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Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

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For Information Contact:

George G. Kaufman
(312) 915-7075

Kenneth E. Scott
(650) 723-3070

Statement of the Shadow Financial Regulatory Committee on

Deposit Insurance Legislation

May 16, 2005

The House of Representatives recently passed the Deposit Insurance Reform Act of 2005. This bill includes a number of changes, most of which the Shadow Financial Regulatory Committee discussed in previous statements No. 165 (December 4, 2000) and No 175 (February 25, 2002). The Committee supports some of these changes – such as increasing the flexibility of the reserve ratio (reserves to insured deposits) and combining the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). However, the committee opposes changes that would increase insurance coverage per account from the current $100,000 to $130,000 (with automatic adjustment for future inflation), extend the time period permitted for the FDIC to replenish any shortfalls in the fund below 1.15% from 1 year to a maximum of 10 years, and remove the currently mandated sharp increase in insurance premiums while the fund is being recapitalized.

Widening the FDIC reserve ratio requirement, from 1.25% to a range with a minimum of 1.15% and maximum of 1.4%, would permit the FDIC both to make some payments without being forced to increase insurance premiums charged to banks and to continue to charge banks premiums when reserves rise above 1.25% and the FDIC believes it desirable to do so. Also, given the increasing similarity of commercial banks and thrift institutions and the continued decline in the number and importance of thrifts, a separate SAIF is unnecessary and may involve some added cost.

Other changes, however, are likely to jeopardize the long-term financial strength of healthy institutions and undermine the protection of taxpayers introduced by the FDIC Improvement Act (FDICIA) of 1991. This act shifted most of the cost of bank failures to uninsured depositors, other creditors, and other banks, by forcing the FDIC both to resolve insolvent banks at the lowest cost to the fund and to replenish any shortfalls in its required reserve ratio within a year by increasing premiums. The latter action helps to protect the fund against further losses that may wipe out the fund altogether and limits the ability of insured banks to operate with lower than breakeven insurance premiums which may lead at the margin to assumption of additional risks. The present threat of a large average 23 basis point increase in premiums if the fund is not recapitalized within one year provides a strong incentive for the FDIC and banks to recapitalize the fund as quickly as possible, and avoiding reaching such a position. Although FDICIA places the initial burden of replenishing the fund on the surviving, healthy banks, continued losses to the fund would jeopardize its solvency and increase the probability of taxpayer rescues.

The proposed flexibility in the reserve ratio also gives the FDIC the ability to vary and smooth premiums over the business cycle, decreasing them when banks are doing poorly and find the premiums harder to meet and increasing them when banks are doing well and can afford the premiums more easily. But further reductions in premiums in bad times are not justified as they might encourage the banks to assume greater risks. Private insurance markets sometimes experience significant premium increases after insurers experience large losses (e.g., after large natural catastrophes), even if many policyholders may find it difficult to pay those higher premiums.

As the Committee has repeatedly emphasized, increasing the account coverage is both unnecessary, as few accounts are in excess of the current $100,000 and much of any excess amounts can be spread over joint accounts in the same bank or in multiple accounts over multiple banks. Moreover, larger depositors contribute to monitoring the banks and any reduction in their incentive to do so could result in greater incentives for banks to take greater risks. These depositors have not been hesitant to invest in noninusured money market funds as substitutes for bank deposits.

The country suffered large costs the in the 1980's when the banks and thrift institutions had incentives to take greater risks and the then Federal Savings and Loan Insurance Corporation (FSLIC) had insufficient funds to protect all the insured deposits. Taxpayers had to make good on a shortfall of some $150 billion. Although changes in legislation and the structure of the industry since then tend to both strengthen the institutions and protect the taxpayers, it is not good policy to chance a return to those days of costly forbearance. The current problems with the Pension Benefit Guaranty Corporation should serve as a warning (see statement 198, September 22, 2003; Statement 208, September 20, 2004; Statement 213, December 6, 2004).