



NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street
Alexandria, Virginia 22314



REPORT TO THE CONGRESS

Study of Further Possible Changes to the Deposit Insurance System

Submitted to Congress pursuant to Section 6(b) of the
Federal Deposit Insurance Reform Conforming Amendments Act of
2005

FEBRUARY 2007

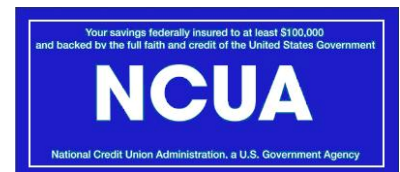


Table of Contents

I.	Executive Summary	1
II.	Role of Deposit Insurance	3
III.	Feasibility of Voluntary Excess Deposit Insurance	9
IV.	Feasibility of Increasing Deposit Insurance Limit for Municipal and Other Units of Local Government	12
V.	Feasibility of Privatizing all Deposit Insurance	16
VI.	Recommendations	24
VII.	References	26
Appendix A	Brief History of Deposit Insurance	28
Appendix B	Overview of the Credit Union System	31
Appendix C	Summary of G-10 Countries Deposit Insurance Programs	34

I. Executive Summary

The National Credit Union Administration (“NCUA”) submits this report pursuant to Section 6(b) of the Federal Deposit Insurance Reform Conforming Amendments Act of 2005 (“the Act”) enacted on February 15, 2006. Section 6(b)(1) of the Act mandates that the Board of Directors of the National Credit Union Administration (NCUA) and the Federal Deposit Insurance Corporation (FDIC) each conduct a study of the three areas listed below. Section 6(b)(2) of the Act requires the NCUA and the FDIC to each submit a report to Congress containing the findings and conclusions of the required study along with such recommendations for legislative or administrative changes as the agency may determine to be appropriate.

In conducting the required studies, we reviewed published related research, analyzed existing deposit insurance schemes in the G10 countries, and conducted an analysis of the existing deposit insurance options available to credit unions. This report summarizes NCUA’s research and provides the conclusions and recommendations as they relate to the National Credit Union Share Insurance Fund (NCUSIF).

Study Areas and Conclusions

1. The feasibility of establishing a voluntary deposit insurance system for deposits in excess of the maximum amount of deposit insurance for any depositor and the potential benefits and the potential adverse consequences that may result from the establishment of any such system.

Conclusion – NCUA does not recommend establishing voluntary federal excess deposit insurance. There is no compelling benefit to excess deposit insurance. Excess deposit insurance is currently available through private insurers and has been for some time, but the demand for this product among federally insured financial institutions has been low. Federal voluntary excess deposit insurance would raise significant issues of pricing and the equitable distribution of costs. Offering additional deposit insurance through the federal system would increase the incentive for insured institutions to engage in riskier activities (moral hazard), and primarily benefit larger depositors.

2. The feasibility of increasing the limit of deposit insurance for deposits of municipalities and other units of general local government, and the potential benefits and the potential adverse consequences that may result from any such increase.

Conclusion - NCUA is neither in favor of, nor opposed to, Congress increasing coverage on these accounts. Benefits exist to increased coverage, including better protection from fraud related to the collateralization of the public funds and eased administration of the accounts for both depositories and depositors. Due to the customary business practice of municipal regulations typically requiring collateralization and safekeeping of the collateral by third parties, the level of risk from fraud is not significant. Conversely, there are drawbacks to increasing coverage of these accounts, particularly reduced market discipline.

-
3. The feasibility of privatizing all deposit insurance at insured depository institutions and insured credit unions.

Conclusion – NCUA concludes the federal government should be the provider of primary deposit insurance. The lessons learned from failures of private deposit insurance schemes should not be forgotten. Federal deposit insurance has played an important role in maintaining confidence in the financial system and the stability of our economy. The public prefers deposit insurance backed by the full faith and credit of the U.S. Government.

Recommendations for Congress

NCUA has two recommendations related to deposit insurance coverage for congressional consideration at this time. The FDIC has mechanisms in place to mitigate the moral hazard risk, which is inherent in deposit insurance. Comparability with the FDIC’s authority in the following two areas will allow NCUA the same ability to offset the risks:

1. Comparability with FDIC’s authority to charge premiums.

Provide NCUA with the authority to assess a premium when the insurance fund’s equity ratio is less than 1.35 percent, provided the premium charge does not exceed the amount necessary to restore the equity ratio to 1.35 percent. This would ensure funding authority comparable to the FDIC.

2. Comparability with FDIC’s prompt corrective action standards.

Provide NCUA with the authority to implement a risk-based Prompt Corrective Action (PCA) system for credit unions comparable to FDIC’s.

Action by NCUA

NCUA will continue to participate in a broad range of financial literacy programs, including initiatives designed to raise awareness and understanding of deposit insurance. This emphasis is particularly timely given the recent changes to deposit insurance provided by the Act. Continued improvements are warranted in financial literacy overall, and in particular, a better understanding of deposit insurance is needed.

II. Role of Deposit Insurance

The U.S. was the first country to introduce a national deposit insurance system. After a largely adverse experience with moral hazard in state level schemes, federal deposit insurance was enacted in 1933 in the midst of a banking crisis.¹ The establishment of the federal deposit insurance system put an end to the devastating bank runs that shut down businesses and contributed to the Great Depression. The system proved to be a success; following its introduction, deposit insurance restored public confidence in the banking system. In the 1980s, when hundreds of banks and thrifts failed, deposit insurance acted as the anchor for public confidence in the banking system.²

During the U.S. crisis with savings and loans (S&Ls) in the 1980s, there were no depositor runs on banks and failures were resolved through a well-established, orderly process. Countries without explicit deposit insurance have not enjoyed such depositor stability during times of crisis. It is noteworthy that more than 20 countries chose to implement new, explicit deposit insurance systems during the 1990's. The benefits of deposit insurance are appreciated worldwide, and the U.S. system has become a model for the rest of the world.³

The 1980s crisis in the U.S. provides a sobering reminder that an inadequately managed deposit insurance system can be costly. U.S. taxpayers absorbed costs of more than \$130 billion to address the S&L crisis following the demise of the Federal Savings and Loan Insurance Corporation (FSLIC). This demonstrates that deposit insurance raises complicated issues and requires a careful balance of competing public policy concerns.⁴

Benefits of Deposit Insurance

In their classic 1963 book, *A Monetary History of the United States, 1867-1960*, Milton Friedman and Anna J. Schwartz wrote (p. 434):

Federal insurance of bank deposits was the most important structural change in the banking system to result from the 1933 panic, and, indeed in our view, the structural change most conducive to monetary stability since state bank notes were taxed out of existence immediately after the Civil War.

Deposit insurance serves public policy by promoting macroeconomic and financial stability. In addition, it also protects small and less sophisticated depositors from loss. Deposit insurance provides a safe and secure place for people to put their money. By eliminating the disruption caused by deposit runs, deposit insurance contributes to the foundation necessary for a robust banking system, and by extension, a dynamic financial system. In turn, the general economy benefits from the stabilizing influence of deposit insurance.⁵

¹ Edward J. Kane and Ash Demirguc-Kunt, *Deposit Insurance Around the Globe: Where Does it Work?*, 2001, p. 4

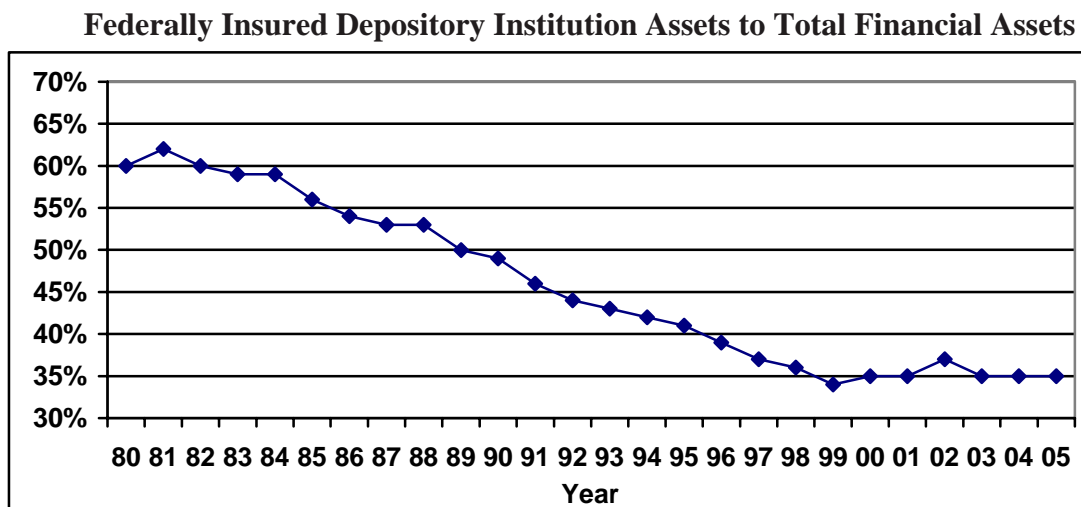
² FDIC, "Options Paper," August 2000, Part I.

³ FDIC, "Options Paper," August 2000, Part I.

⁴ FDIC, "Options Paper," August 2000, Part I.

⁵ FDIC, "Options Paper," August 2000, Part I.

In the U.S., the role insured deposits play in the economy has diminished over time, but is still significant. As the following graph illustrates, the level of assets in federally insured institutions as a percentage of total financial assets declined fairly steadily from 1980 through 1998, but has been stable in recent years.⁶



Source: Federal Reserve Statistical Release, Flow of Funds (Z.1), Second Quarter 2006

The research on deposit insurance consistently cites the following main benefits of deposit insurance:⁷

- **Enhance Macroeconomic and Financial Stability**

A primary benefit of deposit insurance is to reduce or eliminate the threat of sudden financial panic. Former Federal Reserve Board Chairman Greenspan contended “*the safety net ... has played a critical role in this country in eliminating bank runs, in assuaging financial crises, and arguably in reducing the number and amplitude of economic contractions in the past sixty years. Increased macroeconomic stability is a real benefit and should not be taken lightly.*”⁸

Bank runs and financial panics that occurred prior to 1934 have been virtually eliminated. Assuring depositors they will not suffer losses, even if the institution fails, reduces the incentive for an insured depositor to participate in a run. The existence of deposit insurance reduces contagion.⁹ That bank failures in the 1980s and early 1990s did not precipitate any material runs on deposits is evidence deposit insurance serves this purpose well. When banks and credit

⁶ FDIC, *Deposit Insurance and Financial Modernization*, Presented at Confidence for the Future: An FDIC Symposium, January 25, 1998, p. 19.

⁷ A. Warren Moysey, *Deposit Insurance and Other Compensation Arrangements*, Task Force on the Future of the Canadian Financial Services Sector Research Paper, September 1998, p. 10.

⁸ Alan Greenspan, Remarks before the 37th Annual Conference on Bank Structure and Competition, May 10, 2001.

⁹ Contagion results when the demise of one bank spills over to others creating negative externalities, causing a systemic problem for other depositories.

unions fail today, it is the result of poor financial and operational decisions, not because they abruptly became illiquid from a run on deposits.¹⁰

Financial institutions continue to be an important source of business financing, particularly for small and new businesses, which are key sources of job creation and innovation in the U.S. economy. In addition, many financial institutions are leaders in the development of new products. In smaller communities, local banks and credit unions are often the most important source of credit for households and business. These institutions, which are generally more reliant on deposits as a primary source of funds than larger institutions, might be unable to compete for funds without federal deposit insurance.

Also, deposit insurance encourages the use of the deposit system for payments by depositors, thus increasing efficiency and accountability.¹¹ Banks and credit unions are critical providers of certain payment services; the bulk of individual payments continue to be processed through the banking system.¹² Further, deposit insurance provides an incentive structure that promotes good banking practices.¹³ This in turn contributes to greater economic stability.

- **Protect the Small and Unsophisticated Depositor**

In February 2003, Former Federal Reserve Board Chairman Greenspan testified “*deposit insurance has clearly played a key--at times even critical--role in achieving the stability in banking and financial markets that has characterized the nearly seventy years since its adoption. Deposit insurance, combined with other components of our banking safety net ... has meant that periods of financial stress no longer entail widespread depositor runs on banks and thrift institutions ... Looking beyond the contribution of deposit insurance to overall financial stability, we should not minimize the importance of the security it has brought to millions of households and small businesses with relatively modest financial assets.*”¹⁴ [emphasis added]

Because of the small balances of most depositors, and a lack of financial savvy by many, it is not efficient or practical for the depositors to adequately assess and monitor the condition of their depository institution(s).¹⁵ Effectively monitoring a depository requires financial, regulatory, and legal expertise that many individuals and small businesses lack. Some of the critical information needed to perform this task is proprietary, and thus available only to supervisory

¹⁰ Alan S. Blinder and Robert F. Wescott, FDIC, *Reform of Deposit Insurance A Report to the FDIC*, March 20, 2001, Part I.

¹¹ William R. White, Federal Reserve Bank of Chicago, *Are Changes in Financial Structure Extending Safety Nets?*, 2003, p 247.

¹² FDIC, *Deposit Insurance and Financial Modernization*, p. 19.

¹³ Gillian G.H. Garcia, International Monetary Fund, *Deposit Insurance: A Survey of Actual and Best Practices*, April 1999, p.5.

¹⁴ Alan Greenspan, Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs, February 26, 2003.

¹⁵ “I am a free market guy. I struggle with the free market's instability. My experience says that in the free market when an institution is in trouble, the sophisticated depositor flees and the unsophisticated depositor stays. It is a matter of education.” – Former FDIC Chairman Donald Powell, Testimony before U.S. House of Representatives Committee on Financial Services, March 4, 2003.

authorities, not to private market participants - some of whom may actually be competitors.¹⁶ Deposit insurance thus enables the wide participation of small savings in the financial system.¹⁷

- **Promote Competition**

Competition is essential to keeping depository institutions vital, preserving efficiency within the economic system, and in protecting customers from monopolistic practices. Depository institutions compete for large deposits based on price, service, and by demonstrating the soundness of their institution. This competition for funds enhances the entire credit allocation mechanism. Deposit insurance limits designed to cover only smaller deposits do not reduce the amount and rigor of credit judgments by large depositors, thereby maintaining the efficiency of credit allocation.¹⁸

Deposit insurance also ensures the viability of smaller banks and credit unions by allowing them to compete for deposits with large institutions. This promotes competition and consumer choice. Deposit insurance also reduces barriers to entry, contributing to improved competition.

- **Provide Clear Rules Under Which Sound Institutions Operate and Under Which Failed Institutions are Closed or Resolved¹⁹**

The existence of deposit insurance and the related examinations promote the development of safe and sound operations and the sharing of best practices. The timely and effective resolution of failed insured institutions is an important element in the financial safety-net arrangements. Different exit strategies for such institutions may have considerably different cost implications for the deposit insurer and implications for other safety-net participants, the government, the public, and the economy.²⁰

- **Mitigate the Pressure on Government to Provide an Implicit Guarantee**

There remains the remote possibility of a tremendously adverse shock that not only overwhelms the insurance funds, but also places the economy and financial system in a precarious position, necessitating government intervention for the greater good. The taxpayer thus will always bear some residual risk.²¹ Only government, by its position and stature and by its ultimate access to the printing press, can effectively protect against a systemic problem.²² Federal deposit insurance sets the expectation about the government's future commitments to depositors of insolvent institutions. Deposit insurance also allows the government to negotiate rights to intervene in a timely fashion into the affairs of insolvent institutions.²³

¹⁶ Blinder and Wescott, *Reform of Deposit Insurance A Report to the FDIC*, Part I.

¹⁷ Mikhail Frolov, *Deposit Insurance and Its Design: A Literature Review*, Keio University, Tokyo, Japan, January 2005, p.13.

¹⁸ Peter Fisher, Under Secretary for Domestic Finance U.S. Department of Treasury, Testimony before the Committee on Banking, Housing and Urban Affairs United States Senate Deposit Insurance Reform, April 23, 2002.

¹⁹ Garcia, *Deposit Insurance: A Survey of Actual and Best Practices*, p.5.

²⁰ FDIC, "Resolutions of Failed Institutions," p 1.

²¹ Blinder and Wescott, *Reform of Deposit Insurance A Report to the FDIC*, Part I.

²² Moysey, *Deposit Insurance and Other Compensation Arrangements*, p. 14.

²³ Kane and Demircug-Kunt, *Deposit Insurance Around the Globe: Where Does it Work?*, p. 9.

Drawbacks of Deposit Insurance

A deposit insurance system is prone to incentive deficiencies because such a system differs from other forms of insurance in two respects. First, “regular insurance” (e.g., life, health, property and casualty) directly involves just two parties—the guarantor and the entity protected. There are, however, three immediate parties to a deposit insurance contract: the insurer, the depositor, and the institution. Depositors and the institution benefit from the guarantee because the (small) depositor’s accounts are protected, while the institution receives a credit enhancement that both enables it to raise funds at a lower rate than would be possible without the guarantee and shields it from widespread withdrawals. The second difference is that while regular insurance usually protects against the adverse effects of independent events, particularly “acts of God,” bank failures are often not independent events but occur in waves and frequently result from mistakes made by one of the beneficiaries, that is, the institution itself.²⁴

- **Moral Hazard**

When applied to deposit insurance, the term moral hazard refers to the ability of insured institutions to engage in riskier behavior than would be feasible in the absence of insurance. Because insured depositors are fully protected, they have little incentive to monitor the risk behavior of banks or to demand interest rates that are in line with that behavior. Accordingly, banks are able to finance various projects at rates that are not commensurate with the risk of the projects, a situation that under certain circumstances may lead to excessive risk taking and misallocation of economic resources.²⁵

Moral hazard is particularly acute for institutions that are insolvent or close to insolvency. Owners and managers of insolvent or barely solvent institutions have strong incentive to favor risky behavior because losses are passed on to the insurer, whereas profits accrue to the owners.²⁶ Depositors are also subject to the danger of moral hazard since deposit insurance makes them less careful in the selection of their depository institution, and later deters them from moving their funds to a safer haven.²⁷

Moral hazard can be mitigated by creating and promoting appropriate incentives through good corporate governance, sound risk management of individual institutions, effective market discipline, and frameworks for strong prudential regulation, supervision and laws such as Prompt Corrective Action (PCA). These elements involve trade-offs and are most effective when they work in concert.²⁸

²⁴ Garcia, *Deposit Insurance: A Survey of Actual and Best Practices*, p. 6.

²⁵ George Hanc, *Deposit Insurance Reform: State of Debate*, FDIC Banking Review, Volume 12, No. 3, 1999, p. 3.

²⁶ Hanc, *Deposit Insurance Reform: State of Debate*, p. 3.

²⁷ Garcia, *Deposit Insurance: A Survey of Actual and Best Practices*, p. 6.

²⁸ Financial Stability Forum, *Guidance for Developing Effective Deposit Insurance Systems*, September 2001, p. 9.

- **Compressed Margins**

Margins for all financial institutions are compressed when weak institutions bid up deposit rates to attract insured deposits in their efforts to become viable.²⁹

- **Eroded Credit Standards**

Credit standards erode when high risk institutions make funding more readily available to high risk borrowers, than otherwise would be the case. Conversely, the presence of deposit insurance does enable depositories to serve marginal credit quality borrowers that might otherwise have no access to mainstream financial credit.³⁰

- **Agency Problems**

A deposit insurer can encounter agency problems in its relationship with both the government and the industry it oversees. Problems can occur when the insurer places its own interests above that of the depositor. The insurer may also be prone to “regulatory capture,” the placing of the interest of the industry whose deposits they guarantee above the needs of the depositors and the insurance fund.³¹ In addition, the insurer could be unduly influenced by political or special interests (political capture).³²

Conclusion

This section provides a framework for the remaining discussion, conclusions, and recommendations within this report. The understanding of the purpose, benefits and drawbacks of deposit insurance are necessary to evaluate any proposed changes to the U.S. deposit insurance system. The key point in this section is the critical role federal deposit insurance plays instilling public confidence in the financial system and thus, the stability of the economy.

²⁹ Moysey, *Deposit Insurance and Other Compensation Arrangements*, p. 19.

³⁰ Moysey, *Deposit Insurance and Other Compensation Arrangements*, p. 19.

³¹ The Savings and Loan crisis in the U.S. in the 1980s was perhaps an example of regulatory capture. Officials sometimes would hide problems or act too slowly when closing an institution which led to increased costs to the taxpayer.

³² Garcia, *Deposit Insurance: A Survey of Actual and Best Practices*, p. 7.

III. Feasibility of Voluntary Excess Deposit Insurance

Introduction

The level of available federal insurance coverage, combined with the current high level of fully insured deposits, indicates the need for excess deposit coverage for credit unions is limited. As of June 2006, 89.5 percent of federally insured credit union deposits were fully insured. Individual depositors can significantly increase their deposit insurance coverage by structuring their accounts. Taking into account the recent increase in deposit insurance for IRAs, a married couple can effectively obtain \$1.6 million in federal deposit insurance coverage at a single institution. Depositors can also obtain additional insurance coverage by using separate depository institutions.

Optional Excess Coverage Available From Private Sector³³

FDIC notes that there are a small number of private insurance companies that offer excess insurance coverage to banks. Their 2000 Options Paper concluded “to the extent it [private excess insurance] contributes to the goals of deposit insurance, it does so without increasing risks to taxpayers or to the deposit insurance funds.”³⁴

Private excess deposit insurance is also available to many credit unions. There are two private excess deposit insurance funds that operate in the U.S. The first is the Massachusetts Share Insurance Corporation (MSIC) which provides excess share insurance to credit unions in the State of Massachusetts. MSIC was founded in 1961 as a provider of primary deposit insurance for the members of credit unions. The second provider is Excess Share Insurance (ESI), an Ohio corporation. ESI is a wholly-owned subsidiary of American Share Insurance Corporation.

Massachusetts state law requires excess deposit insurance for the customers of state cooperative banks, savings banks, and state-chartered credit unions.³⁵ Excess deposit insurance is provided in Massachusetts as follows:

- The Share Insurance Fund of the Co-operative Central Bank insures the excess deposits in 69 Massachusetts co-operative banks.
- The Depositors Insurance Fund insures excess deposits in 71 Massachusetts savings banks.³⁶
- MSIC currently insures just under \$1 billion in excess shares and deposits in 99 state and federally-chartered credit unions in Massachusetts.³⁷

³³ Private excess insurers benefit from the regulation and supervision provided by federal and state regulators/insurers of their client depository financial institutions, resulting in an unwarranted subsidy of the private insurers.

³⁴ FDIC, “Options Paper,” August 2000, Part IV.

³⁵ Massachusetts state law was amended in 1986 to allow federally-chartered credit unions to join the fund.

³⁶ Co-operative Central Bank and Depositors Insurance Fund, www.coopcentralbank.com and www.difxs.com.

³⁷ MSIC, Company Profile, www.msic.org

Following a regional banking crisis in the late 1980s and early 1990s, the State of Massachusetts changed its banking laws to require federal deposit insurance for all financial institutions. MSIC subsequently converted to being solely an excess deposit insurer. The company is a cooperative insurer owned by participating credit unions. MSIC provides excess deposit insurance of \$500,000 on single accounts and \$1,000,000 on joint accounts. As with federal deposit insurance, IRA accounts are insured separately. MSIC does not have any limits for IRA deposit insurance.³⁸ The primary risks relative to MSIC are geographic risk and concentration risk. Since MSIC insures excess deposits in only one state, it is vulnerable to regional events.

ESI does not provide nationwide coverage, but is currently licensed in 33 states and the District of Columbia, but not in several populous states, such as New York and Virginia. As a private insurer, the company needs to obtain approval to operate in each state. As of 2005, the company insured excess deposits at 266 credit unions in 29 states and the District of Columbia. The total amount of deposits insured by ESI was \$3.5 billion. ESI will insure up to \$250,000 in excess deposits per member.³⁹

Voluntary Excess Coverage through the Federal Insurance Funds

There are several important considerations involved when contemplating providing federal excess deposit insurance. These include the government's role in deposit insurance, the financial impact on the insurance funds, the added liability to the government in the event of default, and determining the appropriate structure and pricing of the excess insurance program.

- The key role of federal deposit insurance is preventing depositor panics and the resulting disruptions to the financial markets. Consistent with the longstanding record of success in achieving this objective, in 2005 the Congressional Budget Office stated that current deposit insurance levels have “proved sufficient to achieve the main objective of deposit insurance”.⁴⁰
- As of June 30, 2006, federally-insured credit unions held \$62.2 billion in uninsured deposits. Because credit unions are required to keep one percent of insured funds on deposit with the NCUSIF, insuring all excess deposits would have little impact (only 2 basis points) on the NCUSIF's equity ratio. The 11.7 percent increase in insured deposits would be offset by the 9.3 percent increase to the NCUSIF deposit. The FDIC's Deposit Insurance Fund (DIF), which is funded by premium assessments, would face a steeper decline in its reserve ratio.
- Providing excess coverage increases the government's risk of loss in the event of a systemic crisis.⁴¹ This increased coverage would amplify some of the drawbacks associated with deposit insurance, in particular the risks associated with moral hazard.

³⁸ MSIC, “2005 Annual Report” and related data, www.msic.org.

³⁹ ESI, “2005 State of the Fund Report” and related data, www.excessshare.com.

⁴⁰ Congressional Budget Office (CBO), *Modifying Federal Deposit Insurance*, Report to the U.S. Senate Committee on Banking, Housing, and Urban Affairs, May 9, 2005, p. 1.

⁴¹ The NCUSIF is well equipped to deal with a systemic crisis in the federal deposit insurance system. There are several layers of protection for the taxpayer built into the NCUSIF (fund retained earnings, 1% deposit, and ability to charge premiums to replenish the fund out of credit unions' available net worth). The NCUSIF's first line of

- The implementation of an excess deposit insurance program poses significant challenges regarding structure and pricing. In a voluntary system, excess insurance would be difficult to price on a limited offering basis and might not prove equitable if the risk was ultimately borne by the entire system.

Conclusion

Congress should not authorize the NCUA and the FDIC to provide voluntary excess deposit insurance. There is no compelling benefit to excess deposit insurance. However, it would increase moral hazard, and a voluntary system would raise issues of pricing and the equitable distribution of cost. In addition, excess deposit insurance has been available from private insurers for some time, but the demand for this product among federally insured financial institutions has been low.⁴²

NCUA believes excess deposit insurance, whether publicly or privately offered, has troublesome economic and public policy implications. In particular, excess deposit coverage increases moral hazard as fewer depositors would have an interest in monitoring the financial condition of their depository institution.

defense, its retained earnings of approximately \$1.4 billion, exceeds the entire amount expensed for insurance losses (approximately \$1 billion) in the 35 year history of the NCUSIF.

⁴² As of December 31, 2005, ESI insures 11.7 percent of uninsured credit union deposits in the states they are licensed to serve. ASI, 2005 *Combined State of the Funds Report for Excess Share Insurance Coverage*, p. 2.

IV. Feasibility of Increasing Deposit Insurance Limit for Municipal and Other Units of Local Government

Introduction

Credit unions have had limited involvement in accepting municipal deposits. Our research indicates municipal deposits currently comprise only 0.5 percent of total credit union deposits.⁴³ A major factor limiting credit union involvement is that a number of states, such as Massachusetts, Arkansas, Alabama, and New Jersey, only permit municipalities to deposit public funds in FDIC-insured institutions. This precludes municipalities from depositing funds in NCUSIF insured credit unions. Federal credit unions, although permitted to accept nonmember public unit deposits, traditionally have not pursued municipal deposits as a funding source. The collateral requirements for balances above federal deposit insurance limits vary from state to state, can be costly to administer, and can negatively impact liquidity.

The primary risk regarding the use of collateral to secure uninsured deposits is fraud. This risk occurs when the collateral securing the municipal deposits does not exist or is insufficient to cover the uninsured portion of the municipal deposit. There has only been one instance of a bank failure that caused a loss to a municipality due to fraud.⁴⁴

In congressional testimony, former FDIC Chairman Powell indicated there is little demand from financial institutions for higher insurance coverage for municipal deposits, stating he has “not found that it causes any bankers any concern that municipal deposits are not insured.”⁴⁵ Additionally, Mr. Powell noted “most states have a central depository where they accept municipal deposits and they pay, very frankly, a rate that most bankers do not want to pay.” The FDIC notes that it is unclear whether local depository institutions would be able to compete effectively for municipal deposits in today’s environment of interstate banking, especially if higher coverage results in the bidding up of interest rates.⁴⁶

Congressional Budget Office Review

The Congressional Budget Office (CBO) reviewed the issues surrounding proposed modifications to federal deposit insurance, including increasing municipal deposit coverage. The CBO report states:⁴⁷

Depositors of amounts above the coverage limit have incentives to monitor banks’ financial condition and operations and to withdraw their funds if they deem the banks to be too risky. So raising deposit insurance coverage would reduce the

⁴³ Municipal deposit data based on a canvas of NCUA field staff, November 2006. The Call Report has been revised to collect data on municipal deposits beginning with the December 2006 cycle.

⁴⁴ Donald Powell, FDIC Chairman, Testimony before U.S. House of Representatives Committee on Financial Services, Federal Deposit Insurance Reform Act of 2003, March 4, 2003.

⁴⁵ Powell, Testimony, March 4, 2003.

⁴⁶ FDIC, “Options Paper,” August 2000, Part IV.

⁴⁷ CBO, *Modifying Federal Deposit Insurance*, p. 5.

incentives for partially insured depositors – in particular, depositors of municipal funds – to constrain risk taking by insured institutions.

and:

Most states have municipal deposit insurance programs or require banks to pledge assets to ensure payment of any municipal deposits above the limit. However, federal deposit insurance provides more secure protection than collateralization. When a bank fails because of fraud, the collateral intended to back municipal deposits may be missing. With federal deposit insurance, no risk of loss exists for insured deposits.

Finally, the CBO report states “the incremental benefits and costs of the proposed increases are likely to be small relative to the total benefits and costs of the entire deposit insurance system.” The CBO concludes “raising coverage levels for various types of larger accounts (municipal and retirement accounts) would increase the safety of those deposits but could further weaken market discipline and increase the costs of federal deposit insurance, particularly in the event of large widespread failures, as occurred in the 1980s and 1990s.”

American Bankers Association Review

The American Bankers Association (ABA) also reviewed the issue of municipal deposit coverage.⁴⁸ The ABA’s advisory group recommended pursuing incremental ways to facilitate the greater availability of public deposits to community banks. Their report identifies a number of issues, including:

- The potential for increased deposit insurance premium assessments could result from expansion of deposit insurance coverage. The Federal Reserve Board estimates that state and local governments hold over \$1 trillion in financial assets.⁴⁹ At the time of the ABA study, commercial banks held \$152 billion in public deposits. Of this amount, \$109 billion was collateralized as part of a state public deposit program. The impact of fully insuring deposits would have resulted in a 6 basis point decline in the Bank Insurance Fund’s reserve ratio.
- Moral hazard associated with 100 percent coverage could cause interest rate escalation from riskier institutions in need of funding.
- The myriad of entrenched local approaches that states and municipalities have developed impose barriers to the implementation of broad-based reform.
- Municipal deposits represent less than 7 percent of total deposits for community banks and only 4.6 percent for all banks (based on December 31, 2005 call report data, this ratio has fallen to 3.54 percent for all banks).

⁴⁸ ABA Community Bankers Council, Public Funds Advisory Group, “Overview and Findings”, Review of issues related to the use of public funds, August 16, 2000.

⁴⁹ FDIC, “Options Paper,” August 2000, Part IV.

The ABA report made a number of recommendations regarding municipal deposits that included:

- The viability of supplemental (FDIC) deposit insurance for public deposits, including risk-based pricing approaches.
- Promoting the acceptability, at the state level, of broader categories of collateral to be pledged against public funds.
- The feasibility of supplemental private insurance alternatives, the effect of which would be to reduce collateral requirements.
- A comparative analysis of the pricing, availability, and feasibility of the alternatives available and a “menu of options” for community banks to choose the alternatives to suit their particular needs.

The report also notes there are 42 states that require the pledging of collateral against municipal deposits and that these requirements are not uniform. The collateral requirements also have negative consequences, including the fact that they are costly to administer and have a negative impact on bank liquidity. There are also seasonality and other volatilities associated with municipal deposits that do not always match well with collateral maturities.

New Methods for Collateralization

Federal Home Loan Bank (FHLB) letters of credit are becoming widely accepted as a form of collateral for municipal deposits. The letter of credit is a credit instrument guaranteeing payment on behalf of its customer for a stated period of time.⁵⁰ This method provides a low cost, efficient means for meeting collateral requirements. In addition, the letter of credit’s value remains constant, eliminating the need to monitor the value of collateral. As of the report date, 27 states allow FHLB letters of credit as a form of collateral for excess municipal deposits.⁵¹

Another new product that has been developed by the private market is deposit placement service. As an example, the Certificate of Deposit Account Registry Service® (CDARS) program was introduced in 2003 and currently provides up to \$30 million in FDIC deposit insurance.⁵² A bank that participates in the network can take a large deposit and either sell or swap shares in increments of less than \$100,000 with other participating banks. The bank retains ownership of the account and the depositor only has to deal with one financial institution. For municipal depositors, this can provide 100 percent insurance coverage and avoid the need for excess collateral. There are a growing number of states that allow municipalities to use pass through deposits services, including California, Ohio, Oregon, Illinois, and Virginia. As this program is limited to FDIC insured institutions, credit unions cannot become members of the network in order to buy or sell shares in municipal deposits.⁵³

⁵⁰ ABA Community Bankers Council, Public Funds Advisory Group, “Overview and Findings.”

⁵¹ ABA Community Bankers Council, Public Funds Advisory Group, “Overview and Findings.”

⁵² Promontory Interfinancial Network, website data, www.promnetwork.com.

⁵³ The principles underlying this program should have equal applicability to federally insured credit unions. See NCUA Office of General Counsel Legal Opinion 03-0709 (August 27, 2003).

Conclusion

NCUA is neither in favor of, nor opposed to, Congress increasing coverage on municipal and other local government unit deposits, due to the limited involvement of credit unions with these deposits coupled with the CBO's conclusion that raising coverage on municipal deposits is likely to have relatively small incremental benefits and costs. There are some benefits to increased coverage, including better protection from fraud for these public funds and eased administration of these accounts. However, the level of risk from fraud is not significant. There are drawbacks to increasing coverage of these accounts, particularly reduced market discipline. Further weighing on the side opposing increasing coverage is the fact the marketplace and state and local governments have been addressing the need for security of these accounts through collateralization, with recent innovations contributing to greater collateral acceptance and more convenient administration.

V. Feasibility of Privatizing All Deposit Insurance

Introduction

Federal credit unions are required to be federally insured. Whether a state-chartered credit union can use private insurance instead of NCUSIF coverage depends on each state's laws. The majority of states require federal deposit insurance given past failures of private deposit insurers, the lack of diversification inherent in private insurers, and public policy considerations regarding the ability to protect consumers and maintain stability and confidence in the financial system.

At times, there have been state-level deposit insurance systems in the United States.⁵⁴ These systems typically acted like clubs with strong supervision and oversight by the state regulator while exiting the system by members was difficult or impossible. These systems had a small number of members with unlimited mutual liability, preventing free riders.

Private insurance has been outlawed in most states in the last fifteen years after various problems led to the private insurers' insolvency. Rhode Island and Texas both prohibited private insurance for credit unions in the early 1990's due to crises of the private insurance funds in their respective states. Other states that required privately-insured credit unions to convert to federal deposit insurance included Florida, Iowa, Kansas, and Missouri. In 1991 alone, 424 privately-insured credit unions converted to NCUSIF coverage. Credit unions in other states such as Georgia and Massachusetts converted to federal deposit insurance voluntarily following the crises with private insurers noted above. In 1996, the state of Washington required the dissolution of the state's private insurance system and its state-chartered credit unions to convert to federal insurance (or an equivalent share insurance program) by the end of 1998.⁵⁵

State-chartered credit unions in Alabama, California, Idaho, Illinois, Indiana, Maryland, Nevada, Ohio, and Puerto Rico have the option to obtain primary deposit insurance from a private company.⁵⁶ With the exception of Puerto Rico,⁵⁷ private insurance in these jurisdictions is provided by American Share Insurance Corporation (ASI), an Ohio corporation. ASI currently serves 178 credit unions with \$13 billion in insured shares, representing 2.5 percent of all insured credit union deposits.

⁵⁴ Thorsten Beck, *The Incentive Compatible Design of Deposit Insurance and Bank Failure Resolution – Concepts and Country Studies*, World Bank Policy Research Working Paper 3043, May 2003, page 8.

⁵⁵ Washington State legislature, RCW 31.12.408 - *Insurance required after December 31, 1998 — Federal share insurance program or an equivalent share insurance program — Director's findings*.

⁵⁶ State-chartered credit unions in Puerto Rico also have the option of insurance operated by the State. At the time of the writing of this report the State of Texas has pending legislation which could result in the ability for state-chartered credit unions in Texas to be privately insured.

⁵⁷ The Corporation for the Supervision and Insurance of Cooperatives (COSSEC) is a public corporation in Puerto Rico, serving 133 cooperatives of savings and credit with \$4.2 billion in total deposits.

Concerns with Privatization of Deposit Insurance

- **Lack of Diversification**

A significant problem inherent with private deposit insurance programs is the inability to achieve sufficient diversification. The consolidation within the financial services industry makes achieving sufficient diversification difficult. This leads to geographic and concentration risk.

A prime example of the concentration risk includes Patelco Credit Union (Patelco) in San Francisco, which is the largest privately-insured credit union in the United States. Patelco converted from NCUSIF coverage in 2002 to ASI coverage. Patelco currently has approximately \$3.3 billion in insured shares, representing approximately 25 percent of the total shares insured by ASI. This represents a very high level of concentration risk. ASI's primary deposit insurance is \$250,000, higher than the standard \$100,000 coverage provided by the NCUSIF. However, losses at ASI-insured credit unions are only covered up to ASI's available resources and its secured line of credit, which serves as a back-up source of funds. ASI's borrowing capacity is limited to the securities it holds. The Government Accountability Office (GAO) has noted this concern with the lack of ASI's ability to absorb catastrophic losses because it does not have government backing, as well as its limited resources.⁵⁸

The Colorado Commissioner of the Division of Financial Services (the state financial institution regulator) reviewed ASI's program in late 2002 in response to state-chartered credit unions' interest in switching from federal deposit insurance to private deposit insurance. The Commissioner ruled state-chartered credit unions in Colorado could not obtain primary deposit insurance through ASI.⁵⁹ The Commissioner concluded ASI's coverage was "not comparable" to NCUSIF coverage due to a lack of ultimate fund backing, lack of geographic and single institution diversification of risk, and involuntary termination provisions.⁶⁰ Also noted was significant concentration risk in California, Illinois, and Ohio, as well as the high concentration risk presented by Patelco. The Commissioner further noted ASI's provisions for involuntary termination of coverage did not have the level of consumer protection afforded by the federal insurance system.⁶¹

⁵⁸ United States General Accounting Office, *Credit Unions – Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management*, October 2003, p. 7.

⁵⁹ The Commissioner noted the failure of Colorado's Industrial Bank Savings Guaranty Corporation (IBSGC), a state-authorized private guaranty fund insuring 14 industrial banks and 9,000 depositors. IBSGC failed in 1987, resulting in partial payouts of only 22 cents on the dollar for depositors a year after the collapse.

⁶⁰ David L. Paul, Colorado Division of Financial Services Commissioner, Letter from Department of Regulatory Agencies, March 5, 2003, pp. 1-5.

⁶¹ ASI employs a 30-day notice termination policy. For credit unions insured by the NCUSIF, if insurance is terminated, credit unions are entitled to a hearing and other due process rights. NCUA must notify all members and coverage remains in place for one year after insurance termination for shares and deposits at the time of termination. 12 U.S.C. §1786(d)(1).

- **Public Expectations Regarding Implicit Government Guarantee**

Another hazard regarding private insurance is the public's expectations regarding implicit coverage by the federal or state governments. For private insurance programs, many members of the public believe the government is responsible for catastrophic losses since both the private insurer and the financial institutions are regulated by the government. As noted by Thorsten Beck, "complete privatization might not be possible since the government and thus the taxpayer is always expected to step in, especially in a catastrophic case."⁶² Per a report issued by the National Association of Federal Credit Unions (NAFCU), "if a private insurer fails, it can only be expected that there will be significant pressure on the federal government to provide financial assistance despite the absence of the backing of the full faith and credit of the U.S."⁶³

Research has shown that a private deposit insurance system would not be as efficient or effective as a government system, as the government would still be responsible for catastrophic loss levels.⁶⁴ The Wharton Financial Institutions Center examined this issue, concluding:

*"Although in theory a private system should allow for efficient pricing of deposit insurance and create positive incentive effects, we are skeptical that in practice private markets would be able to play a major role in insuring bank deposits. There are at least two reasons for this: first, the \$3.5 trillion of insured deposits [2000 data] is extremely large relative to the size of both the banking industry and the insurance markets ... Second, by transferring risk to private markets, FDIC systemic risk would be converted to off-balance sheet counterparty risk. Yet no counterparty would have a solvency standard significantly better than that of the largest and best capitalized banks in the FDIC system, let alone equal to the government's ... In the end, the limited risk absorption capacity of private markets implies an ongoing government responsibility for losses at the far right tail ... We therefore argue that the most practical and lowest cost solution is for the government to own both parts of the loss distribution."*⁶⁵

Blinder and Wescott note there is reason to fear that private insurance companies could not withstand losses in a "100 year flood" environment, and there is concern private insurers would place too much emphasis on profitability as opposed to macroeconomic stability.⁶⁶ The FDIC has also brought up the question of credibility as it pertains to private insurance, noting federal insurance was seen by the public as very credible during the banking crisis in the U.S. during the 1980s.⁶⁷ They also note that "in the event of a private insurer's failure, congressional action to

⁶² Thorsten Beck, *Deposit Insurance as Private Club: Is Germany a Model?* World Bank Policy Research Working Paper 2559, 2001, p. 4.

⁶³ National Association of Federal Credit Unions (NAFCU), *2002 Credit Union Report for the Board of Governors of the Federal Reserve System*, December 2002, p. 25.

⁶⁴ Private insurers also receive a government subsidy both from the implicit government guarantee for catastrophic events, and to the extent the regulation and supervision of financial institutions is provided by the federal and state governments.

⁶⁵ The Wharton Financial Institutions Center, *Deposit Insurance and Risk Management of the U.S. Banking system: How Much? How Safe? Who Pays?*, April 2002, pages 38 and 42.

⁶⁶ Blinder and Wescott, *Reform of Deposit Insurance: A Report to the FDIC*, p. 16.

⁶⁷ FDIC, *Examining the Role of the Federal Government*, Presented at Confidence for the Future: An FDIC Symposium, January 25, 1998, pp. 53–55.

restore public confidence might occur only after significant damage had been done to the banking system.” Thomas E. Hales, Chairman and CEO of U.S.B. Holding Co., Inc., said in answer to the idea of privatization of the insurance fund protecting bank deposits “The full faith and credit of the federal government is essential to an effective deposit insurance system, both to bring long-term stability to the banking system and to ensure depositor confidence in the system.”⁶⁸

- **Failure to Serve Public Policy**

History shows when private insurers fail, depositors at other privately insured institutions, even if those institutions are healthy, lose confidence in their institutions as news of the failures spread. This risk of contagion increases withdrawal rates at all privately-insured institutions, contributing to liquidity crises, and can have broad ramifications for the economy. Deposit insurance backed by the full faith and credit of the U.S. Government, however, has proven a successful vaccine for the risk of contagion.

As noted, private insurers do not provide the same level of consumer protection afforded by federal deposit insurance. Gary H. Stern, President of the Federal Reserve Bank of Minneapolis, argued that complete privatization does not “credibly address the potential for instability in the banking system nor the related TBTF [too big to fail] problem. The complete absence of a federal safety net creates the potential for banking panics which could have substantial financial and real costs...”⁶⁹ In fact, private insurers have consistently demonstrated they do not satisfy the public policy objective of maintaining confidence and stability in our financial system and economy. Consider the failure of the private insurer in Texas (Texas Share Guaranty Corp.) and the collapse of the Rhode Island Share and Deposit Indemnity Corporation (RISDIC) in the early 1990’s.⁷⁰

Some believe that the regulatory burden on banks would be lessened by privatization of the deposit insurance system. The FDIC notes, however, government supervision was in place prior to the establishment of the federal deposit insurance system, and even if the system were completely privatized, “...the government would likely have a strong interest in ensuring the safety and soundness of banking institutions.”⁷¹

- **Impact on Moral Hazard**

Moral hazard “refers to the incentive for insured banks to engage in riskier behavior than would be feasible in the absence of insurance. Because insured depositors are fully protected, they have little incentive to monitor the risk behavior of banks or to demand interest rates that are in line

⁶⁸ Thomas Hales, *Deposit Insurance and Financial Modernization: Comments on Reform Proposal*, Presented at Confidence for the Future FDIC Symposium, January 25, 1998, p. 76.

⁶⁹ Gary H. Stern, President, Federal Reserve Bank of Minneapolis, *Managing Moral Hazard with Market Signals: How Regulation Should Change with Banking*, May 6, 1999 presentation to The 35th Annual Conference on Bank Structure and Competition in Chicago, Illinois, p. 3.

⁷⁰ Vartan Gregorian, President of Brown University, March 14, 1991, “*Carved in Sand*” *A Report on the Collapse of the Rhode Island Share and Deposit Indemnity Corporation*.

⁷¹ FDIC, *Examining the Role of the Federal Government*, pp. 53–55.

with that behavior.”⁷² Moral hazard risk could increase if all deposit insurance was privatized and the insurer did not have a disciplinary role in supervising member institutions. Short of termination of insurance, only the government is adequately empowered to perform a disciplinary role while supervising member institutions. Therefore, moral hazard risk rises absent government participation.

Private insurers in the credit union industry regularly cover higher deposit limits than available with federal insurance, which is contrary to the goal of deposit insurance providing protection for the small, unsophisticated consumer, and also increases the risk of moral hazard. In addition, varying levels of coverage amongst insurers would contribute to confusion by less sophisticated depositors. Also, the belief in an implicit guarantee by the government would lead to inordinate risk taking and pricing anomalies. One only need consider the prevalent concerns about some banks being “too big to fail” for evidence of this.⁷³

- **Impact on Adverse Selection**

Complete privatization of deposit insurance in the U.S. for the credit union industry would likely lead to a problem of adverse selection.⁷⁴ This problem occurs when participation by all institutions is not compulsory and safer institutions decide to opt out of the system when they perceive their participation subsidizes higher risk institutions. Another problem can occur when the insurer decides not to insure higher risk institutions, instead only wanting to deal with “safer” or less risky institutions. The institutions that are not selected by the insurer are then either forced out of business or to seek inferior coverage. Therefore, comparable insurance coverage would need to be required for all institutions, and that would require a supervisory role for the government. Private insurers would simply introduce another layer to the current process, complicating the situation and possibly inhibiting the exercise of the government’s interests.

- **Impact on Principal-Agent Risk**

Principal-agent risk is defined as “situations in which an agent binds the principal but acts in a manner not in the best interest of the principal, either because the two parties’ compensations are not aligned or because the principal lacks the information or power needed to effectively monitor and control the actions of the agent.”⁷⁵ Deposit insurance programs operated by the government have better access to a financial institution’s records than a private company. Some of the critical information needed to monitor risk is proprietary, and thus available only to supervisory authorities, not to private market participants - some of whom may actually be competitors.⁷⁶ This role is thus inherently governmental.

An example of a principal-agent problem was the failure of the Rhode Island private insurance fund (RISDIC). Not only was a large majority of the RISDIC board of directors composed of

⁷² Hanc, *Deposit Insurance Reform: State of the Debate*, pp. 3 & 15.

⁷³ Stern, *Managing Moral Hazard with Market Signals: How Regulation Should Change with Banking*, p. 2.

⁷⁴ Beck, *The Incentive Compatible Design of Deposit Insurance and Bank Failure Resolution – Concepts and Country Studies*, p. 5.

⁷⁵ Hanc, *Deposit Insurance Reform: State of the Debate*, p. 4.

⁷⁶ Blinder and Wescott, *Reform of Deposit Insurance A Report to the FDIC*, Part I.

representatives of RISDIC-insured institutions, but prominent Rhode Island political figures also held important positions in those same institutions. The amount of influence wielded by representatives of insured institutions in the Rhode Island failure is a classic case of a principal-agent problem where the RISDIC board acted as agent for the taxpayers (the principal in this case). The problem could have been significantly alleviated by having an independent board of directors for the insurance fund and would have avoided a situation where the insured had undue influence over the insurer.

It was estimated in 1994 that the timely liquidation and sale of insolvent RISDIC-insured institutions could have saved more than \$350 million to Rhode Island taxpayers. However, partly because of political concerns, prompt corrective action was not taken and it took more than three years for depositors to receive the full amount of their deposits at some affected institutions.⁷⁷

The owners of a private deposit insurance scheme will want to minimize costs while the scheme managers might have personal interests that do not coincide with the owners' interests, thereby creating a principal agent problem.⁷⁸ Principal-agent risk is a factor that should be carefully considered when contemplating a move to a completely privatized deposit insurance system for financial institutions.

Public Preference for Federal Deposit Insurance

The FDIC commissioned a survey in 2001 to evaluate the public's view of federal insurance and the role it plays in savings and investment decisions.⁷⁹ The survey found, "FDIC coverage is a significant factor in investment decisions, especially when household wealth is taken into account." The results of the survey showed that federal deposit insurance plays a significant role in investment decision-making, particularly among more risk-averse investors such as older and lower income households. The backing of federal deposit insurance with the full faith and credit of the U.S. Government plays a significant role in the public's trust of the federal deposit insurance system.

A review of member voting patterns at credit unions converting to private insurance from federal insurance shows most conversions are approved by the members. A review of a sample of conversions to private insurance since 1998 (either through straight conversion or through a merger into a privately-insured credit union), shows 33 percent of members typically voted on the action with 54 percent typically approving such a measure. However, it is important to note the vast majority of information the membership receives on the conversion comes from credit union management in favor of the conversion. More than half of the credit unions that converted to private insurance gave their primary reason for the change as the higher deposit insurance limits offered by private insurers. The next most common reason for conversion was field of membership restrictions of NCUA; these were cases where the credit union converted to a state charter and private insurance at the same time.

⁷⁷ Walker F. Todd, Federal Reserve Bank of Cleveland, *Similarities and Dissimilarities in the Collapses of Three State-Chartered Private Deposit Insurance Funds*, 1994, p. 14.

⁷⁸ Beck, *Deposit Insurance as Private Club: Is Germany a Model?* p. 3.

⁷⁹ FDIC, *Household Survey on Deposit Insurance Awareness*, April 2001, pp. 1-3 & 12.

How Other Countries View Deposit Insurance

Many countries have adopted explicit deposit insurance programs. Explicit deposit insurance exists when the government clearly and precisely expresses the limits of deposit insurance. The number of countries adopting such programs has increased and explicit deposit schemes are more widespread than in the past. Some governments that do not offer explicit deposit insurance programs offer implicit coverage in the midst of crises.⁸⁰ In 1980, only 16 countries had explicit deposit insurance schemes; by 1999 this number had risen to 68.

All G-10 countries have explicit deposit insurance programs with all having compulsory membership except Switzerland.⁸¹ The vast majority of countries have chosen explicit coverage administered by the government instead of private systems. One exception is Germany where the deposit insurance scheme has been completely private since 1975; however, while this may be well suited to Germany's highly concentrated commercial banking system, it has yet to face a major banking crisis. Further, though this type of scheme can help decrease moral hazard it hampers entry into the market by new participants since the highly concentrated system acts like a cartel.⁸²

There is often debate in countries adopting explicit deposit insurance regarding the level of industry vs. taxpayer funding and industry vs. deposit insurer oversight that is appropriate. According to academic research,⁸³ the following factors need to be present to ensure the deposit insurance system works well:

- Financial institutions should bear most, if not all, of the cost of not only *funding* a deposit insurance system, but also of the *failures* that will happen in such a system. This is accomplished by requiring the institutions to pay mandatory premiums to fund the insurance and also by requiring institutions to share in the losses of member institutions. There needs to be adequate incentives for institutions to monitor their peers because oversight by the insurer alone is not optimal. It is also important the insurer have back-up funding from a public source (i.e., taxpayer funds) to ensure the depositor confidence that comes from government oversight and contingent funding.
- *Mandatory participation* in the deposit insurance system should be required of all affected financial institutions - this will avoid the potential problem of member institutions that do not pose a high level of risk opting out of such a system in order to avoid subsidizing weaker or higher risk institutions. This will also force the institutions to monitor each other because they will want to reduce the amount of premiums they have to pay as members of the insurance fund system.

⁸⁰ White, *Are Changes in Financial Structure Extending Safety Nets?*, pp. 273-274.

⁸¹ Asili Demirgüç-Kunt, Baybars Karacaovali and Luc Laeven, *Deposit Insurance Around the World: A Comprehensive Database*, The World Bank Policy Research Working Paper 3628, 2005, p. 9.

⁸² Beck, *Deposit Insurance as Private Club: Is Germany a Model?*, p. 1.

⁸³ Beck, *The Incentive Compatible Design of Deposit Insurance and Bank Failure Resolution – Concepts and Country Studies*, p. 5–6.

- *Oversight* should be undertaken at least partially by the deposit insurer in order to help reduce moral hazard risk – by having a role for the deposit insurer in the regulation and supervision of the member institutions, market discipline will be enhanced. This role should include mandatory participation among member institutions, the right to request extraordinary audits of institutions perceived as unsound, and the power to exclude member institutions that are recklessly managed.

Conclusion

The federal government should be the provider of primary deposit insurance in the United States. Federal deposit insurance has played an important role in maintaining confidence in the financial system and thus, economic stability, especially during periods of significant failures of private insurance schemes. Government sponsored deposit insurance is preferred by the public. The lessons learned from failures of private deposit insurance schemes should not be forgotten. As so succinctly put in Blinder and Wescott's 2001 report, "if it ain't broke, don't fix it."⁸⁴

⁸⁴ Blinder and Wescott, *Reform of Deposit Insurance: A Report to the FDIC*, p. 4.

VI. Recommendations

Recommendations for Congress

NCUA does not recommend privatizing all deposit insurance or establishing a voluntary federal deposit insurance system for deposits in excess of the maximum amount of deposit insurance. We do not have a recommendation either for or against Congress increasing coverage on municipal and other local government unit deposits.

NCUA has two recommendations related to deposit insurance coverage at this time. The FDIC has mechanisms in place to offset the risk of moral hazard with their flexibility in charging insurance premiums and having risk based capital requirements. For consistency between the NCUA and FDIC rules, and to help NCUA mitigate the risk of moral hazard inherent with deposit insurance, NCUA recommends two areas for congressional consideration:

1. Comparability with FDIC's authority to charge premiums.

The FCU Act⁸⁵ allows the NCUA Board to assess a premium on FICUs only if (i) the Fund's equity ratio is less than 1.3 percent; and (ii) the premium charge does not exceed the amount necessary to restore the equity ratio to 1.3 percent. In comparison, the FDIC is allowed to assess a premium when the Deposit Insurance Fund's (DIF) equity ratio is less than 1.35 percent, provided the premium charge does not exceed the amount necessary to restore the equity ratio to 1.35 percent. This provides the FDIC with greater flexibility in managing their insurance fund, allowing them to increase the equity ratio to a higher level during favorable economic conditions.

2. Comparability with FDIC's prompt corrective action standards.

Capital is the NCUSIF's primary line of defense against loss, and risk-based capital requirements are a way of making insured institutions hold appropriate capital for the risks they take. This also aids in more equitably allocating costs. For banks and savings institutions, the statute⁸⁶ allows each appropriate Federal banking agency to design their PCA system. However, the related statute for federally-insured credit unions⁸⁷ does not provide sufficient flexibility to enable NCUA to implement a risk-based PCA system comparable to the FDIC.⁸⁸

⁸⁵ 12 U.S.C. 1782(c)(2)(B)

⁸⁶ 12 U.S.C. 1831o(c)(2).

⁸⁷ 12 U.S.C. 1790d(c).

⁸⁸ In April 2005 NCUA submitted its report entitled Prompt Corrective Action Proposal for Reform to Congress, <http://www.ncua.gov/ReportsAndPlans/special/PCAProposal.pdf>

Action by NCUA

Enhance financial literacy.

In a 1989 *American Banker* survey, 95 percent of respondents said federal deposit insurance was important. In 1994, 94 percent of respondents to a Gallup survey reported federal deposit insurance is important to them.⁸⁹ In a report issued in April 2001, the FDIC contracted with Gallup to conduct a national household survey regarding the public's understanding of federal deposit insurance and the public's deposit insurance needs with the following results:

- 83% knew whether their banks were insured.
- 77% support adjusting the coverage for inflation.
- 57% were aware that the FDIC does not insure all transactions.
- 56% did not know mutual funds are not insured by FDIC.
- 49% correctly identified \$100,000 as the basic level of coverage.
- 47% believed the level of insurance should be raised.
- 12% reported keeping more than \$100,000 in the bank.

The public's support for deposit insurance is clear, but improvements in financial literacy are warranted, in particular, an understanding of deposit insurance. The need to increase awareness and knowledge of deposit insurance is clearly evident from the results of the 2001 FDIC Household Survey on Deposit Awareness in which a lower percentage of Hispanics (59 percent) and African Americans (68 percent) were aware of the FDIC (overall rate was 85 percent). Additionally, the Highlights from the GAO Forum, *The Federal Government's Role in Improving Financial Literacy*, disclosed the lack of knowledge of basic personal finance needed to make informed financial judgments and manage money effectively. The participants offered the following suggestions:

- The federal government should serve as a leader.
- Public-private partnership and interagency coordination should be increased.
- Consumers need financial information on a broad range of topics.
- A variety of methods are needed to deliver financial education effectively.
- Financial literacy programs need to be evaluated.

NCUA will continue to participate in a broad range of financial literacy programs, including initiatives designed to raise awareness and understanding of deposit insurance.⁹⁰ This emphasis is timely given the recent changes to deposit insurance provided by the Federal Deposit Insurance Reform Act of 2005.

⁸⁹ Hales, *Comments on Reform Proposals: Examining the Role of the Federal Government*, p. 76.

⁹⁰ NCUA Chairman JoAnn Johnson currently serves as Chairman of MyMoney.Gov.

VII. References

- American Bankers Association Community Bankers Council, Public Funds Advisory Group. 2000. "Overview and Findings." Review of issues related to the use of public funds.
- American Share Insurance Corporation (ASI). "2005 Combined State of the Funds Report for Excess Share Insurance Coverage."
- Beck, Thorsten. 2001. *Deposit Insurance as Private Club: Is Germany a Model?* World Bank Policy Research Working Paper No. 2559.
- Beck, Thorsten. 2003. *The Incentive Compatible Design of Deposit Insurance and Bank Failure Resolution – Concepts and Country Studies*. World Bank Policy Research Working Paper No. 3043.
- Blinder, Alan S., and Robert F. Wescott. 2001. *Reform of Deposit Insurance A Report to the FDIC*. Federal Deposit Insurance Corporation.
- Congressional Budget Office. 2005. *Modifying Federal Deposit Insurance*. Report to the U.S. Senate Committee on Banking, Housing, and Urban Affairs.
- D'Arsta, Jane. 1991. *No More Bank Bailouts, A Proposal for Deposit Insurance Reform*. Economic Policy Institute Briefing Paper.
- Demirgüç-Kunt, Asili, Baybars Karacaovali and Luc Laeven. 2005. *Deposit Insurance Around the World: A Comprehensive Database*. The World Bank Policy Research Working Paper 3628.
- Ely, Bert. 2001. *The Federal Financial Sector Safety Net—An Overview of the Issues*. Financial Services Roundtable.
- Excess Share Insurance Corporation. "2005 State of the Fund Report."
- FDIC. 1998. *Deposit Insurance and Financial Modernization*, Presented at Confidence for the Future: An FDIC Symposium.
- FDIC. 1998. *Examining the Role of the Federal Government*. Presented at Confidence for the Future: An FDIC Symposium.
- FDIC. 2000. "Options Paper."
- FDIC. 2001. *Household Survey on Deposit Insurance Awareness*.
- FDIC. "Resolutions of Failed Institutions."
- Financial Stability Forum. 2001. *Guidance for Developing Effective Deposit Insurance Systems*. Basel, Switzerland.
- Fisher, Peter. Testimony before the Committee on Banking, Housing and Urban Affairs United States Senate Deposit Insurance Reform. April 23, 2002.
- Frolov, Mikhail. 2005. *Deposit Insurance and Its Design: A Literature Review*, Keio University, Tokyo, Japan.
- Garcia, Gillian. 1999. *Deposit Insurance: A Survey of Actual and Best Practices*, IMF Working Paper 99/54. International Monetary Fund.
- Greenspan, Alan. Remarks before the American Bankers Association. Washington D.C., September 18, 2000.
- Greenspan, Alan. Remarks before the 37th Annual Conference on Bank Structure and Competition. Chicago Illinois. May 10, 2001.

- Greenspan, Alan. Testimony before the Senate Committee on Banking, Housing, and Urban Affairs. Washington D.C. February 26, 2003.
- Gregorian, Vartan, President of Brown University. 1991. *“Carved in Sand”: A Report on the Collapse of the Rhode Island Share and Deposit Indemnity Corporation.* Brown University.
- Hales, Thomas. 1998. *Deposit Insurance and Financial Modernization, Comments on Reform Proposals.* Presented at Confidence for the Future FDIC Symposium.
- Hanc, George. 1999. *Deposit Insurance Reform: State of Debate.* FDIC Banking Review, Volume 12, No. 3.
- Kane, Edward J., and Ash Demirguc-Kunt. 2001. *Deposit Insurance Around the Globe: Where Does it Work?* Policy Research Working Paper No. 2679. World Bank.
- Massachusetts Share Insurance Corporation (MSIC). “2005 Annual Report.”
- Moysey, A. Warren. 1998. *Deposit Insurance and Other Compensation Arrangements.* Task Force on the Future of the Canadian Financial Services Sector Research Paper.
- National Association of Federal Credit Unions (NAFCU). “2002 Credit Union Report for the Board of Governors of the Federal Reserve System.”
- O’Driscoll, Gerald P. Jr. “Deposit Insurance in Theory and Practice.” *Cato Journal.* Vol. 7 No.3 (Winter 1988).
- Paul, David L. Colorado Division of Financial Services Commissioner. “Letter from Department of Regulatory Agencies.” March 5, 2003.
- Powell, Donald. Testimony before U.S. House of Representatives Committee on Financial Services, Federal Deposit Insurance Reform Act of 2003. March 4, 2003.
- Stern, Gary H. Federal Reserve Bank of Minneapolis, President. 1999. “Managing Moral Hazard with Market Signals: How Regulation Should Change with Banking,” presentation to The 35th Annual Conference on Bank Structure and Competition in Chicago, Illinois.
- Todd, Walker F. Federal Reserve Bank of Cleveland. 1994. *Similarities and Dissimilarities in the Collapses of Three State-Chartered Private Deposit Insurance Funds.* Working Paper 9411.
- United States General Accounting Office. 2003. *Credit Unions – Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management.*
- Wharton Financial Institutions Center. 2002. *Deposit Insurance and Risk Management of the U.S. Banking System: How Much? How Safe? Who Pays?* The Wharton School, University of Pennsylvania.
- White, Eugene N. 1997. *The Legacy of Deposit Insurance: The Growth, Spread, and Cost Insuring Financial Intermediaries.* National Bureau of Economic Research. Cambridge, Massachusetts.
- White, William. 2003. *Are Changes in Financial Structure Extending Safety Nets?* Federal Reserve Bank of Chicago.

Appendix A – Brief History of Deposit Insurance

Early History of U.S. Deposit Insurance

At the beginning of the U.S. banking history, banks were governed solely by market forces. Government regulation and supervision of early U.S. banks were modest and appear to have been intended to primarily ensure that banks had adequate reserves to meet their obligations, especially obligations on their circulating notes.⁹¹

Proposals for federal insurance before the Great Depression were viewed as special interest legislation. States had experimented with insurance of bank liabilities before the Civil War and after the panic of 1907. These state systems had, at best, mixed results establishing a strong policy prejudice against federal insurance. Nevertheless, a well-motivated lobby of predominantly rural bankers was keen on securing a federal guarantee system.⁹²

The post World War I period was characterized by a large number of bank closures. Between 1921 and 1928 (inclusive) suspensions averaged 552 per year (Friedman and Schwartz 1963, pp. 438-39). Approximately one-sixth of all banks failed during this period of general prosperity and price stability. The suspended banks tended to be small unit banks, concentrated in agricultural states with state deposit insurance systems.⁹³ Between 1929 and the end of 1933, the number of banks fell from 24,504 to 14,440 and S&Ls declined from 12,342 to 10,596.⁹⁴

The Establishment of Federal Deposit Insurance

Under the Banking Act of 1933 (often called the Glass-Steagall Act), the Temporary Deposit Insurance Fund was organized and scheduled to begin operations on January 1, 1934. The coverage per account was set at a maximum of \$2,500. When the Temporary fund was extended for a year in 1934, President Roosevelt objected to an attempt to increase coverage to \$10,000 since 97 percent of depositors were already covered. Congress raised the limit to \$5,000. The temporary system became permanent under Title 1 of the Banking Act of 1935. The National Housing Act (1934) established the Federal Savings and Loan Insurance Corporation (FSLIC), to provide parallel coverage.⁹⁵

In 1935, 91 percent of the 15,488 commercial banks with 86 percent of the assets joined the system. Of the 566 mutual savings banks, 11 percent took out membership. Most mutual banks, with a majority located in Massachusetts, preferred to remain with existing state insurance that offered higher levels of coverage. By 1940, only 30 percent of the S&Ls had obtained FSLIC

⁹¹ Alan Greenspan, Chairman of the Federal Reserve Board, Remarks before the American Bankers Association, Washington D.C., September 18, 2000.

⁹² Eugene N. White, *The Legacy of Deposit Insurance: The Growth, Spread, and Cost of Insuring Financial Intermediaries*, National Bureau of Economic Research (Cambridge, MA), June 1997, p. 3.

⁹³ Gerald P. O'Driscoll, Jr., *Cato Journal*, Vol. 7, No. 3 (Winter 1988). *Deposit Insurance in Theory and Practice*, p. 662.

⁹⁴ White, *The Legacy of Deposit Insurance*, p. 16.

⁹⁵ White, *The Legacy of Deposit Insurance*, pp. 4-5, 15.

insurance.⁹⁶ By 1949, commercial bank membership crept up to 95 percent and mutual saving bank membership increased to 36 percent; 50 percent of S&Ls with 80 percent of the assets had joined the system.

In 1950, the insurance amount was increased to \$10,000. By 1966, savers were showing great reluctance to hold deposits in excess of the \$10,000 level of coverage. One Board study showed that there was an “artificial bulge” in S&L’s accounts at the \$10,000 level, indicating people were limiting their deposits (Congressional Record, August 23, 1966). The Interest Rate Control Act of 1966 thus raised the insurance limit to \$15,000 and then to \$20,000 in 1970.⁹⁷

Credit Unions Gain Federal Deposit Insurance in 1970

The number of all credit unions, federal and state, more than doubled from 10,571 in 1950 to 23,656 in 1970 with deposits climbing from \$880 million to \$15.5 billion. In 1970, Congress amended the Federal Credit Union Act, creating the National Credit Union Administration and the National Credit Union Share Insurance Fund (NCUSIF). Federal share insurance coverage was set at \$20,000, the same level for banks and S&Ls. The amendment to create a system of insurance for credit unions was not opposed by either banks or thrifts. Insurance coverage had become a matter of pure competitive equality.⁹⁸

For credit unions, the adoption of federal insurance was not initially universal. Many state-chartered credit unions did not want to accept the federal regulations necessary to obtain NCUSIF insurance and created their own insurance funds. In 1981, when California established the California Credit Union Guaranty Corporation, there were sixteen state funds covering 3,150 credit unions with \$12 billion in deposits (NCUA, Annual Report 1982). In the wake of the widespread failures of banks, S&Ls, and credit unions in the 1980s, there was a flight to the NCUSIF which afforded the protection of the full faith and credit of the U.S. Government. In 1981, NCUSIF-insured credit unions held 82 percent of all credit union shares. By 1985, this figure jumped to 92 percent, and rose further to 99 percent in 1995 with the demise of the state insurance plans (NCUA, Annual Reports, 1989, 1995).⁹⁹

Deposit Insurance Expands

In 1970, customers of broker-dealers received guarantees for funds on deposit. Congress passed the Securities Investor Protection Act creating the Securities Investor Protection Corporation (SIPC), providing protection up to a maximum of \$50,000 for both cash and securities with a limit of \$20,000 for cash. The insurance was mandatory for broker-dealers registered with the SEC, making coverage nearly universal.¹⁰⁰ Unlike the deposit insurance agencies, the SIPC is not a government agency. It is a private membership corporation whose members are securities brokers. Its authority is more limited than the deposit insurance funds in that its reserves cannot

⁹⁶ White, *The Legacy of Deposit Insurance*, pp. 4-5, 15.

⁹⁷ White, *The Legacy of Deposit Insurance*, pp. 18-19.

⁹⁸ White, *The Legacy of Deposit Insurance*, pp. 21-22.

⁹⁹ White, *The Legacy of Deposit Insurance*, p. 22.

¹⁰⁰ White, *The Legacy of Deposit Insurance*, p. 25.

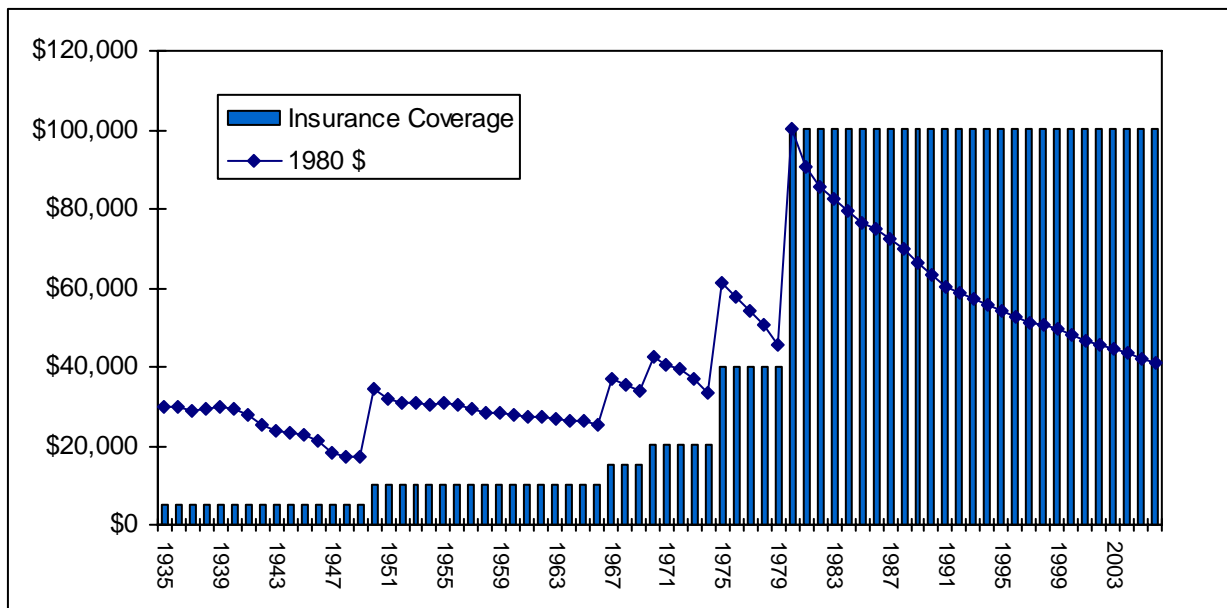
be used to assist mergers or make loans to broker-dealers; they can only be used to pay off customers in the event of insolvency.¹⁰¹

Beginning in 1970, five years of legislation had spread insurance to institutions beyond the banking system and dramatically raised the level of insurance for all accounts.¹⁰² In 1974, Congress passed legislation that lifted individual deposit insurance to \$40,000 and government deposit coverage to \$100,000. This legislation applied to commercial banks, mutual savings banks, thrifts, and credit unions. SIPC protection was raised to \$100,000 in cash and securities, with a \$40,000 maximum for cash. The result was a dramatic rise in real protection.

The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) increased federal deposit insurance coverage on individual accounts from \$40,000 to \$100,000 for banks, thrifts, and credit unions. Customer accounts for broker-dealers were now insured up to a maximum of \$100,000 in cash and \$500,000 for both cash and securities.

The Federal Deposit Insurance Reform Conforming Amendments Act of 2005 increased federal deposit insurance coverage for IRA accounts to \$250,000 and indexed the \$100,000 standard level to inflation.¹⁰³

Deposit Insurance Coverage and the Real Value



¹⁰¹ Jane D'Arsta, *No More Bank Bailouts A Proposal for Deposit Insurance Reform*, Economic Policy Institute Briefing Paper June 1991, p. 4.

¹⁰² White, *The Legacy of Deposit Insurance*, p. 29.

¹⁰³ Pub. L. No. 109-173, 119 Stat. 3601 (2006).

Appendix B – Overview of the Credit Union System

Credit Union Characteristics

Although credit unions have certain characteristics in common with banks and thrifts, they are clearly distinguishable from these other depository institutions in their structural and operational characteristics. Many banks and thrifts exhibit one or more of the following five characteristics; but only credit unions exhibit all five together.¹⁰⁴

1. Credit unions are member-owned,¹⁰⁵ with each member entitled to one vote in selecting board members and making certain other decisions, regardless of the amount of a member's deposits.¹⁰⁶
2. Credit unions do not issue capital stock. Credit unions create capital, or net worth, by retaining earnings.¹⁰⁷
3. Credit unions rely on volunteer, unpaid boards of directors whom the members elect from the ranks of membership.¹⁰⁸
4. Credit unions operate as not-for-profit institutions, in contrast to shareholder-owned depository institutions. All earnings are retained as capital or returned to the members in the form of dividends on share accounts, lower interest rates on loans, or otherwise used to provide products and services.
5. Credit unions may only accept as members those individuals identified in a credit union's articulated field of membership.¹⁰⁹

Size and Composition of the Credit Union System

Credit unions are growing and play an important role in the financial system, but remain small in terms of market share of deposits and financial institution customers. As of June 30, 2006, the FDIC insures approximately \$4 trillion of deposits with \$3.5 trillion in uninsured deposits. The National Credit Union Share Insurance Fund (NCUSIF) insures \$531 billion with \$62 billion in uninsured deposits. The 8,538 federally insured credit unions (FICUs) are almost as numerous as FDIC insured institutions (8,778) but control only 5.7 percent of federally insured institution assets. Credit unions report total membership of over 84 million.¹¹⁰

¹⁰⁴ United States Department of Treasury, "Comparing Credit Unions With Other Depository Institutions," 2001, pp.6-7.

¹⁰⁵ 12 U.S.C. § 1752(1) (defining a federal credit union as "a cooperative association organized ...for the purpose of promoting thrift among its members and creating a source of credit for provident and productive purposes ...").

¹⁰⁶ 12 U.S.C. § 1760.

¹⁰⁷ 12 U.S.C. § 1790d(b)(2)(B)(ii).

¹⁰⁸ See 12 U.S.C. § 1761. Nevertheless, federal credit unions do have the authority to permit a specified number of paid credit union employees to serve as directors. See NCUA, *The Federal Credit Union Bylaws*, art. VI, § 2. Also, some state-chartered credit unions may have paid boards of directors.

¹⁰⁹ 12 U.S.C. § 1759(b). Such requirements for state credit unions vary from state to state.

¹¹⁰ Note that some people belong to more than one credit union.

Like banks and thrifts, credit unions have either federal or state charters. As of June 2006, there are 5,305 federal 3,544 state chartered credit unions respectively, including 178 credit unions privately insured by ASI and 133 insured by the state operated fund in Puerto Rico.

The average FICU is small, with only \$81.6 million in assets. FICUs with more than \$100 million in assets account for only 14 percent of all credit unions, but hold more than 80 percent of all credit union assets. About 45 percent of all credit unions hold less than \$10 million in assets. By comparison, the 122 FDIC-insured institutions (1.34 percent) with assets over \$10 billion hold nearly 74 percent of all FDIC insured institution assets.

Table 2-1
Number of FICUs and Total Assets by Size Category
(Dollars in billions, data as of June 2006)

Asset Size Category	Number of Institutions	Percent of All Credit Unions	Total Assets	Percent of Total Assets
< \$2 million	1,435	16.8%	\$1.3	0.3%
\$2-10 million	2,453	28.7%	\$13.4	1.9%
\$10-50 million	2,685	31.4%	\$64.3	9.2%
\$50-100 million	765	9.0%	\$53.9	7.7%
> \$100 million	1,200	14.1%	\$564.1	80.9%
Total	8,538	100%	\$697	100%

Source: NCUA Call Report Data

Navy FCU is the largest single credit union at \$25.6 billion in assets and holds 3.59 percent of the system's assets. In comparison, Bank of America holds just over 10 percent of FDIC-insured institution assets.¹¹¹ Banking assets are increasingly controlled by the largest institutions. In 1980, there were more than 12,000 banks in the U.S., with institutions with assets greater than \$10 billion controlling 37 percent of total bank assets. These figures had barely changed by 1990, but now there are far fewer banks (8,778), with 122 over \$10 billion in assets controlling 74 percent of total banks' assets. The accepted wisdom, buttressed by economic models, forecasts a continuation of this trend.

Consolidation has also occurred in the credit union industry. Mergers, liquidations, and the formation of relatively few new credit unions combined to reduce the number of credit unions from a peak of 23,866 in 1969 to 8,716, (8,538 FICUs and 178 privately insured by ASI). The number of FICUs with over \$100 million in assets increased from 192 in 1980 to 1,200 as of June 30, 2006, and the share of FICU assets in these larger FICUs increased from 31 percent in 1980 to 81 percent in June 2006.

Globalization of the Financial System

A global revolution in computing and communication is spawning dramatic changes in the financial services industry. Electronic technology is the underlying force driving change in the financial services industry, and thus the federal safety net. Technology is erasing traditional

¹¹¹ FDIC, Statistics on Depository Institutions.

lines of demarcation within the financial services sector. Technology also has facilitated the globalization of financial markets, leading to the emergence of globally active financial conglomerates.¹¹²

The challenge is to provide a statutory and regulatory framework that allows this evolution to occur while maintaining the safety and soundness of individual institutions and stability of the financial system without causing significant market distortions.¹¹³

¹¹² Bert Ely, *The Federal Financial Sector Safety Net—An Overview of the Issues*, March 2001, p. 4.

¹¹³ FDIC, *Deposit Insurance and Financial Modernization*, p. 18.

Appendix C - Summary of G-10 Country Deposit Insurance Schemes¹¹⁴

As part of this study, we reviewed the deposit insurance schemes in place in the G10 Countries. In five countries, the deposit insurance schemes are administered by the government (including Canada, the U.K. and U.S.A.). In three countries, deposit insurance is administered by the banking industry and in three countries administered jointly by industry and government. Only three countries have risk-based premiums. Only Canada and the U.S. include insurance coverage for interbank deposits. France, Germany, Italy, Netherlands, and Belgium exclude certain insider deposits from deposit insurance.

Country name	Coverage amounts explicit=1 implicit=0	Inter-bank deposits insured yes=1 no=0	Coverage limits as of 2003	Insider Deposits Insured yes=1 no=0	Co-insurance yes=1 no=0	Co-insurance percentage	Payment Reserves funded=1 unfunded=0	Risk-adjusted premiums yes=1 no=0	Source of funding government=1 private=2 joint=3	Administration government=1 private=2 joint=3
Belgium	1	0	EUR 20,000 US\$ 25,260	0	1	10	1	0	3	3
Deposit and Financial Instrument Protection Fund. Insiders and assets belonging to Belgian states, regions, communities, provinces and municipalities are excluded. ¹¹⁵										
Canada	1	1	Can. \$60,000 US\$ 46,245	1	0	n/a	1	0	3	1
Canada Deposit Insurance Corporation. Covered deposits include savings and demand deposits, term deposits such as guaranteed investment certificates and debenture issues by loan companies, money orders, drafts, checks, and traveler's checks issued by member institutions. The CDIC does not insure foreign currency deposits, term deposits with a maturity date of more than five years from date of deposit, debentures issued by chartered banks, bonds and debentures issued by governments and corporations, treasury bills, and investments in mortgages, stocks and mutual funds. ¹¹⁶										
France	1	0	EUR 70,000 US\$ 88,410	0	0	n/a	0	0	2	2
Fonds de Garantie des Depots. Debt securities insured by institutions, deposits of the central government, insiders, affiliated companies and money launderers are excluded from coverage.										

¹¹⁴ Demirgüç-Kunt, Asli, Baybars Karacaovali and Luc Laeven, (2005), "Deposit Insurance around the World: A Comprehensive Database," Policy Research Working Paper #3628, Washington, DC: World Bank

¹¹⁵ Deposit and Financial Instrument Protection Fund website, Intervention Regulation

¹¹⁶ Canada Deposit Insurance Corporation website, Protecting Your Deposits

Country name	Coverage amounts explicit=1 implicit=0	Inter-bank deposits insured yes=1 no=0	Coverage limits as of 2003	Insider Deposits Insured yes=1 no=0	Co-insurance yes=1 no=0	Co-insurance percentage	Payment Reserves funded=1 unfunded=0	Risk-adjusted premiums yes=1 no=0	Source of funding government=1 private=2 joint=3	Administration government=1 private=2 joint=3
Germany	1	0	Private: 30% of bank's equity capital; 90% to EUR 20,000 US\$ 25,260	0	1	10	1	0	2	3
Deposit Protection Fund of the Association of German Banks. Insiders are not protected. Protected are all liabilities of banks-to non-banks (private persons, business enterprises, and public agencies) which are required to be shown on the balance sheet item "Liabilities to Customers." ¹¹⁷										
Italy	1	0	ITL 200 Mil. EUR 103,291 (2003) US\$ 130,457	0	0	n/a	0	1	2	2
Inter-bank Deposit Protection Fund. Criminal, government, insider, inter-bank, and bearer deposits are not covered.										
Japan	1	0	10000000 yen US\$ 93,371	1	0	n/a	1	0	3	3 - CB approves decisions
Deposit Insurance Corporation of Japan. Deposits not covered are: Foreign currency deposits, negotiable certificates of deposit, deposits accounted for in special international transaction accounts (deposits of Japan off-shore market accounts), deposits from the Bank of Japan (except treasury funds) and member financial institutions (except deposits related to the investment of fixed contribution pension reserves), deposits from the DICJ, bearer deposits, deposits under an alias or fictitious name, deposits to be re-lent to a third party, money trusts with no guaranteed principal, and bank debentures other than custody products. ¹¹⁸										
Netherlands	1	0	EUR 20,000 US\$ 25,260	0	0	n/a	0	0	3	1
Collective Guarantee Scheme. Deposits of large corporations, other banks, insurance companies, and insiders are not covered. Deposits of small enterprises and small foundations along with deposits of households are protected. Deposits at branches of foreign banks established in other European Union states are not covered.										

¹¹⁷ Bylaws of the Deposit Protection Fund of the Association of German Banks §6, Berlin, March 2005

¹¹⁸ Deposit Insurance Corporation of Japan website, FY2005 A Guide To The Deposit Insurance System

Country name	Coverage amounts explicit=1 implicit=0	Inter-bank deposits insured yes=1 no=0	Coverage limits as of 2003	Insider Deposits Insured yes=1 no=0	Co-insurance yes=1 no=0	Co-insurance percentage	Payment Reserves funded=1 unfunded=0	Risk-adjusted premiums yes=1 no=0	Source of funding government=1 private=2 joint=3	Administration government=1 private=2 joint=3
Sweden	1	0	SEK 250,000 US\$ 34,364	Unknown	0	n/a	1	1	3	1
Deposit Guarantee Board. Only certain deposits are covered. Primarily, a deposit is covered if it is a nominal balance which is available to the depositor on short notice (if the time of notice does not exceed one month). The scheme does not cover deposits made by institutions which can themselves form part of the scheme (i.e. banks and other securities companies). Deposits not covered are bonds and similar instruments and deposits saved on account as pensions. The possibility for exceptions in the EU Directive has not been made use of, which has caused the Board problems in deciding the scope of the guarantee. ¹¹⁹										
Switzerland	1	0	CHF 30,000 US\$ 24,254	Unknown	0	n/a	0	0	2	2
Deposit Guarantee Scheme. The scheme covers savings, salary, pension, investment, and custody accounts as well as medium-term notes. ¹²⁰										
United Kingdom	1	0	100% of first £2000 and 90% of next £33,000 US\$ 19,611	Unknown	1	10	0	0	2	1
Deposit Protection Fund. Deposits of financial institutions are not covered.										
United States	1	1	US\$ 100,000	1	0	0	1	1	3	1
Federal Deposit Insurance Corporation. Coverage includes public unit accounts (i.e., Deposit accounts of the U.S., any state, county, or municipality, the District of Columbia, Puerto Rico, or an Indian Tribe. Coverage extends to the official custodian of the funds belonging to the public unit rather than the public unit itself.) ¹²¹										

The European Union¹²² and Council Directive 94/19/EC¹²³ (as amended by Directive 2005/1/EC) Article 7 defines what deposits may be covered. Article 7(2) states member states may provide that certain depositors or deposits shall be excluded from guarantee or shall be granted a lower level of guarantee. Those exclusions include deposits by government and central administrative authorities, deposits by provincial, regional, local and municipal authorities, and deposits by a credit institution's own directors, managers, members personally liable, holders of at least 5 % of the credit institution's capital, persons responsible for carrying out the statutory audits of the credit institution's accounting documents and depositors of similar status in other companies in the same group.

¹¹⁹ Sweden Deposit Guarantee Board website, Description of the Swedish Deposit Guarantee Scheme

¹²⁰ Swiss Bankers Association website, Self-regulation, The Codes of Conduct, Agreement on depositor protection

¹²¹ Your Insured Deposits, FDIC's Guide to Deposit Insurance Coverage, FDIC-001-2006

¹²² Members of the European Union include Belgium, France, Germany, Italy, Sweden, the Netherlands, and the United Kingdom.

¹²³ Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes