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Statement of The Shadow Financial Regulatory Committee

on

Reduction in Premiums for BIF-Insured Institutions

December 11, 1995

On November 14, the FDIC effectively eliminated premiums for well-capitalized and well-managed banks. This decision was based on its interpretation of the 1991 FDIC Improvement Act's (FDICIA) requirement to maintain a 1.25 percent reserve coverage ratio in the Bank Insurance Fund (BIF). Capping insurance reserves and eliminating insurance premiums is inconsistent with both a well-functioning deposit insurance system and a sound financial system. Therefore, a cap on reserves, as is contained in the pending Budget Reconciliation Bill, should be rejected. Premiums should be imposed on banks commensurate with the risks that they pose to the insurance fund in order to reserve for the loss exposure each bank imposes on the insurance fund.

The adequacy of the BIF reserves cannot be assessed without considering the risk exposure that banks pose to the insurance fund and to taxpayers. Until recently, this exposure has been dealt with by a system of risk-related premiums and capital requirements which trigger prompt corrective action and least cost resolution. As the Committee has pointed out in the past, higher capital trigger points can in principle be substituted for risk-related premiums and the maintenance of a reserve fund. (See Statement 123) But, given the low capital thresholds under the current system, especially the critical level of capital that triggers least cost resolution, capping the insurance fund will shift existing risk to taxpayers.

Further, eliminating risk-related premiums will over time expose taxpayers to additional risk by inviting risk-taking on the part of insured depository institutions. The losses incurred by taxpayers in the 1980s as a result of mispriced insurance and the forbearance policies of the FSLIC (Federal Savings and Loan Insurance Corporation) should serve as an object lesson on the dangers associated with eliminating risk-related insurance premiums.