required to bear for a period of time the assessment rate of 1/12 of 1 per cent which other insured banks have carried. This arrangement, however, would not involve much of an addition to FDIC receipts and would create serious administrative difficulties. Furthermore, it might not be in the public interest since it could discourage banks from FDIC membership.

On the basis of the considerations discussed above, an automatic statutory formula for determination of the assessment rate which would provide for immediate relief of the assessment burden on banks, which would have little pro-cyclical effect, and which would relate growth of the fund to the volume of total deposits at insured banks would be as follows: 1/

Assessments =

Average of recorded losses over preceding 10 years.

Provided that: the assessment rate shall never be in excess of 1/12 of 1 per cent or less than 1/50 of 1 per cent of the assessment base, except that if the insurance reserve fund were greater than 3 per cent of the total deposits, less cash assets and U. S. Government securities, of insured banks, the minimum permissible rate would be 1/100 of 1 per cent.

Some flexibility for administrative discretion could be introduced into deposit insurance assessments. One method would be to permit the FDIC to vary the rate within statutory limits, after consultation with the Board of Governors of the Federal Reserve System and the Secretary of the Treasury. Such authority should be subject to statutory criteria. This might include size of fund, amount of losses, level of reserve requirements, etc., as well as the state of industrial, commercial and agricultural activity. It has been argued that since the existence of the Corporation has been largely confined to periods of increasing activity on all economic fronts, the past loss experience of the Corporation does not provide adequate statistical

1/ An alternative possibility would be to keep the assessment rate at the present 1/12 of 1 per cent and make dividend allowances on the basis of the principles reflected in the formula.

evidence as to future adequacy of the size of the fund or the level of assessment rates. Proposals for administrative discretion with respect to the assessment rate, however, do not contemplate authority to raise the rate above the present level of 1/12 of 1 per cent. Accordingly, with this maximum, the possibility of exceptionally high losses contemplated by proponents of administrative flexibility could probably be covered just as effectively by an automatic formula such as has been suggested as by discretionary authority. If the maximum rate should prove inadequate, the matter of assessments would in any event need to be fully reviewed again by Congress.

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Appendix A

Five-Year Average Assessment Formula

In the body of this study, an assessment formula based on a ten-year moving average of losses to the Corporation was suggested. An alternative method using a moving average of five years is compared with the ten year average method in table 6. Use of the five-year period results in a more rapid increase in assessment rates during the period of heavy bank deposit losses than does the ten year method. Assessments also decline more sharply after the period of heavy deposit losses is past. With the loss experience assumed, the assessments under the five year average plan are also greater at their peak than with the ten year average plan. Both plans would rebuild the fund over the full period illustrated, but the five year average plan would tend to concentrate more of this rebuilding in the period of banking crisis.

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Table 6

Comparison of the Use of a Five Year and a Ten Year
Moving Average for
Computing Assessment for Deposit Insurance for Insured Commercial Banks
(Based on Loss Experience 1930 and After)

(In millions of dollars)

Year	Losses assumed	Assessment as computed by formula based on: Average losses of preceding 5 years		Average losses of preceding 10 years	
		Dollar amount	Per cent of total deposits 1/	Dollar amount	Per cent of total deposits 1/
1950	150	13	.010	13	.010
1951	300	34	.026	13	.010
1952	150	93	.070	40	.030
1953	350	111	.083 2/	54	.040
1954	10	111 2/	.083 2/	107	.080
1955	5	111 2/	.083 2/	94	.070
1956	5	111 2/	.083 2/	94	.070
1957	5	104	.078	94	.070
1958	5	75	.056	94	.070
1959	5	27	.020	94	.070
1960	5	27	.020	94	.070
1961	5	27	.020	67	.050
1962	5	27	.020	40	.030
1963	5	27	.020	27	.020
1964	5	13	.010	13	.010

1/ For purposes of simple computation, the deposit base was assumed unchanged over the years. Excess of interest income over current expenses assumed to average $10 million.

2/ Using the suggested upper limit of 1/12 of 1 per cent.