CURRENT WEAKNESS OF DEPOSIT INSURANCE
AND
RECOMMENDED REFORMS

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Executive Summary

The current deposit insurance system has weaknesses that should be addressed. The time to make these changes is now, while financial institutions are doing well and will be able to adjust to the changes and deal with the costs relatively easily.

The Federal Deposit Insurance Corporation has recommended changes for these reasons:

- Two deposit insurance funds providing identical coverage at potentially different prices could hurt the institution that paid the higher price.

- Inadequate pricing of risk distorts incentives and increases moral hazard.

- Currently, premiums are volatile and are likely to rise substantially during an economic downturn.

- Coverage levels do not keep pace with inflation in a predictable fashion.

The following reforms are recommended by the FDIC and are effective only if all the changes happen, not just selected pieces.

- Merging the Bank Insurance Fund and Savings Association Insurance Fund

- Eliminating restrictions to the FDIC to charge risk based premiums to all institutions

- Eliminating sharp premium swings triggered by deviations from the designated reserve ratio, by setting a target range

- Issuing rebates based on past contribution to the fund

- Indexing insured-deposit coverage ceilings
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ROLE OF DEPOSIT INSURANCE

Due to the banking crisis of the 1930’s Congress established a federal deposit insurance system in order to try to achieve financial stability in the banking industry. The Federal Deposit Insurance Corporation (FDIC) was established to build depositor confidence and help prevent bank panics (Roinick). Initially, in January 1934, deposit insurance covered up to $2500 of deposits in banks that became members of the FDIC. Over the years, there has been an increase in the amount of coverage. The last increase was in 1980, which increased insurance coverage from $40,000 to $100,000 (Greenspan). This increase was “clearly designed to let depository institutions, particularly thrifts, offer an insured deposit free of the then prevailing interest rate ceilings on such instruments, which applied only to deposits below $100,000” (Greenspan).

These deposits were insured 100 percent and not subjected to the interest-rate ceiling. Interest-rate ceiling is a maximum interest rate that can be set. Thrifts began offering higher interest rates in order to improve their liquidity on commercial deposits. This first led to a squeeze on earnings and a loss of capital, and then led to high-risk investments, which led to failure (Greenspan). Thrifts, because offering a higher interest rate to depositors, started to lose some of their profits. They focused on long term assets at a time of rising interest rates, which until they were deregulated, they had no choice. If interest rates are increasing, then the banks are paying more to the depositors than they are making. In order to make up for the losses they began to undertake risky investments. Depositors had no incentive to assess the risk taken on by the bank because their deposits were covered up to $100,000. This increase in the deposit insurance along with other factors led to the savings and loan crisis.

Aside from this problem, deposit insurance, along with the Federal Reserve’s discount window and payment system guarantees, has been able to stabilize banking and eliminate bank runs (Greenspan). As seen above, deposit insurance also has costs to it. It increases moral hazard and adverse selection. Since deposits are covered up to $100,000, there is little incentive for the depositor to keep track of the risky loans that their banks are
undertaking. The small depositor generally does not have over that amount in their accounts.

**REASONS TO WORRY ABOUT DEPOSIT INSURANCE**

The issue today is what should be done about deposit insurance in order to reduce asymmetric information and moral hazard problems. The current deposit insurance system needs to be reformed to be able to continue to serve well the depositors. Flaws in the system undermine the intent to help limit the downside of economic cycles. The time to make these changes is when the depository institutions are doing well. “The funds’ and industries’ current healthy state suggests this is a good time to make those changes” (Seidman). While the institutions are doing well, they will be able to adjust to the changes and be able to pay for the costs of making changes without hurting their profitability too much. Deposit insurance is similar to automobile and house insurance. It is there just in case, and premiums must be paid to have them. Those who take fewer risks will pay lower premiums than those who take excessive risks but not no premiums at all (Seidman).

The FDIC has recommended changes for these reasons:

- Two deposit insurance funds providing identical coverage at potentially different prices
- Inadequate pricing of risk that distorts incentives and increases moral hazard
- Volatile premiums that are likely to rise substantially during an economic downturn
- Coverage levels that do not keep pace with inflation in a predictable fashion

**MAINTENANCE OF TWO SEPARATE FUNDS**

Currently the FDIC gets its funds from two separate funds. These are the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) which over the years have become funds insuring increasingly similar institutions. Both provide the same product to banks and thrifts. This could lead to a problem of premium differentials that could hurt the institution that paid a higher rate.

**INADEQUATE PRICING OF INSURANCE RISKS**

The current deposit insurance system is supposed to be designed to price insurance premiums based on the amount of risk the institution is taking. 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. The FDIC risk classification focuses only on an institution’s PCA (prompt-corrective-action) capital category and its safety
and soundness examination rating. “As a result, the current system fails to capture substantial risk variations among institutions” (Seidman). This has to do with the way they treat the designated reserve ratio. The reserve ratio is the fraction of deposits that the Fed requires be kept as reserves (Mishkin 214). Once the institution exceeds this ratio, they no longer have to pay a premium for deposit insurance. The BIF and the SAIF have exceeded this ratio for some years now, allowing over 90 percent of all institutions to pay almost nothing for deposit insurance (Blinder). The fact that the current system has eliminated premiums for most institutions in the last four years is an area that needs worked on. “This has been the case since the funds reached their statutory capitalization targets in 1995 (BIF) and 1996 (SAIF)” (Seidman). Therefor premiums are not based on risk and do not deal with problems of moral hazard. This has led to market distortions. For example, a small community bank may be paying the same for insurance as a large bank with many deposits but a huge amount of risk. Banks should have to pay some premium because if they do not they get the benefits from the insurance but do not have to pay any of the costs. “Moreover, without risk-based pricing, safe banks unnecessarily subsidize risky banks” (Tanoue). Insurance premiums may also be lower because there is a problem with asymmetric information. This is when one party knows more about the other party involved in a transaction. The information about the amount of risk an institution takes on is not readily available for the FDIC.

**EXCESSIVE PREMIUM VOLATILITY AND PROCYCLICAL BEHAVIOR**

Currently, the designated reserve ratio, the ratio of mandated reserves to insured deposits, for the BIF and the SAIF is set at 1.25 percent. If the ratio is exceeded, premiums are dropped for “well-capitalized and well-rated” institutions (Greenspan). If they drop below 1.25 percent, the FDIC must develop a set of premiums to restore the reserve ratio to 1.25 percent.

“These requirements are clearly procyclical, lowering or eliminating fees in good times when bank credit is readily available and deposit insurance fund reserves should be built up, and abruptly increasing fees sharply in times of weakness when bank credit availability is under pressure and deposit fund resources are drawn down to cover the resolution of failed banks” (Greenspan).
This could cost financial institutions billions of dollars in extra premiums and raise the cost of deposit gathering during business cycle downturns. “Procyclical payments like that could provoke a retrenchment in credit extension, and therefore slow down economic activity, at exactly the wrong times” (Blinder).

**COVERAGE LEVELS THAT DO NOT ADJUST REGULARLY**

Another weakness with the current deposit insurance system is the fact that coverage levels do not adjust on a regular basis. In order to effectively implement risk-based pricing there needs to be adjustments of the coverage levels. This does lead to a problem. What is the ideal coverage level? The FDIC must try to determine a level that will be fair and transparent, protect small depositors, and allows for sound personal financial planning. However, it must not increase the moral hazard problem. Choosing a coverage limit represents a tradeoff among competing goals (Blinder). “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” (Tanoue).

**RECOMMENDED REFORMS**

After assessing the problems of the current deposit insurance system there have been many proposed reforms by the Federal Deposit Insurance Corporation. These include:

- Merging the Bank Insurance Fund and the Savings Association Insurance Fund
- Eliminating restrictions to FDIC to charge risk based premiums
- Eliminating sharp premium swings triggered by deviations from the DRR
- Issuing rebates based on past contribution to the fund
- Indexing insured-deposit coverage ceilings

**MERGING THE BANK INSURANCE FUND AND SAVINGS ASSOCIATION INSURANCE FUND**

The FDIC has proposed merging the BIF and the SAIF as soon as possible. These institutions have become so similar over the years that there are numerous advantages to merging. “The fundamental reason why this makes sense is among the most obvious principles of insurance theory: The bigger the insurance pool, the more likely it is that actuarial calculations hold, so the pool is better able to
handle risks” (Blinder). With a combined fund, there is less probability of insolvency. It would diversify risk, reduce administrative expenses, and widen the fund base for the banking industry (Greenspan). Merging the funds would simplify business for the institutions that hold both BIF and SAIF insured deposits. Currently the funds are assessed separately, which is inefficient because the funds offer identical services (Blinder). “A merged fund would face significantly less concentration risk” (Seidman). There will be some costs to merging the BIF and the SAIF. Many will lose their jobs due to overlapping, but it may create new jobs to regulate the institution. The institutions will have to face a high initial cost to get through the workings of completing the merge. However, I think, the benefits to merging should highly exceed the costs if the funds are not merged.

**ELIMINATING RESTRICTIONS TO FDIC TO CHARGE RISK BASED PREMIUMS TO ALL INSTITUTIONS**

Under the current system, almost all banks pay the same premium, zero, when the fund exceeds the designated reserve ratio. However, it fails to place any premium on banks that are well-capitalized and highly rated as long as the DRR exceeds 1.25 percent of insured deposits (Greenspan). This system both underprices risk and fails to differentiate adequately among banks according to risk. This restriction should be eliminated. This subsidy is inconsistent with the efforts to reduce moral hazard. Institutions that do not have to pay a premium are more likely to engage in riskier behavior that is not in the interest of the depositors. Ideally, risk based premiums should be based on expected future losses over a certain period (Tanoue). In the short-run, a bank engaging in risky behavior may have a smaller chance of failing. However, in the long-run, a bank may have a greater chance of failing due to economic downturns. It deems appropriate to look at price risk premiums on a time of three to five years (Tanoue). It would be difficult to determine what premiums are ideal for the system. In addition, it is difficult to monitor the degree of risk in bank’s assets because often only the bank making the loans know how risky they are.

The FDIC has devoted considerable attention to how best to differentiate banks by risk for purposes of setting deposit insurance premiums. One approach would be to use CAMELS rating. “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” (Tanoue). 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 (Tanoue). A model like this could be used to develop a scorecard that would place banks into risk categories.

**ELIMINATING SHARP PREMIUM SWINGS TRIGGERED BY DEVIATIONS FROM THE DRR**

The current requirements for the designated reserve ratio are procyclical. The reserve ratio should be brought back gradually when it exceeds or declines the target ratio.

The FDIC recommends using surcharges or rebates. It also seems like a good idea to set a target reserve range to eliminate the abruptness of changing premiums. (Greenspan)

The FDIC has requested increased flexibility in setting fund targets and premiums to improve risk based pricing (Seidman). For example, the reserve ratio could be allowed to vary between 1.15 and 1.35. As long as banks stayed between these percentages, they would pay risk based premiums without surcharges or rebates (Tanoue). If the funds fall below this target range, there would be a surcharge to bring them back within the range. Also, if fund is higher than 1.35, rebates would be used to get the fund back within the target range (Tanoue). This target ratio may be successful in easing premium volatility but I am not too sure about the effect on improving pricing based on risk.

**ISSUING REBATES BASED ON PAST CONTRIBUTION TO THE FUND**

The FDIC recommends re-imposing a minimum premium on institutions that are well-capitalized. This would eliminate banks from never paying a premium for deposit insurance. Rebates would be given to institutions whose funds are on the high end of the target range and surcharges for those whose funds are on the low end (Greenspan). Rebates tied to the current assessment base would represent a decrease in the cost of insurance. This would increase moral hazard. With rebates tied to the current assessment base, banks that grew the fastest would get the largest rebates, other things equal (Tanoue). The FDIC recommends smaller rebates for institutions that have never paid a premium. It looks into issuing rebates based on past contribution to the fund. This will help decrease moral hazard. The institutions that are well-capitalized will now have an incentive to reduce risk in order to pay smaller premiums. However, if looking at past
contributions, how far back insurers look, and how to treat mergers and failing bank acquisitions are issues that need to be addressed (Tanoue). It is also important to think about how rebates should be allocated over time. One option is to base rebates on a bank’s share of total premiums paid over a period of years. The FDIC has suggested looking at premiums paid in the last five years as a base and putting less weight on current deposit growth (Tanoue).

**INDEXING INSURED-DEPOSIT COVERAGE CEILINGS**

The FDIC recommends indexing the $100,000 coverage ceiling. Indexing can increase predictability and lessen the potential for large, sudden increases. Other government programs including Social Security, Medicare, and taxes are indexed to inflation and the FDIC recommends indexing deposit insurance as well. They recommend not indexing to the price level, which accounts for inflation only, but to index to nominal GDP per capita (Blinder). The Board of Governors does not agree with indexing the insured deposit coverage level and believe the current level should be maintained (Greenspan). Increasing the level will not help measure the stability of the banking system. An increase will create more problems of moral hazard and adverse selection. Alan Blinder and Robert Wescott recommend increasing the coverage limit slowly and gradually. “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” (Tanoue). It would not be a good idea to lower the amount of insurance coverage. 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 (Tanoue).

**CONCLUSIONS**

In order to change deposit insurance effectively all of the recommended reforms need to take place together. They are designed to work together to eliminate procyclical behavior and moral hazard problems. If you just indexed the coverage level and did not worry about how to issue rebates or making sure every institution is subject to some premium, the Federal Deposit Insurance Corporation could suffer the same weaknesses they do now. Specifically, I agree with the FDIC that coverage levels should not be lowered because it may create uncertainties for depositors, but should be indexed. Setting a target range for the reserve ratio will help maintain stable premium prices for
insurance, in junction with assessing rebates to past contributions to the fund.
References

An April 23, 2002 speech by Alan Greenspan (Chairman of the Board of Governors) titled "Federal deposit insurance reform" can be found at www.federalreserve.gov/boarddocs/hh/2002/july/testimony.htm

A July 26, 2001 speech by Ellen Seidman (Director of Office of Thrift Supervision) titled "Testimony on Federal Deposit Insurance Reform" can be found at http://financialservices.housegov/media/pdf/072601es.pdf

A March 20, 2001 speech by Alan Blinder and Robert Wescott titled "Reform of Deposit Insurance, A Report to the FDIC" can be found at www.icba.org/news_views/test051601a.html

