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TESTIMONY

OF

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COMPTROLLER OF THE CURRENCY

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

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Statement required by 12 U.S. C. § 250

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Chairman Shelby, Senator Sarbanes, and Members of the Committee, I am pleased to have this opportunity to present the views of the Office of the Comptroller of the Currency (OCC) on deposit insurance reform. For almost 70 years, federal deposit insurance has been one of the cornerstones of our nation's economic and financial stability. It has relegated bank runs to the history books and helped our country weather the worst banking crisis since the great depression without significant adverse macroeconomic effects.

Despite this admirable history, there are flaws in our current deposit insurance structure. In fact, efforts to address weaknesses in the system uncovered during the banking and thrift crises of the 1980s and early 1990s have not been entirely adequate to the task. Indeed, the legislation adopted in response to those crises has actually constrained the Federal Deposit Insurance Corporation (FDIC) from taking sensible and necessary actions. This is particularly the case with respect to the FDIC's ability to price deposit insurance in a way that reflects the risks posed by different depository institutions, and to the funds' ability to absorb material losses over the business cycle without causing sharp increases in premiums. Failure to address these issues in the current financial environment poses the danger that the next major domestic financial crisis will be exacerbated rather than ameliorated by the federal deposit insurance system.

In summary, the OCC recommends that:

- the FDIC be provided with the authority to implement a risk-based deposit insurance premium system for all banks;

- the current fixed designated reserve ratio (DRR) be replaced with a range to allow the FDIC more flexibility in administering the deposit insurance premium structure over the business cycle;
- any program of rebates or credits issued when the fund exceeds the upper end of the DRR range take into account the fact that the FDIC and the Federal Reserve already deliver a substantial subsidy to state-chartered banks by absorbing their costs of federal supervision, and that deposit insurance premiums paid by national banks pay, in part, for the supervision of state chartered banks;
- the BIF and SAIF be merged; and
- coverage limits on deposits not be increased.

Eliminating Constraints on Risk-Based Pricing

The ability of the FDIC to set premiums for deposit insurance that reflect the risks posed by individual institutions to the insurance funds is one of the most important parts of deposit insurance reform. While current law mandates that the FDIC charge risk-based insurance premiums, it also prohibits the FDIC from charging premiums to any institution in the 1A category—in general, well-capitalized institutions with composite CAMELS ratings of 1 or 2—whenever the reserves of the deposit insurance funds are at or above the designated reserve ratio (DRR) of 1.25 percent of insured deposits. As a result, 91 percent of all insured depository institutions pay nothing for their deposit insurance even though all institutions pose some risk of loss to the FDIC. Moreover, quite apart from the risk that a specific bank might present, banks are not required to pay even a minimum "user" fee for the governmentally provided benefit represented by the deposit insurance system—a benefit without which, as a practical matter, no bank could engage in the business of taking deposits from the public.

A system in which the vast majority of institutions pay no insurance premium forgoes one of the major benefits of a risk-based pricing system—creating an incentive for good management by rewarding institutions that pose a low risk to the insurance funds. A mandated zero premium precludes the FDIC from charging different premiums to banks with different risks within the 1A category, despite the fact that within the 1A category there are banks that pose very different risks to the funds. The FDIC should be free to set risk-based premiums for all insured institutions.

Dampening Procyclicality and Fund Management

Under current law, whenever the reserve ratio of the BIF or SAIF falls below 1.25 percent the FDIC is required either to charge an assessment rate to all banks high enough to bring the fund back to the DRR within one year, or if that is not feasible, an assessment rate of at least 23 basis points. This sharp rise in premiums, or "cliff effect," is likely to hit banks the hardest when they are most vulnerable to earnings pressure. To avoid creating this procyclical volatility in deposit insurance premiums, it would be preferable to let the funds build in good times and to draw down slightly in bad times.

The OCC supports giving the FDIC the authority to establish a range for the DRR to replace the present arbitrary fixed DRR of 1.25 percent. The FDIC should have the authority to set the range based on its assessment of the overall level of risk in the banking system. We also believe that in establishing the range, the FDIC should provide notice and an opportunity for the public to comment on the proposed range. If a fund falls below the bottom of the range, we believe it would be preferable to allow the FDIC to rebuild the fund gradually to eliminate the 23 basis point “cliff effect.” Adoption of a range and elimination of the “cliff effect” would allow the FDIC more flexibility in administering the premium structure and would minimize the likelihood of sharp increases in premiums during economic downturns when banks can least afford them.

If a fund exceeds the upper boundary of the DRR range, the FDIC should be authorized to pay rebates or grant credits against future premiums. While such credits or rebates seem reasonable, there are two principles that should be observed in determining their allocation and use. First, a system of rebates or credits should not undermine the risk-based premium system. Thus, rebates or credits should not be based on an institution’s current assessment base. If they were, rebates or credits would lower the marginal cost of insurance. For example, if an institution with a risk based premium of 3 basis points received a rebate or credit of 2 basis points for each dollar of assessable deposits, its true premium would only be 1 basis point. Another implication of rebates or credits not undermining risk-based premiums is that institutions that paid high insurance premiums in the past because they posed a higher risk to the funds should not receive larger rebates than less risky institutions of the same size. The fact that these high-risk institutions did not fail during that period does not alter the fact that they subjected the funds to greater than average risks. Finally, an institution that is faced with a high premium because of high risk should not be allowed to completely offset that premium with credits.

The second principle is that the payment of rebates and credits should take into account the fact that not all insured institutions receive the same services for their deposit insurance dollars. The FDIC uses proceeds from the deposit insurance funds to cover its own costs of supervising state-chartered banks, and it does not pass these costs on to the banks. In 2001, this amounted to an in-kind transfer from the FDIC to state non-member banks of over $500 million. During this same time, by contrast, national banks paid over $400 million in assessments to the OCC to cover their own costs of supervision.[1] In a regime under which all institutions were paying premiums, national banks should not be required to pay both for their own supervision, and also for a portion of the supervisory costs of their state-chartered competitors. It would be unconscionable for the FDIC to issue credits or rebates to state-chartered banks without first taking into account the subsidy it provides to these banks by absorbing their costs of supervision—a subsidy that is funded in good part by deposit insurance premiums paid by national banks.

Merger of the BIF and the SAIF

One of the most straightforward issues of deposit insurance reform is the merger of the BIF and the SAIF. The financial conditions of thrifts and banks have converged in recent years, as have the reserve ratios of the two funds, removing one of the primary objections to a merger of the funds. As of the third quarter of 2002, the reserve ratio of the BIF was 1.25 percent, while that of the SAIF was 1.39 percent. The reserve ratio of a combined fund would have been 1.28 percent as of the same date. As is described in greater detail below, many institutions now hold some deposits insured by each fund. But under the current structure, BIF and SAIF deposit insurance premiums could differ significantly depending on the relative performance of the two funds, raising the possibility that institutions with similar risks could pay very different insurance

[1] The Federal Reserve pays for its supervision of state member banks out of funds that would otherwise be remitted to the Treasury. Thus, the taxpayer pays for the supervision of state member banks.

premiums. This would unfairly penalize low-risk institutions insured by the fund charging the higher premiums.

In addition, a combined fund would insure a larger number of institutions with broader asset diversification than either fund individually. It would also decrease the exposure of the funds—especially the SAIF—to a few large institutions. Industry consolidation has led to increased concentration of insured deposits in a handful of institutions. As of September 30, 2002, the three largest holders of BIF insured deposits held 15 percent of BIF insured deposits. The corresponding share for the three largest holders of SAIF insured deposits was 18 percent. For a combined fund the figure would have been 14 percent. For all these reasons, merger of the two funds would result in a diversification of risks.

Further, there is significant overlap in the types of institutions insured by the two funds. As of September 30, 920 banks and thrifts, or roughly 10 percent of all insured depository institutions, were members of one fund but also held deposits insured by the other fund, and BIF-member institutions held 43 percent of SAIF-insured deposits. Finally, merger of the BIF and the SAIF would undoubtedly result in operational savings as the two funds were combined into one.

Increasing Coverage Limits

The question of deposit insurance coverage limits is a challenging one, in part because it is easy for depositors to obtain full insurance of deposits in virtually unlimited amounts through multiple accounts. Proponents of an increase in coverage assert that it would ease liquidity pressures on small community banks and better enable small banks to compete with large institutions for deposits. However, there is little evidence to support this contention. Over the twelve months ending September 30, 2002, deposits at commercial banks with under $1 billion in assets grew at a healthy 3.8 percent annual rate, while loan volume actually declined. As a result, loan to deposit ratios at such institutions fell from 88 percent to 79 percent.

In addition, it is not at all clear that increasing deposit insurance coverage would result in an increase in the deposits of the banking system. One effect could be to cause a shift in deposits among banks. It is far from clear, however, that any such redistribution of existing deposits would favor community banks. Depositors who multiply insurance coverage today by using multiple banks might consolidate their deposits in a single institution if coverage were raised, but there is no way of determining which institutions would be the ultimate beneficiaries when the switching process ended. Moreover, it is quite possible that larger, more aggressive institutions might use the expanded coverage to offer even more extensive governmentally protected investment vehicles to wealthy customers. That could cause an even greater shift of deposits away from community banks and increase liquidity pressures.

For many of the same reasons that we object to an increase in the general insurance limit, we are also concerned about proposals to use the federal deposit insurance system to favor particular classes of depositors such as municipal depositors. Increasing the limit on municipal deposits would not provide municipalities with greater protection—they can already secure their deposits—and it is by no means clear that increasing the deposit insurance limit would result in funds flowing into community banks. In addition, an increase in insured coverage could spur riskier lending because banks would no longer be required to collateralize municipal deposits with low-risk securities.

Conclusion

The OCC supports a merger of the BIF and the SAIF and proposals to eliminate the current constraints on deposit insurance premiums. We also favor elimination of the current fixed DRR and its replacement with a range that would allow the FDIC more flexibility in administering the deposit insurance premium structure. We believe that any credits or rebates issued when the fund exceeds the upper range of the DRR must first take account of the subsidy that state-chartered banks receive as a result of having the costs of their federal supervision absorbed by their federal regulators, and the fact that deposit insurance premiums paid by national banks in effect pay for a large portion of this subsidy.