



Comptroller of the Currency
Administrator of National Banks

Remarks by
John D. Hawke, Jr.
Comptroller of the Currency

**“Deposit Insurance Reform and the
Cost of Bank Supervision”**

Exchequer Club
Washington, D.C.
December 20, 2000

Remarks by John D. Hawke, Jr.

Comptroller of the Currency

“Deposit Insurance Reform and the Cost of Bank Supervision”

Exchequer Club • Washington, D.C.

December 20, 2000

Earlier this year, the Federal Deposit Insurance Corporation (FDIC) launched a full-scale review of the nation’s deposit insurance system. I can scarcely imagine a more opportune time for such a review to occur. The BIF [the FDIC’s Bank Insurance Fund] and the SAIF [the FDIC’s Savings Association Insurance Fund] are both at levels in excess of their statutorily determined reserve ratios. The banking system’s earnings are robust; a ninth consecutive earnings record for the year is still a possibility. Assets and deposits continue to grow, if more slowly than in recent years. Capital is at historical highs. Bank failures are a rarity.

It’s also clear, however, that the economy and the banking system are entering a period of uncertainty. Rising interest rates and a slowdown in economic growth have already had an impact on bank financial statements. In the third quarter of this year, we saw the consequences of increasing credit risk: declines in credit quality and rising loan loss provisions. Securities losses have increased and noninterest income growth has slowed. In addition to opportunities, 2001 will undoubtedly also bring stresses and challenges.

So it’s particularly important that we act *now* to take a fresh look at our deposit insurance system while there’s still time to do it methodically, inclusively, and comprehensively.

An “options paper” released by the FDIC back in August highlighted a number of fundamental issues and has stimulated an especially lively dialogue on the issues of premiums and fund size, which are among the most controversial aspects of the current deposit insurance system.

These areas are badly in need of reform. The law today sets a “designated” reserve ratio for the deposit insurance fund of 1.25 percent of deposits, regardless of the level of risk to which those deposits might be exposed, and severely constrains the FDIC’s ability to charge risk-based premiums when the reserve ratio is above or below that level. That results in a system that charges little or nothing for this insurance today, when banks are earning big profits, and then charges a lot when banks are taking losses and their ability to pay is lessened. And our system does not adequately discriminate in its pricing between risky institutions and prudent, well-managed institutions. To be sure, low-rated banks pay somewhat higher premiums, but well-rated banks that choose to take higher risks do not. In fact, banks taking higher risks receive a twofold deposit insurance subsidy: first, from their more conservative counterparts; and then, like every insured institution, from the U.S. taxpayer through the Treasury Department, which provides a multibillion dollar line of credit and back-up guarantees, all free of charge, to the FDIC. Finally, banks do not compensate the FDIC, or taxpayers, for the use of the deposit insurance system, even though the availability of federal deposit insurance is a government benefit that is essential for the conduct of the banking business.

The deposit insurance “system does not adequately discriminate in its pricing between risky institutions and prudent, well-managed institutions.”

Most analysts today agree that risk-based pricing of deposit insurance makes sense. But what exactly would a risk-based system look like? In a speech last week before the Women in Housing and Finance here in Washington, the OCC’s chief economist, Jim Wilcox, discussed an approach that he has developed, an approach he calls MIMIC—short for Mutual Insurance Model with Incentive Compatibility. Jim was not speaking for the OCC in this speech, but his thoughtful and perceptive analysis will certainly have a bearing on any position the OCC may take in the future.

Under MIMIC, banks would pay a risk-based “user fee” to the FDIC; the FDIC, in turn, would make payments to the Treasury in return for the standing line of credit and “catastrophe insurance” that Treasury currently provides at no cost. The FDIC would set and periodically adjust a risk-based range for the reserve ratio, to ensure that the size of the fund reflects the amount of risk currently in the system. When the fund exceeded the specified range for the reserve ratio, the surplus would be rebated to banks; when it fell short, surcharges would be imposed. And, to ensure that banks adding deposits didn’t reduce the reserve ratio, the MIMIC model would assess a “dilution fee” for each additional dollar of insured deposits. Conversely, banks with shrinking deposits would receive a dilution refund.

MIMIC is one of several risk-based models that have been proposed by various experts on deposit insurance issues. They differ on some key details. But it’s important to recognize that all of these models share the same basic principles—principles that I believe should be embodied in all facets of the deposit insurance reform effort.

“[W]hatever changes we adopt in the current deposit insurance system should make that system more *efficient*, in the sense that the actual costs and benefits of coverage are measured and rationally allocated.”

First, whatever changes we adopt in the current deposit insurance system should make that system more *efficient*, in the sense that the actual costs and benefits of coverage are measured and rationally allocated. Increasing reliance on risk-based pricing would take us at least some distance toward that goal.

This implies that the subsidies that distort our current system—bank to bank, taxpayer to bank, or otherwise—should be eliminated and, as nearly as possible,

deposit insurance should be *priced in accordance with market principles*. Risk-based pricing could end or significantly reduce the subsidies provided by safer banks to riskier banks; the payment of fees to the Treasury, as provided in MIMIC, could reduce the public subsidy that all insured depositories receive today.

Finally, our deposit insurance system must be *transparent*. In order to be allocated equitably, the costs and benefits of deposit insurance must be priced accurately and openly. Reliable and consistent information about the level of risk in the financial system and the ability of the deposit insurance system to cope with that risk would help all the interested parties—financial institutions, investors, bank customers, and taxpayers—make informed economic decisions.

Pursuing efficiency leads to another issue that needs to be resolved. Since the inception of federal deposit insurance, the FDIC has funded its own operations from premiums and earnings from the deposit insurance fund. At present, with so few banks paying premiums, the FDIC relies on the income generated by the fund to pay for FDIC operations. In 1999, \$1.2 billion, out of \$1.8 billion in fund revenues, went to defray the FDIC's costs of operation.

Nearly half of the 1999 amount—about \$600 million—was spent on the FDIC's supervision of state nonmember banks. If that amount did not need to be diverted from the fund to defray FDIC's supervision expenses, the future *insurance* costs of the FDIC to *all* FDIC member institutions, including national banks, would obviously be lower.

If we're to allocate the costs and benefits of deposit insurance equitably and efficiently, we also need to measure and allocate the FDIC's *non-insurance* costs appropriately. In a regime of risk-related premiums, deposit insurance premiums should pay for deposit insurance. And non-insurance costs should be paid for on a similar, efficient basis.

Unfortunately, that's not the way it happens today. The long-standing practice of using insurance premiums paid by all insured institutions to defray the FDIC's costs of routine bank supervision of state nonmember banks is not only inequitable, but it deprives the FDIC of an important source of market discipline over its use of resources. And, very significantly, it has given rise to undesirable tensions in the dual banking system.

Of course, the dual banking system is hardly “dual,” in the sense that the states and the federal government maintain and supervise completely separate banking systems. For many decades, the FDIC and the Federal Reserve have played the preponderant role in the examination and supervision of state-chartered banks. For more than 30 years, almost every time Congress has

“[T]he dual banking system is hardly ‘dual’ . . . the most important division of bank supervisory authority today is not that between the states and the federal government, as may earlier have been the case, but a division among the three federal regulatory agencies.”

imposed new federal bank supervisory and regulatory responsibilities, it has parceled out authority and responsibility among the three federal banking agencies. The result is that today the supervisory functions that the FDIC and the Fed perform for state banks are virtually identical to those performed by the OCC for national banks. To put it another way, while both the FDIC and the Fed have some significant responsibilities beyond those of the OCC, there is virtually no function performed by the OCC for national banks that is not replicated by the FDIC and the Fed for state banks. In short, the most important division of bank supervisory authority today is not

that between the states and the federal government, as may earlier have been the case, but a division among the three federal regulatory agencies.

I think fair-minded people would agree that there is an inherent inequity in a system that requires national banks to pay the OCC for their supervision and then to pay again to support the cost of supervising some of their competitors, the state nonmember banks. At present, national bank contributions account for almost 52 percent of the funds in the insurance fund. Thus, every dollar expended by the FDIC on state nonmember bank supervision represents, in effect, a charge of 52 cents to national banks. And the same can be said of the Fed’s supervision of state member banks, the cost of which is partially offset by the reserve balances held by national banks. In other words, when one considers the extent to which the costs of supervision are borne by

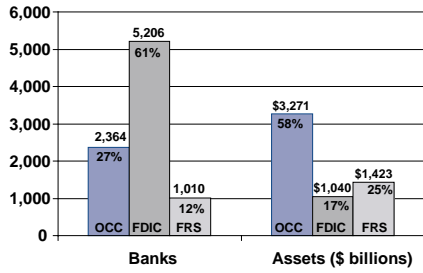
the banks themselves, it is clear that state-chartered banks are the recipients of substantial federal subsidies, delivered by their federal supervisory agencies.

In addition to this inequity, I think most objective observers would be concerned by the implications of this subsidy.

Competition between state and national charters has always been one of the hallmarks of the dual banking system—and one of its greatest strengths. It’s encouraged efficiency, creativity, and responsiveness on the part of the regulators, and enabled banks to choose the charter that most closely matches their business needs and objectives. Typically, banks have made this decision after weighing a variety of factors—among other things, regulatory philosophy, access, the perceived quality of supervisory services, and how much they had to pay for those services.

Yet, because of the subsidy, the assessment differential between a state and a national charter can be substantial, and clearly can affect a bank’s choice of charter. Some states charge less than half of what a comparably sized national bank would pay the OCC—enough to tip the balance for

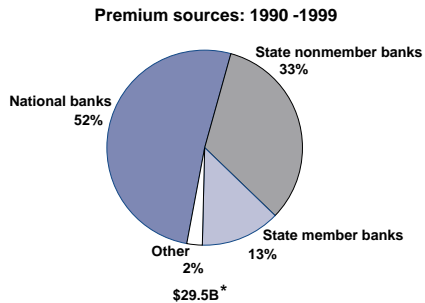
Number of banks and share of assets supervised by the three federal regulators



Figures as of 12/1999

The FDIC supervises the largest number of institutions; OCC-supervised banks hold most of the industry’s assets.

Premium sources, by type of bank, that contributed to rebuilding the Bank Insurance Fund

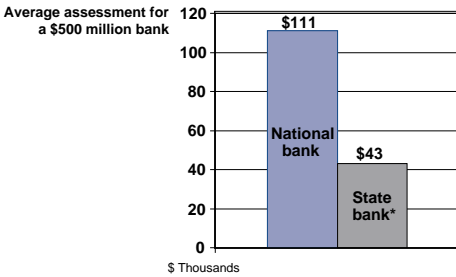


* BIF balance as of year-end 1999

The banking industry rebuilt the Bank Insurance Fund in the early 1990s, paying over \$28 billion in insurance premiums. Over half of these BIF premiums came from national banks.

some banks. As earnings pressures grow in a slowing economy, such considerations may loom even larger for some banks. It is hard to see any compelling reason why federal banking policy should create such incentives to diminish the national banking system. A truly vigorous dual banking system should not be founded on the maintenance of a federal subsidy for state banks.

Example of supervisory assessment differential between national and state banks



* Average fees paid in California, Delaware, Florida, Illinois, New York, and Texas, 1999.

Because state banks pay only for the supervision costs incurred by the states, their supervisory assessments average less than half those of national banks.

State supervisors sometimes argue that this fee differential between state and federal charters stems from the greater “efficiency” of state supervision. But efficiency has nothing to do with it. The fact is that the predominant regulation of state banks is *federal*, and the scope of responsibilities of state bank regulators is typically far narrower than that of the respective federal regulator. When you add up the numbers and compare apples to apples—

comparing the *total* costs of supervising state and national banks, including the costs of federal supervision of state banks—it becomes quite clear that the costs are comparable. Indeed, if there are any inefficiencies in the structure, they are most likely to result from the maintenance of a two-tiered supervisory system—state and federal—for all state-chartered banks. Unquestionably, a single agency could perform these functions at a lower cost than two separate systems of supervision.

Let me be clear: I am not advocating a merger of the federal agencies or elimination of state supervision. I continue to believe in the dual banking system. But so long as state banks are subject to overlapping state and federal regulation, there is bound to be some inefficiency in that component of the regulatory structure.

Text continues on page 10

COMPARISON OF ACTIVITIES OF FEDERAL BANKING AGENCIES

Activities as Primary Federal Regulator of Banks	OCC	FDIC	FRS
Bank Examinations and Reporting	x	x	x
Entry Approvals (e.g., Charter, FDIC Coverage, Fed Membership)	x	x	x
Branch Applications	x	x	x
Merger and Consolidation Applications	x	x	x
Supervisory Enforcement Actions (C&Ds, CMPs, Removals)	x	x	x
Enforce Capital Requirements and Prompt Corrective Action	x	x	x
Enforcement Actions for Any Violation of Law	x	x	x
Enforcement Actions for Unsafe or Unsound Banking Practice	x	x	x
Examine for Community Reinvestment Act Compliance	x	x	x
Enforce the Bank Secrecy Act	x	x	x
Enforce the Securities Exchange Act of 1934	x	x	x
Enforce Laws on Government and Municipal Securities Dealers	x	x	x
Enforce Affiliate and Insider Transactions Rules	x	x	x
Administer Change in Bank Control Act	x	x	x
Supervise Foreign Activities	x	x	x
Right To Approve Directors and Senior Executives	x	x	x
Authority To Prescribe Operational and Managerial Standards	x	x	x
Receive Notices of Branch Closings	x	x	x
Enforce Management Interlocks Act	x	x	x
Participation in FFIEC	x	x	x
Administer Right to Financial Privacy Act	x	x	x
Enforce Bank Protection Act	x	x	x
Enforce Expedited Funds Availability Act	x	x	x
Examine for Truth in Savings Act Compliance	x	x	x
Examine for Truth in Lending Act Compliance	x	x	x
Examine for Fair Credit Reporting Act Compliance	x	x	x
Examine for Equal Credit Opportunity Act Compliance	x	x	x
Administer the International Banking Act	x	x	x
Examine for Fair Debt Collection Practices Act Compliance	x	x	x
Examine for Electronic Funds Transfer Act Compliance	x	x	x
Examine for National Flood Insurance Act Compliance	x	x	x
Examine for Flood Disaster Protection Act Compliance	x	x	x
Examine for Home Mortgage Disclosure Act Compliance	x	x	x
Examine for Fair Housing Act Compliance	x	x	x
Examine for Fair Lending Act Compliance	x	x	x
Examine for Real Estate Settlement Procedures Act Compliance	x	x	x
Examine for Consumer Leasing Act Compliance	x	x	x
Examine for Unfair and Deceptive Practices Law Compliance	x	x	x
Enforce International Lending Supervision Act	x	x	x
Establish and Enforce Real Estate Lending and Appraisal Standards	x	x	x
Participation in the Basel Committee on Banking Supervision	x	x	x

COMPARISON OF ACTIVITIES OF FEDERAL BANKING AGENCIES

Other Supervisory and Regulatory Activities	OCC	FDIC	FRS
Operation of Federal Deposit Insurance System		x	
Insurance Payouts, Receiverships and Resolution of Failed Banks		x	
Approval of Activities of Insured State Banks		x	
Rulemaking on Payment of Interest on Demand Deposits		x	x
Rulemaking Relating to Insider Lending		x	x
Supervision and Regulation of Bank Holding Companies			x
Supervision and Regulation of Edge and Agreement Corporations			x
Rulemaking Relating to Foreign Banking Organizations in U.S.			x
Rulemaking Under Export Trading Company Act			x
Operation of the Payments System			x
Issuance and Distribution of Currency			x
Rulemaking Under Truth in Lending Act			x
Rulemaking Under Equal Credit Opportunity Act			x
Rulemaking Under Consumer Leasing Act			x
Rulemaking Under Truth in Savings Act			x
Rulemaking Under Expedited Funds Availability Act			x
Rulemaking Under Electronic Funds Transfer Act			x
Rulemaking Under HMDA			x
Rulemaking on Interbank Liabilities			x
Rulemaking on Unfair and Deceptive Practices			x
Conduct of Monetary Policy and Operation of Discount Window			x
Rulemaking on Margin Requirements			x
Rulemaking Under Sections 23A and B			x
Setting of Reserve Requirements			x

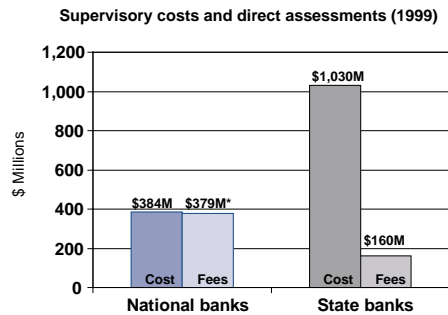
“[T]oday the supervisory functions that the FDIC and the Fed perform for state banks are virtually identical to those performed by the OCC for national banks. To put it another way, while both the FDIC and the Fed have some significant responsibilities beyond those of the OCC, there is virtually no function performed by the OCC for national banks that is not replicated by the FDIC and the Fed for state banks.”

Last year, the OCC spent less than \$400 million to supervise approximately 2,300 national banks, which controlled roughly 58 percent of the U.S. commercial bank assets. Neither we nor the banks we supervise receive subsidies, direct or indirect; national bank assessments cover almost 98 percent of our total expenditures.

Over the same period, the FDIC spent \$590 million on state nonmember bank supervision, and the Federal Reserve spent \$280 million supervising state member banks. When you add in the approximately \$160 million spent by the states, you come up with a grand total of more than \$1 billion—a number that represents the real cost of state bank supervision.

There, in the difference between the \$160 million spent by the states and the \$1 billion total cost of state bank supervision, is the inequity—a funding gap the major part of which is paid by those national banks that have contributed to the FDIC insurance fund and that maintain reserves with the Fed. Of course, American taxpayers also pay for part of these costs, for every dollar that the Federal Reserve spends on the supervision of state member banks is a dollar that is not remitted to the Treasury, as would otherwise be the case.

System-wide supervisory cost and direct assessment comparison between national and state-chartered banks



* The OCC's total revenue for 1999 was \$395M. The additional \$16M represents ancillary income.

The federal cost of supervising national banks is covered by OCC assessments on national banks. Fees paid to state authorities are equivalent to 16% of the cost of state bank supervision.

Those of you who are longtime followers of regulatory issues are probably not hearing this discussion for the first time. The inequity in the funding of federal supervision of state and national banks is an issue that's engaged and vexed Comptrollers of the Currency going back to the days of Jim Saxon in the 1960s,

and one that's been the subject of a fair number of academic studies and legislative reports since then. One approach to

“A truly vigorous dual banking system should not be founded on the maintenance of a federal subsidy for state banks.”

the problem that has frequently been proposed in the past would require the FDIC and the Fed to assess state banks directly for their cost of federal supervision. Every year since 1993, the Office of Management and Budget has proposed such a plan, and every year it has been effectively dead on arrival in Congress. While this approach is in many ways the most straightforward,

since it would end the subsidization of federal supervision for state banks by national banks and restore a healthier competition to the dual banking system, one has to confront the political reality that Congress is not likely to impose such a new charge on state banks.

Others have suggested that the OCC could simply alternate national bank examinations with the FDIC, as the states now do. While that might reduce OCC's costs somewhat, it would clearly add to the FDIC's costs—and it would do so in a most inefficient way, since both of these federal agencies would have to maintain a capacity to examine the same set of national banks. The sum of the parts would inevitably be greater than the whole. As I mentioned earlier, it is precisely this inefficiency that characterizes the current two-tier supervision of state banks.

Moreover, such a plan would *increase* the supervisory burden on national banks by subjecting them to the jurisdiction of two agencies, instead of one. This would effectively destroy one of the key attributes of the national charter—the ability to deal with a single primary regulator.

Some have suggested that the fees charged by the FDIC should simply be unbundled into two components. The first, charged to all, would cover the risk-adjusted cost of deposit insurance; the second would cover the FDIC's cost of supervision, and would be paid by banks whose primary federal supervisor is the FDIC. Others have suggested that the FDIC should remedy the inequity

of using national bank contributions to the FDIC to pay for the costs of state bank supervision by rebating to national banks—or to the OCC, for pass-through to national banks—an amount equal to their contribution to the cost of federal supervision of state banks.

Which of these approaches is the most sensible? I don't have an answer to that question for you today. My purpose in discussing the issue here is simply to raise awareness of its importance and to encourage public dialogue on an issue that we believe must be considered in the context of deposit insurance reform. I look forward to hearing from you and from other interested parties about this subject.

Frequently Asked Questions about Federal Funding of State Bank Supervision

1. Q As a practical matter, if the fee differential between the state and the national charter is eliminated, wouldn't the result be a migration of state banks to the OCC, thus damaging the dual banking system?

A There is no reason to believe that the continued health of our dual banking system depends upon national banks subsidizing the federal supervision of state banks.

Advocates of the state banking system should not underestimate the vitality of their charter. The state system will always be attractive to many banks and does not require a subsidy from national banks to continue to thrive. With the proliferation of state “wild card” laws, plus section 24 of the Federal Deposit Insurance Act, the Riegle-Neal Amendments Act of 1997, and a host of other initiatives, state banks are competitive, innovative, and responsive.

2. Q State banking authorities claim that state bank supervisory costs are lower because they are more efficient. They cite their system of “coordinated supervision” with the Federal Reserve System (FRS) and FDIC as part of an efficient structure that enables them to keep costs down. Are lower state supervisory costs a result of greater efficiency?

A The difference in supervisory costs has nothing to do with efficiency. Rather, it is the result of a very significant difference in the scope of federal and state supervisory functions, and the inevitable consequence of the FDIC and FRS policy of providing free federal supervision to state banks. The cost of that supervision is instead borne by taxpayers and the banking system as a whole.

Although it is true that the FDIC and the FRS alternate examination duties with state authorities, both of these federal agencies provide extensive supervisory and regulatory services to state banks. Congress has increasingly chosen in recent decades to

make both state and national banks subject to federal supervision and regulation, and has enacted a plethora of measures—for example, the Truth in Lending and Bank Secrecy acts, to name only two—applicable uniformly to all banks. Thus, the range of supervisory functions performed by the three federal agencies is practically identical, and far broader than that typically performed by state agencies. What is different is that national banks pay the full cost of their federal supervision, as well as a substantial part of the cost of federal supervision of state banks.

3. Q Don't state banks pay for FDIC supervision and regulation through deposit insurance premiums?

A Both state and national banks pay insurance premiums to the FDIC. In the current environment, with few banks paying any deposit insurance premiums, the majority of the FDIC's revenue is derived from earnings on the Bank Insurance Fund (BIF). National bank premiums paid in the past, and earnings on those accumulated premiums, make up about 52 percent of the current BIF. Similarly, about 33 percent and 13 percent of the BIF can be attributed, respectively, to state nonmember and state member bank premiums paid in the past and earnings on those accumulated premiums. The only difference is that state nonmember banks receive supervision and regulation from the FDIC, while national banks do not.

Deposit insurance premiums should pay for deposit insurance. It is not equitable to use part of the premium to defray the cost of federal supervision and regulation for state banks, while requiring national banks to pay the full cost of federal supervision and regulation.

4. Q Why doesn't the Comptroller explore a supervisory sharing arrangement, similar to what the states have with the FDIC, to reduce the overall cost of running the OCC?

A The arrangements the FDIC has with the states focus on sharing examination responsibilities. This approach is based upon Section 10(d)(1) of the FDI Act, which specifies which federal agency is responsible for examining particular types of depository institutions and when examinations by state authorities may alternate with federal exams in the case of state-chartered institutions. This structure allows the shared and alternate examinations that reduce the cost to state banking departments with savings passed along to state banks in the form of lower fees. There is no statutory authority, however, for the OCC to shift part of its examination functions and other regulatory responsibilities to another federal regulator.

It is probably true that if an alternating examination arrangement for the OCC and FDIC were enacted into law—with the latter's share provided at no cost to national banks—it would result in somewhat lower OCC direct expense and, by extension, lower OCC supervisory fees. However, the responsibilities of the banking agencies include far more than examining banks. The OCC, as their primary regulator, would remain responsible for adopting, administering, interpreting and enforcing regulations applicable to national banks. These responsibilities under federal law would not be transferred to the FDIC and thus the extent of cost savings that would result from sharing examination functions would not be great. But such an arrangement would clearly increase the FDIC's costs, and would result in an extension of the subsidy to national banks. Sound public policy should work toward eliminating this federal subsidy rather than extending it to national banks.

Finally, a sharing arrangement would not reduce the cost of national bank supervision but simply shift a portion of it to another agency. Indeed, the overall cost of supervision would likely increase since the OCC and FDIC would have to maintain separate capacity to examine (and coordinate the examination of) the same set of banks.