LIBRARY
AUG 6 1990
FEDERAL DEPOSIT INSURANCE CORPORATION

TESTIMONY OF

ROGER A. HOOD
ASSISTANT GENERAL COUNSEL
FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D.C.

ON

THE DEPOSIT INSURANCE PROVIDED FOR
BANK INVESTMENT CONTRACTS

BEFORE THE

SUBCOMMITTEE ON GENERAL OVERSIGHT AND INVESTIGATIONS
OF THE HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

10:00 AM
June 21, 1990
Rayburn House Office Building - Room 2222

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Good Morning Mr. Chairman and Members of the Subcommittee. We are pleased to testify on behalf of the Federal Deposit Insurance Corporation regarding "pass-through" deposit insurance currently provided for Bank Investment Contracts ("BICs").

In February of this year, the FDIC prepared and submitted to Congress a report on "pass-through" deposit insurance. The report included an extensive discussion of the "pass-through" deposit insurance provided for BICs. Since the facts and the FDIC's information have not changed appreciably since February, many of the statements and conclusions from that report to Congress are reiterated in our testimony today.

Definition of "BIC"

A BIC is a deposit contract entered into between a bank and its customer which provides that the customer will deposit funds with the bank over a period of time and the bank will repay the amounts deposited plus interest at a guaranteed rate at the end of the contract term, generally from six months to as long as ten years. It is a non-transferable liability (not saleable in a secondary market) of a bank. A BIC is the counterpart of the insurance industry's Guaranteed Investment Contract ("GIC"). The customers for BICs and GICs are, in most cases, sponsors of employee benefit plans such as pension plans or deferred compensation plans which qualify under section 401(k) of the Internal Revenue Code (commonly referred to as "401(k) Plans").

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Like a certificate of deposit, a BIC is an agreement whereby the bank agrees to repay the depositor the amount deposited plus a specified rate of interest after a specified period of time or on a specified date. However, in order to make BICs more attractive to defined contribution plans, they often have contractual terms that are marginally different from a traditional certificate of deposit ("CD").

Two features distinguish BICs from traditional CDs: a "deposit window" feature and a "benefit response" feature. The "window" feature is simply an initial period of time during which pension plan sponsors or participants can deposit monies into a particular BIC contract. Any deposits made during this period are paid a contractual or indexed rate of interest for the life of the BIC contract. The "window" period generally may vary anywhere from a few months to a year. Based on a recent survey, the Federal Reserve Board concluded that the median window period is six months, with no bank having a typical window length of over one year.

In an effort to limit some of the uncertainty concerning the amount of deposits that will be made during a "window" period, contracts frequently contain provisions which place limits on maximum deposit amounts and impose penalties if minimum deposit levels are not reached. In addition, it is not uncommon for BICs to involve one lump-sum deposit (i.e. not to permit additional deposits at all).

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The "benefit response" feature provides for withdrawals from the BIC to accommodate certain plan provisions that allow plan participants, under certain circumstances, to make withdrawals from the fixed-income option (an option that usually invests in BICs or GICs) at book value. Common circumstances under which withdrawals are allowed prior to maturity of the BIC/GIC contract include retirement, disability, termination of employment, hardship, transfers to other investment options under the same retirement plan, and loans. Other withdrawals may take place because of corporate-initiated events. For example, plant closings, reduction-in-force programs, and ownership changes could result in large withdrawals. Increasingly, penalty-free withdrawals are not allowed under many types of corporate initiated events.

Estimate of the Size of the BIC Market

Since banks do not separately report their BIC involvement to the FDIC or any other bank regulatory agency in their Reports of Condition (commonly referred to as "Call Reports"), the FDIC does not have a definite count of how many insured banks offer BICs or the total dollar amount of their outstanding contracts. However, after discussions with bankers, money managers involved in the BIC market and other persons who are knowledgeable about the BIC market, the FDIC estimated that about 25 to 35 banks were actively involved in the BIC market during 1989. The FDIC

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

believes that most of the institutions offering BICs are very large institutions.

The Federal Reserve Board recently conducted a survey on BICs involving 51 banking organizations. The survey was intended to capture all institutions that are major participants in the BIC market. Of the 51 institutions surveyed, 26 indicated that their institutions had BIC liabilities outstanding at the time of the survey and five additional institutions planned to begin offering BICs during 1990. This is consistent with the FDIC's previous estimate that there were about 25 to 35 banks actively involved in the BIC market during 1989.

The responses to the Federal Reserve Board's survey suggest that bank involvement in the guaranteed contract market has grown rapidly in recent years. The FDIC believes that the emergence and rapid growth of the BIC/GIC market during the last 15 years has been in response to a shift from defined benefit retirement programs to defined contribution plans. Under defined contribution plans, employees select directly from several investment options and the relatively conservative BIC/GIC option (sometimes referred to as a fixed-income or fixed-interest option) has been a popular choice.

The GIC first appeared around 1970 and by the mid-seventies most major insurance companies had entered the GIC market. The most

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

rapid growth in the GIC/BIC market, however, occurred during the 1980s. By 1988, roughly one-third of all funds in defined contribution plans were invested in some type of a fixed-income investment, e.g., a GIC or BIC investment. Banks began offering BICs only a few years ago, but their market-share has grown substantially. In 1988, it is estimated that new BICs accounted for about 10 percent of the $30 billion in new guaranteed contracts, up from one percent in the previous year.

The total dollar amount of outstanding GICs and BICs at year-end 1988 was estimated to be around $150 billion. As a result of their survey, the Federal Reserve Board estimates that the market expanded by about 15% in 1989, which would place the total dollar amount of outstanding BICs and GICs at about $172 billion by year-end 1989.

Based upon its survey, the Federal Reserve Board estimates that the total dollar amount of BICs outstanding was $2.3 billion at year-end 1988, and $7.5 billion at year-end 1989. The respondents to the Federal Reserve Board survey indicated that they anticipate about another $3 billion in new BICs will be issued in 1990.

The FDIC's Legal Position

Section 3(1) of the Federal Deposit Insurance Act defines the term "deposit," and in so doing, sets the parameters for what

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

types of bank obligations are insured by the FDIC. The FDIC staff has taken the position that each BIC must be examined in light of section 3(l) of the FDI Act to determine whether it is a "deposit." If a BIC falls within the meaning of the term "deposit," it would be insured on a pass-through basis like most other trusteed employee benefit plan deposits.

The FDIC legal staff has reviewed BICs issued by three insured banks and has concluded, in each instance, that the BIC was a "deposit." The instruments that the FDIC staff examined had several common characteristics. The obligations were incurred by the bank in the usual course of business to obtain funds for the conduct of its business. Each specified a maturity date on which the principal and interest would be returned to the customer. Each provided for interest to be credited periodically and at maturity. Each permitted the withdrawal of all or part of the deposit prior to maturity, provided that the customer gave seven days notice (as is required for all time deposits pursuant to FDIC regulations and the Federal Reserve Board's Regulation Q). In addition, each included the words "deposit agreement" in the title and two used the phrase "time deposit" in describing the nature of the instrument.

Although the FDIC staff has not issued any blanket legal opinion that would apply to all BICs, the three BICs which have been examined are within the meaning of the term "deposit" and thus are entitled to deposit insurance.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Pursuant to certain provisions of the FDI Act, the FDIC's existing and newly revised deposit insurance regulations provide that deposit accounts maintained by fiduciaries (i.e., agents, nominees, custodians, conservators, guardians or trustees) are insured in the amount of up to $100,000 for the interest of each principal or beneficial owner in such accounts, provided that certain recordkeeping requirements are satisfied. Since the insurance coverage for such accounts passes through the fiduciary and is measured by the interests of the beneficial owners of the funds, this type of insurance coverage is commonly referred to as "pass-through" insurance.

Under existing provisions of the FDI Act and the FDIC's regulations, the vast majority of pension plans, profit-sharing plans and other trusteed employee benefit plans are entitled to pass-through insurance for their deposits. In other words, the deposits of most trusteed employee benefit plans are insured in the amount of up to $100,000 for the interest of each beneficiary, provided that the FDIC's recordkeeping requirements for fiduciary accounts are satisfied. This insurance coverage is separate from (in addition to) the insurance coverage provided for any other deposits maintained by the plan sponsor, the trustee or plan beneficiaries in different rights and capacities in the same insured bank. For the reasons stated above, BICs, like most other trusteed employee benefit plans, are eligible for deposit insurance.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Pass-through insurance coverage for the deposits of most pension plans, profit-sharing plans and other trusteed employee benefit plans has been provided by the FDIC since the FDIC's insurance regulations were first adopted in 1967 and even before 1967, pursuant to staff interpretations of the FDI Act. Prior to 1978, however, there was no specific regulation which addressed the insurance coverage provided for deposits of pension and other trusteed employee benefit plans. Pension and other trusteed employee benefit plans usually qualified as irrevocable trusts and their deposits were insured according to each individual trust interest (on a per-beneficiary basis). However, only the vested portions of the participants' interests were considered in determining the participants' insurable interests. All nonvested interests were aggregated and insured up to the insurance limit (which was $40,000 prior to 1980).

In 1978, the FDIC amended its deposit insurance regulations to specifically address the insurance provided for the deposits of pension and other trusteed employee benefit plans. The regulations were amended to expressly provide that the interest of each participant in pension and other trusteed employee benefit plans would be evaluated for insurance purposes as if the interest of the participant had fully vested as of the date that the insured bank was closed. This represented a codification of the FDIC's staff position which was that the deposits of pension and other trusteed employee benefit plans were insured on a

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

pass-through basis (according to the interest of each participant in the accounts). However, the amendment also broadened the insurance coverage provided for such deposits by treating all of the participants' interests as having vested, regardless of whether or not they had actually vested.

BIC Risks

Financial institutions incur certain risks when the maturities of their liabilities do not match the maturities of their earning assets. For example, if a bank funds relatively short-term earning assets by issuing long-term liabilities, such as CDs or BICs, then a general decline in interest rates would reduce its interest income on earning assets, while leaving its interest obligations to depositors unchanged. As a result, the bank's income would fall and could fall quite dramatically if the maturity mismatch between assets and liabilities were large and/or if interest rates declined dramatically. On the other hand, if the general level of interest rates rises rather than falls, the bank's income would increase. Of course, if a bank funded long-term assets with short-term deposits, then the effects of changing interest rates would be the opposite of those just discussed. This risk associated with the maturity mismatch between assets and liabilities is common to the banking industry and is generally referred to as interest-rate risk.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Banks may incur interest-rate risk with traditional forms of deposits as well as BICs. However, the nature of BIC contracts presents some unique risks not generally associated with other types of bank liabilities. These unique risks may be created or magnified when deposit inflows or withdrawals are substantially different than initially anticipated. Deposit inflows may vary because of corporate events, such as changes in employment levels or program benefits, or they may vary as a reaction to market developments, such as developments in the stock market or changes in the level of interest rates.

The effects of changes in the level of interest rates on deposit inflows is a frequent and unpredictable risk confronting the BIC/GIC issuer. For example, if a BIC contract provides for a relatively long deposit window and prevailing interest rates fall after the contract interest rate has been established, the bank may experience a larger than anticipated inflow of deposits as plan sponsors or participants attempt to take advantage of an above-market interest rate. Depending on the magnitude of the change in prevailing interest rates and the inflow of deposits, the bank may not find profitable investments for this increased amount of higher-priced funds. On the other hand, if prevailing interest rates increase after the contract rate has been established and before the deposit window closes, actual deposit levels may be below what was anticipated, since the contract rate would be below prevailing market rates. If the anticipated funds

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

had been committed to investments, the bank would have to replace the shortfall with alternative sources of funds priced at the higher, prevailing market rate. In either case, the combination of changes in the level of interest rates and unanticipated deposit flows (inflows or outflows) will alter interest margins and profitability on the accounts.

For many of the same reasons that deposit inflows may vary during the window period, withdrawals over the life of the contract also may vary. Here again, changes in the level of interest rates will be a major factor influencing withdrawals otherwise permitted by the terms and conditions of the BIC contract. For example, if prevailing market rates move above the contract yield on the BIC/GIC investment, then it is likely that plan participants will increase their withdrawals from the fixed income option by transferring their investments to other investment options under the plan or by obtaining a loan under the plan rather than using funds from other sources that are yielding higher returns. In addition, where contract terms permit it, plan sponsors may make benefit payments by withdrawing funds from the lowest-yielding BIC/GIC contract within a particular fixed-income option. Even a sponsor's decision to terminate a plan (employees receive their accounts at book value) versus suspending a plan (cease contributions but leave current investments in place) may be heavily influenced by the BIC/GIC yield relative to the prevailing market yield.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

This process, whereby cash flows (either deposit inflows or withdrawals) vary depending on whether prevailing interest rates are above or below the BIC/GIC rate, is generally referred to as cash-flow antiselection. If funding from BIC sources is large relative to a bank's total funding sources, the risks posed by cash-flow antiselection also could be large.

There are a number of ways that a BIC issuer can limit these risks. With respect to limiting the risks associated with deposit inflows, BIC/GIC issuers can shorten the window during which deposits will be accepted and incorporate language into the contract that imposes penalties if some minimum level of deposits is not reached or some maximum level is exceeded. Increasingly, BIC/GIC issuers have taken such steps. In fact, in our discussions with banks active in this market, we were told that a large portion of BIC contracts included no window at all, that is, they were simply a lump-sum deposit. In many other cases, deposit windows are no longer than three months and dollar floors and caps are included in the contract language.

Withdrawal risks also can be controlled by limiting the circumstances under which penalty-free withdrawals are allowed and by limiting plan sponsors from paying benefits from the BIC/GIC contract earning the lowest interest rate. Increasingly, penalty-free withdrawals are limited to certain specified events such as death, termination of employment, retirement, or transfer to a non-competing fund (such as an equity fund) within the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

retirement plan. The contract language nearly always contains some sort of penalty for withdrawals that result from plan termination, mass lay-offs, a reduction-in-force, or sale of the corporation.

Contract terms normally prescribe how withdrawals are to be made from the various BIC contracts in order to meet retirement benefits. These contract terms limit the extent to which plan sponsors can withdraw funds from low-rate contracts in paying plan benefits. Also, contract terms often limit employees from making interfund transfers to a competing fixed-income fund, thereby further limiting the withdrawal risk associated with a particular BIC contract.

Risks in the banking industry are further limited by the fact that their involvement in the BIC/GIC market is concentrated in the shorter maturity end of the market, i.e., maturities ranging from one to three years. Since bank assets also tend to have shorter maturities, the consequences of antiselection risk for the industry also are relatively small.

Institutions limit antiselection risks in a number of ways. The most common way is to ensure that the contract is designed to limit penalty-free deposits and withdrawals to certain specified events, thereby limiting the adverse consequences of changing interest rates. In fact, the BIC/GIC market has been moving in this direction and plan sponsors have been willing to accept more

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

deposit and withdrawal restrictions in return for higher contract yields. Of course, it is also important for banks involved in the BIC market to employ the more traditional tools in controlling interest-rate risk as well, such as limiting the mismatch in maturities between assets and liabilities and/or hedging with options or forward contracts.

It is important to note as well that the terms and conditions of BIC funding are but part of a larger process of asset/liability management at banks participating in this market. Consequently, such funding must be considered on a case-by-case basis and in the context of a bank's overall asset/liability management practices. The FDIC believes that the management of BIC funding is well within the traditional capabilities of bank management. We have no evidence to suggest that BICs are causing losses or having other detrimental effects to the banks involved, or that BICs, despite their unique characteristics, pose any undue risk to the banking system or the insurance funds. Nonetheless, given the growth of the BIC market and the interest in the issues raised, it may be useful to develop more definitive information. To this end, we plan to raise with our sister agencies on the Federal Financial Institutions Examination Council the possibility of developing more specific information on bank involvement in BICs.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Conclusion

Pursuant to the provisions of the FDI Act, the FDIC has been providing pass-through insurance coverage for the deposits of most pension plans and other trusteed employee benefit plans for several decades. Providing pass-through insurance coverage for BICs does not represent an expansion of deposit insurance coverage. If a BIC meets the statutory definition of "deposit" then it is accorded the same insurance coverage that is provided for most other trusteed employee benefit plan deposits, provided the FDIC's recordkeeping requirements are satisfied.

The FDIC realizes, however, that there are some unique risks associated with BICs that are not characteristic of other bank liabilities. Nevertheless, operating procedures and contractual arrangements for limiting these risks are well understood. There is no reason to believe that banks lack the ability to understand or use the same methods that are now widely utilized by other market participants. Therefore, the FDIC does not believe that BICs pose an inordinate risk to the Bank Insurance Fund ("BIF").

As we concluded in our report to Congress on pass-through insurance, the extent to which deposit insurance should be provided for various owners and types of deposits should be evaluated by Congress. Any change, however, should be made only after a comprehensive review of the deposit insurance system has been completed. We do not believe that a piecemeal approach to

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

deposit insurance reform would be appropriate. The comprehensive review should take into account the public policy reasons for providing deposit insurance for various types of depositors and deposit instruments. In other words, who should be covered, for how much, and for what policy reasons? We must proceed carefully because we are dealing with extremely complex institutions and markets that have a very direct link to the stability and prosperity of our economy.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis