Statement of
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on Deposit Insurance Reform Before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services U.S. House of Representatives
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Chairman Bachus, Representative Sanders, and members of the Subcommittee, it is a pleasure to appear before you this morning to discuss deposit insurance reform. This remains the top priority of the Federal Deposit Insurance Corporation and I appreciate the continuing interest in pursuing reform on the part of this Subcommittee and the Committee on Financial Services.

The fact that the Committee has twice been able to write legislation that has attracted more than 400 votes in the House of Representatives is an admirable accomplishment. I especially want to thank Chairman Bachus for recently introducing H.R. 1185, The Federal Deposit Insurance Act of 2005. I would also like to thank Committee Chairman Oxley, Representative Frank, Representative Hooley, and others for cosponsoring the bill.

Your commitment to deposit insurance reform and your perseverance in getting reform legislation passed, even in the absence of a current crisis, are in the finest traditions of public service. I remain convinced that our continued persistence will produce reform legislation that is in the best interests of the economy, the public and the industry.

An effective deposit insurance system contributes to America's economic and financial stability by protecting depositors. For more than three generations, our deposit insurance system has played a key role in maintaining public confidence and provided a safe place for savings and retirement funds. This aspect of security becomes more important as Congress looks at alternative savings and retirement vehicles.

While the current system is not in need of a radical overhaul, flaws in the system could actually prolong an economic downturn, rather than promote the conditions necessary for recovery. These flaws can be corrected only by legislation, and the need for that legislation increases with each passing year.

The banking industry has been experiencing rapid change. Unfortunately, the deposit insurance system itself has not kept pace. We are increasingly forced to apply an old fashioned system to a modern, complex and rapidly evolving industry.

Of the FDIC's proposals to reform the deposit insurance system, I want to emphasize today just the three elements of reform that the FDIC regards as most critical: merging the funds, improving the FDIC's ability to manage a merged fund and pricing premiums

properly to reflect risk. These changes are needed to provide the right incentives to insured institutions and to improve the deposit insurance system's role as a stabilizing economic factor, while also preserving the obligation of banks and thrifts to fund the system. There is widespread agreement and support among the bank and thrift regulators for these reforms.

The FDIC'S Recommendations

Merge the BIF and the SAIF

The Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) should be merged. There is a strong consensus on this point within the industry, among regulators and within Congress.

A merged fund would be stronger and better diversified than either fund standing alone. In addition, a merged fund would eliminate the possibility of a premium disparity between the BIF and the SAIF. For these reasons, the FDIC has advocated merging the BIF and the SAIF for a number of years as part of a reform of our insurance system.

Give the FDIC Discretion to Price for Risk and Manage the Fund

Two statutory mandates currently govern the FDIC's management of the deposit insurance funds. One of these mandates can put undue pressure on the industry during an economic downturn. The other prevents the FDIC from charging appropriately for risk during good economic times. Together, they lead to volatile premiums.

When a deposit insurance fund's reserve ratio falls below the 1.25 percent statutorily mandated designated reserve ratio (DRR), the FDIC is required by law to raise premiums by an amount sufficient to bring the reserve ratio back to the DRR within one year, or charge mandatory high average premiums until the reserve ratio meets the DRR. Thus, if a fund's reserve ratio falls sufficiently below the DRR, the requirement for high premiums could be triggered. Since such a large fall is most likely during a recession or depression, the statute could impose a significant drain on the net income of depository institutions when they can least afford it, thereby impeding credit availability and economic recovery. As I will discuss later, there are ways to protect taxpayers while avoiding some of the pro-cyclicality of the present system.

When a fund's reserve ratio is at or above the DRR (and is expected to remain above 1.25 percent), current law prohibits the FDIC from charging premiums to institutions that are both well-capitalized, as defined by regulation, and well-managed. Today, 93 percent of banks and thrifts are well-capitalized and well-managed and pay the same rate for deposit insurance—zero. Yet, significant and identifiable differences in risk exposure exist among these 93 percent of insured institutions.

Pricing for Risk

The current system prevents the FDIC from charging appropriately for risk, which increases the potential for moral hazard and makes safer banks unnecessarily subsidize riskier banks. Both as an actuarial matter and as a matter of fairness, riskier banks should shoulder more of the industry's deposit insurance assessment burden.

The failure to abide by fundamental insurance principles is not merely a theoretical problem. The Pension Benefit Guaranty Corporation, for example, is unable to properly price its premiums for risk, and this inability has contributed to its current deficit of over $23 billion.

The current statute governing deposit insurance premiums also permits banks and thrifts to bring new deposits into the system without paying any premiums. Essentially, the banks that were in existence before 1997 endowed the funds, and newcomers have not been required to contribute to the ongoing costs of the deposit insurance system. Since 1996, almost 1,100 new banks and thrifts, which hold $262 billion in assessable deposits, have joined the system and never paid for insurance. Other institutions have grown significantly without paying additional premiums. Through premiums paid up to 1996, in effect, older and more slowly growing institutions are subsidizing these new and fast-growing institutions.

These problems can be addressed by combining two complementary approaches. First, provide an initial, transitional assessment credit to institutions that capitalized the funds during the early 1990s. Such a credit would provide a transition period during which banks that contributed in the past could offset their future premium obligations through the use of credits. Allocating the initial assessment credit according to institutions' relative assessment bases at the end of 1996, the first year that both funds were fully capitalized, reasonably approximates relative contributions to the funds' capitalization, while avoiding the considerable complications that can be introduced by attempting to reconstruct the individual payment histories of all institutions.

The second approach is to eliminate the existing inflexible statutory requirements and give the FDIC Board of Directors the discretion and flexibility to charge regular risk-based premiums over a much wider range of circumstances than current law now permits.

If the FDIC is allowed to set premiums according to the risks in the institutions we insure, we will attempt, first and foremost, to make premiums fair and understandable. We will also strive to make the pricing mechanism simple and straightforward, and we will temper statistical analysis with common sense. Any system adopted by the FDIC will be transparent and open. The industry and the public at large will have the opportunity to weigh in on any changes we propose through the notice-and-comment rulemaking process.

As the result of many discussions with bankers, trade-group representatives and other regulators, as well as our own analysis, we are looking at several possible pricing methodologies. The primary thrust of these methodologies is to incorporate a variety of financial and other measures to distinguish and price for risk more accurately. For the largest banks and thrifts, it may be necessary to have a different pricing system from the rest of the industry, but the pricing system must not discriminate in favor of or against banks merely because they happen to be large or small. We are actively seeking input

from the industry and Congress regarding possible pricing systems that are analytically sound.

Managing the Fund

The point of the reforms is neither to increase assessment revenue from the industry nor to relieve the industry of its obligation to fund the deposit insurance system; rather, it is to distribute assessments more evenly over time and more fairly across insured institutions.

The FDIC recognizes that accumulating money in the insurance fund to protect depositors and taxpayers means less money in the banking system for providing credit. The current system attempts to strike a balance by establishing a reserve ratio target of 1.25 percent. Under the proposed reforms, allowing the reserve ratio to move within a statutorily established range around 1.25 percent will help ensure that banks are charged steadier premiums during the business cycle. The key to fund management will be to maintain the fund within the statutory range and to bring the fund ratio back into the range in an appropriate timeframe when it moves outside in either direction. As the reserve ratio moves, the Board should have the flexibility to use surcharges or rebates and credits to keep the ratio within the range.

Index the Deposit Insurance Coverage Limit

The reforms just described are critical to improving the deposit insurance system. Let me also mention the most controversial, but least critical, of the FDIC's recommendations, the recommendation on coverage. The FDIC's recommendation is simple: whatever the level of deposit insurance coverage Congress deems appropriate, the coverage limit should be indexed to ensure that the value of deposit insurance does not wither away over time. If Congress decides to maintain deposit insurance coverage at its current level, indexing will not expand coverage or expand the federal safety net. It will simply hold the real value of coverage steady over time. In addition, indexing the limit on a regular basis may prevent possible unintended consequences of large adjustments made on an ad hoc basis in the future.

Legislation

Almost any bill of importance represents a compromise among competing interests and is rarely the bill that any one person would craft, if left to his or her own devices. However, generally speaking, I believe that H.R. 1185 is consistent with the spirit of the FDIC's recommendations. Without a doubt, it would create a system that is significantly better than the existing system.

However, I would like to make just a few general comments on the specifics of legislation, including H.R. 1185.

The greater the range over which the FDIC has discretion to manage the fund, the more flexibility we will have to eliminate the system's current pro-cyclical bias. H.R. 1185 would effectively create a 22.5 basis point range, from 1.15 percent to 1.375 percent.1 I would suggest a somewhat broader range.

The FDIC would also prefer to steer clear of hard triggers, caps and mandatory credits or rebates. Automatic triggers that “hard-wire” or mandate specific Board actions are likely to produce unintended adverse effects, not unlike the triggers in the current law. They would add unnecessary rigidity to the system and could prevent the FDIC from responding effectively to unforeseen circumstances and changing economic and industry conditions. Thus, I would prefer to make rebates discretionary rather than mandatory.

While I believe that the FDIC Board needs greater discretion to manage the fund, we are not suggesting the FDIC be given absolute discretion. We recognize the need for accountability and will work with you to ensure a system that provides it.

Conclusion

The FDIC takes its responsibility to prudently manage the fund and maintain adequate reserves very seriously. I want to reiterate a promise I made to the full Committee two years ago. While Chairman, I will ensure that the FDIC manages the insurance fund responsibly and is properly accountable to Congress, the public and the industry. Our recommendations will ensure that future Chairmen do so as well.

We have been fortunate, in that Congress continues to have an excellent opportunity to remedy flaws in the deposit insurance system before they cause actual damage either to the banking industry or our economy as a whole. We appreciate the Subcommittee’s leadership and continuing efforts on this issue and look forward to working with each of you to get the job done this year.

1 H.R. 1185 would require that the FDIC issue dividends equal to one-half of the amount in the fund above 1.35 percent whenever the fund was between 1.35 percent and 1.40 percent, and dividends equal to the entire amount in the fund over 1.40 percent whenever the fund was over 1.40 percent. The effect of these provisions would have been to cap the fund at 1.375 percent.

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