United States General Accounting Office

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Staff Study

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DEPOSIT INSURANCE

Summary of Analysis of Reform Proposals

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Summary

Our system of federal deposit insurance began operating in 1934. This system, which now protects about $2.4 trillion in deposits, is a major factor promoting the stability of our financial system.

Changes in the financial environment have, however, led government officials and others to propose changes to the deposit insurance system because of concerns that existing arrangements

- create significant competitive inequities among financial market participants,
- probably result in a less than economically optimal allocation of the nation's financial resources, and
- create incentives on the part of insured institution managers to take inappropriate risks.

Prompted by these valid concerns and unprecedented losses in recent years, deposit insurance and executive branch officials have recommended higher insurance fund resources, risk-based deposit insurance premiums, and a number of other measures.

However, practical, comprehensive reform is difficult to design and implement for several reasons. The objectives of our deposit insurance system—protecting investors, promoting stability, and encouraging market efficiency—are not all easily satisfied at the same time. Also, the reactions of financial market participants to changes in deposit insurance are unpredictable, and how a reform proposal would be administered can be unclear. Changes implemented too rapidly or without due provision for long-run consequences could thus prove detrimental. The dilemma posed for those considering reform of the system is that in attempting to correct one perceived problem, we may exacerbate another or create the potential for a more unstable financial system.

This study emphasizes the interrelationship of financing, risk, and industry structure—characteristics of the deposit insurance system. Separate chapters discuss proposals related to the following six topics which a comprehensive strategy for deposit insurance reform must address:

(1) How the largest commercial banks and savings institutions insured by the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC) are treated.

(2) Financing deposit insurance without relying on taxpayer subsidies.

(3) Varying insurance premiums according to the degree of risk posed by individual institutions.

(4) Protecting the deposit insurance system by increasing minimum capital requirements for some or all insured institutions.

(5) Achieving an appropriate degree of consistency between the FDIC and FSLIC insurance programs.

(6) Defining the roles of insured deposits and of insured institutions in the economy.

In this study, GAO does not endorse specific proposals for reform, nor does it conclude that comprehensive congressional action is urgently needed. We observe, however, that action to improve the financing of the deposit insurance fund, such as that proposed in the Federal Savings and Loan Insurance Corporation recapitalization plan, while desirable, will not resolve many important long run banking issues.

Much of the analysis in this study is based on GAO work at the federal bank regulatory agencies. It also draws heavily on governmental, academic, and other studies of the financial services industry and deposit insurance issues. The study was extensively reviewed by recognized experts on financial services industry matters and was forwarded to the five bank regulatory agencies and six trade associations for their review and comment. The comments of the regulators and trade associations along with our responses are contained in the study.

This study is published in two volumes. In the first volume, the major issues posed by deposit insurance reform are addressed. In the second volume supplementary information is provided for readers with specific interest in (1) how deposit insurance works; (2) interrelationships among bank risk, deposit insurance, and bank capital; (3) the history of deposit insurance; (4) changes in the financial services industry that bring into question the special nature of insured deposits and institutions; and (5) the operations of the individual insurance funds.

The tables of contents of both volumes follow this summary. Interested parties can obtain copies of these volumes by contacting Stephen C. Swaim on (202) 452-2409 or me on (202) 275-8678.

GAO wishes to acknowledge the cooperation of all parties involved in the preparation of this study.

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