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TESTIMONY

OF

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COMPTROLLER OF THE CURRENCY

BEFORE THE

SUBCOMMITTEE ON

FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

OF THE

UNITED STATES HOUSE OF REPRESENTATIVES

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The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Chairman Bachus, Congresswoman Waters, and Members of the Subcommittee, I appreciate this opportunity to discuss reform of our Federal deposit insurance system. Too often reform occurs against the backdrop of a crisis. Fortunately, we are not in that position today. The deposit insurance funds and the banking industry are strong. Nonetheless, the flaws in the current deposit insurance system pose an unnecessary risk to the stability of the banking system and so merit a careful and timely review by the Congress.

For the past year-and-a-half, the Federal Deposit Insurance Corporation (FDIC) staff has engaged in an inclusive and thoughtful process to identify and analyze deficiencies in the deposit insurance system and to recommend solutions to those problems. A staff paper released by the FDIC in April 2001, and recent testimony by former FDIC Chairman Tanoue, identified what they believe to be four significant flaws in the existing deposit insurance system:

- First, even though the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) provide an identical product--deposit insurance--for virtually identical institutions, the law requires the FDIC to administer the two as separate insurance funds, sacrificing both operating efficiencies and opportunities for risk diversification.

- Second, the current system of deposit insurance premiums does not adequately reflect the risk that individual depository institutions pose to the deposit insurance system. Currently 92 percent of all FDIC-insured institutions pay no deposit insurance premiums at all. More than 900 banks chartered within the last five years have never paid any deposit insurance premiums. The FDIC's inability to price deposit insurance according to risk results in a "free ride" for riskier banks, distorts management incentives to limit risks, and increases the moral hazard to the funds. It results in less risky banks effectively subsidizing the activities of riskier banks--the exact opposite of what was intended by the legislation that mandated a Federal risk-based deposit insurance system.

- Third, deposit insurance may be "procyclical." Under the present system, when a deposit insurance fund falls below its designated reserve ratio (DRR) of 1.25 percent of insured deposits, the FDIC must raise premiums sufficiently to bring the reserve ratio back to 1.25 percent within a year. If that cannot be done, it must charge every bank a premium of at least 23 basis points of its total domestic deposits until the reserve ratio reaches 1.25 percent. Thus, if an economic downturn leads to a decline in insurance fund reserves, banks could face dramatically higher deposit insurance premiums at the very time that bank earnings and capital are under pressure.

- Fourth, the FDIC staff paper observes that the real value of the level of deposit insurance coverage, set in 1980 at $100,000 per account, has not kept pace with changes in the price level over the past 20 years. Those who seek a safe repository for their savings can offset this reduced coverage in a number of ways. They can, for example, open multiple accounts at a single institution or accounts at multiple institutions. Nonetheless, some banks have argued for an increase in the current coverage limit and the adoption of a framework for periodically adjusting the level of deposit insurance coverage.

There are also several other issues that should be considered in the context of deposit insurance reform. These include the appropriate size of the insurance fund, the desirability of having a fixed designated reserve ratio, and the prospect of issuing rebates when the size of the funds exceeds a specified limit.

The OCC strongly believes that one further set of issues should be considered in this connection. That is the use of the insurance fund to support the cost of bank supervision, and the inequitable treatment of national banks in the way the BIF is currently used to pay the costs of supervision of state nonmember banks.

In my testimony, I review a series of recommendations that I believe will strengthen the insurance fund while reducing the inherent cross subsidization and distortions that arise among institutions under the current deposit insurance system.

Merger of the Insurance Funds

Currently, the FDIC administers the BIF and the SAIF separately. The OCC recommends that the BIF and SAIF be merged. A merged fund would enable the FDIC to operate more efficiently and to realize the benefits of diversification.

The maintenance of separate deposit insurance funds is a historical anomaly that traces its roots back to the 1930s, when the FDIC and the Federal Savings and Loan Insurance Corporation (FSLIC) were created in separate acts of Congress. When the FSLIC was abolished in 1989, and its functions were taken over by the FDIC, there were significant differences in the powers of commercial banks and thrifts. The thrift industry was just emerging from a period of extraordinary problems, and the risk profiles of banks and thrifts differed significantly. Over time, however, those differences have diminished. Significant commingling of the insurance funds, in the form of SAIF-insured deposits held by BIF members and BIF-insured deposits held by SAIF members, has further blurred the distinctions between BIF and SAIF. As of March 31, 2001, 874 banks and thrifts were members of one fund, yet held deposits insured by the other fund. BIF-member institutions held 41 percent of SAIF-insured deposits.

Industry consolidation has led to an increased concentration of insured deposits in relatively few institutions, which increases the risks to the deposit insurance funds. According to the FDIC staff, the share of SAIF-insured deposits held by the three largest institutions increased from 8.7 percent to 15.5 percent between June 1990 and March

2001, while the corresponding share for BIF-insured deposits increased from 5 percent to 13.7 percent. Merging the funds would reduce these concentration risks; for a merged fund, the share of deposits held by the three largest institutions would have been 12.4 percent.

A combined fund would also have better geographic and product diversification. Although the portfolios of banks and thrifts have become more similar in recent years, thrifts are still more highly concentrated in single family mortgages, while banks hold much higher percentages of commercial loans.

Pricing Deposit Insurance

In 1991, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) mandated a risk-based premium system and maintenance of required reserve levels, while providing the FDIC broad discretion to implement these goals. Five years later, the Deposit Insurance Funds Act of 1996 (DIFA) eliminated the FDIC's discretion. DIFA mandated zero premiums for banks in the lowest risk category when the fund equals or exceeds 1.25 percent of insured deposits. Further, it required the FDIC to charge a premium of at least 23 basis points on total domestic deposits when the fund falls below 1.25 percent for more than one year. The result is a pay-as-you-go system in which losses are determined after the fact and survivors are required to pay for the losses incurred in resolving insolvent institutions. Thus, while the size of the fund remains relatively stable, insurance premiums faced by individual banks can be extremely variable, regardless of the risk these banks present. Currently, the vast majority of banks and thrifts pay nothing for deposit insurance.

The OCC concurs with the FDIC staff's recommendation to eliminate the constraints introduced by DIFA on the FDIC's ability to set premiums, particularly the mandated zero premiums for banks in the lowest risk category whenever the insurance fund reserve ratio equals or exceeds 1.25 percent of insured deposits. The OCC further supports the FDIC exploring revisions to the deposit premium structure to improve the actuarial accuracy of the differential premiums paid by banks with different risk profiles. This does not necessarily mean that there is a need for a dramatically new and more complex approach to setting premiums. Even within the context of the FDIC's current matrix of premiums, we believe there are opportunities to make premiums more risk sensitive.

Under the current deposit insurance premium structure, 92 percent of banks (those that are well-capitalized with CAMELS 1 or 2 ratings) pay the same deposit insurance premiums. The risks those banks pose to the insurance funds, however, can vary greatly.[1] That these banks currently pay nothing for deposit insurance is even more troubling. The net result is a pricing system that has severed almost completely any connection between risk and the price of deposit insurance. To maintain a proper incentive structure and to compensate the government for the benefits conferred by

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[1] The FDIC staff noted in its Deposit Insurance Reform Options paper that "the 5-year failure rate for CAMELS 2-rated institutions since 1984 was more than two-and-a-half times the failure rate for 1-rated institutions."

deposit insurance on all banks, even the least risky banks should pay some reasonable minimum insurance premium, regardless of the level of the fund.

Any effort to reform the pricing of deposit insurance should consider the appropriate range of insurance premiums. The premium structure initially adopted by the FDIC under FDICIA, which charged banks in the highest risk category 31 basis points on domestic deposits, seems to have taken into account factors other than risk, including the likelihood that weaker banks would be unable to afford higher premiums. During the banking crisis of the early 1990s, however, the spread between the yields on the debt of the most and least risky banks was at times as much as 700 basis points. While we would not suggest that deposit insurance premiums should exhibit as broad a range as market prices for bank debt, we note that in the current environment spreads on subordinated debt can be as much as 150 basis points among banks that today pay no insurance premiums.

There are, of course, challenges to improving the risk-sensitivity of deposit insurance premiums. Nonetheless, I believe it would be desirable to move incrementally, recognizing that perfection is not the relevant standard. Although measuring risk is an inexact science, I believe that, with the removal of some of the statutory constraints on pricing, the FDIC could implement in a reasonable time a risk-based system that improves significantly upon the existing system.

The Size of the Fund, Rebates and Surcharges

Determining the appropriate size of the insurance funds and deciding when and how to pay rebates or impose surcharges if the funds get too large or too small, are two of the most important issues in deposit insurance reform. The current system is flawed in that the current designated reserve ratio of 1.25 percent of insured deposits has no clear actuarial basis--that is, it has no particular relationship to the risks borne by the funds. Rather, it is based on the actual range of the reserve ratio in the 1960s and 1970s. Recent experience would support consideration of a higher level, although we would prefer that there be no statutorily fixed ratios.

The OCC strongly supports eliminating the current DRR of 1.25 percent. We favor empowering the FDIC to establish a size range for the fund, based on the FDIC's evaluation of the risks borne by the funds and its assessment of potential losses. The FDIC should have the flexibility to adjust that range as the health of the banking system and the risks to the fund change through time. In this context we would support authority for the FDIC to pay rebates when the upper end of the range is exceeded and to impose surcharges when the ratio falls below the lower end of the range. We also believe that the FDIC should have the discretion in addressing the need for surcharges, to take into account the effect such surcharges might have on the performance or health of the banking system. As a corollary, in order to mitigate the procyclical effects of increasing premiums in times of stress, the appropriateness of maintaining a strongly capitalized fund in good times should be recognized.

With the introduction of minimum deposit insurance premiums, it is likely that reserve balances in the funds will periodically exceed the upper end of the target range for the reserve ratios. As a result, it may be appropriate for the funds to pay rebates to insured institutions. To ensure that rebates paid to insured institutions are equitable, it is first necessary to consider the nature of insured institutions' claims on the funds. For instance, institutions that have paid little, if anything, into the funds may have a lesser claim on any rebates compared with institutions that have contributed to building up the funds.

To preserve the integrity of risk-based premiums, rebates to individual banks should be based on a factor that is unrelated to their current premiums. In other words, high-risk banks that pay large premiums should not receive higher rebates per dollar of insured deposits than banks that pose a low risk to the fund. One approach to the calculation of rebates would be to base the rebates on past levels of domestic deposits on which a bank paid premiums.

Any program of rebates should also reflect the benefits that are presently received by FDIC-supervised state nonmember banks in the form of cost-free supervision and examination. Under the current system of bank supervision, the FDIC covers its costs of operations out of the BIF and SAIF. The FDIC spends approximately $600 million dollars a year to supervise state nonmember banks--that is, to perform for state banks exactly those functions the OCC performs for national banks. None of these costs is passed on to state banks in the form of direct assessments. By contrast, the OCC charges national banks for the full cost of their supervision.

This disparity is compounded by the fact that more than half of the funds spent by the FDIC for Federal supervision of state nonmember banks are attributable directly to the accumulated contributions of national banks to the BIF. The earnings of the insurance funds--provided by all banks--finance the supervisory costs of only a portion of the banking industry. In other words, for every dollar the FDIC spends on the supervision of state banks, national banks, by our estimates, effectively contribute about 55 cents.

A key principle at the heart of deposit insurance reform is that the premiums paid by individual institutions should be closely related to the expected costs they impose on the funds. The objective is to identify and eliminate subsidies in the current system that can distort decision making. As the FDIC staff notes in its arguments for a risk-based pricing system, healthy, well-managed banks should not be required to bear the costs and risks presented by less well-managed, riskier banks. Similarly, banking supervision should not be based on a system of subsidies--such as those embedded in the current deposit insurance system--that results in national banks paying a substantial portion of the FDIC's cost of supervising state banks. As a matter of equity among banks, regardless of charter, the OCC believes that reform of our system of deposit insurance should recognize that the *current* system requires that national banks cover a significant portion of the cost of supervising state nonmember banks. Because one of the main purposes of bank supervision is to protect the insurance fund, ensuring that supervision is funded in a fair and equitable manner is inextricably related to the subject of deposit insurance reform.

Attached to my testimony is a paper that discusses the disparity in funding supervision in greater detail and proposes a legislative remedy. Our proposal recognizes that effective supervision is a critical component of a sound deposit insurance system. Because the FDIC insurance fund currently funds Federal supervision of state nonmember banks, we believe that it would make sense to extend the existing arrangement to cover the costs of both state and national bank supervision from the FDIC fund. In other words, instead of funding supervision through direct assessments on banks, we propose that it be funded by payments to supervisors--the OCC and state supervisors--from the insurance fund, to which all banks contribute. This approach would strengthen both Federal and state supervision by ensuring that all supervisors have adequate, predictable resources available to carry out effective supervisory programs.

Coverage Limits

The erosion of the real value of the nominal deposit insurance coverage limit by inflation since 1980 has generated proposals to increase the coverage limit from its current level of $100,000 per account. Opponents of such an increase argue that it is not needed and that it would increase the exposure of the funds and would reduce market discipline.

While this is clearly an issue that deserves consideration by the Congress, the OCC is concerned that an increase in coverage might have unintended effects that most would judge to be undesirable, including an increase in moral hazard. We are fortunate today to have a very strong banking industry, but conditions may not always be so positive. Increasing deposit insurance coverage effectively allows weaker institutions to expand their risk-taking at a time when they should be retrenching--a lesson that we learned painfully during the savings and loan crisis. Increasing deposit insurance coverage also raises the cost to the insurance funds in the event of a bank failure. Reducing the risk of loss for large depositors may undermine market discipline and result in a haphazard reshuffling of existing deposits. We are not persuaded that an increase in coverage is necessary for deposit insurance to fulfill its purposes of preventing depositor runs on banks and providing a basic level of risk-free protection for depositors. Nor have we seen compelling evidence that depositors are demanding increased coverage.

The simple fact is that anyone who wants to use insured bank deposits as a means of holding their wealth can do so today virtually without limits--subject only to the inconvenience of having to open accounts at multiple banks. Of course, one may argue that, because of the relative ineffectiveness of the existing coverage limit, an increase may not have any substantial adverse consequences. But, it is precisely because of the dangers that attend legislating in the presence of uncertainty that the OCC would favor a cautious approach in this area.

The lack of consumer demand for increased deposit insurance coverage is evidenced by the fact that, despite the ability of depositors to achieve virtually unlimited coverage, there is over $1 trillion of uninsured deposits in the banking system, compared with over $3 trillion in insured deposits. This does not suggest, however, that large numbers of Americans are adversely affected by the existing coverage limit; the Federal Reserve's 1998 Survey of Consumer Finances reported that 98.0 percent of all households that held any deposits were fully insured. Moreover, money market mutual funds, which have some of the same features as bank transactions accounts and generally offer higher returns than bank deposits, today hold over $2 trillion, which suggests that many Americans do not see the additional risk involved in holding money market fund shares as particularly significant. Against this background a relevant question for the Congress is whether deposit insurance should be converted into a governmentally protected all-purpose investment vehicle.

Another argument put forth in favor of an increase in the coverage limit is that it would significantly assist community banks in meeting their liquidity and funding needs, and would counteract the competitive disadvantage that community banks believe they face vis-à-vis large banks. Those who hold this view attribute the continuing increase in the average size of deposits at large banks, in both nominal and real terms, to the widespread belief that a "Too-Big-To-Fail" doctrine protects large banks. While it is exceedingly difficult to know whether or to what extent the perception of such potential support for large banks actually affects depositor behavior, the vast holdings of liquid assets in money market mutual funds suggest that yield, rather than safety may be a more significant motivating factor.

Whether an increase in the coverage limit would in fact enhance community bank funding is speculative at best. It is not at all clear that increasing the limit would result in a net increase in the deposits of the banking system. Depositors who multiply insurance coverage today by using multiple banks might simply consolidate their deposits in a single bank if coverage were raised, and there is no way of determining who would ultimately, when the switching process ended, benefit. Similarly, if a coverage increase did attract new funds into the system, it is not at all clear that the benefits would flow to smaller banks. Large, aggressive institutions might simply use the expanded coverage to offer an even more extensive governmentally protected investment vehicle to wealthy customers, with the consequence of increasing the liquidity pressures felt by smaller banks.

If there is a compelling case to be made for increasing the insurance limit and indexing it to inflation, it remains to be made. Consequently, we believe that Congress should move very cautiously in this area, and while it is certainly true that a coverage increase would be less problematic in the context of properly priced deposit insurance coverage, we think this proposal raises some fundamental questions that need to be addressed.[2]

[2] One such question is whether insuring virtually a limitless amount of funds is part of the intent of deposit insurance. Clearly, it would be much easier to decide what to do with the existing $100,000 insurance limit if it were a hard and fast upper bound on coverage that was strictly enforced. There have been efforts to devise ways to limit the total coverage or lifetime payouts that could be obtained by any one individual

Conclusion

Today we have the opportunity to undertake comprehensive Federal deposit insurance reform when both the banking industry and the deposit insurance funds are strong. A primary goal of reform should be to reduce the current cross subsidization embedded in the current system, including the inequitable treatment of national banks in the current use of the fund to pay the costs of state nonmember bank supervision.

The OCC supports the FDIC staff recommendations to merge the BIF and SAIF and to eliminate the current constraints on premiums, particularly the mandated zero premiums for well-managed, well-capitalized banks. We favor elimination of the fixed DRR of 1.25 percent of insured deposits and the empowerment of the FDIC to establish a size range for the fund, based on an assessment of the risks the fund faces. Regarding proposals to increase the insurance coverage limit of $100,000, we have not seen compelling evidence to date that increasing the insurance coverage would either further the purpose of Federal deposit insurance or help to alleviate the liquidity and funding pressures of community banks.

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which have generally been rejected on grounds of administrative complexity. In light of the advances that have been made in information technology, those proposals may deserve a second look.