

**STATEMENT OF**

**KENNETH H. THOMAS, Ph.D.**

**LECTURER ON FINANCE  
THE WHARTON SCHOOL  
UNIVERSITY OF PENNSYLVANIA  
PHILADELPHIA, PA.  
(KHThomas@wharton.upenn.edu)**

**before the**

**FDIC ROUNDTABLE**

**on**

**DEPOSIT INSURANCE REFORM**

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## **EXECUTIVE SUMMARY OF RECOMMENDATIONS**

The following are my deposit insurance reform recommendations for the three broad areas identified in the FDIC Roundtable agenda:

### *I. PRICING*

- 1. Revision of the current risk-based assessment structure to better differentiate among risk profiles, with a provision for “special risk” assessments for de novo institutions, very rapidly growing ones, and other that pose special risks to the deposit insurance funds.*
- 2. Explicit recognition of the “Too Big To Fail” (TBTF) policy in the form of a special assessment for TBTF banks.*
- 3. Significantly expanded market discipline, beginning with the public disclosure of some essential safety and soundness information on banks and thrifts such as CAMELS ratings and a portion of the safety and soundness exam.*
- 4. Significantly improved bank regulatory and supervisory discipline so there are better risk management procedures, earlier identification of problem banks, and a reduction in the cost of failed ones.*
- 5. Merging of the OTS into the OCC as the first step towards a more effective and efficient federal financial institution regulatory structure.*

### *II. MAINTAINING THE FUNDS*

- 1. Merging of the BIF and SAIF insurance funds ASAP.*
- 2. Increasing the 1.25% statutory designated reserve ratio (DRR) to 1.50%.*
- 3. NO cap on the size of the merged fund.*
- 4. NO rebates should be paid.*

### *III. COVERAGE*

- 1. NO increase in the \$100,000 deposit insurance limit.*
- 2. Significantly improved disclosure of non-FDIC insured bank products.*

## **INTRODUCTION**

Chairman Tanoue and members of this Roundtable, I appreciate this opportunity to present my views on the subject of federal deposit insurance reform. The FDIC must be commended for organizing this Roundtable, especially with the inclusion of a wide range of community and public interest viewpoints.

We are entering the new millenium with a template for a totally restructured financial services industry, yet there has been no restructuring of the relevant insurance funds or regulatory agencies. This roundtable, by putting these key issues out for debate, hopefully will allow the industry to move together with their insuring and regulatory bodies into this new financial services era.

I was similarly privileged to testify before the FDIC Board of Directors on this same deposit insurance reform topic on March 17, 1995. I have also testified before Congress on this issue on March 24, 1995 and February 16, 2000.

I have studied the FDIC for the last 35 years. In fact, while a Wharton Ph.D. candidate, I was recruited by the FDIC for an economist position in the early seventies and have nothing but the greatest respect for this agency.

I have taught banking and economics as a Lecturer in Finance at The Wharton School every year since 1970, but I do not come here as an ivory tower academic. I have worked as a consultant to hundreds of banks and thrifts of all sizes throughout the nation since 1969, but I do not represent the views of the bank or thrift industries.

Those views will be well articulated by other members of this roundtable. My goal is to attempt to represent the views of a third party, that of a taxpaying bank depositor.

As a lifelong student of the FDIC, I have collected virtually every one of their publications. In fact, the FDIC staff has contacted me on several occasions to lend them FDIC material from my library that they no longer had! The prized possession of my FDIC collection is a hardbound version of their first Annual Report in 1934.

Whenever I am conducting research on the FDIC and have a question as to what this agency is really about, I refer back to this 1934 document. It states very clearly (p. 7) in the introduction that the FDIC was "created to insure depositors against loss resulting from bank failures." Not to insure individual banks but depositors, so that they maintain confidence in the system. The focus should always be on bank depositors, and this is the perspective I am taking today.

In short, my goal is to present an independent view that will result in good public policy. In the case of the FDIC this means maintaining public confidence in banks through protecting depositors' accounts; promoting sound banking practices; reducing the disruptions caused by bank failures; and, responding to a changing economy and banking system.

The following section outlines the key principles underlying the bank depositors' view as propounded here. Using these principles, three sets of recommendations,

following the broad areas in the Roundtable agenda, are proposed in the subsequent section.

### **PRINCIPLES UNDERLYING THE BANK DEPOSITORS' VIEW**

1. *The protection of bank depositors and the maintenance of public confidence in the banking system is more important than ever today with a volatile stock market fueled by day traders and high-flying IPOs.*
2. *The FDIC fund must NEVER be allowed to become insolvent again, even if by a GAO reserving "technicality," as was the case in 1991 and 1992.*
3. *Taxpayers and the government's "full faith and credit" guarantee not financial institutions ultimately stand behind the federal deposit insurance system, but the banking industry will always take the opposite view that they financed their "own" insurance fund.*
4. *Deposit insurance is but one of many subsidies enjoyed by banks, but the banking industry (and even some regulators) will never concede this point, even if it means a trade association offering \$5,000 stipends for papers proving that such subsidies do not exist! Two small Oklahoma thrifts found out how valuable the deposit insurance subsidy was after they gave up their FDIC insurance and each lost about one-third of their retail deposit base.*
5. *The federal safety net, of which deposit insurance is just one component, should be minimized rather than being expanded, as is the case with the significant increase of powers (and risk exposure) allowable under Gramm-Leach-Bliley (GLB).*
6. *The federal deposit insurance system is not "broken," and any improvements to it should be within the general framework of the existing system, relatively simple, easily understood by the public, and consistent with sound business practices. In this latter regard, the FDIC should adopt a more private rather than public attitude toward the critical issues of pricing, maintaining the funds, and coverage by always asking "What would a private insurance company do in this case?"*
7. *Market discipline is always preferred to regulatory discipline, although a balance between the two must be struck.*
8. *Increased public disclosure of the financial condition of banks and thrifts is the most effective means of market discipline.*
9. *While improved regulatory discipline is desired, banks should not be subject to an undue regulatory burden that would impact their profitability and ability to compete and be responsive to customer needs.*
10. *A healthy, profitable and competitive bank and thrift industry is in everyone's best interest.*

11. *“Competition in laxity” by bank regulators undermines public confidence in the integrity of the bank regulatory and supervisory process.*
12. *Small and large banks and thrifts, including those that are still mutual operations, should be treated equitably to the greatest extent possible.*
13. *Government expenses in the regulation and supervision of banks should be scrutinized for unnecessary duplication and waste of taxpayer monies.*
14. *The best time to strengthen the deposit insurance fund is during good times, because a “pay as you go” scheme to recapitalize the insurance fund during bad times may be insufficient.*
15. *Business cycles have not been repealed, and it is only a matter of time until the next recession begins, despite the Administration unrealistic view that our record economic expansion can continue “indefinitely.”*
16. *All forms of “moral hazard” by banks or their trade associations (e.g., asking them if the \$100,000 should be increased) regarding deposit insurance must be recognized and minimized.*
17. *The TBTF unwritten policy will always exist, regardless of banking industry or regulatory comments to the contrary; a corollary here is that firewalls do not exist during periods of crisis.*
18. *Banks, like their customers, should get what they pay for and pay for what they get (including TBTF coverage).*
19. *There is considerable downside risk for an undercapitalized insurance fund but little for an overcapitalized one, as the money is “still in the bank.”*
20. *Banks and thrifts must very carefully and clearly disclose to all customers, but especially seniors, which of their increasing array of products are NOT federally insured.*

## **RECOMMENDATIONS FOR DEPOSIT INSURANCE REFORM**

### **I. PRICING**

1. **Revision of the current risk–based assessment structure to better differentiate among risk profiles, with a provision for “special risk” assessments for de novo institutions, very rapidly growing ones, and other that pose special risks to the deposit insurance funds.**
  - A. The concept of risk–based deposit insurance assessments, like risk–based capital, is based on both common and economic sense. It appears, however, that regulators may never get either of these “right,” as the regulators always seem to be one step behind those nontraditional bankers who are both aggressive and creative

risk takers. It often seems that regulators basically react to a new problem (e.g., fraudulent subprime lending), as compared to proactively identifying the potential problem so that its consequences and cost to the FDIC are minimized. Even if the regulators miss just *one* of our big but not even giant problem banks, the consequences can be severe as we saw with Keystone National Bank, whose significant losses were solely responsible for making 1999 the FDIC's worst year since the last recession.

- B. The risk-based insurance premium system of the early 1990s was a significant improvement over the previous fixed rate assessments. However, as regulators failed to keep up with the increased willingness and ability of a large portion of the industry to add new types and levels of risks, the system became less effective. What other explanation can be given to a system where its primary fund lost money and had a declining reserve ratio last year, yet allows more than 9,500 institutions to continue paying zero premiums? George Hanc, Associate Director in the FDIC's Division of Research and Statistics, accurately summarized our current system: "Many observers doubt that existing differences in premiums accurately reflect differences in bank risk or provide a sufficient incentive to reduce moral hazard significantly" ("Deposit Insurance Reform: State of the Debate," *FDIC Banking Review*, 1999, Vol. 12, No. 3).
- C. The most logical improvement to the present system would appear to be the establishment of higher capital group *and/or* supervisory subgroup standards so that 92–94% of all thrifts and banks do not fall in just one of nine possible risk assessment buckets. George Hanc's above-cited article is clear in emphasizing that "...higher capital requirements are perhaps the strongest restraint on moral hazard because they force stockholders to put more of their own money at risk (or suffer earnings dilution from sales of shares to new stockholders) and provide a larger deductible for the insurer." The establishment of higher standards for "well" and "adequately" capitalized institutions not only makes the most sense from this perspective but also would probably be the easiest risk differentiation assessment technique to implement.
- D. The recommended improvement to the present system that is proposed here goes a step further by *also* imposing "special risk assessments," a third dimension to the present risk-based assessment scheme. Under this proposal the FDIC imposes special annual assessment premiums, which could be in the 3–10 basis points (bp) range, depending upon how a bank matches up to a "special risk" profile. This "real time" profile is constantly changing based upon examiner input from the field *and* market signals. Recently released public information that is material to bank analysts such as changes in top management; accounting problems; changes in business operations; serious customer service problems; etc. would likewise be included in the special risk profile. The more such factors, the higher the risk and special assessment, which could be increased or decreased during the year depending upon risk behavior. Everything that a private insurer would look at in pricing a Directors and Officers policy as well as those items that an analyst would evaluate in rating a bank, such as debt and equity information, would be considered in this special risk profile. FDIC examiners would spend as much time surfing the Web for market signal data on a targeted bank as they would spend inside it reviewing loan files, board minutes, and other records. Importantly, these proposed special risk

assessments would be published monthly, much like formal enforcement actions (which are not that dissimilar in their overall purpose).

- E. A special risk profile that might be appropriate today would include any bank with *rapid growth* in any key financial indicator such as deposits, assets, or off balance sheet items; such a bank might have a 3 bp annual special assessment under this proposed scheme. A significant concentration in a “targeted” risk profile activity (e.g., subprime lending) would also be the basis for a special assessment, which might be another 3 bp for the very rapidly growing bank in our example. ALL de novo banks and thrifts would be subject to a special risk assessment (e.g., 3 bp) for their first several years of operations, so there are no “free riders.” Thus, a very rapidly growing, de novo bank specializing in subprime lending might have a 9 bp special risk assessment, which could change during the year based on risk behavior. Even though management might consider their operation to be the “best bank” around, the additional public and regulatory scrutiny of their special assessment might reduce the FDIC’s loss exposure in the event of a failure. Too Big Too Fail (TBTF) banks likewise would be subject to a special risk assessment (see following section).
- F. Another example of an item that would be included in the special risk profile would be the rapid growth of secured liabilities, because secured creditors have priority over the FDIC at a failed bank. Treasury Assistant Secretary Greg Baer, in his February 16, 2000 House Banking Subcommittee hearing stated that “...premium rates or the premium assessment base should be changed to reflect more accurately the FDIC’s risk position by accounting for secured borrowings.” He cited an example where a bank could, without any change in its deposit insurance premiums, increase the FDIC’s risk exposure by replacing unsecured borrowing with FHLB advances or repurchase agreements.

## **2. Explicit recognition of the “Too Big To Fail” (TBTF) policy in the form of a special assessment for TBTF banks.**

There are at least four TBTF facts of life. *First*, TBTF has existed since 1984. *Second*, TBTF cannot be eliminated. *Third*, TBTF is an extremely valuable competitive advantage and benefit to the 25 or so banks in this exclusive club. *Fourth*, TBTF banks pay nothing for this privilege.

Realizing that nothing can be done about the first three facts, this recommendation would require a special risk assessment on the total assets (not deposits) of TBTF banks. The assessment, which might be in the 3-8 bp range, would itself be risk based so that a more traditional TBTF bank like Washington Mutual would pay much less than Citibank.

The assessment would be on assets rather than deposits, because the potential risk exposure of the insurance fund arguably is with the entire company not just its insured deposits. (This is consistent with the view of FED Chairman Greenspan that, in the final analysis, there are no firewalls.)

The Comptroller of the Currency suggested that the 11 largest banks in 1984, with roughly \$40 billion or more in assets in current dollars, were TBTF. There are approximately 25 bank and thrift companies with such an asset (not deposit) base. The 20 largest bank and thrift companies, each with at least \$50 billion in assets, represent approximately 50% of the industry's total assets.

As the FDIC's George Hanc mentioned in his discussion of TBTF banks in the aforementioned article in the *FDIC Banking Review*, "... the failure of only one of several currently existing megabanks could deplete or seriously weaken the deposit insurance fund, with potentially adverse consequences for the stability of financial markets."

With an explicit TBTF policy as recommended here, there would be the equivalent of an FDIC sticker on the lobby door, but this one would read "TBTF." And, for that privilege (and the additional risk they generate for the fund), these 25 or so banks will be paying a nominal annual special assessment that will benefit the entire insurance fund. These banks are already getting this TBTF benefit, but under this proposal they will be paying for it.

**3. Significantly expanded *market discipline*, beginning with the public disclosure of some essential safety and soundness information on banks and thrifts such as CAMELS ratings and a portion of the safety and soundness exam.**

While regulatory and supervisory discipline is extremely important (see below), bank management reacts more quickly and strongly to market discipline in the form of increased public disclosure of timely and relevant information.

One of the most popular market discipline proposals is the required periodic issuance of subordinated debt to ascertain the "market's" perception of the risk profile of an individual banking company. This approach assumes, however, that there exists adequate and timely *public* information about banks to enable the market to make an informed decision on the pricing of the debt.

Professor Edward Kane of Boston College recently evaluated various deposit insurance reforms proposals. He concluded that private-sector reforms cannot replace regulatory activities "until institutions are required to disclose more financial information to the public and regulators are forced to reveal problem institutions to the public sooner" (*American Banker*, May 27, 1997).

There are numerous bank rating companies such as IDC, Sheshunoff, Veribanc, and Bauer. Some of these rating services provide limited data at no charge over the Internet, and others charge steep fees for their services. All of these services use the most recent published quarterly call report data as their primary source of information.

Rather than requiring depositors, customers, investors, creditors, and other interested parties to seek out and possibly pay for what may be inconsistent and



inaccurate ratings from these different sources, there is a better approach. The preferred approach would be for the regulators to publicly disclose a bank's most recent safety and soundness (CAMELS) rating and a limited public portion of the bank's exam.

This recommendation would be similar to the approach the federal regulators adopted for CRA starting in January 1, 1990 when a rating and a public performance evaluation (PE) was made available for every examined bank. Despite opposition from bankers (and regulators), the disclosure of CRA ratings and PEs has been an unqualified success in terms of CRA performance; reduced regulatory burden (under the 1995 revised CRA); and, more consistent and well-trained examiners. The latter, whose work product and ratings are constantly under the scrutiny of the public, usually benefit from this experience. These disclosures should have a similarly beneficial impact in the safety and soundness arena.

Because these exam ratings can be up to a year and one-half old, an alternate and perhaps complementary approach would be the public disclosure by the FDIC of the capital group rating (3 possibilities) and supervisory subgroup rating (3 possibilities) for each bank and thrift. The FDIC three-by-three, assessment base distribution matrix has nine possible cells for deposit insurance assessment purposes. As of December 31, 1999, fully 93.7% of BIF banks and 91.6% of SAIF thrifts were in the well-capitalized, top (A) supervisory risk subgroup paying a zero premium. This recommended disclosure would represent perhaps the most powerful form of market discipline on the 6-8% of impacted banks and thrifts,

It can be argued that the disclosure of the FDIC's problem bank and thrift list would be too "stampedish" and possibly harm those institutions. The disclosure of the above-suggested ratings data, however, would be the next best option, as these data do not include conclusionary statements by the regulators on the problem status or likely solvency of a given bank or thrift.

The recommended increased ratings disclosure will allow for more accurate and timely valuations of banks and thrifts by interested parties and a more efficient allocation of banking resources. Other relevant internal data that could reasonably be disclosed, especially for TBTF and other large banks, would include information on the top 10 credit exposures, investments, and off-balance-sheet items; internal credit ratings; loan securitizations; problem and nonperforming loans; and, daily trading activities. The public disclosure of some or all of these data could be argued to be "material" for investors that should be released anyway.

**4. Significantly improved bank *regulatory and supervisory discipline* so there are better risk management procedures, earlier identification of problem banks, and a reduction in the cost of failed ones.**

While market discipline can be significantly enhanced with increased public disclosure of bank data by the regulators, the quality of bank regulatory and supervisory discipline can only be improved through changes by the regulators themselves.

The potential benefits to the deposit insurance system of an improved bank regulatory and supervisory function are tremendous in terms of improved risk management procedures, the earlier identification of problem banks, and a reduction in the cost of failed ones.

Recent hearings at the House Banking Committee on last year's bank and thrift failures indicated that regulators may not have properly regulated and/or supervised several of the failed banks. Bank supervisory lapses have also been cited in recent cases where a bank did not fail but suffered internal problems, such as the alleged money laundering scheme at the Bank of New York.

FED Chairman Greenspan has recently stated that a new regulatory approach is required with megabanks and their complicated and expanding business lines. The demands on regulators in this regard will only increase with the broadening of powers resulting from GLB. Regulators even have a new acronym for this phenomenon: LCBO meaning Large Complex Banking Organization. The proper public policy response should be Better Trained Bank Regulators.

The federal bank regulators are constantly trying to improve their work product, but there are still four different federal agencies, the most for any federally regulated industry.

The most important improvements in the bank regulatory arena would come from consolidated regulatory operations, such as the proposed OTS and OCC merger, which should result in a more efficient and effective work force. The problem, however, is that even if the OTS and OCC are able to execute a smooth merger, the FDIC and FED are still independent agencies.

The inconsistencies and differences in procedures in examining the largest banks was made clear in the January 2000 GAO study titled "Risk-Focused Bank Examinations". Upon reviewing the risk-focused bank exam procedures at three FED and four OCC banks, the GAO concluded that there were numerous differences in key areas such as the decentralized vs. centralized nature of the procedure, the use of resident examiners, etc.

I completed a similar study over a two-year period where I was part of a team who carefully reviewed the public portion and examiner CRA ratings on about 1,500 exams. This was the largest evaluation of bank exams ever undertaken (see The CRA Handbook, McGraw-Hill, New York, 1998).

Although the exams involved bank CRA compliance (not safety and soundness) matters, there was tremendous disparity in the quality of bank examiners and published work product. For example, examiners at some of the 31 regions of the four banking regulators were nearly ten times "tougher" compared to examiners in other regions. I should point out, however, that of the four regulators and their 31 regional offices, the FDIC's New York Region stood out by a wide margin as being the most realistic regulator in terms of noninflated CRA ratings and performance evaluations.

I learned that some regulators more than others were more likely to use tougher public enforcement actions such as C&D orders compared to informal and nonpublic actions. It was clear that the power of public disclosure in such enforcement actions was considerably more effective than traditional means of regulatory discipline.

Assuming the experience gained from these two regulatory studies is representative of other safety and soundness examiners throughout the country, there is a pressing need for greater education and training of the bank examination forces to result in a more consistent and effective work product.

#### **5. Merging of the OTS into the OCC as the first step towards a more effective and efficient federal financial institution regulatory structure.**

It is reasonable to assume that a merged industry with a (hopefully) merged insurance fund would likewise have a merged regulator. This recommended merging of the OTS into the OCC, which could begin with the OTS operating as an OCC division, makes sense for numerous reasons:

- A. The transitional approach of the OTS initially operating as an OCC division, before an outright merger of the two agencies, would enable mutual and state-chartered thrifts the ability to continue their operations in an equitable manner.
- B. The overall quality of the examining force at both the OCC and OTS will increase as a result of such a merger due to the synergistic impact of specialized professionals benefiting from working together. These advantages are most often seen in private sector megamergers, but such economies can also benefit governmental bodies, especially those that have very similar functions.
- C. Both the OTS and OCC are agencies of the Department of the Treasury (DOT), so there is already a common culture (and employer).
- D. There would be substantial cost savings to taxpayers from eliminating duplication and consolidating operations, conservatively estimated by DOT in August 1993 to be at \$12 million annually. Had that merger occurred then, there would have been some \$72 million in taxpayer savings by now.
- E. The OTS' five regional offices in Jersey City, Atlanta, Chicago, Dallas and San Francisco are virtually identical to the OCC's six regional offices in New York City, Atlanta, Chicago, Dallas, San Francisco and Kansas City. Thus, there would be considerable opportunity for office consolidation without the attendant employee relocation costs and family disruptions.

The merging of the OTS into the OCC can be viewed as a first step in a long-awaited consolidation of federal bank regulators. I have long proposed (see Community Reinvestment Performance, Probus Publishing, Chicago, 1993) that a logical first step in this regard would be a common compliance function among the

four federal regulators; this could be organized through the existing FFIEC working group set up for a similar purpose. This shared function would result in more consistent and efficient examinations and ultimately less regulatory burden and taxpayer costs.

The concept of one umbrella regulator at the federal level has been proposed for decades now by various presidential and other banking commissions. This proposal only would make sense, however, if the federal banking agency was totally independent of the Administration (unlike the OCC and OTS). If the FED can be an independent agency for monetary policy, such a consolidated federal banking agency can be one for regulation and supervision.

In addition to the reduced governmental expenses and possibly regulatory burden associated with one federal bank regulator, there is the added advantage that regulatory "competition in laxity" would cease to exist.

This phenomenon apparently reared its ugly head recently according to the *American Banker* ("Visit from Hawke Kept 'National' in Bank's Name," February 11, 2000). They reported that the \$7.1 billion National Bank of Commerce (the nation's 72nd largest) reversed its decision to switch to a state charter based upon the OCC's offer to include the bank in its large-bank supervision program (usually reserved for only the three dozen largest national banks).

The most extreme step in the bank regulatory consolidation process beyond the umbrella federal bank regulator would be for the elimination of the dual banking system which has existed since the formation of the OCC in 1863. Although this proposal receives little serious consideration at the present time, it was discussed somewhat during the S&L crisis because of the federal deposit insurance costs resulting from poor state chartering and supervisory decisions.

For example, since a disproportionate share of all S&L losses were due to state-chartered thrifts in California, Florida and Texas, is it fair that taxpayers in the remaining 47 states paid an equal share of the federal bailout? This is contrary to the basic management precept that **A = R** (or Authority = Responsibility).

If the federal government has ultimate responsibility for bailouts, why shouldn't it likewise have the ultimate authority over all banks? State deposit insurance systems are a thing of the past, and all that is really left is the federal deposit insurance system.

The closest any recent deposit insurance reform proposal has come to this A=R recommendation is the concept of the FDIC issuing capital notes to the public as described in the previously cited survey article. As George Hanc states, under such a proposal, "It would also be appropriate to give the FDIC increased supervisory authority over national and state member banks so that it could better control its risk exposure and could avoid principal/agent problems with other federal regulators."

## II. MAINTAINING THE FUNDS

### 1. Merging of the BIF and SAIF insurance funds.

While many if not all of the other recommendations presented here will generate debate, and most likely opposition from the bank and thrift industries, it is hard to imagine any basis for opposition to the merger of the BIF and SAIF funds. Congresswoman Roukema introduced legislation in this regard on March 13, 2000. The arguments and broad support for this proposal are overwhelming:

- A. A merged fund would eliminate any potential confusion among bank depositors as to “which fund is stronger,” especially during periods when such a distinction may be made between banks and thrifts. On a more practical basis it would eliminate the problem of an unjustified premium disparity.
- B. There is less and less differentiation between banks and thrifts as the strong thrifts have become banks and the weak thrifts have become history. In fact, according to the OTS, national banks hold 22% of SAIF–insured deposits, state–chartered banks hold 16%, and FDIC–supervised state savings banks hold 8%; conversely, approximately 15% of BIF–insured deposits are held by thrifts (*American Banker*, February 7, 2000, p. 4). It makes sense that an increasingly merged industry would be covered by a merged insurance fund.
- C. From an actuarial perspective, a larger more diversified fund would be much stronger in terms of protecting depositors, as the potential risk exposure from the largest insured would be reduced. This is demonstrated by the fact that Bank of America’s approximately 9% share of BIF–insured deposits would drop to 6% for a merged fund, while Washington Mutual’s roughly 9% share of SAIF–insured deposits would fall to 2% (*American Banker*, February 7, 2000, p. 4).
- D. A larger and more diversified merged fund would also be stronger in terms of the potential risk exposure from troubled banks and thrifts. According to *The FDIC Quarterly Profile* (Fourth Quarter 1999), the 66 problem banks as of December 31, 1999 had \$4.5 billion in assets (comparable insured deposit data are not available) representing 15% of BIF’s \$29.6 billion in balances. However, just 13 problem thrifts with even more assets (\$5.5 billion) accounted for 54% of SAIF’s \$10.3 balances. (With only 11 such thrifts at \$4.0 billion as of September 30, this suggests the possible addition of a \$1.5 billion problem thrift during that quarter.) Even though data unavailability precludes a more relevant apples–to–apples calculation of insured deposits of problem banks and thrifts to BIF/SAIF balances, the combined 79 problem banks and thrifts would represent a more palatable 25% of a merged fund’s \$39.9 billion in balances.
- E. Unlike 1995 when the BIF fund was roughly three times as well capitalized as the SAIF fund, they are approximately equal with the SAIF reserve ratio of 1.45% actually exceeding the BIF reserve ratio of 1.37%. This approximate parity of reserve ratios as of December 31, 1999 eliminates any of the controversial issues that existed in 1995 regarding thrifts’ payment of a special assessment to

enter a merged fund or banks' increased exposure with a merged fund assuming FICO obligations.

- F. Key regulators (e.g., FDIC Chairman Tanoue and OTS Director Seidman), Congressional leaders (e.g., Senator Gramm and Congresswoman Roukema) and even bank trade associations (e.g., the ABA) have expressed support for this concept, although the ABA position requires the OTS to be merged into the OCC (a good idea) but the combined fund would be capped with excess reserves being rebated (both bad ideas).
- G. Academics and economists who have studied this issue generally support a merged fund. The most relevant studies have been done at the regulatory agencies themselves. Robert Oshinsky, Financial Economist at the FDIC, concluded in a recent study ("Merging the BIF and the SAIF: Would a Merger Improve the Funds' Viability?") that "...a merger of the funds would substantially decrease the probability of a failure of at least one deposit insurance fund. In addition, it would provide benefits to both the BIF and SAIF." An OCC working paper ("Two Deposit Insurance Funds: In the Public Interest?") jointly prepared in February 1997 by an OCC economist and an FDIC economist likewise concluded that "Combining the deposit insurance funds may result in a lower probability of fund insolvency from unanticipated economic shocks than keeping the funds separate."

## **2. Increasing the 1.25% statutory designated reserve ratio (DRR) to 1.50%.**

There is probably not one bank or thrift executive who would be expected to agree with this recommendation (or the subsequent ones), as higher reserve ratios and premiums would cost them money. Any regulator adopting this 1.50% DRR recommendation would immediately incur the wrath of the industry. The FDIC, for example, would have to argue that there's a "significant risk of substantial future losses" to justify a 1.50% DRR instead of the inadequate 1.25% one.

My March 17, 1995 testimony before the FDIC's Board of Directors and my March 24, 1995 Congressional testimony presented a strong case for an increase in the DRR to 1.50%. Changes in bank competition and regulatory structure, among other things, have significantly increased the insurance fund risk exposure since that time, thereby making the case for a 1.50% DRR stronger than ever:

- A. Megamergers during the last decade have significantly increased the insurance fund risk exposure. Robert Oshinsky, Financial Economist at the FDIC, recently completed a working paper titled "Effects of Bank Consolidation on the Bank Insurance Fund." He found that "...based on historical loss and failure rates, the consolidation that took place between 1990 and 1997 increased the risk of BIF insolvency by approximately 50%, and that megamergers that took place or were announced during the 18 months between year-end 1997 and midyear 1999 increased the risk of insolvency further." If a 1.50% DRR made sense in 1995, it certainly makes even more sense now.

- B. In addition to general megamerger trends, the increased concentration of assets in the hands of a small number of giant banks has further increased the insurance fund risk exposure. According to that same FDIC study, "... the health of the BIF has become more and more dependent on the health of the top 25 banking organizations, and future insolvency may be deeper, and harder to emerge from, than in the past." An *American Banker* story ("FDIC: Big Mergers Change Fund's Risk Calculation," September 8, 1999) about that FDIC study noted that 54.5% of industry assets at midyear 1999 were held by the 25 largest bank holding companies, compared to just 31.8% as of yearend 1990. Again, a 1.50% DRR would provide more protection to bank depositors than the current 1.25% under this environment.
- C. "The little [bank failures] are never going to break you," said Roger Watson, FDIC research director. "It's the low-probability, large-institution failures" that pose the greatest risks to the insurance fund and the taxpayer according to his comments in the above-cited *American Banker* story. He also noted that there is a 12.5% or one in eight chance that BIF would be rendered insolvent if one of the top 10 banks fail. FED Chairman Greenspan recently stated that megabanks "create the potential for unusually large systemic risks in the national and international economy should they fail" (*New York Times*, October 12, 1999). According to the FDIC, just six banks (Bank of America, BankOne, First Union, Wells Fargo, Chase and Fleet/BankBoston) and Washington Mutual comprise 26.2% of domestic deposits. Another FDIC report shows that just 20 banking organizations comprise the top 50% of the industry's total assets. Such tremendous concentration of resources in the hands of a small number of banks suggests the prudence of increasing the DRR to 1.50%.
- D. The TBTF implicit guarantee now covers more banking companies than ever before, again suggesting the advisability of an increased DRR. The combined funds have \$39.7 billion in balances and a combined reserve ratio of 1.39%. There are, however, nearly 20 bank and thrift companies with deposits at or above the approximately \$40 billion level. The TBTF coverage likely extends beyond this group.
- E. Expanded investment, insurance, and other powers under GLB for companies with insured bank deposits will increase the risk exposure of the insurance funds even more than was the case in 1995. Instead of just commercial banking risks, we must now consider risks in the investment banking and insurance fields. Regardless of claimed firewalls and other precautions, a solvency problem at a nonbank affiliate may find its way to the insured bank, thus increasing the funds' risk exposure. Any such increased risk exposure will be better managed with an increased DRR, such as the recommended 1.50% one.
- F. Recent bank failures have been blamed on new types of financial risks that were not common in 1995, thus suggesting an even stronger case now for a 1.50% DRR than was the case then. For example, we learned from a House Bank Committee hearing on February 8, 2000 that participation in subprime lending, asset securitizations, and fraud has been a factor in a disproportionate number of

recent bank failures. (These would represent components of the previously recommended special risk profile.)

- G. The recent and projected growth in insured deposits at existing and new types of financial depositories (e.g., Internet banks) likewise argue for an increase in the DRR. For example, Merrill Lynch recently announced that it will be offering federally insured interest-bearing accounts such as CDs tied to its brokerage accounts. Based on Merrill's projection that it could draw as much as \$100 billion into its CDs compared with "several billion" currently, the FDIC estimated that the BIF reserve ratio would fall from 1.38% to 1.32%, compared to a softened impact on a merged fund going from 1.40% to 1.35%. This and other likely Wall Street innovations further support the need for a 1.50% DRR and a merged fund ASAP. As will be noted in a subsequent historical discussion, Wall Street's continued interest in profiting from FDIC coverage dates back to the deposit brokers (including Merrill Lynch) that were put in business by the 1980 increase in the FDIC insurance limit to \$100,000.
- H. The 1.25% DRR is inadequate as demonstrated by the fact that the FDIC fund was at a 1.24% level in 1981, prior to its dwindling to a negative number in 1991 and 1992. Had the DRR been 1.50% in 1981 (see final argument below why it *could* have been), it is likely that the FDIC would not have had to publicly announce the insolvency of its fund during that period. Besides the obvious embarrassment to the FDIC, such an announcement reduced confidence in the banking system at the worst possible time.
- I. There is another "125" number unfortunately related to the magic 1.25% ratio. This was appropriately recalled by Treasury Assistant Secretary Greg Baer in his February 16, 2000 testimony citing the inadequacy of the 1.25% DRR: "First, it is worth remembering that the thrift crisis – and in particular, the inability of deposit insurance reserves to cover losses from thrift failures – cost the taxpayers of this country over \$125 billion."
- J. An increased DRR such as 1.50% provides bank depositors with greater confidence during periods of financial stress and turmoil. We had the S&L, junk bond and BCCI scandals in the 80s and the Orange County, Mexico, Barings PLC, and Long Term Capital Management collapses in the 90s. There will likely be more financial disasters this decade, and it would be more reassuring to depositors seeking a safe haven that their insurance fund had a higher DRR.
- K. Financial problems and costly bank failures can occur even in the best of times as we saw last year with the First National Bank of Keystone, the most expensive and spectacular failure in 1999. As a result of \$810 million of insurance losses, the most since 1992, this was the first year-to-year decline (\$12 million) in the BIF fund balance since the 1991 banking crisis. With this type of environment it makes infinitely more sense to talk about *increasing* the DRR than giving rebates to free-riding banks. Significantly, the BIF reserve ratio has *decreased for four consecutive quarters in 1999* from 1.41% on March 31; to 1.40% on June 30; to 1.38% on September 30; and, to 1.37% on December 31, 1999. Had the DRR been at the recommended 1.50% level in 1995, the FDIC, with the additional



investment income from a larger fund, would not be in this embarrassing situation of having to admit BIF is losing money for the first time since our last recession.

- L. Assets of *failed* banks and thrifts have not exceeded \$1 billion since 1994. This streak ended last year. Realizing the unforeseen risks in the new millenium, FDIC Chairman Tanoue testified before the House Banking Committee on February 8, 2000 that the FDIC now projects a range of failed bank and thrift assets of \$0.7–3.6 over the next two years. Using the midpoint of \$2.2 billion, this means that the FDIC is projecting failed bank and thrift assets of at least \$1 billion for each of the next two years. Considering the proven insufficiency of the 1.25% DRR regarding the likely BIF loss in 1999 when failed assets exceeded \$1 billion, it would be prudent to increase the DRR to 1.50% so this embarrassment is not repeated in 2000 or 2001. This is especially the case in light of relatively recent legislative cost containment changes such as prompt corrective action, conservatorship at 2% capital, least-cost resolution, and national depositor preference.
- M. A 1998 FDIC working paper (“Capitalization of the Bank Insurance Fund”) by Financial Economist Kevin Sheehan used a two-state Markov-switching model to predict the impact of different required reserve ratios, ranging upward to 1.50%, on BIF solvency and fund balances. He concluded that “...increasing the required reserve ratio while maintaining the current assessment rate would substantially reduce the likelihood of small fund balances.” Using data from 1972–1996, he estimated that with current assessment rates of 23 basis points, the probability that BIF would become insolvent would be only 0.9% with a 1.50% required reserve ratio compared to 3.2% for a 1.25% one. Thus, the probability of the FDIC facing the ultimate embarrassment of an insolvent fund (as was the case in 1991 and 1992) is reduced by more than three and one half times with a 1.50% rather than 1.25% required reserve ratio. This added cushion of 25 basis points in the DRR leverages itself to a substantial amount of added depositor protection and confidence in the system.
- N. A better capitalized fund with a DRR of 1.50% rather than 1.25%, representing more rather than less bank equity, should promote sounder banking practices, because it is the banks’ money that will be tapped first before the taxpayers are asked to support the fund.
- O. A 1.50% DRR is not an unrealistic number for many reasons. *First*, it is just 11 basis point above the 1.39% level of the combined funds as of December 31, 1999, even though that ratio actually declined throughout 1999. *Second*, the FDIC fund ended December 31, 1934, the first full year of the FDIC’s existence at a 1.61% reserve ratio, a fact that should not be ignored in terms of the original intent of the FDIC. *Third*, the FDIC’s reserve ratio was at or above 1.50% for 10 year-end periods since 1934, the highest being 1.96% in 1941 and the most recent being 1.50% in 1963 (near the beginning of our previous post-war record expansion).

- P. According to cited FDIC methodology and data, the 1.25% DRR cannot be verified. The “correct” DRR apparently should have been at least 1.30% and as much as 1.45% (or perhaps even 1.5%) after rounding. Confidence for the Future: An FDIC Symposium (FDIC, January 29, 1998, p. 103), notes that the 1.25% target, first referenced in the Depository Institution Deregulation and Monetary Control Act of 1980 (DIDMCA), “was selected because 1.25 represented the approximate historical average reserve ratio for the FDIC fund prior to 1980.” (There was some historic precedent for this methodology, as the FDIC used the average loss experience of banks over the 1865–1934 period to establish its initial premiums.)

The DIDMCA referenced a broad 1.10–1.40% range for FDIC adjustments of the reserve ratio about the 1.25% midpoint. The 1.25% DRR, with a 1.50% ceiling, was specifically referenced in the 1989 Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA). Using year–end FDIC reserve ratios over the 1934–79 period, I calculated that the *average* was NOT 1.25% but 1.425%. Also, the *median* reserve ratio, a more relevant statistical measure of central tendency, for that period was precisely the same 1.425%. Thus, if the FDIC’s description of how this bedrock 1.25% ratio was calculated is correct, it appears from these revised calculations that someone may have ignored the “4” and read 1.425% as 1.25%. If this bizarre account of FDIC history is in fact true, the “correct” 1.425% DRR would have been rounded up to 1.45% or perhaps even 1.5%, and there would be no need for this current debate!

The only way to get anything close to 1.25% for this 46–year period is to calculate a “weighted” average, which disproportionately weights the inflationary 70s. This results in a 1.29% weighted average over the 1934–79 period, which should have been rounded up to 1.30% (the weighted average for the 36 years preceding the 70s was 1.42%). Regardless of how the math is done, the 1.25% “magic” ratio cannot be verified, and the only numbers that can be verified are in the 1.3–1.5% range.

### **3. NO cap on the size of the merged fund.**

The previous recommendation documented why a 1.50% DRR should be the floor rather than the ceiling for the deposit fund. In fact, an equally important recommendation, which follows from the above–listed principles underlying the bank depositors’ view, is that there should be NO cap on the size of the merged fund. Chief among the reasons for this recommendation are the following:

- A. Any private sector insuring organization would stockpile reserves collected during the good times in anticipation of the bad ones. The insurance fund should be no different and allow its reserve balances to continually grow without any designated cap. Depositors would obviously have much more confidence in an insurance fund with such a conservative policy.
- B. The idea of a “capless” insurance fund is not that dissimilar from a proposal advanced in 1998 by Ron Feldman, a senior financial analyst at the Minneapolis Fed. He proposed that “Banks should have to pay for deposit insurance no

matter how large reserves held by the government,” according to the *American Banker* (“Minneapolis Fed Researcher: Abolish Bank Insurance Fund,” October 22, 1998). He would actually abolish the insurance fund and forward mandatory insurance premiums to the Treasury. The FDIC would tap a Treasury line of credit for any needed funds, and there would be no concern over whether or not the DRR was appropriate as there would be no fund. This approach, while clearly an unconventional one, properly identifies the Treasury and the taxpayer as the ultimate insurer of last resort for the banking system. Importantly, there would be no cap under this proposal, as all banks would pay deposit insurance premiums.

- C. A “capless” insurance fund allows the reserve balances to grow to much more significant levels, thus reducing the likelihood that the DRR will be breached. Once that happens, the banking system effectively transforms to a “pay as you go” procedure, with collected (and usually increasing) assessments being used to replenish the fund. However, with depressed earnings in a slowed economy, assessments may not be sufficient for recapitalization. For example, 1987 bank earnings of \$2.8 billion just exceeded failure losses of \$2 billion but were well below 1988 losses of \$6.7 billion. A capless fund with a much larger cushion protecting the DRR would lead to increased confidence in the system by insured depositors.
- D. Perhaps the most important view in this respect is that of the Treasury, which ultimately backstops the insurance funds. According to Treasury Assistant Secretary Greg Baer, in his February 16, 2000 House Banking Subcommittee hearing, “We oppose a structure that caps the insurance fund and mandates rebates of any “excess” reserves above that cap” (see below).

#### **4. NO Rebates should be paid.**

The recommended deposit insurance system with a 1.50% DRR and no cap on the size to which the fund could grow would NOT allow rebates for the following reasons:

- A. A capless system without rebates would obviously result in a larger and stronger fund, thereby instilling even greater depositor confidence. Treasury Assistant Secretary Greg Baer, in his February 16, 2000 House Banking Subcommittee hearing, expressed one of many reasons why the Administration believes rebates should NOT be paid: “Thus, we believe that allowing the insurance funds to continue building up reserves through interest income during good economic times is good policy.”
- B. Insurance can generally be defined as the substitution of a small certain loss in the form of a premium for a large uncertain loss. As long as banks and thrifts benefit from the large uncertain loss of depositor insurance, they should pay for this privilege with continued assessments and no rebates. According to the above-cited Treasury Assistant Secretary, “Under its current authority, therefore, the FDIC pays no refunds since healthy institutions pay no premiums.” He went on to state one of the reasons why Treasury opposes any cap or rebates: “First,

we do not find sufficient evidence for concluding that any insurance fund net worth above 1.5 percent represents 'excess' capital that should be returned to insured institutions rather than retained by the insurer."

- C. Rebates, which would only exacerbate the current "free ride" deposit insurance assessment situation for over 90% of the industry, would be a form of *negative* premiums where a bank effectively is being paid by the FDIC to take risks! This is not only contrary to the most basic insurance principles, but it is just not the way anyone would or should run a private or public organization.
- D. The idea that insurance premiums should be inventoried as reserves for future losses rather than being returned to banks in the form of rebates is consistent with the logic of many conservative bankers. For example, many such bankers retain their earnings to strengthen capital (i.e., reserves) rather than paying earnings out to stockholders in the form of dividends. Many conservative bankers with good dividend payout ratios have substantial capital cushions. It may be apples to oranges to compare the minimum required capital ratio at an individual bank to the required reserve ratio for the entire system; nonetheless, it is of interest to note that a capital ratio of 2% results in conservatorship, but a DRR of well below that amount is considered satisfactory.
- E. Rebates would make a bad "moral hazard" problem even worse. With over 90% of the industry and all new institutions paying no insurance premiums, the *marginal* cost of adding an extra dollar of insured deposits is zero. The only thing worse than this would be to make this cost negative through authorizing rebates. As the above-cited Treasury Assistant Secretary stated: "...rebates would exacerbate what is already a poor set of incentives around deposit insurance."

### III. COVERAGE

#### 1. NO increase in the \$100,000 deposit insurance limit.

- A. Considering the present environment's increased level of risk exposure for the deposit insurance funds, good public policy dictates consideration of proposals that *reduce not increase* risk exposure. Any increase in the deposits covered by the FDIC will increase risk exposure to the funds. For example, the proposal to provide full insurance coverage on all municipal deposits (over \$42 billion at commercial banks alone as of September 30, 1999 according to the ICBA) should be rejected, as it will unnecessarily increase moral hazard and risk exposure to the funds. This is also true for the proposed doubling of the \$100,000 insurance limit, which is the subject of the remainder of this section.
- B. The previously cited 1999 FDIC article by George Hanc summarizes four general categories of deposit insurance proposals, the first being to "increase depositors' risk exposure." One such proposal is to *reduce* insurance limits. Other such proposals include coinsurance for insured depositors; mandatory loss for insured depositors; and restriction of coverage to particular types of depositors. There is no mention in this article of any proposal to *increase* deposit insurance limits,

because the purpose of those and other reform proposals is to “induce depositors to increase their monitoring of bank risk and, by means of their deposit and withdrawal activity, discipline and restrain risky banks.” The proposal to double the current \$100,000 limit would encourage the opposite type behavior. It would, therefore, not be good public policy.

- C. The proposed doubling of the \$100,000 limit will be condemning us to repeat a mistake we made 20 years ago and vowed never to make again. Shortly after the former FDIC Chairman Helfer was confirmed, she directed her staff to complete a comprehensive study of the banking crises of the eighties and early nineties. The result was titled *History of the Eighties: Lessons for the Future*, which was completed in December 1997. According to the Foreword by then Chairman Hove, “At the very least, the history of the turbulent time in banking should teach us that we cannot afford to be complacent, and the FDIC hopes this study that glances backward will be helpful as we look forward.” The following are excerpts from Volume I, *An Examination of the Banking Crises of the 1980s and Early 1990s* (p. 93) about the increase in the insurance limit from \$40,000 to \$100,000 as part of the 1980 DIDMCA:
1. “In the Senate, the first proposal was to increase the limit to \$50,000, as an adjustment for inflation.” (Had that been done in 1980, it would be equivalent to less than \$100,000 today after adjusting for inflation, and there would be no need to discuss raising the current limit.)
  2. “But, there was clear sentiment in Congress for a greater increase that would help draw deposits into the thrifts. It has been argued that the S&Ls were the driving force behind the increase in insurance, and after the provision passed, the U.S. League of Savings Associations did state that it was ‘particularly helpful.’”
  3. “The lower [\$50,000 proposed Senate] figure remained in the bill, however, until it was replaced by the \$100,000 limit at a late-night House-Senate conference. The decision, scarcely remarked at the time, would come to be viewed by many as having weighty consequences” relative to the S&L crisis and the brokered deposits issue.
  4. “The Federal Reserve supported the proposed increase to \$50,000, but was ‘inclined to favor an increase to \$100,000.’”
  5. Then FDIC Chairman Sprague “noted in testimony before Congress that an accurate adjustment for inflation would mean an insurance level of approximately \$60,000, but he said nothing about a higher increase.”
  6. “Testifying before Congress four years later, [then FDIC] Chairman Isaac noted that he believed Congress had passed the \$100,000 limit over the objections of the FDIC.”

7. Then House Banking Committee Chairman St. Germain replied to Chairman Isaac “that he had agreed with the FDIC at the time but that ‘it was one of the things we had to compromise on...I thought it was a mistake.’”
- D. The FDIC examination of the S&L crisis clearly notes that one of the “Lessons for the Future” is that an unjustified increase in the insurance limit can be a mistake with tremendous consequences. Actually, that official FDIC description of how the unwarranted and unwanted (by the FDIC) increase to \$100,000 in 1980 was pulled off by the S&L lobby was most restrained compared to other accounts. These and other accounts suggest that the proposed doubling of the insurance limit to \$200,000 would be a repeat of a past mistake.
- E. Former FDIC and RTC Chairman Seidman, in his book titled Full Faith and Credit: The Great S&L Debacle and Other Washington Sagas (Random House, New York, 1993), wrote the following (pp. 178–79) about the 1980 increase in the insurance limit to \$100,000:
1. “This in effect made the government a full partner in a nationwide casino, first speculating mainly in real estate, later in extremely volatile mortgage securities, junk bonds, futures and options, and similar Wall Street exotica.”
  2. “It gave the S&Ls practically unlimited access to funds through a \$100,000 ‘credit card’ issued by Uncle Sam.”
  3. “This was the exact opposite of the original intent of deposit insurance, which was to protect small savers.”
  4. “The thanks for this unfortunate piece of legislation goes principally, but not entirely, to [Banking Committee Chairmen Reuss and Proxmire] at the behest, it is said, of Senator Cranston and the S&L industry’s lobbyists ... at a late-night conference committee meeting.”
- F. The most descriptive account of the 1980 increase in the insurance limit to \$100,000 was reported (pp. 24–25) in Inside Job: The Looting of America’s Savings & Loans (McGraw–Hill, New York, 1989) by Pizzo, Fricker and Muolo:
1. “Regulators later said this may have been the most costly mistake made in deregulating the thrift industry.”
  2. “While legislators were hammering out the details of the [DIDMCA] in a late-night session on Capitol Hill, Glen Troop, chief Washington lobbyist for the powerful U.S. League of Savings Institutions, and an associate convinced members of Congress to make the increase.”
  3. “‘It was almost an afterthought,’ a House staffer later told a reporter.”
  4. “Thrift lobbyists were said to have more influence over their regulators than any other regulated industry, and the U.S. League had traditionally participated in regulatory and legislative decisions, even going so far as to

write some of the regulations. Bankers complained that they did not get treated as generously by Congress as did savings and loans because their lobbyists were not as powerful.”

- G. Let us assume that \$100,000 coverage in 1980 approximates \$200,000 in current dollars. The argument that the current deposit insurance limit should be doubled for this reason does not follow. This is because it assumes that the \$100,000 number was the “correct” one in 1980. The above historical description has shown us that the 1980 DIDMCA increase was a primarily an accomodation to the powerful thrift lobby. History also teaches us that the 1980 increase in deposit insurance coverage allowed thrifts to grow much more quickly than would otherwise have been the case, thus adding a significant cost to taxpayers for the S&L bailout. Like the 1982 law permitting S&Ls to buy junk bonds, the 150% increase in the FDIC coverage limit in 1980 was one of many and perhaps the worst deregulation mistake. To adjust a 1980 number for inflation when, in fact, it was the “wrong” number to begin with, merely rubs salt in a still open S&L bailout wound. Had there been no such deregulation change in the limit in 1980 or perhaps even an increase to the then “correct” level of \$50,000 (or even \$60,000), the current value would be about \$100,000, where we are today. Thus, there is no need for any change in the current limit.
- H. This latter argument is very compelling and bears repeating. Important evidence that the increase to \$100,000 in 1980 was a “mistake” is provided by the previously cited 1999 FDIC article by George Hanc. He notes that “Before passage of the 1980 legislation that provided for a \$100,000 limit, the FDIC testified that an accurate adjustment for inflation would raise the limit to only approximately \$60,000.” This is a reference to former FDIC Chairman Sprague. Had that number been adopted in 1980, it would be equivalent to about \$100,000 today according to this same source. This is precisely where we are and where we should remain. Period.
- I. The aforementioned deposit insurance reform proposals (see Hanc) of *reducing* deposit insurance coverage were seriously considered (but not acted upon) in the early 1990s. With the S&L bailout bills beginning to mount, everyone began to realize the extent of the problems associated with the deregulation limit increase in 1980, especially with brokered deposits. There was even a proposal for a \$100,000 maximum coverage *per social security number*. Considering the previously cited significant increases in risk exposure to the FDIC from megamergers, expanded business lines, increased sources of risk at recently failed banks, etc., a case could be made now that we should be debating a *decrease* not an increase in coverage. To the contrary, a credible case cannot be made for any increase in coverage.
- J. Most of the 68 countries with explicit deposit insurance systems identified by the IMF have insurance limits below \$100,000 based on 1998 exchange rates, according to the previously cited 1999 FDIC article by George Hanc. Depositors in those countries would certainly welcome any deposit insurance limit increase here, especially considering the significant recent growth in deposits at foreign offices of our banks. Even though these deposits are technically uninsured, most

foreign depositors are well aware of the implicit TBTF guarantee at giant American banks.

- K. As former FDIC and RTC Chairman Seidman documents, the original intent of deposit insurance, which began with a \$2,500 insurance limit, was to protect “small savers.” The primary beneficiaries of the 1980 increase to \$100,000 were Wall Street firms and deposit brokers. The currently proposed increase to \$200,000 has nothing to do with small or even mid-sized savers. Besides Wall Street and other money brokers, the only beneficiaries would be very wealthy and high net worth depositors, a far cry from the small savers originally envisioned by the FDIC. In fact, the FED’s 1998 Survey of Consumer Finance (*Federal Reserve Bulletin*, January 2000) reports that the median transaction account balance for all families then was \$3,100 and as high as \$19,000 for the richest families with income of \$100,000 or more. The comparable numbers for CDs were \$15,000 and \$22,000, respectively. The median transaction and CD account balances for seniors aged 75 years or more (regardless of income) were \$6,100 and \$30,000, respectively. Thus, the current \$100,000 limit is more than adequate for most Americans.
- L. The first FDIC *temporary* deposit ceiling was raised from \$2,500 to \$5,000 in 1934 according to that year’s *Annual Report*. Hanc’s previously cited article calculates that the 1998 value of that \$5,000 ceiling was only \$59,000. (The FDIC’s first *permanent* ceiling of \$10,000 has a current value of approximately twice that amount.)
- M. Deposit insurance was created in the aftermath of the Great Depression and a total loss of confidence our banking system. The unprecedented jump in the insurance limit to \$100,000 in 1980 occurred at a time of increasing concern in our system, with the onset of the S&L and serious economic problems. Today, as we are enjoying the record post-war economic expansion, there are no such concerns over our financial institutions, “full faith and credit,” or our economy. There simply is no compelling reason now for any increase in deposit insurance limits.
- N. There is absolutely no public outcry over or even widespread interest in the proposal to double the FDIC insurance limit. Everyone knows that any couple can get multiple account coverage, and singles need only open another account at a competing bank via a personal visit, a telephone call or even the Internet. There is no shortage of \$100,000 insured deposit investment opportunities. Some seniors may have a preference to keep their jumbo CDs spread out among several banks in \$100,000 or less amounts, *even if they have the opportunity to keep \$200,000 at one bank*. One senior, for example, specifically stated to me her preference for rolling over her two \$100,000, six-month CDs every other quarter (i.e., the first begins in January and the second begins in March), so she always has the opportunity to get her money every three months; this type of liquidity would not be there if she tied up all \$200,000 for six months.
- O. With over 90% of banks and thrifts getting deposit insurance without paying premiums, the idea of doubling coverage without any cost is reminiscent of ATM



fee “double dipping.” In addition to asking for a capped fund with rebates and taking advantage of effectively free insurance coverage, there is now this interest in doubling up on it.

- P. Obviously there will be considerable support for this proposal from within the industry, so it is up to the FDIC, Congress, and, of course, the Treasury to reject this proposal, which unjustifiably increases the risk exposure for the insurance funds. No one stood up to the powerful thrift lobby in 1980 when the \$40,000 limit was unjustifiably increased to \$100,000; we are still paying the consequences for that mistake in this new millenium. As Treasury Assistant Secretary Baer soberly reminded Congress in his February 16, 2000 testimony: “Although the banking industry is justifiably unhappy at the \$793 million per year in FICO interest payments that it and the thrift industry make to refinance the S&L cleanup, taxpayers currently make \$2.3 billion in annual interest payments on REFCorp bonds and billions more on Treasury bonds issued for the same purpose.”

## **2. Significantly improved disclosure of non–FDIC insured bank products.**

GLB should mean a more competitive array of banking, securities and insurance products more conveniently available to a broader segment of our economy.

Besides the potential increase in risk exposure to the deposit insurance fund from the nonbank activities, there is also the possibility that some of the public may be confused by them in terms of their FDIC coverage. This may result in even greater risk exposure to the fund if bank customers buy non-FDIC insured bank products under the assumption that they were insured.

A case in point that really struck home happened a few months ago when my mother-in-law called me about an unbelievable 10% CD for 24 months at a local bank. Before calling to have the funds transferred she called me to tell me about this great deal, as she knows I regularly follow local CD rates. When I saw the advertisement for the 10% CD I was likewise shocked by this great rate, even if for two years, until I read the very small print to discover that this was an UNINSURED investment note.

Even after I told her about the small print she still could not read it, until she got her magnifying glass to confirm what I said. "How can they do this" she angrily stated. Within 24 hours I got the almost identical call from my mother, but she was able to read the fine print by just taking off her glasses.

How small was this print? The "10%" was in a gigantic 2.75" typeface, dominating the ad, which appeared in the business section. The bank's name, which connotes federal insurance, was much smaller at only 5/16", compared to the miniscule "not insured by the FDIC" at only 1/16". Thus, the eye-catching "10%" was roughly 44 times the size of the FDIC disclaimer!

With the rapidly increasing proportion of senior citizens in states like Florida, special care should be taken to fully disclose the FDIC disclaimer, at least in the same typeface as the word "bank," which implies FDIC-insured to most seniors. Otherwise, there is the potential for increased risk exposure to the deposit insurance fund, as duped seniors may legitimately think they are buying FDIC insured products.