

Congress Should Dump Ratio For Deposit Insurance Funds

■ BY BERT ELY

Recent articles about rapid deposit growth at some banks and thrifts have sparked fears about higher deposit insurance premiums.

However, there is absolutely no rational reason why deposit growth should trigger premium hikes.

The threat of higher premiums is driven by the congressional requirement that the Federal Deposit Insurance Corp.'s Bank Insurance Fund and Savings Association Insurance Fund each maintain a minimum balance of at least 1.25% of estimated insured deposits.

There are two conceptual flaws with the minimum requirement. First, contrary to widely held belief, that portion of a fund's balance below 1.25% is not available to absorb losses arising from bank and thrift failures. That's because if a fund's balance dips below the minimum, the FDIC must increase premiums to quickly rebuild the balance to a 1.25% ratio.

Second, the reserve ratio concept bears absolutely no relationship to the theory or practice for determining how insurance entities should be capitalized.

Because of the minimum requirement, deposit growth auto-

matically increases the amount in the two funds that is off-limits to deposit insurance losses.

Some data will illustrate this point. From June 30, 1997, to June 30, 2000, deposit growth boosted the portion of the bank fund balance not available to absorb losses by \$2.5 billion. That is, \$2.5 billion of funding dropped below the 1.25% line. Consequently, even though the total bank fund balance grew \$2.4 billion in that period, the balance above the minimum ratio actually declined \$95 million, to \$2 billion.

In November the FDIC projected that the bank fund's fenced-off portion could increase as much as another \$1.95 billion by June 30 of this year. Such a jump would trim its loss-absorbing cushion above the minimum requirement to just \$370 million, about half the cost of resolving another failure like the 1999 collapse of First National Bank of Keystone in West Virginia.

(Because of slower deposit growth and lower losses in that same three-year period, the thrift fund's balance above the minimum requirement grew \$800 million, to \$1.3 billion.)

Despite the growth in insured deposits, taxpayer risk from deposit insurance losses has not

increased, because various congressional enactments over the last 12 years have eliminated that risk. Instead, Congress has ensured that healthy banks and thrifts will pay for all future deposit insurance losses.

Because deposit growth fences off a steadily larger amount of the balance in a deposit insurance fund, the 1.25% requirement increases the likelihood of future deposit insurance assessments (read taxes) on those institutions currently not paying premiums.

Congress can prevent those assessments through a very simple action — drop the 1.25% requirement and instead fix a specific dollar amount below which a fund may not drop.

For example, using the June 30, 2000, minimum requirements, the bank fund would be frozen at \$27.78 billion and the thrift fund at \$9.23 billion. If the two funds were merged (a simple bookkeeping exercise), the new fund would be frozen at \$37 billion. Once these dollar minimums were set, future deposit growth would not



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threaten higher premiums for any bank or thrift.

The only event that would trigger a premium assessment would be substantial deposit insurance losses that exceed the FDIC's income less operating expenses.

Although the FDIC has suffered some large losses in recent years because of regulatory negligence, increased congressional heat on the regulators should help to hold future losses to a tolerable level. This proposal would not bar the FDIC from continuing to assess risk-sensitive premiums on higher risk institutions.

Given its obviousness and simplicity, why has the FDIC not proposed to freeze the required fund balances? In a paper issued last August, the FDIC clearly indicated that it wants to substantially increase its premium income, even though banks and thrifts paid \$33 billion of premiums in the early and mid-1990s to rebuild the two insurance funds.

Why does the FDIC want to boost its premium income, no matter what? Viewed through the lens of arcane but politically important federal budget accounting, a plausible answer emerges.

The two funds have reported substantial net income in recent years, except for a relatively small loss for the bank fund in 1999 because of the Keystone failure. This income has added to the fund balances. However, and this is a big however, the bulk of the

FDIC's income, interest on its portfolio of Treasury securities, does not represent real revenue to the federal government.

Absent that interest income, the FDIC is running a budget deficit that exceeds \$1 billion annually. That is, FDIC losses and operating expenses substantially exceed its premium and other nongovernmental income.

A portion of this deficit stems from the fact that the FDIC is overstaffed by at least 2,000 employees. The larger part of this deficit is inevitable, for it stems from the fact that the FDIC was extremely profitable, for budgetary purposes, in the early and mid-1990s, when it levied huge premiums on banks and thrifts.

The banking industry agreed to pay an enormous prepaid insurance premium in return for the potential of zero premiums for the safest institutions once each fund reached the minimum reserve ratio.

Congress should not waltz on this deal by authorizing the FDIC to tax healthy banks and thrifts a second time for their deposit insurance.

Instead, Congress should lean hard on the FDIC to cut its bloated staff and on all the regulators to move faster in closing insolvent institutions. Congress should clearly state: No more Keystones.

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