An Evaluation of Further Possible Changes to the Deposit Insurance System

FDIC Staff Study

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Summary

This study examines the feasibility and consequences of taking three actions: privatizing deposit insurance, establishing a voluntary deposit insurance system for deposits in excess of the maximum amount of FDIC insurance, and increasing the limit on deposit insurance coverage for municipalities and other units of general government. As a result of the study, the FDIC does not recommend privatizing deposit insurance, providing a voluntary deposit insurance system for deposits above the maximum amount of FDIC insurance, or increasing the limit on municipal deposits.

The study begins by reviewing arguments made by the proponents of privatizing deposit insurance and concludes, first, that privatization will not result in the elimination of moral hazard since moral hazard is an effect of all types of insurance. Further, recent regulatory and statutory improvements in federal banking law have given the FDIC better tools to control moral hazard. Second, much of the regulatory burden on banks is unrelated to deposit insurance and will not go away with privatization. Third, privatization would not remove the taxpayer from ultimate responsibility for losses arising from a systemic crisis. Government intervention in a systemic failure—to prevent broader problems—is really an economic issue, not a deposit insurance issue. Recent changes have also reduced the risk of a systemic failure as well as made it considerably more difficult to make a systemic risk determination.

Other factors also argue against a private deposit insurance system: the failure of earlier private insurance systems, the availability of private capital to replace the federal guarantee, and cost and public policy considerations. A review of the failed record of private deposit insurance systems in the U.S. reveals that insufficient confidence in the private deposit insurance guarantee in the past rendered the systems unable to prevent panics. The FDIC questions whether a high

degree of public confidence is possible without the knowledge that the government stands behind the guarantee. Additionally, an earlier FDIC study found the availability of private risk capital to underwrite a private deposit insurance system to be limited—a finding buttressed by insurers' unwillingness, subsequent to September 2001, to provide terrorism insurance absent a government loss-sharing agreement. Furthermore, the costs of private deposit insurance would be prohibitively high, and the goals of a private system might not coincide with public policy goals.

The second part of the study examines the need for and ramifications of FDIC provision of voluntary excess deposit insurance. It finds that depositors in need of additional coverage have other options as a result of technological advances and private sector initiatives, including deposit-placement services and deposit sweep programs, and that these services reduce the need for FDIC involvement. Furthermore, the FDIC would probably be expected to retain the additional risk because reinsurer capacity and interest is limited. The study further concludes that developing a vibrant private sector excess deposit insurance market would require an FDIC risk-sharing protocol of some type.

The third part of the study considers the specific issue of increased municipal deposit coverage. Again, municipalities and other units of general government have other alternatives that address this need, which include deposit-placement services and surety bonds. Additionally, the FDIC concludes that such increased coverage would represent a departure from the traditional goals of deposit insurance. Furthermore, the FDIC does not generally favor treating one class of depositors differently from others as would be the case if municipal deposits received increased coverage. Providing greater coverage for municipal deposits also removes an aspect of market discipline inherent in the system and has cost ramifications.

Introduction

The Federal Deposit Insurance Corporation (FDIC) is required by the Federal Deposit Insurance Reform Conforming Amendments Act of 2005 (FDIRCAA) to study the feasibility and consequences of (1) privatizing deposit insurance, (2) establishing a voluntary deposit insurance system for deposits in excess of the maximum amount of FDIC insurance, and (3) increasing the limit on deposit insurance coverage for municipalities and other units of general local government. FDICRCAA also requires that the FDIC submit to Congress a report containing the FDIC's findings and conclusions and recommendations, if any. This document is the report required by FDIRCAA.

The Modern Deposit Insurance System

While federal deposit insurance began in 1933, the modern federal deposit insurance system is largely the result of legislative changes made in the past two decades. In the 1980s, a crisis in the savings and loan industry culminated in the insolvency of the Federal Savings and Loan Insurance Corporation and taxpayer funding of the agency's deposit insurance obligations. Almost concurrently, a similar crisis in the banking sector—the worst since the 1930s—nearly exhausted the resources of the FDIC's deposit insurance fund. Congress responded to the two crises by reevaluating the federal deposit insurance system, and enacted a series of reforms. One was the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Many of FDICIA's provisions were designed specifically to remedy the weaknesses in the deposit insurance system that the recent crises had brought to light. Specifically, FDICIA

- Required the banking industry to recapitalize the deposit insurance funds, reducing the likelihood that the public would have to fund deposit insurance obligations in the future.
- Permitted the FDIC to borrow up to $30 billion from the Treasury so that funds would be available to close and resolve insolvent institutions quickly.
- Introduced prompt corrective action, which restricted the activities of banks with low capital levels and required earlier closure of critically undercapitalized banks.
- Mandated that the FDIC enact the least-expensive cost solution to resolve bank failures (except in the case of systemic risk and only when recommended by at least two-thirds of both the FDIC Board of Directors and the Board of Governors of the Federal Reserve, and a determination of the Secretary of the Treasury —in consultation with the President).
- Introduced risk-based deposit insurance premiums so that riskier banks paid more, thereby mitigating moral hazard.

Recently Congress again addressed deposit insurance, enacting the Federal Deposit Insurance Reform Act of 2005 (FDIRA), which builds on the reforms instituted under FDICIA. FDIRA also

- Merges the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) into a single Deposit Insurance Fund (DIF).
- Allows the FDIC to manage the level of the DIF within a certain range.
- Allows the FDIC to charge risk-based premiums regardless of the level of the reserve ratio.

- Authorizes one-time assessment credits to institutions that replenished the insurance funds in the early 1990s, and provides for dividends when the reserve ratio reaches certain thresholds.
- Allows for future upward adjustments of insurance coverage levels for inflation, and immediately increases the insurance coverage limit of retirement accounts to $250,000.

I. Privatizing Deposit Insurance

Since its inception in 1933, the federal deposit insurance system has achieved its traditional goals: promoting financial market stability, protecting the economy from the disruptive effects of bank failures, and protecting the deposits of small savers. However, despite its successes, some have argued that privatizing deposit insurance would be an improvement over publicly provided deposit insurance. Several privatization proposals were promoted in the 1980s, and proposals continued to be put forth through the late 1990s, even as deposit insurance reforms were being debated. The proposals assume that a private deposit insurance system (or a public system with lesser powers) could fulfill the role and functions of the current federal system more safely and efficiently than the current federal system does. The FDIC has explored the issue of privatization at some length, and in January 1998 hosted a conference—Confidence for the Future, An FDIC Symposium—that looked closely at the issue.

A summary of FDIC findings based on the 1998 conference follows, beginning with the arguments in favor of privatization; then the proposals that have been made; followed by an analysis of the proposals' assumptions, objectives, and recommendations; and concluding with a discussion of other considerations (history, availability, cost, and public policy).

Arguments for Privatizing Deposit Insurance

Privatization proponents generally maintain that the costs arising from a government-run deposit insurance system are greater than the benefits, that the problems associated with a government-run deposit insurance system are inherent and insurmountable, and that the only solution to the problems is to privatize deposit insurance. The various reasons given for this stance are different but overlapping and generally involve concerns about moral hazard, government supervision and regulation, and a perceived belief that some institutions are "too big to fail."

Concerns about Moral Hazard. In the insurance context, the term "moral hazard" refers to the tendency for insured parties to take on more risk than they would if they had not been indemnified against losses. Because deposit insurance reassures depositors that their money is safe, it removes the incentive for depositors to critically evaluate the condition of their bank, so even unsound banks have little difficulty obtaining funds, and riskier banks can obtain funds at costs that are not commensurate with the banks' levels of risk. Thus, unless deposit insurance is properly priced to reflect risk, banks can take on more risk than if they were subject to the market discipline of paying creditors a real risk-adjusted return. A truly risk-based assessment would discourage such risky behavior.[1] The moral-hazard problem is particularly

[1] As discussed below, historically the moral-hazard problem created by deposit insurance has also been mitigated by banking regulation and the supervision of depository institutions. Among the regulatory actions that have been used to reduce the risks associated with moral hazard are capital standards, examinations, safety-and-soundness regulations, and enforcement actions.

acute for insured depository institutions that are at, or near, insolvency but are allowed to operate freely (or without restrictions) because any losses are passed on to the insurer, whereas profits accrue to the owners. This provides an incentive for unhealthy institutions to gamble with insured deposits in the hope of returning to profitability.

Concerns about Government Supervision and Regulation. A major concern of some privatization proponents is the degree of government oversight that they consider to be a by-product of government-sponsored deposit insurance: they argue that government involvement results in the intrusive regulations, product restrictions, and social obligations that are placed on insured banks and thrifts. Their argument is that government-sponsored insurance subjects banks to intense safety-and-soundness regulation and limits both the products banks may offer and the affiliations they may have. The claim is that regulation inspired by deposit insurance not only limits choices and opportunities and hinders rapid response to changes in the business environment but is also expensive. And inasmuch as this costly regulation is directed to only one—ever smaller—segment of the financial industry (depository institutions), it makes insured depository institutions less competitive with other financial providers that are not so encumbered. Proponents of privatization seek, therefore, to decouple deposit insurance from the "full faith and credit" of the U.S. government, or otherwise reduce taxpayer risk, to remove the justification for federal supervision and regulation of the banking industry.

Concerns about "Too-Big-To-Fail"(TBTF). Privatization proponents tend to be especially critical of the systemic-risk exception provided in FDICIA. They argue that when Congress provided a statutory exception from the least-cost resolution in the case of systemic risk, it acknowledged that certain depository institutions were too-big-to-fail. The argument is that because of the size or perceived importance to the financial system of large institutions, their

uninsured depositors and creditors are treated differently from those of smaller institutions. Privatization proponents argue that TBTF has the potential to shift the costs for megabank failures to the taxpayer: as long as the "full-faith-and-credit" backing of the U.S. Treasury supports deposit insurance, taxpayers inevitably will be responsible for any losses resulting from bank failures that exceed the resolution capacity of the deposit insurance fund.

Proposals for Privatizing Deposit Insurance: Commonalities and Differences

Consistent with the proponents' concerns about moral hazard, they generally propose more market-oriented systems, but differ in how to achieve it. One proposal would replace publicly provided deposit insurance with a system of cross-guarantees under which small groups of banks would form syndicates that would insure the deposits of banks that contracted with them.[2] Another proposal would convert the FDIC into a privately owned and operated insurance company, shifting from the current system's reliance on detailed rules and procedures to a system more focused on performance and market discipline.[3] A third proposal would transfer ownership and management of the FDIC to the banks and would set an explicit limit on the use of deposit insurance in order to encourage market discipline.[4] A fourth would retain the FDIC as a public entity but would reduce its powers.[5]

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[2] Petri Proposal, introduced by Rep. Thomas E. Petri (R-WI) (U.S. Congress, House [1996]). This proposal was introduced only once and was not discussed in the subsequent debate on deposit insurance reform.

[3] Bank Administration Institute and McKinsey & Company (1996).

[4] Kovacevich (1996).

[5] Bankers Roundtable (1997).

All the proposals envision more-relaxed bank supervision and regulation. Most seek to reduce the regulatory and supervisory powers of bank regulatory agencies to allow banks to become competitive, full-service providers of financial products and services. One proposal would exempt banks from federal safety-and-soundness regulations and reporting requirements, replacing them with private restrictions by member banks.[6] It would also abolish the FDIC and the regulatory and supervisory functions of the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS). Another proposal would reward well-capitalized, well-managed institutions with less-intrusive regulation, expanded product opportunities, and lower regulatory "taxes."[7]

The proposals are particularly concerned with the issue of TBTF. Most of them would provide deposit insurance coverage for small deposits only. All of them seek to protect the taxpayer from responsibility for a systemic collapse by preventing the insurer from being able to fund a systemic-risk exception. Most of them would eliminate the full-faith-and-credit backing of the insurer as well as the insurer's line of credit with the Treasury. However, one proposal sees the need for a bank-funded backup fund to explicitly protect insured deposits against a system wide collapse.[8]

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[6] Petri Proposal (U.S. Congress, House [1996]).

[7] Bank Administration Institute and McKinsey & Co. (1996).

[8] Petri Proposal (U.S. Congress, House [1996]). The fact that this proposal finds that a backup fund would be necessary to maintain depositor confidence at critical times would appear to recognize that a system of cross-guarantees might not always be able to replace a government guarantee of deposits.

Critical Analysis of Privatization Assumptions, Objectives, and Recommendations

Can Privatization Alleviate the Moral-Hazard Problem?

Proponents of privatization generally assume that the moral hazard fostered by deposit insurance can be eliminated through privatization. As noted above, moral hazard in the insurance context refers to the incentive for insured entities to engage in riskier behavior than they would have in the absence of any insurance protection. The problem of moral hazard is inherent in insurance itself. The private provision of deposit insurance does not by itself alleviate the moral-hazard problem, which is endemic to all insurance systems, not just deposit insurance, regardless of management or ownership.

Furthermore, recent improvements in federal banking regulation and supervision have given the FDIC better tools with which to control moral hazard. Historically, the moral-hazard problem created by deposit insurance has been mitigated by banking regulation and supervision of depository institutions. Among the regulatory actions that have been used to reduce the risks associated with moral hazard are capital standards, examinations, safety-and-soundness regulations, and enforcement actions. In particular, PCA (prompt corrective action), introduced under FDICIA, has been effective in stopping banks with low capital levels from gambling on a return to profitability while the FDIC bears the risk. A properly constructed risk-based premium assessment system can also combat moral hazard, and the recently passed Federal Deposit Insurance Reform Act of 2005 (FDIRA) has given the FDIC increased ability to manage its insurance fund and set premiums according to the riskiness of the insured entity. Although moral hazard continues to be an important issue facing the FDIC as insurer, the FDIC believes that the recent reforms have enabled it to better control moral hazard.

Would Privatization Release the Banking Industry from Unnecessary Regulatory Constraints?

A privately funded and privately administered system of deposit insurance would not remove the banking industry from all regulation and constraint. Most bank regulations do not flow from the FDIC as deposit insurer but from the chartering authority, whether it is the Office of the Comptroller of the Currency (OCC) for national banks, the Office of Thrift Supervision (OTS) for savings associations or the state chartering authorities for state-chartered banks. Bank supervision by the OCC, the Federal Reserve, and the states predates the federal deposit insurance system. And much of the rest of the regulatory burden on insured institutions is the result of statutes and regulations that are unrelated to deposit insurance. For instance, after the events of September 11, 2001, regulators began strictly enforcing the provisions of the Bank Secrecy Act of 1970, and financial institutions that fall under the U.S. Patriot Act are now subject to much stricter supervision. Insured institutions are also subject to the Community Reinvestment Act (CRA), which is again unrelated to deposit insurance—and has recently been criticized for imposing undue burdens on financial institutions.[9] Reporting requirements under such laws are not based on deposit insurance coverage and will not be eliminated if deposit insurance is privatized.

In addition, historically the functions of banks—as both financial intermediaries and as conduits for controlling the money supply—have been deemed too important to the economy to be left to the vagaries of an unregulated marketplace. Public policy makers would be unlikely to abandon concern for prudent banking practices if deposit insurance reverted to the private sector.

[9] See, for instance, Bernanke (2006), acknowledging that amendments to CRA increased the reporting burdens for some institutions; and Hilgert (2004), quoting Robert Rowe, regulatory counsel for the Independent Community Bankers of America.

Many believe that, as Representative James Leach noted, "Because a sound economy requires a safe and sound banking system, public liabilities exist even if public funds are not placed in jeopardy by statute."[10] Undoubtedly policy makers would also continue to be concerned about implicit public guarantees. These concerns would be likely to manifest themselves as continued government regulation to ensure both the efficient operation of the financial system and the protection of consumers and individual savers.

It is more likely that, in addition to continued public regulation, a privately owned and profit-seeking deposit insurer would demand oversight. At a minimum, any prudently operated for-profit deposit insurer would probably require adherence to best practices and would insist on access to management and on-site visits to monitor the condition and riskiness of institutions. It is unlikely that the private insurer would rely on market-generated information alone. Virtually all insurance policies—health, life, and liability—contain restrictions and limitations on coverage as well as conditions on approval in order to control risk.

For instance, American Share Insurance Company, a private primary and excess deposit insurer to credit unions, requires monthly financial reports from its members, examines them regularly, and supervises them closely. A review of the history of state-sponsored deposit insurance plans also reveals that the more successful private insurers were extremely vigilant in the regulation and supervision of member banks. In the pre–Civil War Indiana plan, regarded by some as the best of the nonfederal deposit insurance plans, insured banks were legally branches of the State Bank of Indiana. Bank examinations were semiannual, and the directors of the State Bank had powers that exceeded those granted to bank regulators today. The State Bank of Indiana also had the authority to dictate whether banks in the state expanded or contracted the

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[10] Leach was speaking at the FDIC conference Confidence for the Future (FDIC [1998]).

availability of credit, and on occasion it exercised this authority. In contrast (as described below), weak supervision of member banks was considered a major factor in the collapse of the Ohio, Maryland, and Rhode Island private deposit insurance plans in 1985 and 1991. It is unclear, therefore, how the change from a public to a private deposit insurance system would affect the regulatory constraints under which the banking industry operates.

Would Privatization Remove the Taxpayer from Responsibility for Losses from a Systemic Failure?

In particular, several of the privatization proposals include a call for the elimination of the ability of the government to enact a systemic risk solution. They maintain that when Congress provided a statutory exception from the least-cost resolution requirement in the case of systemic risk, it acknowledged that certain depository institutions were too-big-to-fail. They believe that uninsured depositors and creditors of large institutions are treated differently than those of smaller institutions, and that as long as the "full faith and credit" backing of the U.S. Treasury supports deposit insurance, taxpayers inevitably will be responsible for any losses resulting from bank failures that exceed the resolution capacity of the deposit insurance fund.

Economic Policy Issue: The possibility of a systemic risk determination—which allows government intervention to prevent broader problems—is not simply a deposit insurance issue, but rather an economic issue that is best evaluated within the context of a wider public policy debate. The elimination of the possibility of a systemic risk exception would require a government commitment to allow banks—and in the broader context, other very large and important businesses—to fail even when their failure would jeopardize the stability of the U.S. financial system. If the failure of a private firm were to threaten the stability of the U.S.

economy—whether that firm were a bank, a financial services company, or a non-financial business—it is unrealistic to assume that the government would never intervene in the national interest. History is replete with examples of such intervention.

In the United States, the federal government has provided financial assistance to avoid large corporate bankruptcies (for example, Chrysler and Lockheed), assisted the banking and financial sectors when they were threatened by the less-developed-country debt crisis in the 1980s, and provided financial aid to the Mexican government—an important trading partner—during that country's financial crisis in 1995.

More recently, ten days after the terrorist attacks of September 11, 2001, Congress passed a $15 billion package of direct cash infusion and loan guarantees to aid the domestic airline industry. And, in 2002, with affordable commercial terrorism insurance unavailable, Congress passed temporary legislation that established a federal government backstop for 90 percent of insured losses resulting from certain terrorist acts up to an annual $100 billion industry-aggregate limit.[11] (This legislation was extended for an additional two year period in December 2005 with modifications that reduced the government's liability.)

Foreign governments have also intervened when their financial systems have been threatened. Japan launched several very expensive bailouts of its banks in the recent past and the "East Asian Tiger" countries (South Korea, Thailand, Indonesia and others) affected by the global currency crisis in the late 1990s undertook massive interventions to strengthen their financial sector. In fact, the vast majority of all industrialized nations in modern history have intervened to save their largest failing banks in order to protect their financial system.

[11] The federal payment is subject to an insurance company deductible. An insurer's deductible is calculated as a percentage of the value of direct earned premiums.

Reduced Potential for a Systemic Situation. Reforms enacted in FDICIA make a threatened bank failure substantially less likely to pose a systemic risk. As mentioned earlier, certain provisions in FDICIA were designed specifically to reduce systemic risk. These include prompt corrective action (including the establishment of capital level requirements), limits on interbank credit exposures, final net settlement authority, and reinforcement of netting provisions for interbank payments. Additionally, recent legislative changes have made the deposit insurance system more market-based. The greater flexibility to assess risk-based premiums provided to the FDIC by FDIRA should make the premium structure more market-based and discourage moral hazard. Finally, the use of certain failed-bank resolution techniques, including the use of bridge banks and advance dividend payments to uninsured claimants, has mitigated some of the adverse consequences associated with bank failures. Thus, the pressure on bank regulators and policymakers to invoke a systemic risk determination under FDICIA is lessened.

Greater Difficulty Making a Systemic Determination. FDICIA also requires that in order to make a systemic risk determination and waive the least-cost requirement for resolving insolvent institutions, the Secretary of the Treasury – in consultation with the President – must determine there would be "serious adverse effects on economic conditions or financial stability." Such a decision could only be reached after favorable written recommendations from both the FDIC Board of Directors and the Board of Governors of the Federal Reserve System, with at least two thirds of the members of each Board voting in favor of the recommendation. FDICIA further requires that the Government Accountability Office review any determination under this extraordinary exception.[12] These FDICIA-mandated requirements ensure that a systemic-risk

[12] 12 U.S.C. § 1823 (c)(4)(G)(iv) (2001).

determination would be made only after serious discussions at the highest levels of government about the merits of each case.

Systemic Risk and Too-Big-To-Fail are not Synonymous. Finally, it is important to emphasize that the systemic risk exception does not protect large banks from failing. The systemic risk exception only provides an exception from the least-cost resolution in the case of a systemic risk determination: large banks can still fail, and stockholders will take their losses. FDICIA only permits the FDIC to waive the least cost resolution in a systemic situation, which might result in more protection for uninsured creditors than under a non-systemic bank failure. However, as mentioned above, FDICIA protections make protection of uninsured creditors less likely.

Other Considerations: History, Availability, Cost, and Public Policy

Other considerations also raise questions about the advisability of replacing public deposit insurance with a private system. One such consideration is the fate of past private deposit insurance in the United States.[13] Another is the likely sufficiency of private risk capital to underwrite a private deposit insurance system. A third is cost in the absence of the federal guarantee. And a fourth is the public policy perspective on deposit insurance.

[13] Historically, private deposit insurance systems have acted as primary insurers (replacing the role the FDIC currently has as insurer) or as excess deposit insurers (providing insurance in addition to the FDIC insurance limit). As discussed below, there are no longer any private primary insurers for banks and savings associations in the United States.

History and Lessons of Private Deposit Insurance in the United States

The state of New York implemented the first deposit insurance plan in the United States in 1829, and between then and the Civil War, five other states created programs. In all of these programs, the emphasis was on protecting holders of banknotes rather than depositors. Three of the insurance plans failed, and the other three vanished soon after the establishment, during the Civil War, of the National Banking System. After the panic of 1907, eight mostly midwestern states created mutual deposit insurance systems. All of these plans failed by 1931. After the 1930s, at least 30 additional nonfederal insurance plans were established to protect the deposits of all depository institutions—banks, thrifts, industrial banks and loan companies, and credit unions. Most of these plans failed or ceased operation during the thrift crisis of the 1980s. Others were phased out when their sponsoring states decided, after witnessing the problems elsewhere, to require federal deposit insurance for all state institutions. Today, no private provider of primary deposit insurance to banks and savings associations remains. (As mentioned above, American Share Insurance Company continues to provide primary and excess deposit insurance to credit unions).

With a couple of exceptions, these private deposit insurance plans were sponsored by state governments, though the states did not back the plans financially. Almost all the plans were mutual insurance funds, though three of the early plans were based on a system of mutual guarantees in which banks guaranteed one another's banknotes. One completely privately held company began insuring credit union deposits in 1962, and several private companies provided reinsurance for deposits until they left the business in the mid-1980s.

Historically, private insurance plans have had to contend with two serious issues: concentration of risk, and lack of liquidity in the midst of a crisis. Nearly all failed private

insurance plans collapsed because of the failure of one or more large insured institutions. As described below, in many of these cases, insured depositors were either not protected—or protected only with substantial assistance from state taxpayers—and received access to their funds only after a prolonged period of time.

In one study of the commonalities of failed private deposit insurance systems in the United States, the author finds that these systems typically shared five characteristics: (1) free exit from the system; (2) concentration risk (the failure of large institutions often brought down the whole system); (3) fraudulent acts by regulators, banks, and politicians; (4) limited regulatory powers; and (5) inaction on the part of insurers and state regulators.[14]

Many of the failed systems actually had relatively high reserve ratios when their crises occurred. However, they were unable to handle the failure of a very large member of their system. The system could not ensure immediate access to funds, i.e., the system was not able to fulfill the liquidity function of an insurer, and this lack of liquidity forced bank runs on other member banks, overwhelming the entire system. Typically, deposits were frozen, and state governments had to step into the breach. Lacking funds to cover the insured deposits immediately, the states generally repaid them over some period of time, sometimes years.

In the more recent failures of private insurance systems (Ohio and Maryland in 1985, Rhode Island in 1991),[15] many insured depositors had to wait months—and in the case of Maryland, years—to receive the full return of their principal. The state of Ohio was forced to commit $151 million of nontax revenues to support a bond issue to fund depositor claims; most Ohio depositors received full availability of their funds within six months. In the case of

[14] English (1993).

[15] Todd (1994).

Maryland, the state committed state-sponsored bond revenues sufficient to satisfy insured depositor claims over a *five-year period*. Some depositors did not receive their funds in full until 1989, four years after failure. In the case of Rhode Island, the state requested and received a *federal* loan guarantee of the state bonds it issued to satisfy insured depositor claims. In the end Rhode Island covered the losses on its own, and Rhode Island depositors eventually received their funds in full, although many had to wait at least a year after the failure of the state deposit insurance fund.

As the history of private deposit systems suggests, to fulfill all three of the responsibilities traditionally assumed by federal deposit insurance,[16] a private, industry-funded deposit insurer not only needs enough resources to protect small depositors but also must be capable of providing stability to the entire banking system, especially in times of great financial and economic turmoil. Insufficient public confidence in the deposit insurance guarantee could render the system unable to prevent or stem banking panics.

There are legitimate questions as to whether any private deposit insurance system could obtain or maintain the necessary level of confidence in the deposit guarantee to prevent market instability during times of financial or economic turmoil. As history has shown, the insurance system must have not only the resources to handle isolated failures successfully but also the capability of handling catastrophes. And because the performance of the banking industry is closely tied to the performance of the economy, bank failures often come in waves—with one failure leading to, and building upon, another.

[16] To promote financial market stability by maintaining depositor confidence in the banking system, to protect the economy from the disruptive effects of bank failures, and to protect the deposits of small savers.

During a crisis, a private insurance fund typically must acquire financing from the banking industry through its line of credit—or from other private sources—at a time when the entire industry and perhaps the economy is in financial trouble. This is expensive in the short run, and related interest costs can hamper attempts to recapitalize the insurance fund for many years after the crisis has passed.

It is doubtful that depositors would continue to have confidence in a depleted or weakened insurance fund without the knowledge that the U.S. Treasury stood behind the deposit guarantee. As Milton Friedman notes in his 1963 monetary history of the United States, federal deposit insurance:

> has succeeded in achieving what had been a major objective of banking reform for at least a century, namely, the prevention of banking panics. . . . [B]anking panics have occurred only during severe contractions and have greatly intensified such contractions, if indeed they have not been the primary factor converting what would otherwise have been mild contractions into severe ones. That is why we regard federal deposit insurance as so important a change in our banking structure and as contributing so greatly to monetary stability—in practice far more than the establishment of the Federal Reserve System.[17]

Availability of Private Capital

Another consideration is whether enough risk capital is available to underwrite private deposit systems. In the 1990s, in keeping with a provision of FDICIA, the FDIC explored the

[17] Friedman and Schwartz (1963), 440–42.

feasibility of establishing a private reinsurance system for deposit insurance.[18] The FDIC found that reinsurers had only limited interest in engaging in reinsurance agreements with the FDIC on terms acceptable to the FDIC. Some reinsurers wished to limit their risk by either reinsuring only the strongest banks or charging prohibitively high premiums to banks judged to be involved in above-average risk. At the completion of the study,[19] Marsh McLennan concluded that

- The capacity of the reinsurance market could theoretically exceed $5 billion, but that capacity would be available only if all the major insurance companies or reinsurance companies participated and for transactions that had a very low probability of loss.
- Reinsurance companies would operate to their maximum capacity only if the first losses were paid by the FDIC. And even if the FDIC took the first losses, reinsurers would provide maximum capacity only when the transaction was rated the equivalent of AA or AAA. Multiline insurers expressed interest in higher-risk transactions, but the capacity of this segment of the market was limited—between $200 million and $500 million.
- Reinsurers were not interested in sharing losses with the FDIC on a proportional basis, even if they received a proportional share of any premiums. Reinsurance companies advised the FDIC that if losses were shared on a proportional basis, their capacity would be limited to no more than $100 million.

[18] FDIC (1993). The study was done in three phases beginning in 1993. The final report (Marsh & McLennan Companies [2001]) was completed in December 2001.

[19] Marsh & McLennan Companies (2001). (Figures have not been adjusted for inflation).

- Existing transactions would affect an insurance company's decision to participate in other transactions. For example, if a bank had a previous credit default guaranteed by the insurer, the insurer would not be likely to participate in any further reinsurance transactions with that client. For this reason, most reinsurers would prefer a transaction that excluded, or substantially limited, coverage of the largest banks.
- Reinsurers would be more likely to participate if transactions were bundled and structured with a three- to five-year term because reinsurers felt better able to judge risk on a portfolio basis and not on an individual bank-by-bank pricing basis. Likewise, reinsurers were uncomfortable in assessing risk beyond a five-year period.

The doubts about the availability of sufficient private risk capital to fund a private deposit insurance system were buttressed by events following the terrorist attacks of September 11, 2001. As mentioned, subsequent to September 11, the private insurance/reinsurance industry required a government risk-sharing arrangement in order to continue providing commercial terrorism insurance. The small number of private insurance firms currently providing excess deposit insurance in the United States (as will be described in a later section) also reinforces doubt about the sufficiency of private capital to support a private deposit insurance system.

Cost in the Absence of the Federal Guarantee

There is also the issue of cost. The Marsh McLennan study referenced above found that a reinsurance company's price for excess deposit insurance coverage could be expected to be higher than if the FDIC were providing the coverage because reinsurers' pricing would represent a free-market charge without government support.

Federal Reserve Chairman Alan Greenspan in 2002 testified about the likely cost of deposit insurance in the absence of the federal guarantee.[20] He stated that realistically the government subsidy could not be eliminated because, without it, the average premium would need to increase to such a high level to insure against the improbable case of very large losses that most depository institutions would be discouraged from offering broad insurance coverage. He made the case that in deposit insurance, unlike life or casualty insurance, each insured loss is not independent of others. Deposit-run contagion produces a far larger extreme-loss tail on the probability distribution and therefore requires substantially higher premiums to offset this risk. No private deposit insurer would ever be able to match the FDIC premium and cover its risks.

Public Policy Perspective

An issue that has been infrequently addressed in this debate is the difference between the goals of a public deposit insurance system and the goals of a privately run system.[21] These differences are significant. To maintain economic stability, public regulators historically have promoted the entry of newly chartered institutions into banking markets and have encouraged vigorous competition among banking organizations. Federal deposit insurance is available to all

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[20]Greenspan (2002).

[21] Hanc (1999).

qualifying banks, and it is not easily terminated. These are not givens under a private system. One would expect that the major objective of a private system would be to maximize the profit of its deposit insurance business, not to achieve any public policy goal. Under a mutual guaranty system, one might expect members to be interested in minimizing cost, risk, and competition. To lower the costs, risks, and competition for the existing members of the group, it would not be surprising if a mutual guaranty system denied coverage to newly chartered or otherwise risky banks, or only agree to provide insurance at very high rates or for very short-term contracts.

II. Establishing Voluntary Excess Deposit Insurance

The FDIC has also been asked by Congress to address the feasibility of the FDIC's offering or guaranteeing—to depositors or banks on a requested basis—deposit insurance in amounts that exceed the statutory limit. The FDIC researched this subject thoroughly in the 1990s. Market changes over the last two decades (especially deposit-placing services and sweep programs) have reduced the need for FDIC-provided excess deposit insurance coverage, but if Congress approved such a change, there are two approaches to providing excess insurance that could work.

A Changed Banking Environment

Recent technological advances have provided depositors with many additional options for depositing their money. For instance, depositors no longer need to physically visit a depository institution to make a deposit: by using the Internet and commercial listing services, they are able to obtain the desired insurance coverage with minimal effort. Deposit insurance regulations have

also been revised to make it easier for a depositor to judge how a deposit can be held in one financial institution under different rights and capacities, keeping the deposit fully protected.

Two recent private sector initiatives that have been particularly popular are deposit-placement services and deposit sweep programs. In deposit-placement services, large deposits are split by private companies into smaller pieces and distributed to member banks so that the total deposit is insured by the FDIC. In deposit sweep programs, a depository institution "sweeps" demand deposit accounts into other market instruments, sometimes avoiding uninsured status in the event of bank failure.

Deposit-Placement Services. A deposit-placement service allows participating banks and thrifts to provide their customers with insurance on deposits that exceed the statutory insurance limit while retaining the bank-customer relationship. To illustrate how a deposit-placement service does this, let us assume that a customer goes into a participating bank or thrift to make a deposit of $500,000. The bank originating the deposit retains $100,000 in an insured account and distributes the remaining $400,000 among four other participating institutions, with the depositor having full FDIC coverage.[22] In fact, a deposit-placement service is a form of brokerage in which the risk associated with the increased coverage is passed to the FDIC—a condition that contrasts sharply with existing private excess deposit insurance coverage. Risk is

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[22] This is an illustration of a one-way sell transaction. Deposit-placement services also offer reciprocal transactions in which the money ($400,000 in our example) that is transferred out of the originating bank is replaced with other deposits from other participating institutions equaling (in our example) $400,000. As a result of a reciprocating transfer, the originating bank maintains its deposit base.

minimized, however, since deposits placed through this type of service are considered to be brokered deposits, and therefore only well-capitalized institutions can participate.[23]

In 2003, the FDIC responded to an inquiry from a deposit-placement service as to whether pass-through deposit insurance rules apply to funds placed with the service. The FDIC responded that on the basis of the information it had been given, deposit insurance would "pass through" from the agent (the deposit-placement service) to the owner of the funds provided that disclosure, record keeping, and other requirements were adhered to in the process.[24] As a result, deposit-placement services became an alternative for people who were seeking deposit insurance coverage of funds in excess of $100,000.

Deposit Sweep Programs. Many insured depository institutions offer customers the option of "sweeping" funds out of a deposit account into an alternative investment vehicle. Several types of sweep accounts are available, including retail and commercial sweep accounts. Retail sweep accounts may or may not change the insurance status of the depositor, but commercial sweeps do change it. Commercial sweeps are widely available, and some provide protection for deposit accounts over the FDIC insurance limit in the case of bank failure.

In a commercial sweep, the depositor has the option of sweeping funds held in a demand deposit into a variety of instruments, including certain money market instruments or a money market mutual fund. If the goal of the depositor is to remain fully protected in the case of bank failure, any funds held in the deposit account above the FDIC insurance limit are usually swept into either a money market mutual fund or into securities sold under agreements to repurchase

[23] 12 U.S.C. § 1831(f) (2001).

[24] DiNuzzo (2003).

(“repos”).[25] There are other alternatives, but these vehicles are the most widely recognized by the general public. Sweeps began in the 1960s and the primary motivation for their development was avoiding the prohibition on paying interest on demand deposit accounts, but the use of the programs has greatly expanded since then.

Options for FDIC Provision of Excess Deposit Insurance Coverage

The recent developments described above have lessened the need for the FDIC to provide excess deposit insurance. However, if the FDIC were to provide voluntary excess deposit insurance, there are two general approaches that could work. One would be to provide excess deposit insurance directly to banks on a requested basis at an additional cost with the FDIC absorbing any risks not covered by the participating banks’ premiums. The other would be to pass some of this newly assumed risk on to a reinsurer; that is, the FDIC could purchase reinsurance for the additional coverage to be provided. At this time, Congress has not authorized the FDIC to offer excess insurance and the FDIC does not do so.

FDIC Provision of Excess Deposit Insurance Directly to Banks

The FDIC has considered how it might provide voluntary excess deposit insurance. Issues that would need to be resolved would include the availability of such excess insurance, limits to the excess coverage in order to protect taxpayers and the insurance fund, and a price for the excess coverage. Congressional authorization would be required to permit the FDIC to directly provide excess voluntary deposit insurance.

[25] It should be noted that in the case of other sweep programs, the status of the deposit upon bank failure may be questionable.

Availability. The FDIC might limit the availability of excess deposit coverage to only well-capitalized and well-managed institutions. For instance, it might institute term policies that would be cancelled if the institution failed to meet requisite capital standards or its CAMELS rating declined. A methodology for informing depositors about this change in status would need to be established to ensure that depositors received prompt and adequate notice.

Caps or Co-Insurance. The FDIC might place a limit, or cap, on the amount of excess coverage that it would insure. In addition, the depositor might share in any losses on the excess deposit: for example, only 80 percent of the excess deposit might be insured up to the designated cap.

Pricing. A decision would need to be made on whether participating institutions would pay a uniform premium. One possibility might be to assess a surcharge for accounts over the insurance limit on a rising scale, that is, a higher premium per dollar of excess coverage. Another possibility might be for a participating institution to have a lower premium based on its asset mix.

Reinsurance on the FDIC's Exposure

Alternatively, the FDIC might guarantee its exposure with a private sector reinsurer. The FDIC would continue to provide deposit insurance coverage up to its statutory limit, but the FDIC's risk on the excess would be transferred to a competitive market of private insurers. Congressional authorization would be required for such insurance to be provided. As mentioned above in the section on privatizing deposit insurance, the FDIC has explored the feasibility of establishing a private reinsurance system for deposit insurance. (The study focused on reinsurance of the FDIC's primary deposit insurance, not excess deposit insurance, but its

findings hold.) The study found that reinsurer capacity was limited and that reinsurers had only limited interest in engaging in reinsurance agreements with the FDIC on terms acceptable to the FDIC.

Privately Underwritten Excess Deposit Insurance

As described above, one approach to voluntary excess deposit insurance would be for the FDIC to provide this insurance directly, and either absorb all risk or to shift this risk to a reinsurer. A second approach would be for the FDIC to guarantee private secondary issuers of excess deposit insurance for a fee. Private secondary insurers currently provide coverage for excess deposits with either the bank or the depositor purchasing the coverage, but most banks and depositors have not taken advantage of these services. FDIC involvement could invigorate the development of this market.

Private Excess Deposit Insurance Today. Several private excess deposit insurance plans were started in the 1990s, but most have since been terminated. The handful of insurance companies that currently offer private excess deposit insurance plans reportedly provide it as a way to retain the banks' property casualty insurance, directors and officers insurance, and other business.

Three companies that currently private excess deposit insurance are Bancinsure, an insurance company that writes excess coverage for institutions that are customers for the company's other types of bank insurance products; Travelers Casualty and Surety Co. of America, which provides excess coverage in the form of a private depository bond; and Kansas Bankers Surety Company, a provider of surety insurance to banks in many states. Only a small

percentage of the banking system's excess depositors have taken advantage of the availability of this private excess deposit insurance.

In addition, in Massachusetts excess deposit insurance continues to be provided to state-chartered cooperatives and savings banks by the Share Insurance Fund of the Co-Operative Central Bank (SIF) (for co-operative banks) and the Depositors Insurance Fund (DIF) (for savings banks). The SIF and DIF are private, industry-owned excess deposit insurance companies. Both funds are backed solely by their own assets. Neither the Commonwealth of Massachusetts nor the U.S. government has any liability for the companies' obligations. Both funds insure deposits above the FDIC limit, in full, dollar for dollar, without restriction.

FDIC Loss-Sharing Protocol. For private excess insurance to be more attractive to potential providers and customers, the FDIC would probably have to assume some of the risk. In the absence of an FDIC loss-sharing arrangement, the pricing for excess private insurance of deposits would probably be prohibitive. In the determination of how much risk the FDIC would assume, the most important issue to be resolved would be the interplay between the amount of risk the FDIC would retain in such a program and the pricing of such excess coverage. The FDIC's share of risk could be minimal—perhaps, in the extreme, as little as 1 percent of anticipated expected losses—but that retained component would have to protect the insurer from extreme events.

Benefits of Private Excess Deposit Insurance. Like any insurance, private excess deposit insurance can create moral hazard: if large depositors are able to insure previously uninsured deposits, they have little incentive to monitor the institutions in which they have deposited these funds. Moral hazard is somewhat offset, however, because the private insurance companies that are absorbing the risk of providing excess insurance have an incentive to take the depositors'

place in monitoring the institutions. The FDIC also benefits in other ways from a well-structured private excess insurance program. The additional benefits are more deposit coverage without increasing the size of the FDIC insurance fund, risk exposure, or the premiums levied on banks; a market mechanism that has the potential to price risk more accurately at individual banks; the additional level of overview that would be provided by the private insurers and the likely insurance sector support for deposit insurance and banking safety related issues.

III. Increasing the Limit on Deposit Insurance for Municipalities and Other Public Units

Municipal deposits (also known as public deposits) are those funds belonging to a state, county, or municipal or political subdivision that are held by an official custodian. Under current law, each official custodian is insured up to $100,000 for time and savings accounts, and $100,000 for all demand deposits held by a single in-state institution. For deposits held by public officials in out-of-state insured institutions, the official custodian receives $100,000 in insurance coverage for all deposits held by any single out-of-state institution regardless of whether the deposits are in time and savings accounts or are demand deposits.[26]

The majority of states require that any public deposits not covered by federal deposit insurance be collateralized. Typically the collateral securing the deposits consists of high-quality government securities. The rationale for requiring collateral protection is to limit the extent to

[26] 12 C.F.R. §330.15(a)(2) 2006. Insurance coverage for municipal deposits, as for general deposits, may be adjusted for inflation beginning January 1, 2011. Federal Deposit Insurance Reform Act of 2005, Pub. L. No. 109–171, § 2101–2109, § 2103, 120 Stat. 4, 9–11 2006).

which a government, its agencies, and ultimately the local taxpayers are exposed to a bank's credit risk.

FDIC-insured institutions report secured or collateralized deposits as "Preferred Deposits" on their Fourth Quarter Call Reports. Preferred Deposits are municipal deposits held by insured institutions that are uninsured and therefore require collateralization.[27] At the end of the Fourth Quarter 2005, state and local governments held $2,153.1 billion in financial assets.[28] FDIC-insured institutions held $269.7 billion, or 12.5 percent, of these assets, with 78.9 percent of these deposits ($212.7 billion) requiring a pledge of collateral.

As funding challenges increase for depository institutions, it is understandable that municipal deposits have attracted attention.

Current Practices in Supervising and Administering Collateral

The states currently require one of three options for the supervision and administration of collateral: full collateralization; statewide collateral pools; and uncoordinated, autonomous collateral pledging.[29]

Uniform Statewide Collateralization Requirements. The most common practice among the states is full collateralization of public deposits. Under this system, the responsibility for enforcing and implementing the collateral program is left to either state or local officials. For

[27] Financial institutions are not authorized to collateralize private deposits. As a result, identifying Preferred Deposits as reported on the Call Report as municipal deposits is valid.

[28] Board of Governors of the Federal Reserve System (2006).

[29] Much of the information contained herein describing state systems of collateralization is derived from Larson (2006).

banks, the economic costs associated with full collateralization are an obvious disadvantage of this practice—the cost of establishing the custodial account (the full cost is borne by the bank) and the opportunity cost of foregone higher income normally earned through loans. Although full collateralization of public funds appears to provide the public depositor with ultimate protection, at least three risks remain. First, the market value of the collateral pledged by the bank may be less than its face value, so that the protection ends up being inadequate. Second, there is always a risk of fraud in both the supervision and the administration of the collateral system. And third, the collateral accepted by some government entities has a limited secondary market, so the public depositor could experience a loss of liquidity if liquidation became necessary; if a buyer could not be found, the depositor might need to hold the security until maturity.

Statewide Collateral Pools*:* Some state legislatures have created statewide collateral pools. These pools are supervised by a state central agency that administers all collateral set aside by banks throughout the state as security for the portion of the municipal deposits not covered by FDIC insurance. For example, Florida requires that banks deposit with the state agency acceptable securities equal to 50 percent of the deposit not covered by FDIC deposit insurance. Statewide collateral pools reduce the costs to individual depository institutions in two ways. Banks are saved the cost of individually supervising and administering the assets used as collateral, and partial collateralization allows them to invest the assets that would otherwise be pledged under a full collateralization program into higher paying assets, such as loans. Local governments and agencies also save under this method as the administration of the collateral is managed by a central agency. States using this method typically require the collateral pool to

exceed the total public deposits held by the largest institution in the state. Florida and the state of Washington are among the states using this system.

Uncoordinated, Autonomous Collateral Pledging. Some states have enacted statutes that permit public treasurers to obtain collateral for public funds at their discretion. This method is called the "home rule" or permissive approach, and it places complete responsibility for the collateralization practices on local officials. Because there is a lack of uniformity in collateralization agreements, each agreement must be separately negotiated by both the depository institution and the public official. This lack of standardization results in an increased risk of error or negligence in the market-monitoring processes and the safekeeping procedures, as well as an increased cost to the depository institution (which is usually passed on to the municipality through deposits bearing a lower yield).

The Issues—Background and Overview

On March 7, 2000, FDIC Chairman Donna Tanoue announced a comprehensive review of the deposit insurance system, including reviews of the sufficiency of the deposit insurance guarantee, the merger of the Bank Insurance Fund with the Savings Association Insurance Fund (as well as maintenance of these funds at the appropriate level), and the pricing of deposit insurance. Additional coverage for municipal deposits was not foremost on the list of issues the FDIC anticipated examining, but the subject received attention from the beginning. It was brought up at the first formal conference on deposit insurance reform hosted by the FDIC, a roundtable held in 2000, where it evoked conflicting views.[30]

[30] FDIC (2000b), 66–68.

The subject was also brought up in congressional proposals on deposit insurance reform that were part of the FDIC review announced by Tanoue. Some of the proposals suggested that the FDIC insure 80 percent of in-state municipal deposits over the basic insurance coverage to a maximum of $2 million or $5 million; other proposals would have provided 100 percent coverage of municipal deposits regardless of balance. The appendix of the present report summarizes the congressional bills affecting deposit insurance coverage of municipal deposits that were introduced between 2000 and 2005.

The FDIC laid out some of the options for providing additional coverage for public deposits in its Options paper, which was released in August 2000.[31] At the time the FDIC did not take a position on the issue, but Donald E. Powell, who succeeded Donna Tanoue as chairman, commented in 2003 that:

> With respect to municipal deposits, the current drafts of the House bill put . . . coverage at the lesser of $5 million, or 80% of the amount over the standard coverage level. Call Report data suggests that smaller institutions are pledging an increasing percentage of their securities in order to hold public deposits. This trend may imply that smaller institutions are becoming increasingly constrained in their investment options. Raising the coverage level on public deposits could provide banks with more latitude to invest in other assets, including loans. Higher coverage levels might also help community banks compete for public deposits and reduce administrative costs associated with securing these deposits. On the other hand, the collateralization requirement places a limit on the ability of riskier institutions to attract public funds, while a high deposit insurance limit would not. Traditionally, we [the FDIC] have taken a dim view of treating one class of

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[31] FDIC (2000a).

deposits—in this case, municipals—dramatically differently than the others and we have communicated that concern to Capitol Hill.[32]

Although the conference report that accompanied the Federal Deposit Insurance Reform Act of 2005 (FDIRA) did not discuss municipal deposits, the discussions of previous bills contained arguments on both sides of the issue. The key point made by those in favor of providing increased coverage was that such an increase would keep municipal deposits in local institutions, where they would be used to meet local needs.[33] But at least one member of the House, Congressman John LaFalce, argued that increasing the insurance coverage of municipal deposits would not benefit municipalities but, rather, would benefit "a very limited group of banks. . . . The increase in municipal deposit insurance coverage . . . will cost everyone potential premium increases and has the potential to seriously raise the level of risk in the banking system."[34]

Some industry leaders viewed the coverage of municipal deposits as more important than increased insurance on general deposit accounts. They reasoned that, when a state requires collateral for public deposits, a bank's administrative burdens are increased as a direct result.[35] However, some of the participants at the FDIC roundtable in 2000 made clear their belief that, if the insurance coverage of municipal deposits were increased, nothing would prevent banks from

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[32] FDIC (2003).

[33] For example, U.S. Congress, House (2002b and 2003b).

[34] U.S. Congress, House (2002b).

[35] Blackwell (2002).

bidding up the interest rates paid in order to increase their volume of such deposits, and the result would be a distortion in the market.[36]

Arguments for Increasing Municipal Deposit Coverage

Proponents of increased municipal deposit coverage have three major arguments: that increased municipal deposit coverage would make bank operations more efficient and less costly; that it offers a higher degree of safety than collateralization and provides additional protection to the public at large; and that it would permit smaller institutions to compete more effectively for these deposits.

Efficient Operations. Providing deposit insurance for a higher level of municipal deposits would arguably benefit insured institutions by making it more efficient and less costly for banks to compete for these deposits, with the result that the market could be expanded. There are no comprehensive data about the costs of collateralizing uninsured municipal deposits. It has been reported that the cost of setting aside collateral is typically 15 to 25 basis points.[37] Although the limited nature of the data makes it impossible for overall conclusions to be drawn about the costs of providing collateral to bank municipal deposits, it is clear that by tying up a bank's assets, the pledging of collateral reduces a bank's liquidity and increases its opportunity costs.

Safety of Public Deposits. For collateralization to safeguard public deposits effectively, the bank's collateral must be adequate and the security agreement must be enforceable. Both conditions must hold. A case that evolved out of the failure of Guaranty Savings and Loan

[36] FDIC (2000b), 66–68.

[37] Cocheo (2003).

Association (Guaranty Savings) in 1992 highlights the risk of collateralization to a public organization even after prudent steps have been taken by responsible officials. In that case a medical center had placed almost $1 million in deposits with Guaranty Savings. A collateralization agreement was executed between the parties, and security was pledged to cover the uninsured funds. But when the bank failed, the court denied the depositor access to the funds because the security agreement failed to meet the requirements under the law for its enforceability.[38] In another bank failure, municipal deposits in Iowa were covered by a sinking fund that was designed to guarantee the uninsured deposits of state and local governments. If there was a shortfall in the sinking fund, each bank holding uninsured public funds was to be assessed according to the volume of uninsured public deposits it held. When Hartford-Carlisle failed, there was a shortfall of $8.6 million, which became the responsibility of other Iowa banks.[39] In both cases, the fund manager took prudent steps to secure the deposits, but it was not enough to protect the uninsured portion of the deposits.

Of course, in cases of fraud, there is no guarantee that the collateral will be available if the bank fails. And even when there is no malfeasance, the market value of the collateral at the time of failure may have fallen. However, since public deposits are in most cases the taxpayers' money, increasing the insurance coverage of public funds would provide additional protection to

[38] North Arkansas Medical Center v. Barrett, 962 F.2d 780 (8th Cir. 1992).

[39] See Bengtson (2000). In the case of Hartford-Carlisle, the FDIC was able to repay the banks that had paid the assessment because it recovered more from the sale of Hartford-Carlisle's assets than had originally been expected. Iowa continues to provide for full coverage of public deposits through a sinking fund.

the public at large while reducing a local government's exposure to an individual bank's credit risk.

Competition for Municipal Deposits. One of the main arguments for increasing the deposit insurance limit on municipal deposits is that higher coverage might allow smaller institutions to compete more effectively for these deposits without having to pay higher rates to attract them. But although additional coverage may enable local (and smaller) institutions to reduce their cost of holding municipal deposits, there is no evidence that these institutions would successfully compete if higher insurance coverage led to a marked bidding-up of the interest rate paid on public deposits.[40] In fact, the numbers suggest that smaller institutions are doing quite well in attracting municipal deposits: as of December 31, 2005, FDIC-insured institutions with less than $1 billion in total assets held only 16 percent of the total deposits held by FDIC-insured institutions but approximately 25 percent of all collateralized public deposits.

Arguments against Increasing Municipal Deposit Coverage

The arguments against increasing municipal deposit insurance coverage involve how the increase might affect (1) the primary goals of deposit insurance and the health of the deposit insurance system, (2) market discipline, and (3) cost.

Effects on Primary Goals of Deposit Insurance. As just discussed, there are arguments for increasing the insurance coverage of municipal depositors. But among the things the FDIC considers in evaluating changes to the deposit insurance system are how the change would promote the three primary goals of deposit insurance and how it would affect the future health of

[40] Government officials must sometimes go outside the community to get the highest rate on public deposits.

the deposit insurance fund. As noted several times in this study, the traditional goals of deposit insurance are to promote financial market stability by maintaining depositor confidence in the banking system; to protect the country's local, regional, and national economies from the disruptive effects of bank failures; and to protect the deposits of small savers.

In terms of these traditional rationales, there is little justification for increasing the coverage of municipal deposits. Rather, as discussed above, individual banks would be the direct beneficiaries of increased coverage through the reduced administrative costs of holding collateral and the increased liquidity, and municipal depositors might receive higher rates of return. (Taxpayers in local communities, and the local economy, might also see some indirect benefits, but only in cases in which local institutions were able to compete with the services and yields offered elsewhere.)

The FDIC does not generally advocate favoring one depositor class over another. Although individual retirement accounts were recently given coverage above that provided for general depositors, these accounts are usually held for the long term and are less likely to move to riskier institutions in response to higher yields or other attempts to gather deposits quickly. This would not necessarily be the case with municipal deposits, since these deposits do not generally function as core deposits: balances in municipal deposit accounts vary greatly during the year, typically soaring when property taxes are collected, and running close to zero at other times.

Effects on Market Discipline. Additionally, providing greater insurance coverage for public deposits removes an aspect of the market discipline inherent in the system.[41] State and local governments are generally expected to have the financial sophistication necessary to

[41] See, for example, CBO (2005).

monitor the depository institutions they are using. Increasing insurance coverage on municipal deposits would end up shifting the risk of loss from the municipality or government agency to the FDIC, thereby increasing moral hazard.

Effect on Cost. There are also cost considerations. The FDIC has studied the likely cost of providing increased coverage of public deposits. As of December 31, 2005, insured institutions held nearly $213 billion in uninsured public deposits. Fully insuring these deposits would have lowered the deposit insurance fund reserve ratio from 1.25 percent to between 1.18 percent and 1.19 percent, potentially leading to higher assessments.

When the authors of the present study reviewed the comments of interested parties as reported by the banking industry press, they found that general support waned for increased coverage of municipal deposits once it became apparent that deposit insurance premiums could increase as a result. The FDIC examined the failures of insured institutions from 1995 through 2005 and projected that approximately $7.5 million would have been added to FDIC's costs if municipal deposits had been fully insured.[42]

FDIC Structuring of Increased Municipal Deposit Insurance

The FDIC has thought about how it might structure increased municipal deposit insurance coverage that is consistent with its public policy goals. If the FDIC were to offer optional excess coverage for municipal deposits, it would seek to structure the coverage in such a way as to limit any loss exposure, constrain any risk of an increase in moral hazard, and restrict

[42] This figure does not include collateralized municipal deposits since insurance coverage of these deposits would not have changed the FDIC's losses.

the ability of riskier banks to use the coverage as a source of deposit gathering. Possible ways of implementing increased municipal deposit insurance while maintaining FDIC goals follow.[43]

Availability. The FDIC could limit the availability of excess municipal deposit coverage—for example, by using term policies that would be cancelled if the institution failed to meet requisite standards; one possibility would be to allow only well-capitalized institutions to participate. If a participating institution lost its eligibility to offer the extra coverage, its insurance for public deposits would revert to coverage under the general deposit insurance rules. Although the FDIC could require the depository institution to advise the public officials of any loss of coverage, ensuring that the depositors received prompt and adequate notice could mean that the task of notification might fall to the FDIC. State legislatures might want to amend their laws so that only institutions eligible for excess municipal coverage would be eligible to hold such deposits.

Caps. Much as previous legislative proposals placed an upper limit on the deposit insurance coverage for municipal deposits, caps could be placed on each deposit in the program; for example, insurance coverage for municipal deposits could be limited to a maximum of $2 million. And, in an effort to maintain market discipline despite the increased coverage, the municipal depositor could share in any losses: for example, only 80 percent of the deposit might be insured up to the maximum coverage. For a further control on aggressive deposit gathering, the raised insurance level could be limited to in-state deposits, as some state and previous congressional proposals have done: increased insurance coverage would be available only when

[43] It is assumed that because of the added costs involved, premiums for excess municipal deposit coverage would be paid only by those institutions that offered the additional coverage (though that need not be the case).

the deposit was from a municipality in the same state as the insured institution. Or limits could be placed on the aggregate value of the public deposits held by any one institution, especially if these deposits were limited to the institution's total equity capital.

Pricing. A decision would need to be made on whether all participating institutions would pay the same premium when offering excess coverage for municipal deposits or whether riskier institutions would pay a higher premium. An option might be to reduce the premiums of a participating institution to the extent that it held low-risk assets that were not already pledged; or perhaps it could deduct these assets from the total value of the municipal deposits assessed. On its face, this option appears to avoid some of the administrative costs associated with a strict pledging arrangement, but safeguards would need to be in place that prevented the manipulation of capital—safeguards whose cost would most likely reduce or wipe out any savings.

Private Sector Options

As indicated above, although many interested parties initially voiced support for increasing deposit insurance coverage for municipal deposits, support waned when it became clear that the new coverage would not come without cost.[44] For this reason, the FDIC examined the private sector options available to municipal governments as an alternative to collateralization. The major private sector alternatives discussed here are surety bonds and deposit-placement services. (Note that reinsurance—as discussed earlier—is also an option for the excess coverage of municipal deposits.)

Surety Bonds. Most states allow municipal governments to protect their local deposits using means other than collateralization. At least 30 states allow the use of a surety bond. In

[44] See, for example, Cocheo (2001).

this case, the surety bond is issued by the insurance company to guarantee the payment of principal and interest on the covered deposits. Since use of a surety bond means the local government exchanges its exposure from the bank's credit risk to its exposure from the insurance company's credit risk, most states provide guidelines for the insurance companies eligible to issue a qualifying policy. Surety bonds eliminate much of the administrative burden for both the municipality and the bank since there is no need for custodial agreements, security agreements, or a continual revaluation of the collateral. With payment generally made on the bond within 24 to 48 hours, public officials do not have to wait to take possession of the collateral securities and then go through liquidation. And from the bank's perspective, surety bonds are more economical and efficient because they do not tie up the bank's collateral and they save the bank in both administrative cost and the opportunity cost of collateralization.

Despite the advantages, some public officials are wary of using surety bonds because the negotiation of the contract is between the bank and the insurance company. Nevertheless, if proper precautions are taken, surety bonds are a legitimate and more efficient alternative to collateralization.

Deposit-Placement Services. As discussed above in Part II, in the section "A Changed Banking Environment," the FDIC issued an advisory opinion in 2003 confirming that pass-through deposit insurance rules apply to deposits placed through a deposit-placement service. As a result, FDIC-insured institutions that use deposit-placement services can effectively provide their depositors with FDIC-insured deposits above the statutory limitation (currently $100,000 for general deposits). Although, initially, deposit-placement services were of limited use to municipal depositors because of the dollar limits, today a single $30 million deposit can obtain FDIC insurance coverage if all applicable FDIC rules are followed. Certainly the cost of using a

deposit-placement service is greater than what the cost would be if the FDIC offered excess municipal deposit coverage, but it may well be less than the administrative costs of a collateralization program. Additionally, by using a deposit-placement service the bank has a savings in opportunity costs.

Since most state statutes explicitly set out the methods that can be used to secure public deposits, using a deposit-placement service for public deposits may require state legislative action. But some state legislatures are recognizing the benefit of such systems and have recently begun to amend their laws to explicitly permit the use of a deposit-placement service (for example, Missouri, Ohio, and Oregon). Other states are allowing local governments to use deposit-placement services but with restrictions (such as requiring municipal deposits to be kept within the state even when using a deposit placement service or by placing a limit on a local agency's funds that could be deposited using a deposit-placement service).

Summary of the FDIC's Position

The FDIC concludes after studying the issue of excess deposit insurance coverage for municipal deposits that such increased coverage would represent a departure from the traditional goals of deposit insurance. While it may be the case that increased federal coverage for public deposits would contribute to local communities, it appears that state government and private sector alternatives have arisen that further protect municipal deposits. If federal deposit insurance coverage were to be increased, it would be necessary to address concerns about increased exposure to the Deposit Insurance Fund, moral hazard and appropriate pricing of such coverage.

APPENDIX

Review of Congressional Proposals Affecting Insurance Coverage for Municipal Deposits, 2000–2005

Even before a comprehensive deposit insurance reform bill was introduced in Congress, separate bills were introduced in the Senate and House of Representatives that provided extra protection for municipal deposits.[45] Both of these bills provided that in-state municipal deposits would be fully insured. No maximum was provided as to coverage. Both bills died in their respective committees.

It was not until after Chairman Donald Powell succeeded Chairman Tanoue at the FDIC that a comprehensive deposit insurance reform bill was introduced in Congress. In 2002 bills were introduced in both the House and Senate that would have increased the coverage for instate municipal deposits to 80% of all such deposits above $130,000 up to $5 million.[46] (The bills would have increased the coverage limits for individual accounts from $100,000 to $130,000). The House passed the bill on May 22, 2002, but the Senate Committee on Banking, Housing, and Urban Affairs never took action.

In 2003, Chairman Powell again pursued deposit insurance reform with the same results: the House overwhelmingly passed a bill that would have increased the insurance for in-state municipal deposits above the limitation provided in the new legislation ($130,000) up to a maximum of $2 million.[47] The Senate bill, which also increased deposit insurance coverage

[45] U.S. Congress, Senate (2001); and U.S. Congress, House (2001).

[46] U.S. Congress, House (2002a).; and U.S. Congress, Senate (2002).

[47] U.S. Congress, House (2003a).

from $100,000 to $130,000, provided for a maximum of $5 million for in-state municipal deposits. But again the Senate Committee on Banking, Housing, and Urban Affairs failed to take action.[48]

During the 109th U.S. Congress, several bills were introduced that included provisions relating to municipal deposits. Early in the year, a bill was introduced in the House entitled Municipal Deposit Insurance Protection Act of 2005 (MDIPA). This bill, unlike the previous attempts to enact deposit insurance reform, was not comprehensive and solely dealt with municipal deposits. Under MDIPA, deposit accounts would have remained insured for $100,000 but in-state municipal deposits would have been fully insured up to $2 million and 80% of any in-state municipal deposits that exceeded this amount would have been protected.[49] The bill was referred to the Subcommittee on Financial Institutions and Consumer Credit but was not the subject of any hearings or legislative action.

Two other bills were introduced in the House in 2005. Each of them provided that in-state municipal deposits would be insured to $2 million or 80% of those deposits over $130,000 (the new basic coverage for deposit accounts), whichever is less.[50] Both bills were passed by the full House with overwhelming support. But the bill that became law was introduced in the Senate on October 27, 2005, and although it provided for an inflation index for general depositors beginning April 1, 2010, municipal deposits received no additional coverage.[51] The bill became law on February 8, 2006.

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[48] U.S. Congress, Senate (2003).

[49] U.S. Congress, House (2005c).

[50] U.S. Congress, House (2005a and 2005b).

[51] U.S. Congress, Senate (2005).

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