

Alan Greenspan: Deposit insurance

Testimony of Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C., 26 February 2003.

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Chairman Shelby, Senator Sarbanes, and members of the Committee, it is a pleasure to appear once again before this Committee to present the views of the Board of Governors of the Federal Reserve System on deposit insurance. Rather than refer to any specific bill, I will express the broad views of the Federal Reserve Board on the issues associated with modifications of deposit insurance. Those views have not changed since our testimony before this Committee on April 23, 2002.

At the outset, I note that the 2001 report of the Federal Deposit Insurance Corporation (FDIC) on deposit insurance highlighted the significant issues and developed an integrated framework for addressing them. Although as before the Board opposes any increase in coverage, we continue to support the framework constructed by the FDIC report for addressing other reform issues.

Benefits and costs of deposit insurance

Deposit insurance was adopted in this country as part of the legislative effort to limit the impact of the Great Depression on the public. Against the backdrop of a record number of bank failures, the Congress designed deposit insurance mainly to protect the modest savings of unsophisticated depositors with limited financial assets. With references being made to "the rent money," the initial 1934 limit on deposit insurance was \$2,500; the Congress promptly doubled the limit to \$5,000 but then kept it at that level for the next sixteen years. I should note that the \$5,000 of insurance provided in 1934, an amount consistent with the original intent of the Congress, is equal to slightly less than \$60,000 today, based on the personal consumption expenditures deflator in the gross domestic product accounts.

Despite its initial quite limited intent, the Congress has raised the maximum amount of coverage five times since 1950, to its current level of \$100,000. The last increase, in 1980, more than doubled the limit and was clearly designed to let depositories, particularly thrift institutions, offer an insured deposit free of the then-prevailing interest rate ceilings on such instruments, which applied only to deposits *below* \$100,000. Insured deposits of *exactly* \$100,000 thus became fully insured instruments in 1980 but were not subject to an interest rate ceiling. The efforts of thrift institutions to use \$100,000 CDs to stem their liquidity outflows resulting from public withdrawals of smaller, below-market-rate insured deposits led first to an earnings squeeze and an associated loss of capital and then to a high-risk investment strategy that led to failure after failure. Depositors acquiring the new larger-denomination insured deposits were aware of the plight of the thrift institutions but unconcerned about the risk because the principal amounts of their \$100,000 deposits were fully insured by the federal government. In this way, the 1980 increase in deposit insurance to \$100,000 exacerbated the fundamental problem facing thrift institutions - a concentration on long-term assets in an environment of high and rising interest rates. Indeed, it significantly increased the taxpayer cost of the bailout of the bankrupt thrift institution deposit insurance fund.

Despite this problematic episode, deposit insurance has clearly played a key - at times even critical - role in achieving the stability in banking and financial markets that has characterized the nearly seventy years since its adoption. Deposit insurance, combined with other components of our banking safety net (the Federal Reserve's discount window and its payment system guarantees), has meant that periods of financial stress no longer entail widespread depositor runs on banks and thrift institutions. Quite the opposite: Asset holders now seek out deposits - both insured and uninsured - 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 importance of the security it has brought to millions of households and small businesses with relatively modest financial assets. Deposit insurance has given them a safe and secure place to hold their transaction and other balances.

The benefits of deposit insurance, as significant as they are, have not come without a cost. The very process that has ended deposit runs has made insured depositors largely indifferent to the risks taken by their depository institutions, just as it did with depositors in the 1980s with regard to insolvent, risky thrift institutions. The result has been a weakening of the market discipline that insured depositors would otherwise have imposed on institutions. Relieved of that discipline, depositories naturally feel less cautious about 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 risks it takes with its creditors' resources. This incentive to take excessive risks at the expense of the insurer, and potentially the taxpayer, is the so-called moral hazard problem of deposit insurance.

Thus, two offsetting implications of deposit insurance must be kept in mind. On the one hand, it is clear that deposit insurance has contributed to the prevention of bank runs that could have destabilized the financial structure in the short run. On the other, even the current levels of deposit insurance may have already increased risk-taking at insured depository institutions to such an extent that future systemic risks have arguably risen.

Indeed, the reduced market discipline and increased moral hazard at depositories have intensified the 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 thrift institutions to attract more resources, at lower costs, than would otherwise be the case. In short, insured institutions receive a subsidy in the form of a government guarantee that allows them both to attract deposits at lower interest rates than would be necessary 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.

In sum, from the very beginning, deposit insurance has involved a tradeoff. Deposit insurance contributes to overall short-term financial stability and the protection of small depositors. But at the same time, because it also subsidizes deposit growth and induces greater risk-taking, deposit insurance misallocates resources and creates larger long-term financial imbalances that increase the need for government supervision to protect the taxpayers' interests. Deposit insurance reforms must balance these tradeoffs. Moreover, any reforms should be aimed primarily at protecting the interest of the economy overall and not just 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 a further increase in moral hazard or reduction in market discipline. In addition, we urge that the implementing details be kept as straightforward as possible to minimize the risk of unintended consequences that comes with complexity.

Issues for reform

The FDIC has made five broad recommendations.

1. *Merge BIF and SAIF*

The Board supports the FDIC's proposal to merge the Bank Insurance Fund (BIF) with the Savings Association Insurance Fund (SAIF). Because the charters and operations of banks and thrift institutions 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. Merging the funds would diversify their risks, reduce administrative expense, and widen the fund base of an increasingly concentrated banking system. Most important, because banks and thrift institutions receive the same level of federally guaranteed insurance coverage, the premiums faced by each set of institutions should be identical as well. Under current arrangements, the premiums faced by equally risky institutions could differ significantly if one of the funds falls below the designated reserve ratio of 1.25 percent of insured deposits and the other fund does not. Should that occur, depository institutions would be induced to switch charters to obtain insurance from the fund with the lower premium, a result that could distort our depository structure. The federal government should not sell a single service, like deposit insurance, at different prices.

2. Reduce statutory restrictions on premiums

Current law requires the FDIC to impose higher premiums on riskier banks and thrift institutions but prevents it from imposing any premium on well-capitalized and highly rated institutions when the corresponding fund's reserves exceed 1.25 percent of insured deposits. The Board endorses the FDIC recommendations that would eliminate the statutory restrictions on risk-based pricing and allow a premium to 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.

The current statutory requirement that free deposit insurance be provided to well-capitalized and highly rated institutions when the ratio of FDIC reserves to insured deposits exceeds 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 to many institutions when fund reserves meet some ceiling level. This free guarantee is of value to institutions even when they themselves are in sound financial condition and when macroeconomic times are good. At the end of the third quarter of last year, 91 percent of banks and thrift institutions were paying no premium. That group included many institutions that have never paid a premium for their, in some cases substantial, coverage, and it also included 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 highly rated banks and thrift institutions. And these two variables - capital strength and overall examiner rating - do not capture all the risk that institutions could create for the insurer. The Board believes that the FDIC should be free to establish risk categories on the basis of any economic variables shown to be related to an institution's risk of failure, and to impose premiums commensurate with that risk. Although a robust risk-based premium system would be technically difficult to design, a closer link between insurance premiums and the risk of individual institutions would reduce moral hazard and the distortions in resource allocation that accompany deposit insurance.

We note, however, that although significant benefits from a risk-based premium system are likely to require a substantial range of premiums, the FDIC 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 on premiums is required, it should be set quite high so that risk-based premiums can be as effective as possible in deterring excessive risk-taking. In that way, we could begin to simulate the deposit insurance pricing that the market would apply and reduce the associated subsidy in deposit insurance.

Nonetheless, we should not delude ourselves into believing that even a wider range in the risk-based premium structure would eliminate the need for a government back-up to the deposit insurance fund, that is, eliminate the government subsidy in deposit insurance. To eliminate the subsidy in deposit insurance - to make deposit insurance a real *insurance* system - the FDIC average insurance premium would have to be set high enough to cover fully the very small probabilities of very large losses, such as those incurred during the Great Depression, and thus the perceived costs of systemic risk. In contrast to life or automobile casualty insurance, each individual insured loss in banking is not independent of other losses. Banking is subject to systemic risk and is thus subject to a far larger extreme loss in the tail of the probability distributions from which real insurance premiums would have to be calculated. Indeed, pricing deposit insurance risks to fully fund potential losses - pricing to eliminate subsidies - could well require premiums that would discourage most depository institutions from offering broad coverage to their customers. Since the Congress has determined that there should be broad coverage, the subsidy in deposit insurance cannot be *fully* eliminated, although we can and should eliminate as much of the subsidy as we can.

I note that the difficulties of raising risk-based premiums explain why there is no real private-insurer substitute for deposit insurance from the government. No private insurer would ever be able to match the actual FDIC premium and cover its risks. A private insurer confronted with the possibility, remote as it may be, of losses that could bankrupt it would need to set especially high premiums to protect itself, premiums that few, if any, depository institutions would find attractive. And if premiums were fully priced by the government or the private sector, the depository institutions would likely lower their

offering rates, thereby reducing the amount of insured deposits demanded, and consequently the amount outstanding would decline.

3. *Relaxing the reserve ratio regime to allow gradual adjustments in premiums*

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 be discontinued for well-capitalized and highly rated institutions. 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 the fund ratio is not likely to be restored to its statutorily designated level within twelve months, the law requires that a premium of at least 23 basis points be imposed on all insured entities.

These requirements are clearly procyclical: They lower or eliminate fees in good times, when bank credit is readily available and deposit insurance fund reserves should be built up, and abruptly increase fees sharply in times of weakness, when bank credit availability is under pressure and deposit fund resources are drawn down to cover the resolution of failed institutions. The FDIC recommends that surcharges or rebates 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 support such increased flexibility and smoothing of changes in premiums. Indeed, we recommend that the FDIC's suggested target reserve range be widened to reduce the need to change premiums abruptly. Any floor or ceiling, regardless of its level, could require 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 supporting a widening of the range for the designated reserve ratio, the Board recommends 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. In short, to enhance macroeconomic stability, we prefer a reduction in the specificity of the rules under which the FDIC operates and, within the broad guidelines set out by the Congress, an increase in the flexibility with which the board of the FDIC can operate.

4. *Modify the rebates system*

Since its early days, the FDIC has rebated "excess" premiums whenever it considered its reserves to be adequate. This procedure was replaced in the 1996 law by the requirement that no premium be imposed on well-capitalized and highly rated institutions when the relevant fund reached its designated reserve ratio. The FDIC's 2001 proposals would re-impose a minimum premium on all banks and thrift institutions and a more risk-sensitive premium structure. These provisions would be coupled with rebates for the stronger entities when the fund approaches the upper end of a target range and surcharges when the fund trends below the 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 consequent FDIC exposure. The devil, of course, is in the details. But varying the rebates in this way makes considerable sense, and the Board endorses it. More than 900 banks - some now quite large - 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 ceilings on the coverage of insured deposits*

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

In the Board's judgment, increasing the coverage, even by indexing, is unlikely to 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 be important bulwarks against bank runs. Thus, the problem that increased coverage is designed to solve must be related either to the individual depositor, the party originally intended to be protected, or to the individual bank or thrift institution. Clearly, both groups would prefer higher coverage if it cost them nothing. But the Congress needs to be clear about the nature of a specific problem for which increased coverage would be the solution.

Depositors. Our most recent surveys of consumer finances suggest that most depositors have balances well below the current insurance limit of \$100,000, and those that do have larger balances have apparently been adept at achieving the level of deposit insurance coverage they desire by opening multiple insured accounts. Such spreading of assets 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. A bank would clearly prefer that the depositor maintain all of his or her funds at that bank and would prefer to reduce the need for depositor diversification by being able to offer higher deposit insurance coverage. Nonetheless, depositors appear to have no great difficulty - should they want insured deposits - in finding multiple sources of fully insured accounts.

In addition, one of the most remarkable characteristics of household holdings of financial assets has been the increase in the diversity of portfolio choices since World War II. And, since the early 1970s the share of household financial assets in bank and thrift deposits has generally declined steadily as households have taken advantage of innovative, attractive financial instruments with market rates of return. The trend seems to bear no relation to past increases in insurance ceilings. Indeed, the most dramatic substitution out of deposits has been the shift from both insured and uninsured deposits into equities and into mutual funds that hold equities, bonds, and money market assets. It is difficult to believe that a change in ceilings during the 1990s would have made any measurable difference in that shift. Rather, the data indicate that the weakness in stock prices in recent years has been marked by increased flows into bank and thrift deposits even without changed insurance coverage levels.

Depository Institutions. Does the problem to be solved by increased deposit insurance coverage concern the individual depository institution? If so, the problem would seem disproportionately related to small banks because insured deposits are a much larger proportion of total funding at small banks than at large banks. But smaller banks appear to be doing well. Since the mid-1990s, adjusted for the effects of mergers, assets of banks smaller than the largest 1,000 have grown at an average annual rate of 13.8 percent, more than twice the pace of the largest 1,000 banks. Uninsured deposits, again adjusted for the effects of mergers, have grown at average annual rates of 21 percent at the small banks versus 10 percent at the large banks. 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 and profits rise if their currently uninsured liabilities received a government guarantee. But that is the issue of whether subsidizing bank profits through additional deposit insurance serves a national purpose. I might add that throughout the 1990s and into the present century, return on equity at small banks has been well maintained. Indeed, the attractiveness of banking is evidenced by the fact that more than 1,350 banks were chartered during the past decade, including more than 600 from 1999 through 2002.

Some small banks argue that they need enhanced deposit insurance coverage to compete 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 the FDIC Improvement Act of 1991 (FDICIA), the 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. The market has clearly evidenced the view, consistent with FDICIA, that large institutions are not too big for uninsured creditors to take at least some loss should the institution fail. For example, no U.S. banking organization, no matter how large, is AAA-rated. In addition, research indicates that creditors impose higher risk premiums on the uninsured debt of relatively risky large banking organizations and that this market discipline has increased since the enactment of FDICIA.

To be sure, the real purchasing power of deposit insurance ceilings has declined. But there is no evidence of any significant detrimental effect on depositors or depository institutions, with the possible exception of a small reduction in those profits that accrue from deposit guarantee subsidies that lower the cost of insured deposits. The current deposit insurance ceiling appears more than adequate to

achieve the positive benefits of deposit insurance that I mentioned earlier, even if its real value were to erode further.

Another argument is often raised by smaller banks regarding the need for increased deposit insurance coverage. Some smaller institutions say that they are unable to match the competition from large securities firms and bank holding companies with multiple bank or thrift institution affiliates because those entities offer multiple insured accounts through one organization. I note that since the Committee's last hearings on this issue, the force of small banks' concerns has been reduced by recent market developments in which small banks and thrift institutions can use a clearinghouse network for brokered deposits that allows them to offer full FDIC insurance for large accounts. The Board agrees that such practices by both large and small depositories are a misuse of deposit insurance. Moreover, raising the coverage limit for each account is not a remedy for small banks because it would also increase the aggregate amount of insurance coverage that multidepository organizations would be able to offer. The disparity would remain.

Conclusion

Several aspects of the deposit insurance system need reform. The Board supports, with some modifications, all of the recommendations the FDIC made in the spring of 2001 except indexing the current \$100,000 ceiling to inflation. The thrust of our recommendations would call for a wider permissible range for the size of the fund relative to insured deposits, reduced variation of the insurance premium as the relative size of the fund changes with banking and economic conditions, a positive and more risk-based premium net of rebates for all depository institutions, and the merging of BIF and SAIF.

There may come a time when the Board finds that households and businesses with modest resources are having difficulty in placing their funds in safe vehicles or that the level of deposit coverage appears to be endangering financial stability. Should either of those events occur, the Board would call its 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 depository institutions, expand moral hazard, and reduce the incentive for market discipline without providing any clear public benefit. 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 that as our financial system has become ever more complex and exceptionally responsive to the vagaries of economic change, structural distortions induced by government guarantees have risen. We have no way of ascertaining at exactly what point subsidies provoke systemic risk. Nonetheless, prudence suggests that we be exceptionally deliberate when expanding government financial guarantees.