

Deposit Insurance Reform: 2 Problems, 5 Solutions

■ BY BERT ELY

Congress will soon consider deposit insurance reform, inspired in part by the Federal Deposit Insurance Corp.'s recently announced reform proposals.

Though these proposals do not represent comprehensive reform, they could precipitate significant, and potentially positive, changes in federal deposit insurance.

The FDIC proposals suffer two fundamental flaws.

First, they take as a given that a deposit insurance fund should have a fund balance equal to a specified percentage of estimated insured deposits. The FDIC Improvement Act of 1991 set 1.25% as the minimum "designated reserve ratio."

This notion underlies the FDIC's rationale for levying premiums on all banks and thrifts, making its reform proposals unnecessarily controversial. Understandably, those who paid \$33 billion to build the Bank Insurance Fund and the Savings Association Insurance Fund to a 1.25% ratio oppose paying again for their deposit insurance.

Second, the FDIC tangled its proposals, needlessly complicating them. Chopping the proposals into bite-size pieces will

make them an easier sell while establishing potential political tradeoffs.

Congress should address five distinct reforms, in the following logical sequence.

• **One:** Least controversial is merging BIF and SAIF. A merger would reduce the likelihood of a large loss driving a fund balance below 1.25%, which would trigger premium assessments on the deposits insured by that fund. Further, many banks and thrifts have deposits insured by both funds, undercutting any rationale for keeping them separate.

• **Two:** Establish a fixed minimum dollar balance for the merged fund. As explained in my March 2, 2001, *American Banker* article, "Congress Should Dump Ratio for Deposit Insurance Funds," there is absolutely no justification for the reserve ratio concept. Worse, as insured deposits grow, an increasing portion of a fund balance (the amount below 1.25%) is fenced off from absorbing losses. Consequently, deposit growth alone can cause higher premiums, which makes no sense whatsoever.

The FDIC does not need additional premium income — the premiums it collected in the 1990s generate ample interest

income to finance the FDIC's operating expenses and a tolerable level of insolvency losses. The FDIC can readily assess risk-sensitive premiums on institutions above a threshold level of riskiness without having to charge everyone. Congress should not use reform as an excuse to levy a new tax on bank deposits.

Instead, Congress should establish a permanent minimum dollar balance for a merged fund. Premiums would not be charged against all banks and thrifts unless losses drove the fund's balance below that amount.

Like the 1.25% ratio, the minimum balance would be arbitrary. In my earlier article I suggested \$37 billion as a minimum required balance for a merged fund as of last June 30. On March 31, 2001, a merged fund would have had a balance of \$43.7 billion, \$6.7 billion above the suggested minimum.

If losses remained low, as they should under the FDIC Improvement Act's prompt corrective action requirement, then the fund balance over the minimum amount would grow. This would provide the industry and taxpayers with increased protection against future catastrophic losses.

• **Three:** Immediately rebate

assessments on fast-growers to slow-growers. By adopting a minimum dollar balance for a merged fund, deposit growth would no longer be a factor in setting premiums. Removing this threat would help lessen the division that has developed between new and fast-growing institutions' as compared with slow-growing ones.

It would still be true that the new and fast-growers would not have made any contribution to the fund balance, so a fairness argument can be made that those with faster-than-average deposit growth should make a proportionate contribution to the fund. However, such contributions should immediately be rebated to those with slower-than-average growth. This would effectively rebalance everyone's contribution to the fund.

In the context of a minimum dollar balance for the fund, though, it might not be worth the political fight to enact this rebalancing measure.

• **Four:** Base risk-sensitive premiums on leading indicators of banking risk. Banks and thrifts with risk factors above a threshold level should pay an explicit premium. However, it should be based on leading indicators of banking risk, not the lagging indicators the FDIC has proposed, such as nonperforming loans and capital levels.

Leading risk indicators fall into two categories — specific to a bank and external to it. Internal indicators include rapid growth, poor controls, and risk mismatches, such as

extremes in maturity mismatching. External indicators center on exposures to unhealthy sectors or regions of the economy or to asset bubbles, such as inflated land prices or overbuilt real estate markets.

Basing premiums on leading risk indicators would not only discourage risky banking before the fact but also reduce the likelihood that a weak bank would be slugged with high premiums. Weak banks, of course, should always be encouraged to recapitalize themselves or to merge with a stronger institution.

• **Five:** Address the deposit insurance limit issue. The first four recommendations deal solely with FDIC finances, which makes it easier to address a nonfinancial issue, deposit insurance limits. Some fear that higher limits will trigger across-the-board premiums. That would not happen if a minimum dollar balance were adopted for the fund, since the resulting increase in insured deposits would not drive a premium hike.

The limit issue breaks into two pieces — an immediate substantial jump in the dollar limit and indexing the limit in the future. There is also the related issue of providing complete coverage for municipal deposits. These concerns can be addressed reasonably if Congress first resolves the financial issues, as recommended above.

Mr. Ely is the principal in Ely & Co., a financial institutions and monetary policy consulting firm in Alexandria, Va.