

## **The New FDIC Insurance Premium Assessments: A Better Way**

Scott Hein and Timothy Koch

April 6, 2009

Effective January 1, 2009 the FDIC increased the annual insurance assessment rate by 7 basis points applied to all insured deposits at banks. Given the sharp decline in Deposit Insurance Fund (DIF) reserves, the FDIC initially proposed an additional one-time special premium assessment of 20 basis points, but subsequently lowered it to 10 basis points if Congress authorizes an increase in the FDIC's borrowing capacity to \$100 billion along with emergency authority to borrow up to \$500 billion.

The FDIC appears to understand the strain this places on banks at a particularly difficult time. As FDIC Chairman Sheila Bair recently stated, "The new assessments are a significant burden, especially during a financial crisis and a recession when bank earnings are under pressure."<sup>1</sup> Unfortunately, history suggests that most banks are forced to simply absorb the cost of deposit insurance. Given the current economic environment, banks are now quite sensitive to the impact on aggregate profits going forward. More importantly, the new assessments raise fundamental questions of fairness.

What seems to be missing in the FDIC's plan is recognition that the global financial crisis centers around the very largest banks and financial institutions in the world and that the community banks in this country are now suffering "collateral damage" just like the many individuals who are newly unemployed. Community banks bear little blame for the crisis which derives primarily from the actions of large financial institutions, including large commercial and investment banks, insurance companies and related financial firms. However, under the new assessment plan community banks will suffer disproportionately relative to their overall risk to the financial system.

### Large Financial Institutions and the FDIC

Large financial institutions have long gotten a low-cost "pass" on their organizational structure and financial activities. Many of them invested heavily in unregulated businesses and products, operated with high levels of financial leverage and awarded extraordinary bonuses to key risk takers for profits that were largely illusory. These large institutions have not paid their share of the cost of protecting the system yet are the beneficiaries of the federal government's guarantee not to let them fail. Consider the following:

- FDIC insurance premiums only apply to domestic deposits of U.S. commercial banks; foreign deposits, which are held in larger proportional amounts at large banks, however, are similarly protected under the government guarantee but are not priced
- Despite the widespread appreciation for Enron's problems, large financial institutions were allowed to establish special purpose vehicles, such as structured investment vehicles, that were effectively unregulated; such entities generated heavy credit losses

- Many large financial institutions are engaged in financial activities that are unsupervised, unregulated and thus not monitored; the holding company form of organization allows them to operate outside the banking system
- Unlike community banks, many large financial institutions have entered into derivative contracts and trading positions far beyond their ability to adequately measure and manage the associated risks; the use of these products and associated services was not adequately supervised, regulated or monitored
- Large financial institutions operated with unsustainably high levels of financial leverage, much more so than community banks. They justified this, and regulators accepted this justification, based on faulty risk management models; large institutions were allowed, de facto, to set their own minimum capital ratios
- Many nonbank firms have converted to bank holding companies, including Goldman Sachs, Morgan Stanley, American Express, CIT, GMAC, The Hartford and Lincoln National; while some of these firms have operated small industrial loan companies (ILCs) and thus paid FDIC insurance premiums, the ILCs had limited amounts of FDIC-insured deposits relative to their assets, off-balance sheet activities and risks associated with their primary businesses. The two insurance companies, The Hartford and Lincoln National, bought small thrift institutions in order to qualify for government assistance and thus never paid into the DIF prior to conversion.

Large financial institutions have operated with a different business model than community banks and have dramatically underpaid both FDIC insurance premiums and any charge for federal guarantees they receive given the risks they have taken. The new guarantees are exemplified by federal regulators granting bank holding company status to nonbank firms so that they can qualify for government assistance even beyond FDIC-insured deposits. For instance, all of the firms listed previously qualify for and/or have received assistance in the form of the Troubled Asset Relief Program (TARP) and Temporary Liquidity Guarantee Program (TLGP). The TLGP allows banks to offer unlimited amounts of insured deposits to the same customer and, more importantly, to sell FDIC-insured debt. Under the latter program, Goldman Sachs and Morgan Stanley have each issued billions of dollars in FDIC-insured debt at rates modestly higher than comparable maturity Treasury rates.<sup>2</sup> This low-cost borrowing represents a direct federal government subsidy.

Consider, for example, how GMAC has benefited from its conversion to a bank holding company in December 2008. GMAC soon received \$5 billion in TARP funds and announced that it had the ability to issue up to \$17.5 billion in federally-guaranteed debt under the TLGP. At the time, GMAC was 51% owned by Cerberus, so the government is subsidizing private equity investors. Not surprisingly, the prices of GMAC notes and bonds jumped after the conversion. In subsequent months, GMAC Bank has paid among the highest rates offered on savings accounts, money market accounts and small time deposits as it builds its core deposit franchise. Such benefits allow GMAC to offer lower rates on automobile loans in competition with community banks.

## The FDIC Insurance Assessment and Fairness

Community bankers have widely criticized the announced FDIC insurance assessments as unfair, particularly the special assessment of 10 or 20 basis points. The criticisms emphasize that 1) community banks will bear a disproportionate burden for losses that are primarily due to activities of large financial institutions; 2) Treasury continues to prop-up problem institutions, such as Citigroup and AIG, while they increase the operating expenses of community banks; 3) many large financial institutions should be assessed at higher rates given their greater risk and complexity; and 4) some large firms with financial activities receive the benefits of federal guarantees, but have not paid significant amounts into the insurance fund (GMAC, Goldman Sachs, Morgan Stanley, CIT, American Express, The Hartford, Lincoln National and GE).<sup>3</sup>

Figure 1 documents the sharp decline in the DIF in 2008 where the reserve balance fell from 1.22 percent of insured deposits at the beginning of the year to just 0.40 percent at the end of 2008. Under the FDIC Reform Act of 2005, the FDIC is required to replenish the fund when the reserve ratio falls below 1.15 percent. During 2008, 25 insured institutions with combined assets of \$372 billion failed. While a number of these bank failures are community banks, the proportion of community banks that failed in 2008 is quite small in comparison to the entire population of community banks. Moreover, the costs of the community bank failures have been quite small. The two biggest failures in terms of assets were Washington Mutual and Indy Mac with \$299 billion and \$28 billion in assets, respectively, at the time of failure. While Washington Mutual's failure was at no cost to the DIF, the failure of Indy Mac accounted for an estimated \$9 billion in losses to the insurance fund. The magnitude of average assets for the other 23 failed banks was almost \$2 billion, indicating that the decline in DIF can be attributed largely to failures of institutions with more than \$1 billion in assets. Absent these large institution failures, the DIF ratio would be closer to 1.15 percent of insured deposits. Linking the decline in DIF reserves to risks associated with different sized institutions leads to alternative methods of replenishing the fund.

### A Better Way to Increase DIF Reserves

There are more reasonable ways to charge FDIC insurance premiums that would be fairer to all firms, rather than continue the current system as proposed. Possibilities include:

- **Have large financial institutions pay a 'systemic risk insurance premium.'**  
The new FDIC insurance assessments beginning in the third quarter of 2009 differentiate between banks based on amounts of brokered deposits, collateralized Federal Home Loan Bank advances, and unsecured debt funding. Because recent failed banks with the greatest brokered deposits and FHLB advances have had higher loss rates, premiums will increase with these exposures such that higher-risk banks will pay more. Banks that operate with unsecured debt lower risk to the insurance fund. These changes to the way insurance premiums are calculated are a good first step. To capture systemic risk, the FDIC should add a premium tied to a

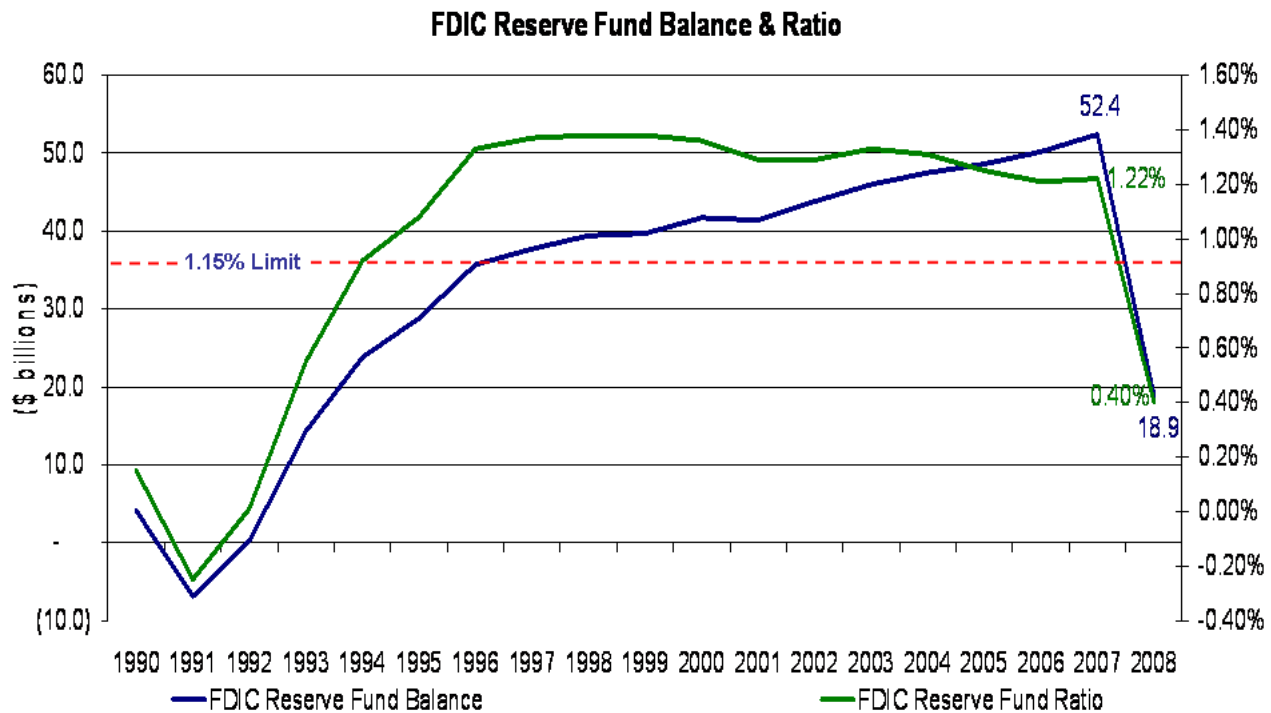
firm being perceived as Too Big to Fail. *Such a premium should apply regardless of whether the firm operates with FDIC-insured deposits.*

- **Charge premiums based on total assets or total liabilities and net off-balance sheet exposures.** Chairman Bair has noted that the FDIC cannot legally impose premiums based on firm size. Congress should authorize such premiums. Size estimates should include net off-balance sheet exposures as well as either total assets or liabilities.
- **Charge firms that have the capacity to issue insured debt under the TLGP and allocate a portion of the premiums to the DIF.** Issuers of FDIC-insured debt under the TLGP currently pay a fee for the guarantee. This charge effectively represents a usage fee. If the proceeds are sufficient to cover losses on the debt, any excess will presumably be added to the DIF. Large financial institutions and their holding companies are the primary beneficiaries of this program and federal regulators have broad discretion as to which firms qualify to issue insured debt. However, the availability of issuing insured debt by itself improves the liquidity of any firm that qualifies regardless of whether the firm actually issues debt. Like a facility fee that banks charge for providing available credit to their borrowers, the FDIC should charge firms a fee based on the amount of their FDIC-insured debt capacity. This fee would decline as the firms issue such guaranteed debt.
- **Charge a fee allocated to DIF to cover nonbank firms that convert to bank holding companies.** It seems obvious that any firm that never pays an insurance premium should not qualify for insurance. Yet, federal regulatory authorities have allowed firms such as The Hartford and Lincoln National to buy small savings banks and immediately qualify for a wide range of federal programs and guarantees tied to FDIC insurance. The value of the guarantees and access to federal assistance far exceeds the cost of acquiring small insured institutions. Firms that have operated outside the bank regulatory system that acquire institutions with insured deposits should pay a fee for actual conversion to a bank holding company or any related action that similarly grants access to federal guarantees and FDIC-insured debt.
- **Rebate a portion of the net proceeds generated by the federal government under the Troubled Asset Relief Program (TARP) to replenish the insurance fund.** Under TARP the federal government issued preferred stock to qualifying institutions generating income in excess of 5 percent of the funds allocated. FinPro has estimated that the federal government will earn net income of over \$3 billion on just the first \$327 billion tranche of the program even after Citigroup converts all of its preferred stock to common stock.<sup>4</sup> On April 3, 2009, Bank of America announced that it would pay \$713 million in preferred dividends to the Treasury for its outstanding TARP funds. As additional TARP funds are allocated, the amount of net income will increase. The government should allocate a portion of the net income derived from the TARP receipts versus financing costs to the insurance fund in payment for providing the assistance.

## Summary

Community bankers recognize the value of deposit insurance and are willing to pay a reasonable price for it. However, the recently proposed special insurance assessment is particularly unfair to community banks that have done little, if anything, to contribute to the financial crisis. Higher insurance assessments essentially represent a tax on traditional bank deposit gathering activities. For many banks, the higher deposit premiums will wipe out annual profits, while the largest institutions receive a wide array of federal subsidies to lower borrowing costs and operate with a guarantee not to be allowed to fail. Most community banks continue to make loans and grow their loan portfolios. Now is not the time to increase their taxes to pay for the mistakes of the large banks when there are better alternatives.

Figure 1



<sup>1</sup>Remarks by FDIC Chairman Sheila Bair to the Independent Community Bankers of America, 2009 National Convention and Techworld; Phoenix, Arizona, March 20, 2009.

<sup>2</sup>Bary, Andrew, "Resurrection on Wall Street," Barron's, March 16, 2009

<sup>3</sup>GE has the capacity to issue up to \$139 billion in insured debt under the TLGP. It has already issued federally insured commercial paper and announced the issuance of longer-term insured debt. It is not a bank holding company.

<sup>4</sup>Economic Solutions: An Alternative Proposal, FinPro, Liberty Corner, NJ, March 17, 2009.