

**Keeping the Promise:  
Recommendations for  
Deposit Insurance Reform**

**Federal Deposit Insurance Corporation  
April 2001**

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## LETTER FROM THE FDIC CHAIRMAN

In the 67 years since it was founded to put an end to the devastating bank runs that contributed to the Great Depression, the deposit insurance system managed by the Federal Deposit Insurance Corporation (FDIC) has served our country well. It has been an anchor for public confidence in the banking system. The reform measures the FDIC is recommending in this paper will ensure that the deposit insurance system will continue to serve well in the new century the many individuals, families, small businesses, charities, and local governments that rely on their local depository institutions.

These reform recommendations could not come at a better time, positioned as we are between a past of unprecedented prosperity and an uncertain future. The past decade of economic expansion has contributed to a strong, well-capitalized banking industry. Both the bank and savings association insurance funds are fully capitalized. The numbers of troubled institutions and bank failures are very low by historical standards. But good times never last forever, as the recent slowdown in the economy shows.

Deposit insurance is intended to help bank depositors weather uncertain times, and, in the process, to help limit the downside of economic cycles. Flaws in the current system, however, undermine that intent. The lack of risk-based pricing for most institutions can encourage imprudent risk-taking. By placing financial burdens on banks when they are least able to bear them, and by limiting credit availability when the economy needs liquidity, the current deposit insurance system could make an economic downturn longer and deeper than it would otherwise be. For example, it is possible that, in difficult times, deposit insurance premiums could reduce the pre-tax net income of insured institutions by almost \$9 billion. On the basis of recent average capital- and loans-to-assets ratios for all insured institutions, this could reduce bank lending by more than \$60 billion at the precise time in the business cycle when credit is most needed in communities around the country.

We need to address these flaws now – while the industry is strong and the overwhelming majority of institutions remain healthy. If we wait, an economic downturn can trigger unintended consequences that would harm the public that deposit insurance is intended to protect.

April 5, 2001

Donna Tanoue  
FDIC Chairman

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## EXECUTIVE SUMMARY

### Introduction

Deposit insurance is a federal program that directly affects tens of millions of Americans by insuring their deposits at banks and savings associations. The public relies on the Federal Deposit Insurance Corporation (FDIC) to protect insured depositors, resolve banking problems quickly, and help maintain public confidence in insured depository institutions. Over the years, this program has worked well, but it has become evident that there are a number of weaknesses in the system.

In August 2000, the FDIC issued an Options Paper that discussed weaknesses in the present deposit insurance system and offered possible solutions. Since then, the FDIC has reached out to hundreds of individual bankers, and the industry groups that represent them, to solicit their opinions. Further, the FDIC has conducted intensive internal analysis, including modeling insurance fund performance under various reform scenarios. This paper is the result of these efforts.

The FDIC has identified four weaknesses with the current system that need to be corrected in a timely fashion. Deposit insurance is provided by two insurance funds at potentially different prices; deposit insurance cannot be priced effectively to reflect risk; deposit insurance premiums are highest at the wrong point in the business cycle; and the value of insurance coverage does not keep pace with inflation in a predictable fashion.

### Recommendations

The FDIC recommends the following changes to address these weaknesses in the system:

***The Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) should be merged now.***

A combined fund would be stronger and would prevent the destabilizing effects that would result if one fund required premiums while the other did not. Moreover, many banks and thrifts today have commingled BIF- and SAIF-insured deposits. A merger of the funds also would greatly simplify reporting and accounting responsibilities for both the institutions and the FDIC.

***The current statutory restriction on the FDIC's ability to charge risk-based premiums to all institutions should be eliminated; the FDIC should charge regular premiums for risk regardless of the level of the fund.***

Current law restricts the FDIC from charging premiums to most banks that are well-capitalized and highly rated by supervisors as long as the insurance fund is above a Designated Reserve Ratio (DRR) of 1.25 percent of insured deposits, or \$1.25 for every \$100 of insured deposits. Today, 92 percent of the industry does not pay for deposit insurance, and the more than 900 banks that were chartered within the last five years have never paid any premiums. This system both underprices risk and does not adequately differentiate among banks according to risk. The FDIC should be allowed to charge risk-based insurance

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premiums to all institutions, as Congress envisioned in its 1991 bank reform legislation (FDICIA).

***Sharp premium swings triggered by deviations from the DRR should be eliminated. If the fund falls below a target level, premiums should increase gradually. If it grows above a target level, funds should be rebated gradually.***

As noted above, the law requires that the FDIC not charge premiums to well-rated banks when the deposit insurance funds exceed the DRR. However, if a fund drops below the DRR and cannot be replenished within one year, the law requires the FDIC to assess premiums across-the-board at a rate of at least 23 basis points.

The emphasis of the current deposit insurance system on maintaining the 1.25 percent DRR creates the potential for volatile premiums. This is likely to result in the industry paying high premiums when both banks and the economy can least afford it. The deposit insurance system should work to smooth economic cycles, not exacerbate them. It would be preferable for the fund to absorb some losses and for premiums to adjust gradually. This can be accomplished by establishing a target for the fund. If the fund varied from the target, surcharges or rebates would be used to gradually bring the fund back to the target. The target could be a range within which premiums would be constant. Alternatively, it could be a fixed reserve ratio such as the current DRR.

***Rebates should be based on past contributions to the fund, not on the current assessment base.***

Rebates are an important part of a deposit insurance system if the FDIC is to charge positive risk-based deposit insurance premiums at all times and yet avoid excessive growth of the insurance fund during long stretches of good years. However, it is important that rebates not create perverse economic incentives. A rebate tied to the current assessment base could create moral hazard problems by decreasing the cost of insurance and could even create a situation in which banks would be paid to grow. Fairness dictates that rebates should be based on past contributions to the fund.

***The deposit insurance coverage level should be indexed to maintain its real value.***

Over time, inflation eats away at the value of deposit insurance. Unlike other important government programs such as Social Security, Medicare, and even taxes, deposit insurance is not indexed to inflation. Although Congress has periodically adjusted the coverage level (the current level of \$100,000 was set in 1980), both the timing and the size of these adjustments have been unpredictable. While it is for the Congress to decide the initial coverage level, that level should be indexed to the Consumer Price Index in order to maintain its real value. This would ensure more predictable adjustments in response to inflation, as compared with the *ad hoc* changes made in the past.

\* \* \*

These recommendations are not intended to alter the assessment burden on the industry significantly; instead, they are designed to spread that burden more evenly over time in a way that provides appropriate economic incentives.

**Table ES-1 – Assessment, Rebates and Surcharges Calculated for Two Typical Banks Current System (Status Quo) Versus a System of Rebates and Surcharges**

| Banks rated 1A in the current system would be divided into 3 risk categories | Insurance Category (Assessment Rate) | Strong Economy (Rebates)<br>(Designated Reserve Ratio at 1.4%) |           |                       |  | Weak Economy (Surcharges)<br>(Designated Reserve Ratio at 1.1%) |             |                     |  |
|--|--------------------------------------|--|-----------|-----------------------|--|---|-------------|---------------------|--|
|  |                                      | Premium -  | Rebate* = | Net Payment to FDIC** | Payment Under Current System (Status Quo)*** | Premium +   | Surcharge = | Net Payment to FDIC | Payment Under Current System (Status Quo)*** |
|  |                                      |  |           |                       |  |   |             |                     |  |
| <b>Small Bank</b>  | 1a+ (1 bp)                           | \$6,522  | \$7,237   | (\$715)               | \$0  | \$6,522   | \$7,240     | \$13,762            | \$71,720                                     |
| \$81.0 million in assets****   | 1a (3 bp)                            | 19,566   | 7,237     | 12,329                | 0  | 19,566  | 7,240       | 26,806              | \$71,720                                     |
| 65.2 million in assessable deposits  | 1a- (6 bp)                           | 39,133   | 7,237     | 31,895                | 0  | 39,133  | 7,240       | 46,372              | \$71,720                                     |
| <b>Large Bank</b>  | 1a+                                  | \$653,408  | 725,274   | (\$71,866)            | \$0  | \$653,408   | \$725,283   | \$1,378,692         | \$7,187,400                                  |
| \$10.0 billion in assets   | 1a                                   | 1,960,225  | 725,274   | 1,234,951             | 0  | 1,960,225   | 725,283     | 2,685,508           | 7,187,400                                    |
| 6.534 billion in assessable deposits   | 1a-                                  | 3,920,450  | 725,274   | 3,195,176             | 0  | 3,920,450   | 725,283     | 4,645,733           | 7,187,400                                    |

\*\* This example assumes that when the fund exceeds 1.35 percent, 30 percent of the excess would be rebated to banks; and when the fund falls below 1.15 percent, a surcharge of 30 percent of the shortfall would be assessed.

\*\*\* In today's system (status quo), the premium paid by 1A-rated banks is zero when the fund exceeds 1.25 percent. If the fund were to fall below this "hard target", the premium would be increased to either 23 basis points, or to the amount required to bring the fund back to 1.25 percent within one year, whichever amount is less.

\*\*\*\* Represents the median asset size for all FDIC-insured institutions.

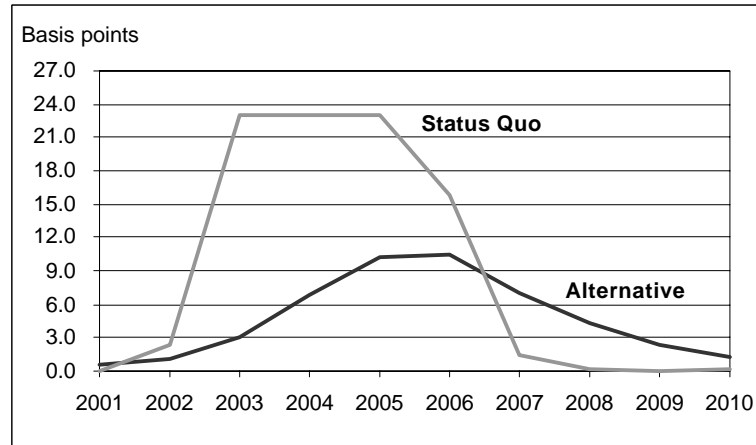
**How Might These Recommendations Work?** To illustrate how these reforms could affect banks and the insurance fund, the FDIC performed numerous simulations on a merged fund incorporating assessment and rebate scenarios in differing economic climates. The examples below assume that the 92 percent of the industry currently not paying any premiums is disaggregated into three groups (1a+, 1a, 1a-) paying risk-based premiums of 1, 3 and 6 basis points, respectively. The fund is allowed to float in a range from 1.15 percent to 1.35 percent of insured deposits. If the merged fund falls outside this range, there is a surcharge or rebate equal to 30 percent of the difference between the fund and 1.15 and 1.35 percent, respectively. Rebates are allocated on the basis of past payments to the fund. The FDIC recognizes that there are many ways to implement these recommendations, and we anticipate further discussion to work out the details. This example is for illustrative purposes only.

Table ES-1 shows the premiums and net payments in the example outlined above for a hypothetical small and large bank, when the fund is at 1.40 percent and 1.10 percent, respectively. At the 1.40 percent fund level, rebates are paid and the safest banks get back slightly more than they pay. At a 1.10 percent fund level, there are surcharges for all institutions, but in all cases total payments are considerably below what they would be under the status quo. Note that while rebates and surcharges are similar, they are not identical. This is because rebates are based on past contributions to the fund and surcharges are based on the current assessment base. For the typical institution, this will yield similar results. For a *de novo* institution, on the other hand, there would not be any rebates initially, since they have never paid anything into the fund.

Chart ES-1 shows the net payments that would be paid by the institutions in the best risk class in a high-loss scenario—in this case the percentage losses suffered by the BIF during the last banking crisis—under the current premium system and under the example described above. The difference is striking and demonstrates how the proposed system helps to dampen volatile premiums. Instead of premiums rising abruptly from zero to 23 basis points, remaining at 23 basis points for a number of years, and then falling back to zero, premiums rise gradually from 1 basis point to about 10.5 basis points and then decrease gradually to

about 2 basis points at the end of the 10-year period. Similar results hold for other institutions. For example, for 1a- institutions, premiums would peak at about 15.5 basis points as opposed to 23 basis points under the status quo. Because the insurance fund would be allowed to absorb more losses under the proposed system, billions of additional dollars would be available to the banking industry to help fuel economic growth in the trough of the business cycle.

**Chart ES-1 – Effective Assessment Rates under a High-Loss Scenario for Banks in the 1a+ Category**



**Rapidly Growing Institutions.** Recent developments have highlighted the concern raised by rapidly growing institutions that dilute the reserve ratio and pay nothing for deposit insurance. The FDIC’s recommendations would address this issue in several ways. First, under the assessment system described above, a decrease in the reserve ratio would have, at most, a gradual effect on banks’ net payments to the FDIC. Second, regular risk-based premiums for all banks would mean that fast-growing institutions would pay as they gathered deposits. In particular, fast growth, if it posed greater risk, could result in additional premiums through the operation of the FDIC’s expanded discretion to price risk. Finally, if rebates are based upon past contributions, net payments to the FDIC from fast growers when the FDIC is paying rebates would initially be greater than for established institutions or institutions growing more slowly.

## Conclusion

The FDIC’s proposed reforms will make the system function more efficiently and fairly, in a way that provides the appropriate economic incentives for all participants and lessens the burden on banks and bank borrowers during an economic downturn. These reforms are interrelated and should be implemented as a package. Piecemeal implementation of individual parts could introduce new distortions and aggravate the problems the recommendations are designed to address.

Implementation of these reforms presents complicated issues. The FDIC looks forward to working with the Congress, the banking industry and the public to improve the deposit insurance system.

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## I. INTRODUCTION

Deposit insurance is a federal program that directly affects tens of millions of Americans. The public relies on the Federal Deposit Insurance Corporation (FDIC) to protect insured depositors, resolve banking problems quickly, and help maintain public confidence in insured depository institutions. Over the years, this program has worked well, but it has become evident that there are weaknesses in the system that need to be addressed in a timely fashion.

In August 2000, the FDIC released a paper that discussed weaknesses in the deposit insurance system and options for addressing them.<sup>1</sup> Since the publication of the Options Paper, the FDIC has conducted intensive analysis, including modeling insurance fund performance under various reform scenarios. Further, the FDIC has engaged in aggressive outreach to hundreds of individual bankers and the industry groups that represent them, as well as surveyed consumers to solicit their opinions. This paper is the result of these efforts. It presents a series of recommendations designed to provide deposit insurance more efficiently and more fairly, in a way that provides the appropriate economic incentives to all participants in the system.

In particular, the FDIC makes the following recommendations: (1) The Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) should be merged. (2) The current statutory restrictions on the FDIC's ability to charge risk-based premiums to all institutions should be eliminated; the FDIC should charge regular premiums for risk regardless of the level of the insurance fund. (3) Sharp premium swings inherent in the current deposit insurance system should be eliminated; instead, if the fund falls below a target level, premiums should increase gradually; if it grows above a target level, funds should be rebated gradually. (4) Those rebates should be based on past contributions to the fund, not the current assessment base. (5) The coverage level should be indexed to keep pace with inflation.

Section II briefly describes the current deposit insurance system, while Section III describes the weaknesses of this system. Section IV sets forth the FDIC's recommendations for reforming the system. It also discusses some issues pertaining to implementing these recommendations and provides numerical examples. It is important to note that the numerical examples are for illustrative purposes only. They are intended to help the reader understand the implementation issues involved in our proposals and the effect they may have on banks and the insurance fund.<sup>2</sup> We recognize the need for ongoing discussion to work out the best implementation of these reforms. Section V contains concluding remarks.

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<sup>1</sup> Federal Deposit Insurance Corporation. "Deposit Insurance Options Paper." Washington, D.C., August 2000.

<sup>2</sup> Except where the context requires otherwise, the term "banks" will generally refer to all FDIC-insured institutions.



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## II. THE CURRENT DEPOSIT INSURANCE SYSTEM

The FDIC currently administers two deposit insurance funds: the BIF and the SAIF. Although originally intended to insure bank and savings association deposits separately, today both insure deposits at banks and savings associations. In some cases, both insure deposits at the same institution. Both provide identical insurance coverage of up to \$100,000, and both operate under the same statutory assessment system. An important difference is that assessment rates for the BIF and the SAIF are set separately.

The current assessment system used by the BIF and the SAIF has its roots in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). FDICIA directed the FDIC to implement a risk-based insurance system. It also required the FDIC to maintain each fund at a designated reserve ratio (DRR), the ratio of mandated reserves to insured deposits, of 1.25 percent. When a fund's reserve ratio—the ratio of its balance to insured deposits—falls below the DRR, the FDIC must raise premiums by enough to bring the reserve ratio back to the DRR within a year or must charge at least 23 cents per \$100 of deposits (23 basis points) until the reserve ratio meets the DRR.<sup>3</sup>

For example, a fund of \$8 billion that insured \$1 trillion in deposits would have a reserve ratio of 0.8 percent. Since this is below the 1.25 percent DRR, the FDIC would be required to charge premiums of at least 23 basis points unless it believed that lower premiums would be sufficient to raise the reserve ratio to 1.25 percent within one year. For a bank with \$100 million in assessable deposits, a 23-basis-point insurance premium would amount to \$230,000 a year.

To implement the risk-based pricing required by FDICIA, the FDIC placed institutions into risk classes based on two criteria: capital levels and supervisory ratings. Three capital categories—well capitalized, adequately capitalized, and undercapitalized—were based both on leverage ratios and risk-based capital ratios. The well, adequately, and undercapitalized categories were given the numbers 1, 2, and 3, respectively. Also, three supervisory subgroups, termed A, B, and C, were developed. These supervisory subgroups were generally based on a bank's composite CAMEL rating, a rating assigned by bank supervisors at the end of a bank examination, with 1 being the best rating and 5 being the lowest.<sup>4</sup> Generally speaking, banks with a CAMEL rating of 1 or 2 were put in supervisory subgroup A, those with a CAMEL rating of 3 were put in subgroup B, and those with a CAMEL rating of 4 or 5 were put in subgroup C. Thus, in the current assessment system, the highest-rated banks are assigned to group 1A and lowest-rated banks to group 3C.

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<sup>3</sup> If the reserve ratio is not brought back to the DRR within a year, the FDIC must establish a schedule for returning the reserve ratio to the DRR within 15 years. Rates under the schedule cannot be lower than 23 basis points, but could be higher.

<sup>4</sup> CAMEL is an acronym for component ratings assigned in a bank examination: Capital, Asset quality, Management, Earnings, and Liquidity. In 1997, an additional component, "S" for Sensitivity to market risk, was added. A composite CAMELS rating combines these component ratings, again with 1 being the best rating.

**Table 1 - Assessment Rates  
As of January 1, 1993**

| Capital Group             | Supervisory Subgroup |    |    |
|---------------------------|----------------------|----|----|
|                           | A                    | B  | C  |
| 1. Well Capitalized       | 23                   | 26 | 29 |
| 2. Adequately Capitalized | 26                   | 29 | 30 |
| 3. Undercapitalized       | 29                   | 30 | 31 |

The three capital categories and three supervisory subgroups form a nine-cell matrix for risk-based premiums. When this system was implemented in 1993, both the BIF and the SAIF were well below the DRR and the premiums ranged from 23 basis points for 1A institutions to 31 basis points for 3C institutions. Table 1 shows the distribution of premium rates applicable to banks and thrifts at the inception of the risk-based system in 1993.

**Table 2 – Current Assessment Rates**

| Capital Group             | Supervisory Subgroup |    |    |
|---------------------------|----------------------|----|----|
|                           | A                    | B  | C  |
| 1. Well Capitalized       | 0                    | 3  | 17 |
| 2. Adequately Capitalized | 3                    | 10 | 24 |
| 3. Undercapitalized       | 10                   | 24 | 27 |

The BIF reserve ratio surpassed the DRR in 1995 and the FDIC lowered premiums on BIF deposits, ultimately reducing them to zero for 1A-rated banks. The SAIF reserve ratio surpassed the DRR in 1996, after the SAIF collected a special assessment of more than 65 basis points in accordance with the provisions of the Deposit Insurance Funds Act of 1996 (Funds Act). The Funds Act prohibited the FDIC from assessing banks and thrifts unless they “exhibit financial, operational, or compliance weaknesses ranging from moderately severe to unsatisfactory, or are not well capitalized,” as long as a fund’s reserve ratio exceeded (and was expected to remain above) the DRR. Translated, this means that, with a few exceptions, as long as a fund’s reserve ratio exceeds 1.25 percent, the FDIC generally may not charge premiums to well-capitalized institutions with CAMELS ratings of 1 or 2.

Table 2 shows the current rate matrix for both the BIF and the SAIF. As required by law, since the reserve ratios for the BIF and the SAIF exceed 1.25 percent, the assessment rate for 1A institutions is zero. Since most institutions are well capitalized and have a 1 or 2 CAMELS rating, as of December 31, 2000, 92 percent of all institutions were not paying premiums for deposit insurance.

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### III. WHY CHANGE THE CURRENT SYSTEM?

Although the current deposit insurance system is working well in the current environment, it has a number of weaknesses, including the following: (1) two deposit insurance funds providing identical coverage at potentially different prices; (2) inadequate pricing of risk that distorts incentives and increases moral hazard; (3) volatile premiums that are likely to rise substantially during an economic downturn; and (4) coverage levels that do not keep pace with inflation in a predictable fashion.

#### **A. *Two Deposit Insurance Funds.***

The BIF and the SAIF provide an identical product to both commercial banks and thrifts. Yet BIF and SAIF premiums are set separately. This raises the possibility of institutions with similar risk characteristics paying different premiums. Under the current premium structure, it would be entirely possible for one institution to be paying 23 basis points for deposit insurance while a competitor across the street that posed similar risk to its insurance fund was paying nothing. This is precisely what happened in late 1995 and 1996, when even the best-rated SAIF institutions were still paying premiums while the best-rated BIF institutions were not.

#### **B. *Inadequate Pricing Of Risk.***

Insurers generally price their product to reflect their risk of loss. The further that pricing deviates from expected loss, the greater the incentive for managers to take risks they would have avoided if the insurance had been appropriately priced. A zero price for the FDIC's guarantee encourages new deposits to enter the system, allowing some banks to enjoy the benefits of deposit insurance without shouldering any of the costs. Moreover, without risk-based pricing, safe banks unnecessarily subsidize risky banks.

FDICIA directed the FDIC to adopt risk-based pricing, but current law prevents it from doing so effectively. As noted above, 92 percent of all institutions currently pay nothing for deposit insurance. There are two problems with this. First, all institutions pose some risk to the fund and should pay for deposit insurance. Second, there are large and identifiable differences in risk exposure among these institutions. Nevertheless, the law prohibits the FDIC from distinguishing among them for purposes of pricing insurance.

This inability to price risk appropriately has had a number of negative effects already. Since very little in premiums has been collected since 1996, the deposit insurance system is almost entirely financed by those institutions that paid premiums in the past. There are currently over 900 newly chartered institutions that have never paid premiums. In addition, deposit insurance that is underpriced creates an incentive for institutions to grow rapidly. Since they are not paying for insurance, new institutions and fast-growing institutions are benefiting at the expense of their older competitors and slower-growing competitors. Rapid deposit growth lowers a fund's reserve ratio and increases the probability that additional failures will push a fund's reserve ratio below the DRR, resulting in a rapid increase in premiums for all institutions.

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***C. Volatile Premiums That Are Likely To Rise Substantially In An Economic Downturn.***

The rules governing the operation of the current deposit insurance system are focused on maintaining the 1.25 percent DRR at the expense of volatile premiums. In particular, as discussed above, when the DRR falls below 1.25, the FDIC must charge premiums of at least 23 basis points, unless a lower premium would be sufficient to restore the reserve ratio to the DRR within one year. Since bank failures and hence FDIC insurance expenditures are most likely to occur in an economic downturn, a fund is most likely to drop below the DRR in an economic slowdown or recession.

This means that banks are likely to be faced with very steep deposit insurance payments when earnings are already depressed. Such premiums would divert billions of dollars out of the banking system and raise the cost of gathering deposits at a time when credit already might be tight. This, in turn, could cause a further cutback in credit, resulting in a further slowdown of economic activity at precisely the wrong time in the business cycle.

***D. Deposit Coverage Does Not Keep Pace With Inflation in a Predictable Fashion.***

One of the purposes of deposit insurance is to provide depositors with a safe place to invest without the burden of monitoring their banks. Over time, inflation eats away at the value of deposit insurance. Unlike other government programs such as Social Security, Medicare, and even taxes, deposit insurance is not indexed to inflation. Although Congress has periodically adjusted the coverage level (the current level of \$100,000 was set in 1980), both the timing and the size of these adjustments have been unpredictable.

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#### **IV. RECOMMENDATIONS FOR REFORMING THE DEPOSIT INSURANCE SYSTEM**

To address the existing weaknesses in the deposit insurance system, the FDIC recommends the following reforms:

- The BIF and the SAIF should be merged.
- The current statutory restrictions on the FDIC's ability to charge risk-based premiums to all institutions should be eliminated; the FDIC should charge regular premiums for risk regardless of the level of the fund.
- Sharp premium swings triggered by deviations from the DRR should be eliminated. If the fund falls below a target level, premiums should increase gradually. If it grows above a target level, funds should be rebated gradually.
- Rebates should be based on past contributions to the fund, not the current assessment base.
- The coverage level should be indexed to keep pace with inflation.

The FDIC does not view deposit insurance reform as a revenue-raising exercise. The FDIC's proposals related to pricing are not intended to increase the assessment burden, but to spread that burden more evenly over time and more fairly across institutions.

All of the proposed reforms would require statutory changes.<sup>5</sup> They should be implemented as a package. Picking or choosing one part without the others could well weaken the deposit insurance system. For example, raising coverage with no change to the pricing system would exacerbate the distortion of incentives that already exists. Paying rebates without risk-based pricing for all institutions would increase the need to raise premiums in bad times. And a poorly designed rebate system could negate the benefits of any deposit insurance pricing system, and make incentive problems much worse than they are now. For example, giving rebates proportional to a bank's current assessable deposits could give banks an incentive to grow in order to increase the amount of their rebate.

This section presents the FDIC's recommendations in more detail and discusses some of the issues pertaining to implementing the reforms. The numerical examples are for illustrative purposes, and are intended to help readers understand the implementation issues involved with the proposals and the effect they might have on banks and the insurance fund. The FDIC recognizes the need for an ongoing discussion to work out the best implementation of these reforms and looks forward to working with the Congress, the industry and the public to improve the deposit insurance system.

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<sup>5</sup> The FDIC has the statutory authority to change at any time the assessment rates for institutions that are not well capitalized or do not have one of the two best examination ratings. Changing the assessment rates for this group of banks, which currently comprises about eight percent of insured institutions, would not address the problems with the current deposit insurance system described in this paper.

Other important issues were raised in the Options Paper and merit further analysis. These issues include the systemic-risk exception as provided by FDICIA, the pricing of the full faith and credit guarantee for the insurance funds, simplification of the deposit insurance rules, and opportunities for FDIC risk-sharing and price discovery through reinsurance and the capital markets. The FDIC intends to do further work on these issues.

**A. Recommendation: The BIF and the SAIF Should be Merged Now.**

As discussed above, the BIF and the SAIF offer an identical product. Yet, as long as there are two separate funds, the potential for a premium disparity and competitive inequality exists. In addition, a merged fund, as depicted in Table 3, would be stronger and better diversified than either fund standing alone.

Moreover, many institutions currently hold both BIF- and SAIF-insured deposits. The SAIF has truly become a hybrid fund, with more than 40 percent of SAIF-insured deposits now held by commercial banks. The costs to insured institutions associated with tracking their BIF and SAIF deposits separately, and the complications this introduces for mergers and acquisitions, could be eliminated by merging the funds.

**Table 3 - A Merged Fund Would Be Stronger than Two Separate Funds**

| <b>Bank Data</b>                            | <b>BIF</b> | <b>SAIF</b> | <b>Merged BIF and SAIF</b> |
|---|------------|-------------|----------------------------|
| <b>Number of Fund Member Banks</b>          | 8,572*     | 1,333       | 9,905                      |
| <b>Median Asset Size (\$ millions)</b>      | \$81       | \$124       | \$86                       |
| <b>Assessment Base (\$ billions)</b>        | \$3,327    | \$823       | \$4,150                    |
| <b>Total Insured Deposits (\$ billions)</b> | \$2,302    | \$753       | \$3,055                    |
| <b>Insurance Fund Data</b>                  |            |             |                            |
| <b>Fund Balance (\$ billions)</b>           | \$31       | \$11        | \$42                       |
| <b>Reserve Ratio</b>                        | 1.35%      | 1.44%       | 1.37%                      |

\*Excludes insured branches of foreign banks.

**B. Recommendation: The Current Statutory Restrictions on the FDIC's Ability to Charge Risk-Based Premiums to All Institutions Should Be Eliminated; the FDIC Should Charge Regular Premiums for Risk Regardless of the Level of the Fund.**

Under the current assessment system almost all banks pay the same premium, zero, when the fund exceeds the DRR. This system both underprices risk and fails to differentiate adequately among banks according to risk. Current law restricts the FDIC from charging premiums to most banks that are well capitalized and highly rated. This restriction should be eliminated.

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Deposit insurance premiums should reflect expected losses, that is, premiums from a risk group should cover losses the group experiences on average.<sup>6</sup> An implication of this approach is that since all banks present some risk, all banks should pay at least some deposit insurance premium.

Ideally, risk-based premiums should be forward looking. That is, premiums should be based on expected future losses over a specified time horizon. A bank engaging in risky activity may have a very low probability of failing within the next year but a much higher probability of failing over a longer period that encompasses changes in the economic cycle or the maturing of its risk assets—primarily loans. These considerations suggest that a time horizon longer than one year, perhaps on the order of three to five years, is probably appropriate.

A second issue in determining risk-based premiums is estimating expected losses over a longer time horizon, such as five years. There are a number of ways to do this. One could extrapolate current economic conditions or try to predict the business cycle. However, such an approach might lead to premium volatility as economic conditions change or change in ways that are not anticipated. An alternative approach is to allow for a representative range of past business conditions.

Table 4 shows estimated risk-based premiums for the current nine-cell pricing matrix based on a five-year time horizon and failure and insurance loss rates over the 15-year period from 1984 to 1999. This period saw both banking crisis and economic boom and thus contains a range of business conditions.

**Table 4 – Unrestricted Risk-Based Premiums in a Nine-Cell Matrix (1984-1999)**

| Capital                   | Supervisory |      |      |
|---------------------------|-------------|------|------|
|                           | A           | B    | C    |
| 1. Well Capitalized       | 3.7         | 8.9  | 17.8 |
| 2. Adequately Capitalized | 10.3        | 20.7 | 50.3 |
| 3. Undercapitalized       | 19.8        | 41.6 | 96.8 |

This simple example illustrates a fundamental consideration in pricing deposit insurance: expected loss premiums for the riskiest banks are likely to be so high that they could cause additional failures. As a realistic measure, such premiums will have to be capped and some portion of the cost borne by less risky institutions.

The FDIC has devoted considerable attention to how best to differentiate banks by risk for purposes of setting deposit insurance premiums—in particular, how to differentiate among

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<sup>6</sup> This statement implicitly assumes that the FDIC is risk-neutral. We considered and rejected trying to impose assessments that had a risk premium analogous to what a risk-averse private investor would demand. Such premiums would be much higher and more volatile.

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banks currently assigned to the best, or 1A, risk category. A straightforward way would be to use CAMELS ratings (1s versus 2s). There are, however, some drawbacks to this approach. Because there is an 18-month statutory examination cycle, a system based primarily on changes in CAMELS ratings may not be sufficiently responsive to changing conditions. The CAMELS approach might also raise concerns about subjectivity in the assignment of ratings.

Another approach to differentiating banks by risk is to use a statistical model that uses examination ratings, financial ratios and, for large banks, possibly certain market signals as inputs to project failure rates. Such a model could be used to develop a scorecard that would slot banks into risk categories. In the private sector, similar modeling approaches are used to score loan applicants or estimate default rates on obligations of public or private companies.

Table 5 provides an example of such a scoring model. The scorecard in Table 5 was derived from a statistical failure-prediction model similar to those used to generate credit scores, with the weights based on the explanatory power of the variables.<sup>7</sup> Again, this scorecard is presented for illustrative purposes. Many additional variables, such as loan concentrations, off-balance-sheet exposures, and liability structures, are candidates for inclusion in the model.<sup>8</sup> New banks less than five years old were not scored by the model because of their unique financial characteristics. For large, complex financial institutions, it may be advantageous to develop a separate approach, possibly including market data such as stock or bond prices. Finally, additional work is needed on the treatment of fast-growing institutions, in particular whether risky growth should be determined objectively as it is in this example, or subjectively through the supervisory process.

A scoring model developed along these lines could be used to score all institutions and replace the current nine-cell matrix entirely. Such an approach is promising. However, to keep things simple in the example below, the scorecard is used only to disaggregate the 1A category into three separate risk categories as follows:

- Group 1a+: Score of 3 or less
- Group 1a (new): Score of 4 or 5
- Group 1a–: Score of greater than 5, plus all current 1A banks less than five years old

Table 6 gives an example of such a matrix.

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<sup>7</sup> The weight on asset growth was assigned judgmentally. A 40 percent annual asset growth rate is approximately the 98<sup>th</sup> percentile of asset growth for all banks during the years 1985 to 1999.

<sup>8</sup> James Marino and Rosalind Bennett, “The Consequences of National Depositor Preference,” *FDIC Banking Review* 12(2), October 1999, pp. 19–38.



**Table 5 - Pricing Deposit Insurance with a Scoring Model**

| <b>Scoring Factors</b>                         | <b>Range of Scores</b> | <b>Maximum Score</b> |
|--|------------------------|----------------------|
| CAMELS = 1                                     | 0                      | <b>50</b>            |
| CAMELS = 2                                     | 1                      |                      |
| CAMELS = 3                                     | 4                      |                      |
| CAMELS = 4                                     | 15                     |                      |
| CAMELS = 5                                     | 50                     |                      |
| Equity to Assets > 12%                         | 0                      | <b>14</b>            |
| Equity to Assets = 6% to 12%                   | 1                      |                      |
| Equity to Assets < 6%                          | 14                     |                      |
| Net Income to Total Assets > 1.25%             | 0                      | <b>10</b>            |
| Net Income to Total Assets = 0.65% to 1.25%    | 1                      |                      |
| Net Income to Total Assets = 0% to 0.65%       | 2                      |                      |
| Net Income to Total Assets < 0%                | 10                     |                      |
| Nonperforming Loans to Total Assets < 1%       | 0                      | <b>10</b>            |
| Nonperforming Loans to Total Assets = 1% to 3% | 2                      |                      |
| Nonperforming Loans to Total Assets > 3%       | 10                     |                      |
| ORE to Total Assets < 1%                       | 0                      | <b>6</b>             |
| ORE to Total Assets = 1% to 3%                 | 2                      |                      |
| ORE to Total Assets > 3%                       | 6                      |                      |
| Noncore Funding to Total Assets < 15%          | 0                      | <b>3</b>             |
| Noncore Funding to Total Assets = 15% to 30%   | 1                      |                      |
| Noncore Funding to Total Assets > 30%          | 3                      |                      |
| Liquid Assets to Total Assets > 50%            | 0                      | <b>2</b>             |
| Liquid Assets to Total Assets = 30% to 50%     | 1                      |                      |
| Liquid Assets to Total Assets < 30%            | 2                      |                      |
| Asset Growth < 40%                             | 0                      | <b>5</b>             |
| Asset Growth > 40%                             | 5                      |                      |
| <b>Total</b>                                   |                        | <b>100</b>           |

| <b>Application of Scoring Framework</b>                      |     |
|--|-----|
| If Bank is 1A and Total Score is 3 or less classify as:      | 1a+ |
| If Bank is 1A and Total Score is 4 or 5 classify as:         | 1a  |
| If Bank is 1A and Total Score is greater than 5 classify as: | 1a- |

The Risk Scorecard is intended for established banks and banks other than large, complex banking organizations.

**Table 6 - Assessment Rates Based on Modified 1A Category**

| Capital Group             | Supervisory Subgroups |    |     |    |    |
|---------------------------|-----------------------|----|-----|----|----|
|                           | A                     |    |     | B  | C  |
|                           | 1a+                   | 1a | 1a- |    |    |
| 1. Well Capitalized       | 1                     | 3  | 6   | 12 | 25 |
| 2. Adequately Capitalized | 12                    |    |     | 25 | 30 |
| 3. Undercapitalized       | 25                    |    |     | 30 | 40 |

In Table 6, the assessment rates for the riskiest institutions are considerably below those shown in Table 4. The rates have been capped in this example to reflect the concern over rates being so high as to cause additional failures, as discussed earlier.

By disaggregating the 1A category, 92 percent of the industry no longer pays the same assessment rate. As shown in Table 7, 42.7 percent of institutions would still find themselves in the lowest-risk category, 1a+; an additional 26.5 percent would be in the new 1a category; while 23 percent would be in the 1a- category.

For purposes of illustration, Tables 6 and 7 include large, complex institutions. They also include institutions chartered over the past five years, which were put in the 1a- category. Premiums for new institutions, based on insurance losses from 1985 to 1999, would exceed 20 basis points during their first five years. This is much higher than the 6 basis points that would be charged 1a- institutions in Table 6. The treatment of new banks in Table 6 is intended to reflect a balance between the goals of risk-based pricing, on the one hand, and the disinclination to deter new bank formation unduly, on the other.

Table 7 also shows the distribution of the assessment base by risk categories. On the basis of this distribution, the FDIC would gather \$1.4 billion in annual premiums, for an industry average assessment rate of 3.5 basis points. Significantly, 3.5 basis points is just about the effective premium rate the FDIC charged from 1950 to 1980.

**Table 7 - Distribution of Banks and the Assessment Base with a Modified 1A Category, December 31, 2000**

| Capital Group |                    | Supervisory Subgroups |       |         |       |         |       |      |      |      |      |
|---------------|--------------------|-----------------------|-------|---------|-------|---------|-------|------|------|------|------|
|               |                    | A                     |       |         |       |         |       | B    |      | C    |      |
|               |                    | 1a+                   |       | 1a      |       | 1a-     |       |      |      |      |      |
| 1. Well       | Number of Banks    | 4,233                 | 42.7% | 2,634   | 26.5% | 2,282   | 23.0% | 485  | 4.9% | 70   | 0.7% |
|               | Base (\$ billions) | 1,579.6               | 38.0% | 1,323.7 | 31.8% | 1,104.0 | 26.5% | 85.6 | 2.1% | 13.8 | 0.3% |
| 2. Adequate   | Number of Banks    | 172                   |       |         |       | 1.7%    |       | 25   | 0.3% | 11   | 0.1% |
|               | Base (\$ billions) | 41.8                  |       |         |       | 1.0%    |       | 5.4  | 0.1% | 4.5  | 0.1% |
| 3. Under      | Number of Banks    | 4                     |       |         |       | 0.0%    |       | 2    | 0.0% | 6    | 0.1% |
|               | Base (\$ billions) | 0.6                   |       |         |       | 0.0%    |       | 0.2  | 0.0% | 0.5  | 0.0% |

Total Revenue (\$ billions) = 1.4

Effective Rate (basis points) = 3.5

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***C. Recommendation: Sharp premium swings triggered by deviations from the DRR should be eliminated. If the fund falls below a target level, premiums should increase gradually. If it grows above a target level, funds should be rebated gradually.***

The emphasis of the current deposit insurance system on maintaining the 1.25 percent DRR creates the potential for volatile premiums. This is likely to result in the industry paying high premiums when both banks and the economy can least afford it. The deposit insurance system should work to smooth economic cycles, not exacerbate them. It would be preferable for the fund to absorb some losses and for premiums to adjust gradually. This can be accomplished by establishing a target for the fund. If the fund varied from the target, surcharges or rebates would be used to bring the fund back to the target gradually. The target could be a range within which premiums would be constant. Alternatively, it could be a fixed reserve ratio such as the current DRR.

For example, the reserve ratio could be allowed to vary between 1.15 percent and 1.35 percent. Banks would pay risk-based premiums such as those in Table 6 with no rebates or surcharges so long as the reserve ratio remained within the range. If the fund fell below 1.15 percent of insured deposits, there would be a surcharge equal to, for example, 30 percent of the difference between the reserve ratio and 1.15 percent. If the fund rose above 1.35 percent, there would be a rebate equal to 30 percent of the difference between the reserve ratio and 1.35 percent. Thus, there would be a range of plus or minus 10 basis points around 1.25 percent within which the fund would be allowed to fluctuate without rebates or surcharges. The range could be larger or smaller.

Alternatively, one can imagine a fixed reserve ratio of 1.25 percent, with rebates or surcharges equal to 30 percent or some smaller percentage of the difference between the reserve ratio and 1.25 percent. A smaller percentage may be appropriate given that the adjustments start immediately.

There are trade-offs between a range on the one hand and a fixed reserve ratio on the other (the same trade-offs exist to a lesser extent between a larger or smaller range). Other things equal, a range has the advantage of generally being less procyclical. It takes longer before surcharges kick in, and allowing the fund to build higher before rebates creates a bigger cushion to absorb losses. On the other hand, a fixed reserve ratio results in surcharges whenever the fund is below a particular ratio and rebates whenever the fund is above that ratio. As discussed below, rebates based on past contributions to the fund are one of the ways the FDIC's reform proposal deals with fast growers and new entrants taking advantage of a fund built up by others.

Whether the target is a fixed reserve ratio or a range, determining the target is equivalent to asking what is the appropriate size of the insurance fund. There is no one correct answer to this question, because it involves a trade-off between two important policy goals. The smaller the fund, the higher premiums will need to be under adverse scenarios in order to maintain the solvency of the fund. On the other hand, if the goal is to avoid any risk of insolvency, even from the proverbial "hundred-year flood," the fund would probably have to be quite high. Although a large fund would protect the taxpayer from any loss, it would do

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so at the cost of taking funds out of the banking system that could otherwise be used to provide credit. On balance, the existing 1.25 percent reserve ratio target that Congress has selected does not appear to be a bad starting place, either as a fixed target or as the midpoint of a range.

The framework proposed by the FDIC relies on surcharges and rebates to bring the fund back toward a target. The current statutory target, the DRR, is defined relative to insured deposits, and for simplicity the examples presented here are based on targets tied to insured deposits. The target could be expressed analytically, in terms of the risk exposure of the fund. For example, something akin to a credit rating could be calculated and the FDIC could be required to maintain an investment grade credit rating.

There is also the question of how surcharges and rebates should be allocated across banks. With respect to surcharges there is no reason that they should not be assessed against the current assessment base. For example, if there were a 2-basis-point surcharge, then the best-rated bank with \$100 million in assessable deposits would pay a risk-based premium of 1 basis point, or \$10,000 plus a \$20,000 surcharge, for an effective premium rate of 3 basis points. The one exception to this rule might be for the worst-rated institutions. As discussed earlier, there is concern that premiums could get so high that they could push institutions that might otherwise have survived into failure. Because of this concern, the surcharges for the riskiest institutions may have to be capped or scaled back.

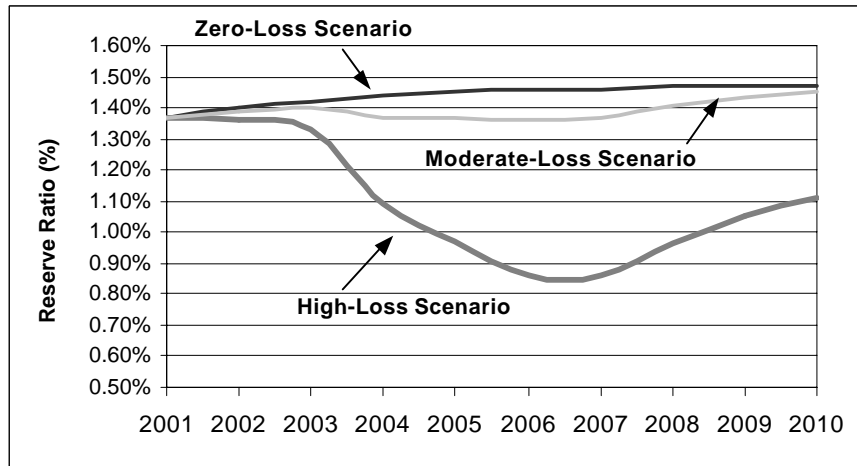
Rebates are a different matter. Tying rebates to the current assessment base could give insured institutions an incentive to grow simply to get a larger rebate. This would exacerbate moral hazard. In the next section, we discuss the FDIC's recommendation that rebates not be tied to the current assessment base.

Finally, one more issue should be addressed. What if the fund keeps on growing or shrinking despite the rebates or surcharges designed to slow its movement away from the target? A deposit insurance fund serves vital purposes—protecting taxpayers from loss, ensuring that adequate resources are readily available when problems arise, and helping to smooth the costs of deposit insurance over time. However, maintaining a fund involves a trade-off, as noted earlier, since money in the fund could also be put to useful purposes by the banking industry. At some point when the fund is growing, the balance may tip in favor of returning funds to the banking industry rather than retaining them in the deposit insurance fund. Similarly, as a fund continues to shrink, at some point it may be appropriate for banks to provide more support for the fund. One might consider a cap on the fund above which all funds are rebated to the industry or a floor below which all losses would have to be made up by the industry quickly.

How would all this work? Chart 1 shows the level of the fund under three economic scenarios—no loss, moderate loss, and high loss. The high-loss scenario is based on the percentage losses suffered by the BIF during the last banking crisis. The moderate-loss scenario is based on losses one-quarter the amount suffered during the last crisis. Losses do not reflect the reserves set aside by the FDIC for losses on banks that did not actually fail during the crisis period, and this fact moderates the effect on the reserve ratio in Chart 1. The chart is based on the assessment structure with a target range as discussed above; the results

would be similar if it were based on a fixed reserve ratio. Base premiums are set in accordance with the risk-based premium rates in Table 6. The fund is allowed to fluctuate between 1.15 percent and 1.35 percent. When it falls outside this range, there are surcharges and rebates equal to 30 percent of the difference between the reserve ratio and the lower and upper bounds of the range, respectively.

**Chart 1 - Merged Fund Reserve Ratios under Various Loss Scenarios**

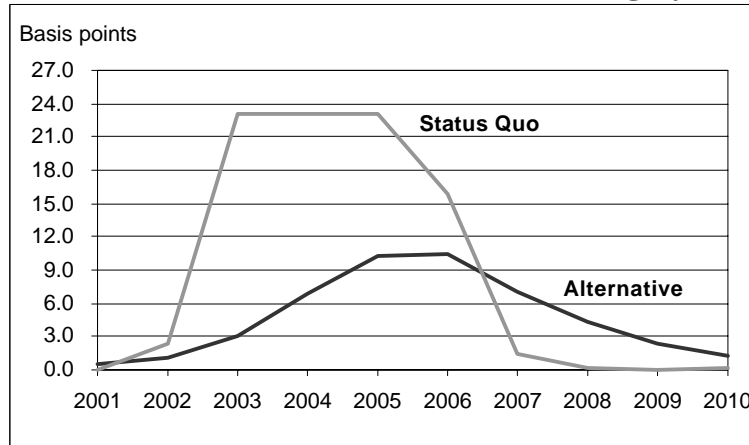


The "High-Loss Scenario" and the "Moderate-Loss Scenario" assume losses at 100 percent and 25 percent, respectively, of the actual insurance losses (without reserves), in the last banking crisis.

Chart 1 illustrates that the fund fluctuates over a much larger range than the 1.15 to 1.35 percent range, depending on economic conditions. But, even with no insurance losses for 10 years the fund never quite reaches 1.5 percent of insured deposits. Gradual rebates are sufficient to prevent the fund from growing without bound.

What happens to premiums, especially in the high-loss scenario, where there are substantial surcharges? Chart 2 shows the effective premiums that would be paid by a 1a+ institution in a high-loss scenario under the current premium system and under the revised system proposed above. The difference is striking and demonstrates how the proposed system helps to dampen volatile premiums. Instead of premiums rising rapidly from zero to 23 basis points, remaining at 23 basis points for a number of years, and then falling back to zero, premiums rise gradually from 1 basis point to about 10.5 basis points and then decrease gradually to about 2 basis points at the end of the 10-year period. Similar results hold for other 1A institutions. For example, for 1a- institutions, premiums would peak at about 15.5 basis points as opposed to 23 basis points under the status quo. Because the insurance fund would be allowed to absorb more losses under the proposed system, billions of additional dollars would be available to the banking industry to help fuel economic growth in the trough of the business cycle.

**Chart 2 – Effective Assessment Rates under a High-Loss Scenario for Banks in the 1a+ Category**



**D. Recommendation: Rebates should be based on past contributions to the fund, not on the current assessment base.**

Rebates are an important part of a deposit insurance system if the FDIC is to charge positive risk-based deposit insurance premiums at all times and yet avoid enormous growth of the insurance fund during long stretches of good years. As demonstrated above, even gradual rebates can serve to limit the growth of the fund. However, it is important that rebates not create perverse economic incentives. Rebates tied to the current assessment base would, in effect, represent a decrease in the cost of insurance. This would increase moral hazard. As discussed earlier, with rebates tied to the current assessment base, banks that grew the fastest would get the largest rebates, other things equal.

If premiums are not based on the current assessment base, there are two questions: (1) How should rebates initially be allocated? (2) How should that allocation change over time as more and different banks pay into the system?

With respect to the initial allocation, fairness dictates that it be based on past contributions to the fund. Basing rebates on past contributions raises certain issues: how far back in time to look for determining the past contributions (the data only go to 1984); how to treat mergers and failing bank acquisitions; and how to account for the SAIF capitalization. None of these problems is insurmountable, however, and one could come up with reasonable rules for determining the initial allocation of any rebates.

The next question is how that allocation would change over time. One possibility is to track premiums received and rebates paid, so that, at any point in time, rebates could be calculated on the basis of past payments to the fund. A crucial issue here is how far back banks are given credit for premiums they paid for purposes of calculating their rebates. If there is no limit on this look-back period, it would take decades for a new bank's rebate share to "catch up" with its older competitors. An alternative would be to base rebates on a bank's share of total premiums paid over a period of years. Such a system might be based on premiums paid

over the last five years, or to give current deposit growth less weight, rebates could be based on premiums paid between five and 10 years ago. In such a case, rebates in, say, 2010 would be based on premiums paid between 2001 and 2005. In any case, the longer the lag, the longer it will take new institutions to catch up.

There are two additional factors to take into account in designing a rebate system. First, to prevent anomalous results, each bank might be required to maintain a positive “net credit balance” with respect to the FDIC. That is, premiums paid minus rebates received over some defined number of years should never be negative. Second, there is a question whether the additional premium a bank pays because of its above-average risk category should count toward a rebate. One possibility is to give banks credit only for premiums they would have paid had they been classified among the safest banks.

Table 8 contains an example that helps clarify how rebates might work. It compares premiums and rebates for two banks under the moderate-loss scenario. As in the previous examples, rebates equal to 30 percent of the difference between the reserve ratio and 1.35 percent are paid when the reserve ratio exceeds the upper end of the range. Rebates are initially allocated by past payments to the funds. After five years, they are determined by premiums paid in during the previous five to 10 years.

**Table 8**  
**Cash Flows for a \$100 Million Institution Growing at 3 Percent per Year**  
**(30% Rebate)**

| \$100 Million<br>1a+ |                       | Moderate Loss (Last Crisis x 1/4) |            |           |           |           |           |            |            |            |            |
|----------------------|-----------------------|-----------------------------------|------------|-----------|-----------|-----------|-----------|------------|------------|------------|------------|
|                      |                       | 2001                              | 2002       | 2003      | 2004      | 2005      | 2006      | 2007       | 2008       | 2009       | 2010       |
|                      | Base Premium          | \$10,000                          | \$10,300   | \$10,609  | \$10,927  | \$11,255  | \$11,593  | \$11,941   | \$12,299   | \$12,668   | \$13,048   |
|                      | (Rebate) or Surcharge | (\$13,757)                        | (\$16,752) | (\$6,595) | (\$4,946) | (\$3,336) | (\$7,657) | (\$18,887) | (\$26,929) | (\$31,901) | (\$33,894) |
|                      | Net Cash Flow         | (\$3,757)                         | (\$6,452)  | \$4,014   | \$5,982   | \$7,919   | \$3,936   | (\$6,947)  | (\$14,630) | (\$19,234) | (\$20,846) |
|                      | Net Cash Flow (bp)    | (0.4)                             | (0.6)      | 0.4       | 0.5       | 0.7       | 0.3       | (0.6)      | (1.2)      | (1.5)      | (1.6)      |

**Cash Flows for a Previous Fast-Growing \$1 Billion Institution Growing at 3 Percent per Year**  
**(30% Rebate)**

| \$1 Billion 1a+<br>Previous Fast<br>Grower |                       | Moderate Loss (Last Crisis x 1/4) |            |           |           |           |            |            |             |             |             |
|--|-----------------------|-----------------------------------|------------|-----------|-----------|-----------|------------|------------|-------------|-------------|-------------|
|  |                       | 2001                              | 2002       | 2003      | 2004      | 2005      | 2006       | 2007       | 2008        | 2009        | 2010        |
|  | Base Premium          | \$100,000                         | \$103,000  | \$106,090 | \$109,273 | \$112,551 | \$115,927  | \$119,405  | \$122,987   | \$126,677   | \$130,477   |
|  | (Rebate) or Surcharge | (\$13,757)                        | (\$16,752) | (\$6,595) | (\$4,946) | (\$3,336) | (\$15,314) | (\$75,549) | (\$161,575) | (\$255,210) | (\$338,939) |
|  | Net Cash Flow         | \$86,243                          | \$86,248   | \$99,495  | \$104,327 | \$109,214 | \$100,613  | \$43,857   | (\$38,588)  | (\$128,533) | (\$208,461) |
|  | Net Cash Flow (bp)    | 0.9                               | 0.8        | 0.9       | 1.0       | 1.0       | 0.9        | 0.4        | (0.3)       | (1.0)       | (1.6)       |

Note: Rebate rule assumes banks' rebate shares are determined by the percentage of total premiums they paid during a period of time in the past, in this example the period between ten years before the current assessment period and five years before the assessment period.

The first bank is a hypothetical 1a+ bank with \$100 million in deposits that are growing at 3 percent a year. Base premiums are 1 basis point a year. Since, as can be seen in Chart 1, under the moderate-loss scenario, the reserve ratio exceeds 1.35 every year, rebates are paid every year. Initially, rebates for this institution exceed premiums so there is a net cash flow from the FDIC to the bank. As the reserve ratio falls, rebates get smaller. For a number of years, the bank pays the FDIC more than it receives in rebates. Then, as FDIC insurance

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losses decrease, rebates increase again and the bank once again gets a net cash flow from the FDIC.

The second bank was once a \$100 million bank, but it has grown very rapidly over the last few years and now has \$1 billion in deposits. Its growth has since slowed and it is now growing at 3 percent a year. The bank is also rated 1a+, so it also pays premiums of 1 basis point a year, but since it is 10 times the size of the first bank, its premiums are 10 times those of the first bank. Rebates are based on past contributions to the fund, and since the bank used to be a \$100 million bank, we assume that it paid in the same amount as the first bank. Thus, for the first five years, both banks receive identical rebates. The premiums paid by the second bank far and away exceed its rebates for the first five years, and for those five years, its net cash flow is not substantially lower than its assessments. After five years the second bank begins to get credit for its higher premiums, and by the end of 10 years it has caught up—both its premiums and rebates are 10 times those of the small bank.

### ***Rapidly Growing Institutions***

Recent developments have highlighted the concern raised by rapidly growing institutions that dilute the reserve ratio and pay nothing for deposit insurance. The FDIC's recommendations would address this issue in several ways. First, under the assessment system described above, a decrease in the reserve ratio has, at most, a gradual effect on net payments. This means the effect of new deposit growth on other insured institutions would be substantially diminished.

Second, regular risk-based premiums for all banks would mean that fast-growing institutions would pay increasingly larger premiums as they gathered deposits. In addition, fast growth, if it posed greater risk, could result in additional premiums through the operation of the FDIC's expanded discretion to price risk.

Finally, as described with respect to Table 8 above, with rebates based upon past contributions, when the FDIC is paying rebates, net payments to the FDIC from fast growers would be greater than for established institutions or slower growers. Over time, as all institutions paid assessments (and as rebates were made on the basis of past assessments), funds from more recent assessments would replace funds from older assessments and new institutions would become eligible for rebates based on the premium they paid.

### ***E. Recommendation: The deposit insurance coverage level should be indexed to maintain its real value.***

As noted earlier, a primary purpose of deposit insurance is to give depositors a safe place to save, invest and manage their accounts without the burden of monitoring the financial condition of their banks. Federal deposit insurance is important, not only to individuals and families, but also to the many small businesses, charities and local governments that commonly rely on local financial institutions. The level of coverage has been changed by Congress six times since the inception of the system in 1934 and, generally, those increases



have kept pace with or exceeded inflation. However, in the past 20 years, the real value of the current \$100,000 coverage level has fallen by about half (based on the Consumer Price Index, or CPI). The real value is now less than it was in 1974, when the nominal coverage level was increased to \$40,000.

Deposit insurance is an important element of the government’s overall effort to promote public confidence in the banking system and, as such, it should not be allowed to erode in value. There are two ways of maintaining the real value of the deposit insurance coverage level. One way is through *ad hoc* increases. As shown in Table 9, this is what has been done in the past.

**Table 9 – Nominal Deposit Insurance Levels**

| Year           | Amount  | Percent Increase | Years from Last Increase | Value of Coverage (1980 Dollars)* |
|----------------|---------|------------------|--------------------------|-----------------------------------|
| 1934 (January) | \$2,500 | ---              | ---                      | \$15,373                          |
| 1934 (June)    | 5,000   | 100              | 0.5                      | 30,746                            |
| 1950           | 10,000  | 100              | 16                       | 34,191                            |
| 1966           | 15,000  | 50               | 16                       | 38,148                            |
| 1969           | 20,000  | 33               | 3                        | 44,905                            |
| 1974           | 40,000  | 100              | 5                        | 66,856                            |
| 1980           | 100,000 | 150              | 6                        | 100,000                           |
| 2000           | 100,000 | ---              | 20                       | 43,728                            |

\* Indexed using the CPI.

The alternative is a more systematic method of maintaining the real value of the coverage level through an indexing system. An indexing system can increase predictability and lessen the potential for large, sudden increases. Bankers and depositors would be able to predict the timing and magnitude of coverage level increases better. This predictability would enhance financial planning on the part of depositors and facilitate bankers’ planning when coverage changes occur, thereby lowering costs. Other important government programs, such as Social Security, Medicare, and even taxes, are indexed to maintain their real value. Federal deposit insurance should be treated in the same fashion, once the Congress determines the initial coverage level.

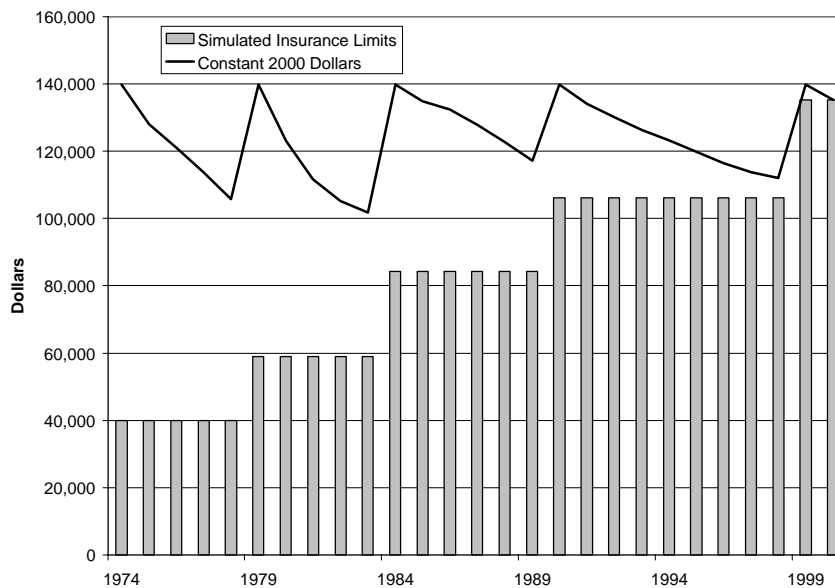
## **Indexing**

Given an initial coverage level, two questions must be answered in order to implement indexing: What index should be used, and when should the level be adjusted? Possible indices are numerous, and include price, wealth, and income indices. For pragmatic reasons the FDIC believes the CPI would be appropriate. It is widely understood and accepted and is quickly available. It also captures inflation reasonably well.

There are many possible rules for deciding when to increase the coverage level, including the passage of time and significant declines in the level's real value. A combination of a minimum period of time between level increases and a minimum percentage decline in the value of the level seems to work best. Because changing the level can impose burdens on banks and thrifts (for example, by requiring new training for employees and changes to signs and advertising materials), input from the industry is needed on what the minimum time period and necessary percentage declines should be.

Chart 3 shows an example of a CPI-based indexing system. A number of starting points could have been selected. Starting with today, the initial coverage level would be \$100,000. Starting with 1980, the level would be approximately \$200,000. The example in Chart 3 shows how the system would have worked if implemented in 1974, when the coverage level was \$40,000. In the example, the coverage level is adjusted no earlier than every five years and only if the real value drops below 80 percent of the previous level. Using these rules with 1974 as a base year would have produced a coverage level today of approximately \$135,000.

**Chart 3 – Deposit Insurance Indexing System that Adjusts Coverage No Earlier than Five Years and Only When the Real Value Drops below 80 Percent.**



Such a system could have a safety-valve feature for periods of extraordinary inflation. For example, if coverage erodes in value by more than 25 percent over any three-year period, the level could be adjusted.

The FDIC believes that coverage levels should be in round numbers (for example, to the nearest \$5,000) and should not be allowed to decrease. A decline in the coverage level would put a burden on the public to monitor the level to avoid becoming uninsured, and, by creating uncertainty, could undermine the purpose of deposit insurance.

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## The Starting Point for the Coverage Level

As noted earlier, one of the purposes of deposit insurance is to give depositors a safe place to invest without the burden of monitoring the financial condition of their banks. What level of coverage is appropriate for this purpose is open to debate and, in the view of the FDIC, is appropriately reserved for the Congress to determine. In deciding the starting point for the coverage level, there are a number of factors to consider. The remainder of this section provides information and perspective on several of the relevant factors.<sup>9</sup>

*Adequacy of the current level.* As noted earlier, since 1980, the real value of the coverage level, based on the CPI, has fallen by about half. The real value of the level is now less than it was in 1974, when the nominal coverage level was \$40,000

A recent household survey that the FDIC commissioned from the Gallup Organization found that nearly half (47 percent) of households (specifically, those members most knowledgeable about the finances of the household) believe the level should be raised, while only 27 percent of households believe that the insurance level is at the appropriate level today. On the other hand, in an American Bankers Association (ABA) survey of high-wealth households, only 30 percent said that the current level of FDIC insurance is too low.

Households are not the only depositors to consider. Many businesses, including small businesses, have a need for deposit accounts exceeding \$100,000. In a survey of small-business owners conducted by the ABA, 49 percent thought that the \$100,000 deposit insurance level was too low.

*Moral hazard.* The 1980 increase in deposit insurance coverage to \$100,000 is widely viewed as playing a role in the ensuing savings-and-loan crisis. The increase in coverage to \$100,000, combined with lifting Regulation Q ceilings at the same time, facilitated an influx of deposits into thrifts.<sup>10</sup> Whether the higher coverage level increased moral hazard is uncertain, however. Many factors contributed to the savings-and-loan crisis, and the confluence of these factors likely explains the magnitude of the crisis.<sup>11</sup>

It is clear, however, that regulatory practices in the 1980s imposed inadequate restraints on moral hazard,<sup>12</sup> whether higher coverage levels increased moral hazard or not. FDICIA attempted to address the regulatory failures of the 1980s by granting new tools to regulators, while restricting their discretion in using the tools. Among other things, FDICIA introduced prompt corrective action and higher capital requirements, and greatly restricted “too-big-to-fail” practices. These tools have not been tested in a downturn, but are designed to counteract moral hazard.<sup>13</sup>

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<sup>9</sup> For additional information, see the FDIC “Deposit Insurance Options Paper,” pp. 35–49.

<sup>10</sup> The Depository Institutions Deregulation and Monetary Control Act of 1980 began the process of lifting the old Regulation Q ceiling on the interest rates that banks could offer depositors.

<sup>11</sup> Federal Deposit Insurance Corporation. *History of the Eighties—Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s*. FDIC, 1997.

<sup>12</sup> George Hanc, “Deposit Insurance Reform: State of the Debate.” *FDIC Banking Review* 12(3), 1999, p. 4.

<sup>13</sup> As discussed earlier, FDICIA’s concept of a DRR (as altered by subsequent legislation) has increased moral hazard by eliminating deposit insurance premiums for most banks.

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In addition, the deposit insurance reforms recommended in this paper would go a long way toward mitigating any increase in moral hazard that might stem from raising the deposit insurance coverage level. The primary problems associated with an increase in coverage arise from underpriced deposit insurance. Raising coverage without addressing this issue would exacerbate the pricing flaws in the system.

Nevertheless, the potential remains for higher coverage levels to facilitate deposit-gathering by institutions that engage in high-risk activities. An increase in insurance levels would tend to reduce the cost of rapidly gathering large amounts of insured funds and therefore might accelerate the use of brokered funds and similar techniques. In principle, banks could gather the same amount of funds under the existing level by attracting more brokered deposits, but an increase in the level might make it easier for investors to place large amounts into insured deposits directly without the use of brokers, a form of self-directed "hot" money.

*Municipal deposits, IRAs, and excess coverage.* Some have suggested that higher coverage levels would be appropriate for certain types of deposits. The potential benefits and consequences of favoring some deposits with higher coverage levels are uncertain. It is the FDIC's view that these proposals should be explored further, through additional analysis and discussions among the interested parties.

- Public entities typically require banks to pledge low-risk securities to protect the portion of municipal deposits that is not insured by the FDIC. Analysis of Call Report data suggests that smaller institutions are pledging an increasing percentage of their securities in order to hold public deposits. This trend may imply that smaller institutions are becoming increasingly constrained in their investment options. Raising the coverage level on public deposits could provide banks with more latitude to invest in other assets, including loans. Higher coverage levels might also help community banks compete for public deposits and reduce administrative costs associated with securing these deposits. On the other hand, the collateralization requirement places a limit on the ability of riskier institutions to attract public funds, while a high deposit insurance limit would not.
- Because retirement accounts tend to be long-term investments, over time they can reach relatively large balances that exceed the coverage provided by FDIC insurance. Thus, raising the coverage level on IRAs could encourage depositors to invest more of their retirement savings in insured bank deposits. Because these deposits are usually held for the long term, they may be less likely to shift to riskier institutions in response to higher yields or other attempts to gather deposits quickly.
- A small number of private-sector insurance companies offer excess deposit insurance coverage for a fee. The demand for this product is currently described by some providers as minimal to moderate. However, demand was higher during the banking crises of the 1980s and early 1990s and could increase during future downturns. Some banks have expressed a willingness to pay an additional premium to increase FDIC insurance coverage in order to retain existing large deposits or obtain new deposits. The FDIC believes that additional analysis is warranted to explore the possibilities for providing excess coverage or backstopping the coverage provided by private insurers.

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## V. CONCLUSION

The FDIC's recommendations are as follows:

- The BIF and the SAIF should be merged.
- The current statutory restrictions on the FDIC's ability to charge risk-based premiums to all institutions should be eliminated; the FDIC should charge regular premiums for risk regardless of the level of the fund.
- Sharp premium swings triggered by deviations from the DRR should be eliminated. If the fund falls below a target level, premiums should increase gradually. If it grows above a target level, funds should be rebated gradually.
- Rebates should be based on past contributions to the fund, not the current assessment base.
- The coverage level should be indexed to keep pace with inflation.

These reforms will make the deposit insurance system function more efficiently and fairly, in a way that provides the appropriate economic incentives for all of the participants.

As indicated earlier, this set of recommendations should be implemented as a package. The proposed reforms are interrelated, so that picking and choosing could easily produce unintended consequences or make things worse.

Implementation of these reforms presents complicated issues. The FDIC looks forward to working with the Congress, the banking industry and the public to improve the deposit insurance system.