

New Reforms for Deposit Insurance

BY PATRICIA WESCOTT

On Feb. 8, President Bush signed into law substantial changes to the nation's system of deposit insurance. Collectively known as the Federal Deposit Insurance Reform Act of 2005, the reforms are intended to instill greater market discipline among insured institutions — banks and thrifts that have deposits guaranteed up to \$100,000 per account. Specifically, the new provisions include:

- Grant the Federal Deposit Insurance Corp. (FDIC) more flexibility with the premiums it charges institutions for deposit insurance;
- Merge the two insurance funds, the Bank Insurance Fund and the Savings Association Insurance Fund;
- Increase coverage for certain retirement accounts;
- Perhaps adjust for inflation coverage on all types of insured accounts every five years, starting in 2010.

The provisions take effect no later than Nov. 5. Much of this reform is based on ideas that were first floated by the FDIC in 2001. Passage was stymied for several years amid bargaining between advocates of an immediate increase in deposit insurance coverage and those opposed to any increase. The resulting compromise provides an immediate increase in deposit insurance coverage for a limited group of accounts, with the potential for future increases that match inflation.

The FDIC currently targets reserve fund balances to equal 1.25 percent of insured deposits. If the fund exceeds 1.25 percent, well-capitalized and highly rated institutions pay no insurance premiums. All institutions are required to provide premiums of at least 0.23 percent — or 23 “basis points” — of insured deposits in times when the fund falls below target. This means the FDIC either charges no premiums to most institutions when the fund is strong, or high premiums to all institutions, leaving it little room to adjust for actual risk.

Upon completion of the merger of the insurance funds, which must occur no later than July 1, the newly formed Deposit Insurance Fund's reserve ratio will be set each year and allowed to range between 1.15 percent and 1.5 percent of insured deposits. Additionally, a cap will be placed on the new Deposit Insurance Fund at 1.5 percent via a system of mandatory dividends, and the 23 basis point cliff is eliminated. This paves the way for a new risk-based premium system in which how much an institution pays is controlled by the risk it poses to the insurance fund, much as envisioned (but never fully implemented) by the Federal Deposit Insurance Corporation Improvement Act of 1991. Now, the FDIC gains flexibility in determining premiums,

acting in certain respects like a private insurer.

The bill provides for one-time deposit insurance credits (the pool totaling \$4.7 billion) for reducing, but not eliminating, future deposit insurance premiums for those institutions that had contributed to the insurance funds prior to 1996. The new rule aims to promote fairness and address the “free rider” problem of institutions that never paid premiums after 1996, thanks to the earlier contributions of institutions whose payments built up the insurance fund to strong levels.

Additionally, the new law retains deposit insurance coverage at \$100,000 per account, but now with an inflation adjustment process. Starting in 2010 and every five years thereafter the new law gives the FDIC and the National Credit Union Administration discretionary authority to increase coverage with respect to inflation for individual, retirement, and municipal accounts by tracking the Personal Consumption Expenditure Index. The bill also provides for the increase of coverage of retirement accounts to \$250,000.

Though increasing deposit insurance coverage might seem like an obvious and reasonable move, doing so concerns some economists. Such an increase could lead to an overall reduction in market discipline. That is, people now holding greater than \$100,000 in deposits (even though they are a small minority of depositors) will have less incentive to keep a close watch on their deposits. Thus, the “moral hazard” problem — the idea that insurance may lead to heightened risk-taking — will be increased. What is worse, the raised insurance ceiling will attract new depositors, giving banks greater means to act on the increased incentives to take risk.

Then why increase deposit insurance coverage? The purpose of deposit insurance, established by the Federal Banking Act of 1933, was to prevent mass bank runs and to safeguard depositors with few financial assets from the loss of their deposits. Some argue that during the past 25 years inflation has eroded the value of deposit insurance coverage. Deposit insurance was last increased in 1980 from \$40,000 to \$100,000. In raising coverage, policymakers have sought to preserve the reputation of deposits as safe havens for financial assets. Whether this is worth the cost of the accompanying increase in moral hazard, and reduction in market discipline, is something economists and analysts will be watching closely in the coming years. **RF**

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