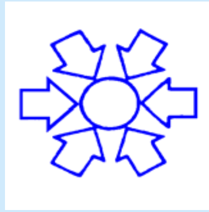

Financial Services Management

Deposit Insurance Reform

CFO	Government Relations Action Item

Cite

S. 1932

Deficit Reduction Act of 2005

H.R. 4636

Federal Deposit Insurance Reform Conforming Amendments Act of 2005

Recommended Distribution

CFO, Asset/Liability Management, Treasury, Corporate Planning, Legal, Government Relations

Document Website

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Overview

Senate and House leaders have reached a compromise on deposit insurance legislation that would combine the Bank Insurance Fund (BIF) and Savings Association Insurance Fund (SAIF) and revise the allowable range for the designated reserve ratio (DRR) to between 1.15% and 1.50% of total insured deposits. Insurance coverage for general and municipal accounts could be indexed for inflation, and coverage for retirement accounts would be raised substantially.

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Impact

After years of failure, proponents of deposit insurance reform were able to broker a compromise on legislation between Senate and House leaders late last year. However, the celebration was short-lived, as the legislation's passage was delayed because of procedural issues related to the larger budget reconciliation bill in which some of the deposit insurance reform provisions were included. Further, Senate rules forced some of the larger package into a stand-alone bill that must now pass on its own. This analysis assesses the provisions contained in both bills.

Although the deposit insurance legislative package would increase coverage for retirement accounts, it would not do so for municipal deposits and general accounts, instead allowing the FDIC to index them for inflation. Senate Banking Committee Chairman Shelby (AL) and the Administration have been reluctant to raise coverage in the past, but can apparently live with indexing over outright coverage increases. However, as noted above, the indexing would be done at the discretion of the FDIC, potentially delaying any increases in coverage for the foreseeable future. Advocates of coverage increases believe it essential to preserving small-bank competitiveness; opponents fear it would increase "moral hazard" and, thus, the ultimate risk to the FDIC.

The compromise legislation also includes language desired by the House requiring the FDIC to implement a restoration plan to address low fund levels, thus potentially limiting long-term low levels at the FDIC that might force a taxpayer rescue akin to that of the early 1990s. However, it does not address lifeline accounts, which had been a key provision for House Democrats who wanted to force expanded services to the "unbanked."

The legislation keeps provisions contained in the original Senate bill[1] requiring a lower DRR during troubled periods. This could potentially increase risk to the DIF (the newly combined BIF/SAIF fund) over time, but should ease concerns for institutions worried about paying larger premiums at the same time earnings are under stress. Likewise, large bank worries that coverage increases will drop the DRR and thus require sharp premium increases should also be mitigated by the legislation's more modest approach to raising coverage. The bill also bars the FDIC from premising risk-based premiums solely on bank size – a fear raised by the increasing FDIC focus on systemic risk and the problems it has assessing the overall condition of the nation's very largest banks. The language would, however, permit the FDIC to assess premiums based, for example, on a bank's business mix. Thus, those active in non-traditional businesses or higher-risk ones could face higher premiums, as could larger institutions with significant amounts of international deposits.

An industry effort to include a provision limiting premiums for the least risky banks to only 1 basis point is not in the final bill, possibly also leading to heightened premiums.

Banks are also concerned that the FDIC could immediately take advantage of the power to bring the DRR to 1.50%. When discussing similar legislation in the past, the

[1] See Client Report DEPOSITINSURANCE16, *Financial Services Management*, August 18, 2005.

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FDIC has argued it would not do so and pointed to language that requires it to drop assessments during periods of economic difficulty. However, the 1.50% ceiling is higher than the one contained in the original House proposal and thus could put pressure on the FDIC to hike premiums at the outset of the new DIF.

What's Next

S. 1932, the broad budget reconciliation measure, was passed on December 21 by the Senate but stalled in the House before the close of the year. H.R. 4636 was passed by the House on December 19 and the Senate on December 22. The industry is confident that the budget bill can be passed quickly in early February. However, ongoing Congressional disputes over fiscal policy – not to mention House leadership battles – could complicate passage of the reconciliation bill, potentially endangering deposit-insurance reform.

Analysis

I. Deposit Insurance Fund (DIF)

As noted, the legislation would merge the BIF and SAIF into a single Deposit Insurance Fund. The merger would occur no later than the first calendar quarter beginning 90 days after the date of enactment.

II. Coverage Limits

A. General Accounts

The maximum insured deposit limit would remain at $100,000 until at least April, 2010. Thereafter, the FDIC and NCUA would jointly decide whether a limit adjustment is warranted, taking into account economic conditions, the overall state of the fund, potential problems among depositories and whether an increase would cause the DRR to fall below 1.15%. Coverage limits could be adjusted upward to reflect inflation, with such determinations taking place every five years.

In determining whether an adjustment is warranted, the FDIC and NCUA would multiply the Department of Commerce's Personal Consumption Expenditures Chain-Type Index by $100,000, at which point the amount would be rounded down to the nearest $10,000. If they decide to raise coverage, the FDIC and NCUA would have to publish the intended increase in the *Federal Register* and notify Congress.

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B. Employee Benefit Plans

Pass-through deposit insurance coverage would be provided for employee benefit plans. However, consistent with other provisions governing pass-through coverage, only well- or adequately-capitalized institutions could accept funds that would be insured. "Employee benefit plans" would be defined as they are in tax law, and include such plans as deferred compensation ones.

C. Retirement Accounts

"Retirement Accounts" would be insured up to $250,000 and subject to the inflation adjustments noted above for general accounts.

D. Municipal Accounts

Insurance coverage for municipal deposits could only be adjusted for inflation, the overall coverage limit would not be raised.

III. Premiums and Assessments

A. Designated Reserve Ratio

The bill would allow the FDIC to set the DRR, now at 1.25% of insured deposits, within a range between 1.15% and 1.50%. The DRR would have to be set in advance of each calendar year. In setting the DRR, the FDIC would need to seek to prevent sharp swings in assessment rates and consider:

- the risk of loss both during the year and in the future;
- the economic conditions generally affecting insured institutions, with the DRR to increase during favorable economic conditions and decrease during unfavorable ones, notwithstanding the increased risk of loss to the DIF this cycle may cause; and
- any other appropriate factors.

Any proposed changes to the DRR would be subject to public notice and comment period.

B. Premiums

The FDIC Board would be required to set "necessary or appropriate" assessments, considering:

- estimated operating expenses of the DIF;
- estimated case resolution expenses;
- the projected effects of assessments on the capital and earnings of insured depositories;
- factors related to making the assessment system more risk-based; and
- any other factors the Board determines are appropriate.

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The FDIC would not be allowed to bar banks from the lowest risk category solely because of their size.

Any future revisions or modifications of the assessment system would need to be subjected to public notice and comment.

Penalties for failing to pay timely assessments would equal not more than one percent of the amount of the assessment due for each day overdue.

C. Credits and Dividends

1. Excess Amounts

If, at the end of a calendar year, the DRR were to exceed 1.50%, the FDIC would be required to pay a cash dividend to refund premiums paid by institutions.

If the DRR were equal to, or exceeded, 1.35%, but remained below 1.50%, the FDIC would have to provide a cash dividend equal to 50% of the excess amount necessary to maintain the DRR at 1.35%.

Dividends would be awarded after consideration of the following factors:

- the ratio of an institution's assessment base at the end of 1996 as compared to the assessment base of all combined depositories;
- the amount of assessments paid after 1996 by an institution;
- portions of assessments paid by an institution which reflect any heightened levels of risk-taking; and
- any other factors the FDIC deems appropriate.

The FDIC could suspend or limit dividends if it determined that the DIF were at significant risk of loss over the next year and it is likely that such losses would be high enough to justify a temporary hike over the 1.50% ratio. In making this determination, the FDIC would need to consider the impact on the economy, the banking system and the fund's levels. An explanation of this would have to be sent to Congress.

Decisions on renewal or repeal of dividends terminations would have to be reviewed annually.

2. One-Time Credit

The bill would require the FDIC to pay a one-time credit of 10.5 basis points (or approximately $4.7 billion) of the combined BIF/SAIF assessment bases as of year-end 2001. As with the above dividends, the credit would be based on institutions' assessment base relative to the total combined BIF/SAIF 2001 assessment base. The credit would be used to offset future premiums.

The use of the credit would be limited to 90% of assessments for fiscal years 2008-2010. The use of the credit is further limited to 3 basis points when the DRR is

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below 1.15% and to the average assessment rate for all banks when the credit is used by higher-risk banks.

D. Restoration Plan

If the DRR were to fall below 1.15%, the FDIC would be required to raise premiums to restore the fund within five years. Should extraordinary circumstances exist, the FDIC could take longer.

IV. Regulations and Studies

Within 270 days of enactment, the FDIC would need to issue final regulations:

- designating the reserve ratio for the DIF;
- implementing increases in insurance coverage;
- implementing provisions of the Act pertaining to the issuing of dividends;
- covering provisions applicable to assessments; and
- implementing the one-time assessment credit.

Within one year of enactment, the FDIC would be required to conduct:

- a joint study with the NCUA of the feasibility of voluntary deposit insurance, privatizing insurance coverage, and of increasing the deposit insurance limit for municipalities; and
- studies on the feasibility of using alternatives to estimated deposits when calculating the DRR and its method for determining probable bank failures.

The GAO would be required within one year to conduct studies on:

- the efficiency and effectiveness of the prompt corrective action framework, the effectiveness of internal controls and the appropriateness of the FDIC's organizational structure; and
- the potential impacts of Basel II and Basel IA.

In addition, the FDIC would be required to undertake bi-annual surveys of bank efforts to serve the unbanked.

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