Laurence H Meyer: Federal deposit insurance reform

Testimony of Mr Laurence H Meyer, Member of the Board of Governors of the US Federal Reserve System, before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services, US House of Representatives, 26 July 2001.

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It is a pleasure, Mr Chairman, to appear before this subcommittee to present the views of the Board of Governors of the Federal Reserve System on deposit insurance reform as proposed by the Federal Deposit Insurance Corporation (FDIC) this past spring. At this point, the Federal Reserve Board's views are necessarily general because the FDIC's recommendations were purposefully quite broad.

That said, on behalf of the Board I want to compliment the FDIC for an excellent report that highlights the issues and develops an integrated framework for addressing them. We urge the Congress to use that framework for promptly developing a detailed legislative proposal that addresses the most important deficiencies in our current deposit insurance system. I hope my comments this morning will be helpful in doing so.

Benefits and costs of deposit insurance

As background to our suggestions, the Board believes it is important first to understand the benefits and costs of deposit insurance. Deposit insurance has played a key – at times even critical – role in achieving the stability in banking and financial markets that has characterized the past almost seventy years. Deposit insurance, combined with other components of our banking safety net – the Federal Reserve's discount window and payment system guarantees – and with enhanced macroeconomic stability resulting from monetary and fiscal policies, has meant that periods of financial stress are no longer characterized by depositor runs on banks and thrifts. Quite the opposite: Asset holders now seek out deposits as safe havens when they have strong doubts about other financial assets.

Looking beyond the contribution of deposit insurance to overall financial stability, we should not minimize the security it has brought to millions of households and small businesses. Deposit insurance has provided a safe and secure place for those households and small businesses with relatively modest amounts of financial assets to hold their transaction and other balances.

These benefits of deposit insurance, as significant as they are, have not come without cost. The very same process that has ended deposit runs has made insured depositors largely indifferent to the risks taken by their banks because their funds are not at risk if their institution is unable to meet its obligations. As a result, the market discipline to control risks that insured depositors would otherwise have imposed on banks and thrifts has been weakened. Relieved of that discipline, banks and thrifts naturally feel less inhibited from taking on more risk than they would otherwise assume. No other type of private financial institution is able to attract funds from the public without regard to the risk it takes with its creditors' resources. This incentive to take excessive risks is the so-called moral hazard problem of deposit insurance, the inducement to take risk at the expense of the insurer.

Because of the reduced market discipline and moral hazard, there is an intensified need for government supervision to protect the interests of taxpayers and, in essence, substitute for the reduced market discipline. Deposit insurance and other components of the safety net also enable banks and thrifts to attract more resources than would otherwise be the case. In short, insured banks and thrifts receive a subsidy in the form of a government guarantee that allows them both to attract deposits at lower interest rates than would be required without deposit insurance and to take more risk without the fear of losing their deposit funding. Put another way, deposit insurance misallocates resources by breaking the link between risks and rewards for a select set of market competitors.

From the very beginning, deposit insurance has involved a tradeoff. On the one hand, there are benefits from the contribution of deposit insurance to overall financial stability and the protection of small depositors. On the other hand, deposit insurance imposes costs from the inducement to risk-taking, the misallocation of resources, and the increased need for government supervision to protect the taxpayers' interests. The crafting of reforms of the deposit insurance system must struggle to balance these tradeoffs. Moreover, the Board urges, we should be reasonably certain that any reforms are aimed primarily at protecting the public interest and not the profits or market shares of particular businesses.

The Federal Reserve Board believes that deposit insurance reforms should be designed to preserve the benefits of heightened financial stability and the protection of small depositors without at the same time increasing moral hazard or reducing market discipline. This view underpins the response of the Federal Reserve Board to the FDIC's recommendations. In addition, although at this time we are responding to very broad recommendations, we urge that the implementing details be kept as straightforward as possible to minimize the risk of unintended consequences that comes with complexity.

Recommendations for reform

The FDIC has made five broad recommendations.

1. Merging BIF and SAIF

The Board strongly supports the FDIC's proposal to merge the BIF and SAIF funds. Because the charters and operations of banks and thrifts have become so similar, it makes no sense to continue the separate funds. Separate funds reflect the past, but neither the present nor the future. Equally important, the insurance products provided to the two sets of institutions are identical, and thus the premiums should be identical as well. Under current arrangements, the premiums could differ significantly if one of the funds fell below the designated reserve ratio of 1.25 percent of insured deposits and the other fund did not. Merging the funds would also diversify their risks and reduce administrative expenses.

2. Statutory restrictions on premiums

Current law requires the FDIC to impose higher premiums on riskier banks and thrifts but restricts its ability to impose any premium on well-capitalized and highly-rated institutions whenever the corresponding fund's reserves exceed 1.25 percent of insured deposits. The Board strongly endorses the FDIC recommendations that would (1) require that a premium be imposed on every insured depository institution, no matter how well capitalized and well rated it may be or how high the fund's reserves, and (2) eliminate the statutory restrictions on risk-based pricing.

The current statutory requirement that free deposit insurance be provided to well-capitalized and well-rated banks when FDIC reserves exceed a predetermined ratio maximizes the subsidy provided to these institutions and is inconsistent with efforts to avoid inducing moral hazard. Put differently, the current rule requires the government to give away its valuable guarantee when fund reserves meet some ceiling level. This free guarantee is of value to banks and thrifts even when they themselves are in sound financial condition and when macroeconomic times are good. At the end of last year, 92 percent of banks and thrifts were paying no premium. Included in this group were banks that have never paid any premium for their, in some cases substantial, coverage and fast-growing entities whose past premiums were extraordinarily small relative to their current coverage. We believe that these anomalies were never intended by the framers of the Deposit Insurance Fund Act of 1996 and should be addressed by the Congress.

The Congress did intend that the FDIC impose risk-based premiums, but the 1996 Act limits the ability of the FDIC to impose risk-based premiums on well-capitalized and well-rated banks. And these two variables – capital strength and examiner overall rating – do not capture all of the risk that banks and thrifts could create for the insurer. The Board believes the FDIC should be free to establish risk categories based on any well-researched economic variables and to impose premiums commensurate with these risk classifications. Although a robust risk-based premium system would be technically difficult to design, a closer link between insurance premiums and individual bank or thrift risk would reduce moral hazard and the distortions in resource allocation that accompany deposit insurance.

We note, however, that significant benefits in this regard are likely to require a substantial range of premiums but that the FDIC has concluded in its report that premiums for the riskiest banks would probably need to be capped in order to avoid inducing failure at these weaker institutions. We believe that capping premiums may end up costing the insurance fund more in the long run should these weak institutions fail anyway, with the delay increasing the ultimate cost of resolution. The Board has concluded, therefore, that if a cap is required, it should be set quite high so that risk-based premiums can be as effective as possible in deterring excessive risk-taking.

3. Designated reserve ratios and premiums

The current law establishes a designated reserve ratio for BIF and SAIF of 1.25 percent. If that ratio is exceeded, the statute requires that premiums on well-capitalized and well-rated banks must be discontinued. If the ratio declines below 1.25 percent, the FDIC must develop a set of premiums to restore the reserve ratio to 1.25 percent; if it appears that the fund ratio cannot be restored to its statutorily designated level in twelve months, the law requires that a premium of at least 23 basis points be imposed on the least risky category of banks.

These requirements are clearly procyclical, lowering or eliminating fees in good times when bank credit is readily available and fund reserves should be built up, and abruptly increasing fees sharply in times of weakness when bank credit availability is under pressure and fund resources are drawn down to cover the resolution of failed banks. The FDIC recommends that surcharges or rebates should be used to bring the fund back to the target reserve ratio gradually. The FDIC also recommends the possibility of a target range for the designated reserve ratio, over which the premiums may remain constant, rather than a fixed target reserve ratio and abruptly changing premiums.

We strongly support such increased flexibility and smoothing of premiums. Indeed, we recommend that the FDIC's suggested target reserve range be widened in order to reduce the need to change premiums sharply. Any floor or ceiling, regardless of its level, could result in requiring that premiums be increased at exactly the time when banks and thrifts could be under stress and, similarly, that premiums be reduced at the time that depositories are in the best position to fund an increase in reserves. Building a larger fund in good times and permitting it to decline when necessary are prerequisites to less variability in the premium. In addition to widening the range, the Board would recommend that the FDIC be given the latitude to temporarily relax floor or ceiling ratios on the basis of current and anticipated banking conditions and expected needs for resources to resolve failing institutions.

4. Rebates

Since its early days, the FDIC has rebated "excess" premiums whenever it felt its reserves were adequate. This procedure was replaced in the1996 law by the requirement that no premium be imposed on well-capitalized and highly rated banks and thrifts when the fund reaches its designated reserve ratio. The FDIC proposals would re-impose a minimum premium on all banks and thrifts and a more risk-sensitive premium structure. These provisions would be coupled with rebates for the stronger entities when the fund approaches what we recommend be a higher upper end of a target range than the FDIC has suggested, and surcharges when the Fund trends below what we suggest be a lower end of a target range.

The FDIC also recommends that the rebates not be uniform for the stronger entities. Rather, the FDIC argues that rebates should be smaller for those banks that have paid premiums for only short periods or that have in the past paid premiums that are not commensurate with their present size and hence FDIC exposure.

The devil, of course, is in the details. But this latter proposal makes considerable sense, and the Board endorses it. There are over 900 banks – some now quite large – that have never paid a premium, and without this modification they would continue to pay virtually nothing, net of rebates, as long as their strong capital and high supervisory ratings were maintained. Such an approach is both competitively inequitable and contributes to moral hazard. It should be addressed.

5. Indexing insured-deposit coverage ceilings

The FDIC recommends that the current $100,000 ceiling on insured deposits be indexed. The Board does not support this recommendation and believes that, at this time, the current ceiling should be maintained.

In the Board's judgment, it is unlikely that increased coverage, even by indexing, today would add measurably to the stability of the banking system. Macroeconomic policy and other elements of the safety net, combined with the current, still-significant level of deposit insurance, continue to underpin the stability of the financial system. Thus, the problem that increased coverage is designed to solve must be related to either the individual depositor, the party originally intended to be protected by deposit insurance, or to the individual bank or thrift. Clearly, both groups would prefer higher coverage if there were no costs. But Congress needs to be clear about the problem for which increased coverage would be the solution.

Depositors

At the Federal Reserve, we frequently receive letters from banks urging that we support increased deposit insurance coverage. But we virtually never receive similar letters from depositors, who are not shy about sharing their many other concerns. This experience may reflect the fact that, as our surveys of consumer finances suggest, depositors are adept at achieving the level of deposit insurance coverage they desire by opening multiple accounts. Such spreading of asset holdings is perfectly consistent with the counsel always given to investors to diversify their assets – whether stocks, bonds, or mutual funds – across different issuers. The cost of diversifying for insured deposits is surely no greater than doing so for other assets. An individual bank would clearly prefer that the depositor maintain all of his or her funds at that bank, and would prefer to eliminate the need for depositor diversification by being able to offer higher deposit insurance coverage. Nonetheless, the depositor appears to have no great difficulty – should he or she want insured deposits – in finding multiple sources of fully insured accounts.

In addition, the singular characteristic of postwar household financial asset holdings has been the increasing diversity of portfolio choices. The share of household financial assets in bank deposits has been declining steadily throughout the postwar period as households have taken advantage of innovations that make available to them attractive financial instruments with market rates of return. There has been no break in that trend that seems related to past increases in insurance ceilings. Indeed, the most dramatic substitution out of deposits in recent years has been from both insured and uninsured deposits to equities and mutual funds. It is difficult to believe that a change in ceilings during the 1990s would have made any measurable difference in that shift. In fact, bankers' comments and the data indicate that the weakness in stock prices in recent quarters has been marked by increased flows into bank and thrift deposits.

Depository institutions

Does the problem to be solved by increased deposit insurance coverage concern the individual depository institution? If so, the problem would necessarily be concentrated at smaller banks that generally do not have access to the money market or foreign branch networks for supplementary funds. Since the mid-1990s, banks' U.S. assets have grown at an average annual rate of 7.7 percent. Adjusted for the effects of mergers, the smaller banks, those below the largest 1,000, have actually grown at a more rapid average annual rate of 13 percent. Uninsured deposits at these smaller banks have also grown more rapidly than at larger banks – at average annual rates of 20.5 percent at the small banks versus 10.9 percent at the large banks, both on the same merger-adjusted basis. Clearly, small banks have a demonstrated skill and ability to compete for uninsured deposits. To be sure, uninsured deposits are more expensive than insured deposits, and bank costs would decline if their currently uninsured liabilities received a government guarantee. But that is a different matter, and raises the issue of a subsidy in its starkest terms. I might add that throughout the 1990s, small banks' return on equity was well maintained. Indeed, the attractiveness of banking is evidenced by the fact that 1,363 banks were chartered during the past decade, two-thirds since 1995, when bank credit demands began to intensify.

Some small banks argue that they need enhanced deposit insurance coverage to equalize their competition with large banks because depositors prefer to put their uninsured funds in an institution considered too big to fail. As I have noted, however, small banks have more than held their own in the market for uninsured deposits. In addition, the Board rejects the notion that any bank is too big to fail. In FDICIA, Congress made it clear that the systemic-risk exception to the FDIC's least-cost resolution of a failing bank should be invoked only under the most unusual circumstances. Moreover, the resolution rules under the systemic-risk exception do not require that uninsured depositors and other creditors, much less stockholders, be made whole. Consistent with this view, the market clearly believes that large institutions are not too big for uninsured creditors to take at least some loss, with spreads on their subordinated debt larger than those on similar debt of large and highly rated nonbank financial institutions. Indeed, there are no Aaa-rated U.S. banking organizations.

Another argument often raised by smaller banks regarding the need for increased deposit insurance coverage is their inability to match the competition from those large securities firms and bank holding companies with multiple bank affiliates, offering multiple insured accounts through one organization. While the Board believes that such offerings are a misuse of deposit insurance, raising the coverage limit for each account would also increase the aggregate amount of insurance coverage that large multibank organizations would be able to offer, so the disparity would remain.

Conclusion

The Board commends the FDIC for its review, analysis, and recommendations for reform of the deposit insurance system. There are several aspects of that system that need reform. The Board supports, with some modifications, all of the FDIC's recommendations except indexing of the current $100,000 ceiling. The thrust of our proposed modifications would call for a wider permissible range for the size of the fund relative to insured liabilities, reduced variation of the insurance premium as the relative size of the fund changes with banking and economic conditions, and a premium net of rebates.

There may come a time when the Board finds that households and businesses with modest resources are finding difficulty in placing their funds in safe vehicles and/or that there is reason to be concerned that the level of deposit coverage could endanger financial stability. Should either of those events occur, the Board would call our concerns to the attention of the Congress and support adjustments to the ceiling by indexing or other methods.

But today, in our judgment, neither financial stability, nor depositors, nor depositories are being disadvantaged by the current ceiling. Raising the ceiling now would extend the safety net, increase the government subsidy to banking, expand moral hazard, and reduce the incentive for market discipline, without providing any real public benefits. With no clear public benefit to increasing deposit insurance, the Board sees no reason to increase the scope of the safety net. Indeed, the Board believes the time has come to draw the line on expanding government guarantees.