

America's Community Bankers®

DEPOSIT INSURANCE FOR A NEW CENTURY:

A COMPREHENSIVE RESPONSE
TO FDIC REFORM OPTIONS

JANUARY 2001





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January 2001

Dear Community Bankers:

As you know, the FDIC released its Options Paper on Deposit Insurance last August. It is my pleasure to provide you ACB's comprehensive response on this issue. The options paper addressed issues raised by insured institutions and their representatives – proposals to set a ceiling on the fund, provide rebates, and increase coverage – it also asked for comments on a full range of deposit insurance issues. In addition to ACB's comprehensive views, this booklet includes the FDIC's introduction to its Options Paper, my cover letter to FDIC Chairman Tanoue, a brief history of deposit insurance, and a roster of ACB's Deposit Insurance Team.

On December 14, 2000, I led an ACB delegation which included our Second Vice Chairman Russ Taylor, Deposit Insurance Team Co-Chair Harry Doherty, ACB President and CEO Diane Casey and ACB Legislative Counsel Stephen Verdier, to meet with FDIC Vice Chairman Andrew Hove and FDIC staff to brief them on our letter.

While we discussed each major issue, each of us emphasized ACB's strong recommendation that the FDIC take immediate action to deal with the issue of excessive deposit growth. Our concern, expressed in the formal letter, is that unusually rapid growth in insured deposits could cause either the BIF or SAIF to fall below the statutory minimum of 1.25 percent of insured deposits, triggering a 23 basis point premium. Given the unease expressed by our members about this possibility, we urged the FDIC to also quickly seek more flexibility in any future fund recapitalization schedule.

We urged the FDIC to ask Congress to take quick action on these issues, as well as the long-standing FDIC and ACB priority of merging the two funds. That would allow longer-term deposit insurance reforms to take place in an orderly atmosphere.

Another issue we highlighted for the FDIC was our strong support for a substantial increase in deposit insurance coverage for retirement accounts. Americans are being asked to personally manage more and more of their retirement funds, so we believe it is essential that they be provided with far more than \$100,000 coverage currently available. ACB also supports a modest increase of the non-retirement account coverage, indexing coverage from the 1974 level of \$40,000. In today's dollars, that would provide coverage between \$115,000 and \$130,000. ACB believes that a more substantial increase, e.g., doubling coverage to \$200,000, would trigger unacceptable premium increases.

ACB's positions are summarized on pages 2 and 3 of our comment letter to the FDIC.

continued on next page

ACB's Comprehensive Response to FDIC Reform Options, continued.

The concept of doubling deposit insurance has garnered a good deal of attention. ACB did not jump on that bandwagon. Instead we asked community bankers what they thought and as a result crafted a position that we have consistently been able to maintain. We asked to know whether the financial and regulatory costs to community banks would outweigh the benefits.

Our officers held discussions with hundreds of you in meetings throughout the year. We surveyed our members on the key issues. A 32-member Deposit Insurance Team – drawn from a number of ACB volunteer committees – held five meetings. (A roster of the team is included in this booklet.)

Former FDIC Chairman Ricki Helfer advised the team, which found her insights invaluable. Ms. Helfer retains the ability to take positions independent of ACB as the debate develops. ACB and former Chairman Helfer – as well as current Chairman Donna Tanoue – agree on one thing: the Bank Insurance Fund and the Savings Association Insurance Fund should be merged without delay or prior condition.

The team had to wrestle with a number of difficult questions, most prominent was the matter of increased coverage levels and how to pay for them. We concluded that the financial and regulatory costs of a doubling in coverage would likely be unacceptable. ACB's comment goes far beyond these issues, however. We agreed to some increase in the FDIC's authority to impose risk-based premiums on a broader range of institutions than is now permitted. However, we have two caveats:

1. The highest rated institutions should continue to be exempt from premiums while the deposit insurance fund remains above the 1.25 percent statutory minimum.
2. ACB supports this additional authority provided the other important reforms we recommend are included in the final package.

These are the essential elements of this package:

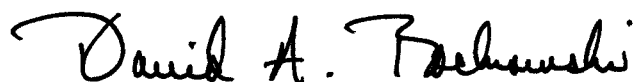
- Congress should set a ceiling on the deposit insurance fund (giving the FDIC the ability to adjust it).
- Reserves that exceed the ceiling should be returned to insured institutions on a risk-based basis.
- Institutions that grow at a rate significantly above the industry average should be required to compensate the fund by paying a special premium on excess growth.
- If the fund falls below 1.25 percent, the FDIC should have the authority to spread the recapitalization over a reasonable period.
- Congress should index coverage levels and provide substantial increases in coverage levels for retirement savings.

No one can predict the future of deposit insurance reform in the new Congress. While these issues generally do not cause partisan divisions, there are widely varying views within the industry and among policy makers in Washington.

Regardless of how this issue develops, I am confident that ACB's comments will provide a firm basis for testimony before the Congress and for comments to other interested parties. Read these comments and let the FDIC and your Members of Congress know what you think. Also, let ACB staff know what you think.

Finally, thank you for your support.

Sincerely,



David A. Bochnowski
Chairman

DEPOSIT INSURANCE FOR A NEW CENTURY: ACB'S COMPREHENSIVE RESPONSE TO FDIC REFORM OPTIONS

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December 13, 2000

The Honorable Donna Tanoue
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Dear Chairman Tanoue:

Enclosed with this letter are the formal comments of America's Community Bankers in response to the Deposit Insurance Options Paper, which the FDIC issued in August.

We developed our positions by holding discussions with hundreds of our members in multiple forums, as well as seeking their views via survey. ACB's 32-member Deposit Insurance Team held 5 meetings, 4 by conference call and a final in-person session on December 4, 2000. In addition, ACB's Community Institutions Committee examined these matters during our recent national convention. Throughout the year, ACB's officers discussed deposit insurance issues with our members at ACB management conferences, seminars, and state association meetings. We also met with the board of the American League of Financial Institutions, which represents minority thrifts, during their annual meeting to solicit their views.

ACB strongly endorses the FDIC's position that the Bank Insurance Fund and the Savings Association Insurance fund should be merged immediately, without delay or prior condition. As you have repeatedly pointed out, this will result in a fund that is stronger than either is today.

In addition, ACB's comment covers the full range of issues raised in the Options Paper. This letter summarizes our major positions.

ACB would accept some broadening of the FDIC's authority to impose risk-based premiums on a broader range of institutions than is now permitted. However, we have two caveats:

1. The highest rated institutions should continue to be exempt from premiums while the deposit insurance fund remains above the 1.25 percent statutory minimum.
2. ACB supports this additional authority provided the other important reforms we recommend are included in the final package.

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Letter to the Honorable Donna Tanoue, Chairman, FDIC, continued.

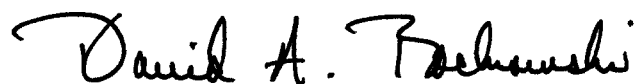
These are the essential elements of this package:

- Congress should set a ceiling on the deposit insurance fund (giving the FDIC the ability to adjust it).
- Reserves that exceed the ceiling should be returned to insured institutions on a risk-based basis.
- Institutions that grow at a rate significantly above the industry average should be required to compensate the fund by paying a special premium on excess growth.
- If the fund falls below 1.25 percent, the FDIC should have the authority to spread the recapitalization over a reasonable period.
- Congress should index coverage levels starting with the 1974 limit of \$40,000. If unacceptable premium increases are a condition for an immediate increase in coverage, Congress should at least index coverage from the current \$100,000 level.
- Congress should also provide substantial increases in coverage levels for retirement savings.

ACB believes that these changes would substantially strengthen the deposit insurance system by providing additional risk-based incentives; preventing an undue accumulation of reserves and returning funds to communities; preventing an unsafe dilution of the fund through excessive growth; providing for an orderly recapitalization of the fund when necessary; and maintaining the role of deposit insurance in our nation's savings and retirement systems.

ACB appreciates this opportunity to present our views. We look forward to working with the FDIC and the Congress on this important matter.

Sincerely,



David A. Bochnowski
ACB Chairman
Chairman, President & CEO
Peoples Bank, SB



December 13, 2000

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/OES
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Re: Deposit Insurance Options Paper
August 2000

Dear Mr. Feldman:

America's Community Bankers (ACB) is pleased to comment on the issues presented in the FDIC's Deposit Insurance Options Paper.¹ ACB commends the FDIC for reaching beyond a few narrow deposit insurance issues and seeking comment on a wide range of concerns. ACB represents the nation's community banks of all charter types and sizes. ACB members pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

Merge BIF and SAIF

We also commend the FDIC for its continued strong advocacy of merging the Bank Insurance Fund and the Savings Association Insurance Fund. Simply stated, a combined fund would be stronger than either one standing alone. If Congress does nothing else regarding deposit insurance issues, it should merge the funds without delay. There is no reason to postpone this reform if broader issues cannot be resolved promptly. This is a particularly good time to merge the funds, since both are substantially above the statutory reserve ratio. The SAIF ratio is actually higher than BIF's, but each would benefit from the geographic and business diversity that the other would bring to a combined fund.

The Reform Process

Many of the options that the FDIC has raised would also require Congressional action, while some – particularly some changes to the risk-based premium system – could be implemented by the FDIC without further legislation. This letter provides ACB's views on the full range of issues raised in the Options Paper — pricing deposit insurance for individual banks, the FDIC structure most appropriate to fund any losses, and coverage levels.

¹ FDIC Deposit Insurance Options Paper, August 2000 ("FDIC Options Paper").

We developed our positions by holding discussions with hundreds of our members in multiple forums, as well as seeking their views via survey. ACB's 32-member Deposit Insurance Team held 5 meetings, 4 by conference call and a final in-person session on December 4, 2000.² In addition, ACB's Community Institutions Committee, Mutual Institution Committee, and our Board of Directors examined these matters during our recent national convention. Throughout the year, ACB's officers discussed deposit insurance issues with our members at ACB management conferences, seminars, and state association meetings. We also met with the board of the American League of Financial Institutions, which represents minority thrifts, during their annual meeting to solicit their views.

How a Reformed System Would Work

ACB's ideal scenario for the deposit insurance system includes creation of a single, stronger Deposit Insurance Fund through a merger of BIF and SAIF. The fund would continue to grow through a combination of earnings and risk-based premiums. The highest rated institutions would not be assessed as long as the fund remained above the statutory minimum of 1.25 percent of insured deposits. Once the fund reaches a new ceiling that would be set by Congress (after close consultation with the FDIC), the FDIC would provide risk-based rebates of any excess funds. The FDIC would have the discretion to adjust this ceiling under strict standards and procedures.

If the fund fell below the statutory 1.25 percent reserve ratio, the FDIC should be allowed to spread the recapitalization over a reasonable period. (Current law requires the FDIC to impose a 23 basis point premium to make up a shortfall that it expects will persist for a year.) This would allow the FDIC to balance the goals of replenishing the fund and maintaining a healthy banking system.

To maintain the integrity of the deposit insurance fund, institutions that grow at rates significantly above the industry average should pay a special premium on their excess growth. This should not apply to relatively small, *de novo* banks or to institutions that acquire existing insured deposits. It would not discourage regular competitive growth by established institutions or the formation of new competitors. However, it would deal with institutions that dilute the deposit insurance fund's reserve ratio by precipitately moving large amounts of funds under their effective control from uninsured to insured status.

ACB also recommends indexing the coverage levels to help maintain the role of deposit insurance in the nation's financial system. Congress should use as a base the last time it adjusted coverage primarily for inflation, which was in 1974. At that time, it increased coverage to \$40,000. If adjusted for inflation since that time, the current coverage limit would be between \$115,000 and \$130,000.³

To recognize the increasingly important role that individual retirement savings plays in the economy and in our pension system, ACB recommends that Congress substantially increase the separate deposit insurance coverage for IRA, 401(k), and similar retirement accounts.

Summary of ACB Positions

1. ACB recommends that Congress set a ceiling on the deposit insurance fund's reserve ratio, giving the FDIC the ability to adjust that ceiling using strict standards after following full notice and comment procedures.
2. Reserves in the fund that exceed the ceiling should be returned to insured institutions based on their average assessment base measured over a reasonable period and based on premiums paid in the past. Rebatable premiums would include the SAIF special assessment, but not the high-growth special assessments.

² See Appendix for roster.

³ Raising the Deposit-Insurance Limit: A Bad Idea Whose Time Has Come? James B. Thomson; Federal Reserve Bank of Cleveland Research Department; April 15, 2000 (\$115,000 in 1999 dollars); FDIC Options Paper, p. 45 (\$130,000 in today's dollars).

3. When the fund is above its statutory minimum level the highest rated institutions would continue to be exempt from premiums, but the FDIC should have authority to impose a small risk-based premium on other institutions. ACB supports this additional authority provided the other important reforms we recommend are included in the final package.
4. Institutions that pose substantial risk to the fund would have their rebates reduced or eliminated.
5. In measuring risk for rebate or premium purposes, the FDIC should rely on additional objective information and not increase its current reliance on subjective examiner judgment.
6. Institutions that grow at a rate significantly above the industry average should be required to compensate the fund by paying a special premium on excess growth. This would avoid dilution of the fund by making the fund whole with respect to any excess growth, preventing the imposition of unnecessary premium costs on other institutions.
7. The special growth premium will not apply to smaller institutions for a reasonable period after they are chartered. It would also not apply to growth through merger or acquisition.
8. If the fund falls below the 1.25 percent designated reserve ratio (DRR), the FDIC should have the authority to spread the recapitalization over a reasonable period. This would be more responsible than the current law that requires the FDIC to impose a 23 basis point annual premium if the fund is expected to remain below 1.25 percent for a year.
9. ACB strongly supports the current FDIC role as a provider of deposit insurance and strongly opposes proposals to privatize deposit insurance coverage.
10. ACB supports indexing coverage levels to maintain purchasing power. Congress should index coverage levels starting with the 1974 limit of \$40,000. That would result in a coverage level of between \$115,000 and \$130,000 in today's dollars.
11. So long as the fund is above its statutory minimum of 1.25 percent of insured deposits, this modest increase in coverage should not require any more than a very minimal risk-based premium. If unacceptable premium increases are a condition for an immediate increase in coverage, Congress should at least index coverage from the current \$100,000 level.
12. Congress should also provide substantial increases in coverage levels for retirement savings in conjunction with its work on social security or pension reform or as part of deposit insurance reform, provided this can be accomplished without an unacceptable premium increase.

Our complete comments are organized below in accordance with the FDIC Options Paper.

Pricing Deposit Insurance

Should all banks pay some premium?

The Options Paper states that, "If deposit insurance were priced according to risk, it is likely that every bank...would pay something for deposit insurance."⁴ This statement fails to take into account the fact that most insured institutions paid substantial premiums in the 1990s to capitalize the FDIC funds. Both BIF- and SAIF-insured institutions paid approximately 24 basis points annually for several years, and SAIF-insured institutions made an additional one-time, 66 basis point payment in 1996. Since those institutions have never caused insurance losses, ACB believes that they have already made advance payment to compensate the fund for risk that they pose.

⁴ FDIC Options Paper, p. 3.

Nevertheless, there may be some benefit to imposing risk-based premiums on a wider range of institutions than is now permitted. Under current law, the FDIC may not charge premiums if the fund is above the 1.25 percent reserve ratio, except on “institutions that exhibit financial, operational, or compliance weaknesses ranging from moderately severe to unsatisfactory, or are not well capitalized....”⁵ ACB believes that giving the FDIC the authority to impose a very modest risk-based premium even when the fund is above the statutory minimum could discourage riskier behavior and pave the way for other reforms. Such a premium should not extend to the highest rated institutions. Not only have they already paid substantial premiums, they – by definition – impose an extremely slight risk to the fund.

This broadened premium authority should not, however, be granted in isolation. ACB believes that a more reasonable recapitalization procedure, rebate authority, an excess-growth premium, indexed coverage levels, and greater coverage for retirement accounts are essential elements of a balanced plan.

Should there be a premium on excessive growth?

A special premium on excessive growth is essential to help prevent the fund from falling below 1.25 percent. As long as the fund remains above 1.25 percent, insured institutions can add an unlimited amount of insured deposits to the system without paying any premiums. This may lower the reserve ratio even if the absolute amount of money in the fund stays the same or if it grows modestly through earnings. It could even trigger an across-the-board premium if the fund were to fall below the 1.25 minimum. Therefore, ACB believes Congress should require the FDIC to assess growth-related premiums on institutions that grow at a rate significantly over the industry average. A growth-related premium would do two things. First, it would help the fund maintain its capitalization so that these institutions would not be “free riders” on premiums paid by long-standing members. Second, it would recognize that unusual growth is an important risk factor.

ACB believes this is an issue of great urgency. Therefore, we urge the FDIC to announce quickly that it will recommend that any premium be imposed as of the date it recommends that Congress impose such a premium. This procedure would be consistent with actions by Congress that have made new rules effective as of the date of a bill’s introduction or the date of the first formal committee action.

Assessing a special premium only on significant growth would allow premium-free growth by an institution that had developed a particularly successful business plan. But, it would address the case of, for example, a diversified financial firm that was simply transferring significant amounts of uninsured funds under its effective control into its insured bank.

ACB believes that the special premium should compensate the fund at the then-current reserve ratio to avoid dilution of the fund. The FDIC should have the flexibility to collect this premium over a reasonable period to avoid imposing an undue shock on the affected institutions. While the premium might be collected over time, it should be booked immediately as a receivable in the fund to maintain its coverage ratio.

Ironically, Congress preserved the FDIC’s ability to impose special assessments on *de novo* institutions.⁶ Congress recognized that these institutions can be expected to grow at rates that exceed the industry average and impose other risks. However, because of their relatively small size, they cannot be expected to dilute a multi-billion dollar deposit insurance fund. The same thing cannot be said about an existing institution – now effectively exempt from premiums – that embarks on a new business plan that could

⁵ 12 U.S.C. 1817(7)(b)(2)(A)(v).

⁶ 12 U.S.C. 1815(d)(1)(A).

add tens of billions to the insured deposit base. So, while the law correctly recognizes the risk that a *de novo* institution may impose, it forces the FDIC to ignore the risk posed by an existing institution that begins growing at a rate significantly above the industry average.

Since the FDIC already has authority to impose a risk-based premium on *de novo* institutions, it is not necessary to impose special growth premiums on them. As indicated, they add little in absolute dollar terms to the insured deposit base, even if their rate of growth is very rapid. In addition, public policy should encourage the establishment of *de novo* institutions to increase credit availability to all segments of the economy. Finally, when the FDIC imposes a risk-based premium on these institutions where their level of growth or other factors impose significant risk, they already provide income to the fund.

As indicated above, the special excess growth premium should not apply to institutions that grow by acquiring existing deposits from other insured institutions. By definition, these deposits are already included in the insured deposit base, so shifting them from one institution to another does not dilute the fund.

Should the recapitalization schedule be modified?

ACB strongly supports changing the assessment system to address the case where the fund falls below 1.25 percent. The current system requires the FDIC to re-impose a minimum 23-basis-point premium if a fund falls below 1.25 percent and is expected to remain there for a year or more. As the Options Paper notes, the current system “amounts essentially to charging nothing in times of prosperity, and a lot in times of adversity, thereby potentially magnifying swings in the banking cycle.”⁷ Congress should correct this by giving the FDIC authority to spread any recapitalization over a reasonable period. The FDIC should impose these premiums on a risk-based basis.

The system we have outlined above introduces substantial risk-based incentives, while avoiding imposing premiums on the highest rated institutions when they are not needed. However, institutions would know that they could face premiums if the fund falls below 1.25 percent and could be rewarded with risk-based rebates once the fund exceeds the new ceiling. In between, institutions that impose some risk would pay modest premiums, while those that undermine the health of the fund by growing at extraordinary rates would pay a special premium.

Should the FDIC change the way it measures risk?

The Options Paper asks whether the FDIC should “rely on supervisory judgment, . . . other information,” or “hybrid approaches.”⁸ ACB believes that the FDIC should base its judgments of risk on currently available, objective information. It should not increase its reliance on supervisory evaluations. ACB believes that the current CAMELS rating system already includes a sufficient amount of examiner judgment. The FDIC currently gathers a substantial amount of objective information via Call Reports. This information is far more consistent across the range of institutions than examiner judgments. While we recognize that there is no complete substitute for direct observation by trained examiners, no amount of training can completely eliminate inconsistencies from one examiner team to the next. If call report data are not adequate, then the reporting requirement should be refined — unneeded reporting removed, worthwhile additional requirements added.

⁷ FDIC Options Paper, p. 5.

⁸ *Ibid.* p. 11.

Should deposit insurance be priced from the bottom up or the top down?

In its options paper, the FDIC states “a ‘bottom-up’ view would set pricing at the individual bank level and let overall revenue result from the sum of payments across banks. A ‘top-down’ view would instead attempt to estimate appropriate aggregate funding needs and then allocate prices across banks based on risk.”⁹ ACB recommends against adopting either approach exclusively.

A bottom-up approach with no cap could lead to an ever-growing fund that would withdraw too much funding from the private market. Such a fund could also tempt policy makers to divert excess funding to non-insurance purposes.

Elsewhere in this letter, we recommend that Congress set a ceiling on the fund (while giving the FDIC some flexibility to adjust it under strict standards after following notice and comment procedures). To reach that ceiling the FDIC should rely on earnings and risk-based premiums. Though it would set a ceiling, a pure top-down approach also has drawbacks. It would limit the FDIC’s ability to impose assessments and provide rebates in amounts that differ according to the relative risks posed by individual institutions.

Thus, we recommend a combination of the two approaches. From the top-down approach, we recommend imposing a cap on the fund (which the FDIC could adjust). From the bottom-up approach, we recommend a combination of risk-based premiums (where appropriate and needed), excess growth premiums, and risk-based rebates.

Should the FDIC use peer comparisons or absolute ratios?

ACB believes there is some value in measuring an institution’s risk by comparing it with other, similar institutions. Comparisons would be useful in relatively good and stable times and outliers would tend to stand out. However, in times of general economic difficulty a peer comparison approach could be misleading. If most institutions were doing equally poorly and presenting serious risk, a pure peer analysis would fail to set off alarm bells. We also note that as each institution pursues increasingly diversified strategies, it is becoming harder to find true peers. As in the debate over bottom-up versus top-down premium structures, the answer has to be a careful combination of the two approaches.

Should the FDIC use market information to determine premiums?

The Gramm-Leach-Bliley Act requires a test of whether market mechanisms might help regulators measure and reduce risk among the largest institutions. Section 108 of the GLB Act directs the Federal Reserve and the Treasury to study the implications of requiring large insured depository institutions and depository institution holding companies to maintain a portion of their capital in the form of subordinated debt.¹⁰

This approach may be useful in comparisons among large institutions that pose a systemic risk and which may benefit from perceived too-big-to-fail protection unavailable to community banks. Nevertheless, ACB opposes using similar market-related tests for deposit insurance pricing. We share the concerns expressed in the Options Paper. First, the markets would likely take the too-big-to-fail implicit guarantee into account, giving higher ratings to larger institutions.

⁹ FDIC Options Paper, p. 11.

¹⁰ Public Law 106-102, Nov. 12, 1999.

Second, the FDIC has more information about all banks than anyone in the private market. Unless the examination process is poorly conceived and implemented, it surely generates insights that are not available to the market. Market signals may be used to confirm or redirect examination resources, though any banking concern big enough to be the object of intense market scrutiny probably has a permanent examiner on site anyway.

Third, market pricing is a combination of a judgment about the particular institution involved and general conditions. During some periods, institutions may not be able to issue debt at all. Finally, ACB does not believe that it is appropriate for the FDIC to rely on private firms' judgment when making an important public policy decision, e.g., the amount of premium to charge for federal deposit insurance and the level of rebates to provide.

Smaller institutions would be particularly disadvantaged by increased reliance on market judgment to assess premiums. It is rarely efficient for smaller institutions to issue debt of any type, and what may be issued is thinly traded. While the law permits the FDIC to establish separate pricing mechanisms for large banks,¹¹ we believe that widespread use of that authority is unnecessary and potentially divisive. ACB is concerned that such a system may discriminate against smaller institutions in certain geographic markets and those with concentrations in particular assets, e.g., home mortgage loans.

Should the FDIC enter into private reinsurance contracts to obtain market judgment about risk?

ACB understands that the FDIC has begun the process of studying this question with a private-sector firm. The issue is whether the FDIC could draw on information from the reinsurance markets for deposit insurance pricing. ACB believes the FDIC should look carefully to determine whether the private reinsurance market has the capacity to reinsure any substantial portion of depository institutions. It should also examine whether private reinsurance activities might impose an unwarranted insurance premium differential between large and small institutions. Finally, private reinsurance firms might seek access to examination data generally not made available to private parties.

While not included as a possibility in its Options Paper, ACB wishes to reiterate at this point that we strongly oppose proposals by others to privatize deposit insurance. The nation's economy has depended for decades on the FDIC and the ultimate backstop of the Federal Government. The private insurance market would be unable to engender the kind of public confidence made possible by the FDIC.

Structure of the Deposit Insurance Fund

Should Deposit Insurance be Based on a User-Fee or Mutual Model?

The Options Paper raises the question of whether the deposit insurance system should be reconfigured on a user-fee or mutual model. ACB believes it would not be useful to adopt a pure version of either. The terms themselves conjure up specific approaches from the past that may be misleading models for the future and could confuse more than clarify the debate. Instead, policy makers should decide the specific characteristics that they want today's system to have. It may be that the final product will look more like one than the other. We expect that it will have many elements more characteristic of a mutual arrangement. That is certainly how it has worked in the past. Congress has asked insured depository institutions to pay whatever it would take to pay the costs of running the system. And, for much of the history of the system, from 1950 until the 1980s, the law provided for rebates to insured institutions. Those certainly are characteristics of a mutual model.

¹¹ 12 U.S.C. 1817(b)(1)(D).

Of course, when it became impossible for institutions insured by the Federal Savings and Loan Insurance Corporation to cover the losses of its fund, the government did step in. And, the Treasury advanced funding to the BIF when it became necessary. These actions were characteristic of the user-fee model. Even here, however, SAIF- and BIF- insured institutions had to pay substantial premiums to recapitalize their funds. In addition, Congress insisted that insured institutions – first SAIF-insured institutions and then all FDIC-insured institutions – pay the interest on Financing Corporation (FICO) bonds that were issued to pay depositors. This “mutual” feature will be with us for years to come.

It is very clear that under the current statutory scheme, insured institutions are members of an assessable mutual system, with only a reimbursable financing line of credit from the Treasury. The only effective constraint on assessments is when they are causing more new failures than they are paying to resolve.

Former FDIC Chairman Ricki Helfer recently answered the question of mutual versus user-fee model this way:

*Those kinds of categorizations can be useful for analytical purposes perhaps, but sometimes they can also obscure rather than clarify the relevant issues. Neither categorization best represents the way the system operates now nor the way that it can best serve American depositors in the future. The short answer to the FDIC's questions is that there are elements of both in a system that has risk-based deposit insurance and permits rebates from an over-capitalized fund. Buried in the terminology is the real issue: is there a maximum reserve ratio for each deposit insurance fund that can be identified at any particular time based on then existing circumstances? If there is, should banks enjoy rebates of reserves above that level, and can we design a rebate system that meets our second goal by maintaining a risk-based deposit insurance system and still provide rebates to banks from reserves above the ceiling?*¹²

The approach we suggest – pick the characteristics of the fund first and avoid artificial labels – also enables policy makers to avoid awkward proposals that would unnecessarily complicate their decision-making. For example, a pure mutual model might resemble the National Credit Union Share Insurance Fund (NCUSIF). Under that system, institutions maintain deposits in the fund and simultaneously carry them as assets on their books.¹³ The General Accounting Office criticized this accounting treatment in 1991 and suggested that credit unions write off these assets over time.¹⁴ Since credit unions are not publicly traded, this accounting issue is not heavily debated and does not affect investors. In contrast, stockholder-owned banks and savings institutions must be responsive to investor concerns. As a result, a pure mutual-model similar to NCUSIF might have to include a number of artificial constructs to conform to accounting rules. There does not seem to be any substantial public policy benefit to the exercise.

Many of the policies we recommend elsewhere in this comment – a cap on the fund, rebates, increased risk-based premium authority, and excess-growth premiums – tend to reinforce the mutual aspects of the system. But, we recommend them because we believe they will strengthen and improve the system, not to add new mutual features.

¹² The Deposit Insurance System: What Reforms Make Sense?; Ricki Helfer, December 4, 2000; Address to America's Community Bankers, pp. 8-9 (Helfer, Dec. 4, 2000)

¹³ FDIC Options Paper, p. 31.

¹⁴ Credit Unions – Reforms for Ensuring Future Soundness; GAO/GGD-91-85, July 1991, pp. 171-174

Should a Rebate System be Reinstated?

As indicated elsewhere in this comment, ACB strongly believes that Congress should set a ceiling on the fund and rebate excess payments on a risk-based basis. During the 106th Congress, ACB supported legislation introduced by Senator Rick Santorum (R-Penn.) and Frank Lucas (R-Okla.) that would have set a 1.35 percent ceiling and used the excess to pay interest on FICO bonds.¹⁵ Once the FICO bonds were repaid, excess funds would be used to pay rebates. The bill would have given the FDIC authority change the ceiling.

ACB continues to believe that this is a constructive approach to a serious potential problem that could be caused by a substantially overcapitalized insurance fund. However, the broader approach we outline in this letter could lead to full rebates more promptly than provided for in the Santorum/Lucas bill. Whatever the mechanism Congress provides, resources not needed for reasonably foreseeable deposit insurance purposes should not remain in Washington.

ACB agrees with former Chairman Helfer's recent comment:

I believe it is possible for the FDIC to develop analytical tools that will permit it to identify a ceiling on the funding needs of the deposit insurance system at any particular time — a DRR that would change as circumstances change. . . . The purpose of establishing a ceiling DRR is so that insurance funds will not grow beyond a size that can be justified on the basis of the needs of the deposit insurance system, thereby withdrawing capital from banks who could have contributed to economic growth by leveraging those funds to meet the economic needs of their communities. Amounts accumulated in the system over and above the DRR ceiling should be rebated to banks to facilitate economic activity, which benefits every one.¹⁶

What Level Should the Fund Reach Before the FDIC Pays Rebates?

ACB believes that Congress should adopt the approach taken in the Santorum/Lucas legislation and determine an appropriate ceiling for the fund. In deciding the actual ceiling amount, ACB recommends that Congress consult closely with the FDIC. The agency has already done considerable historical analysis on the level of the funds and income needed to maintain them.¹⁷ Clearly, the agency could adapt that analysis to determining a reasonable ceiling to recommend to Congress. As provided in the Santorum/Lucas bill, Congress should give the FDIC flexibility to adjust the ceiling. However, the agency should have to meet clearly stated standards before adopting a change. The FDIC should be required to find that there is a higher level needed to meet a substantial and identifiable risk to the fund or the financial system.

In addition, Congress should require the FDIC to follow a full notice and comment process under the Administrative Procedure Act before making any change to the ceiling. Any delay associated with this process should not cause undue concern, since the FDIC would, in all likelihood, be making a change when the fund was near its ceiling, substantially above the 1.25 percent minimum.

¹⁵ S. 2293

¹⁶ Helfer, Dec. 4, 2000, pp. 9-10

¹⁷ 60 Fed. Reg. 42680 (Aug. 16, 1995).

How Should Rebates be Allocated?

The Santorum/Lucas legislation would provide rebates to all insured institutions once the FICO obligation is met. Until that time, excess funds in BIF and SAIF, or a new DIF, would be used to offset all insured institutions' FICO obligation or would remain in the fund. ACB continues to believe that this approach has merit and would support the Santorum/Lucas bill as a stand-alone proposal. However, we also believe that there is considerable merit to providing for a risk-based rebate system that could provide rebates before the FICO obligation ends. Under the system we favor, the riskiest institutions would get no rebates, while the safest institutions would get higher than average rebates. Those in between could expect average rebates. These differential rebates would provide the same risk-reduction incentive as variations in premiums when the fund needs them to impose them on the bulk of insured institutions. All institutions would know that as the fund approached the ceiling, they could expect to benefit by operating in a less risky manner.

Should the Systemic Risk/Too-Big-to-Fail Mechanism be Changed?

In FDICIA, Congress substantially limited the FDIC's ability to provide unlimited protection to depositors in too-big-to-fail institutions. The FDIC may not protect uninsured depositors and creditors if that would increase costs above simply covering insured deposits. As the Options Paper notes, this least-cost test can be overcome only if "the Secretary of the Treasury, upon the recommendation of two-thirds of the Boards of the FDIC and the Federal Reserve, and after consultation with the President, determines that a threatened bank failure would pose serious adverse effects on economic conditions or financial stability, the least-cost requirements can be avoided...."¹⁸ This procedure has never been implemented, but it certainly appears to impose substantial procedural hurdles to further FDIC involvement in the too-big-to-fail process.

Nevertheless, it is still possible that at some point the FDIC will step in under the systemic-risk exception to the least-cost requirement. The law requires that the FDIC impose a special assessment on all fund members to defray the excess cost of a systemic-risk resolution. Unlike normal assessments, this special assessment is based on total assets (minus equity capital and subordinated debt). When adopted in 1991, it was thought that this would tend to shift costs to larger banks that relied less on deposits to fund their assets. This did not exempt banks that could never expect to benefit from a systemic-risk rescue, but it was hoped that it would rebalance the scales to some extent.

This analysis is becoming dated because community banks themselves rely more on funding from the Federal Home Loan Banks as the competition for deposits becomes more severe. The balance sheets of large and small banks – in terms of their reliance on deposits as compared to borrowed funds – are likely to become more similar over time. Therefore, Congress may wish to consider doing directly what they attempted to do indirectly in 1991 and exempt banks under a certain size from any systemic-risk special assessment.

Though the FDIC's role in the too-big-to-fail process may be reduced, the Federal government, particularly the Federal Reserve, continues to have a major role in dealing with financial crises. Under the new financial structure provided under the Gramm-Leach-Bliley Act, this implicit shift of much of the too-big-to-fail responsibility from the FDIC to the Federal Reserve has merit. The fact remains, that invoking this protection for larger financial firms provides benefits to a just a few firms. Policy makers should continue to explore ways to impose some cost for this benefit, recognizing it is difficult to explicitly price an implicit benefit.

¹⁸ FDIC Options Paper, p. 33.

Coverage Levels

Should Congress Increase General Coverage Limits?

ACB supports indexing coverage to maintain purchasing power. We also strongly support substantially increasing coverage for retirement savings, such as IRA and 401(k) accounts. In either case, we support increases provided they are not accompanied by substantial additional premiums. Most ACB members are skeptical that increases in general deposit insurance coverage levels would significantly increase funding. Former FDIC Chairman Helfer is even more skeptical. She recently said that “there is very little evidence that doubling the coverage limits will expand the deposit base of smaller banks. Community bankers that I have talked to think that very little benefit will result from a significant increase in coverage limits.”¹⁹

However, it could improve community bank funding in some markets. In addition, increased coverage can be a helpful accommodation to some customers who wish to deposit relatively large, one-time receipts from, for example, the sale of a home or an inheritance. This would be valuable to a consumer who values safety, but is unlikely to fuel substantial sustained deposit growth throughout the banking system. Residual concerns that excess growth could result can be dealt with by ensuring that rapidly growing institutions pay a deposit insurance premium that reflects the greater risk they pose to the system and maintains the capitalization level of the fund.

Most ACB members believe that they can more effectively increase funding by offering increased interest rates, not through increased deposit insurance coverage. However, they recognize that these deposits are not as “loyal” as core deposits. Similarly, ACB members are concerned that increasing coverage levels could increase the size of very large deposits, complicating banks’ liquidity management. Large deposits attracted simply by relatively high rates of interest often leave just as quickly as they are attracted. This could be the case with larger deposits attracted by increased deposit insurance coverage.

Though ACB recommends that a premium be imposed on institutions that experience unusually high growth, we do not believe that even doubling nominal insurance coverage would justify a substantial premium increase on all institutions. Even if coverage is increased to \$200,000, the average account balance is certain to remain very substantially below that level. Small depositors with say, \$1500, in checking and savings accounts are not going to increase their total deposits just because the upper insurance limit is increased. And, competitive factors suggest that substantially increased nominal coverage will not increase the overall deposit base by a large amount. Depositors with large sums may shift insured deposits from one bank to another to consolidate balances or take advantage of higher interest rates. But, one bank’s gain may well be another bank’s loss. ACB members who responded to our survey estimated only a net gain of 3 percent as a result of increasing insurance coverage to \$200,000. Thus, doubling coverage levels is not the same as doubling the FDIC’s risk.

Should Coverage Limits be Indexed?

If a substantial increase in coverage is not feasible, ACB supports indexing of the \$100,000 level to maintain its purchasing power. This would not completely address the loss of coverage to inflation experienced since coverage was increased to \$40,000 in 1974 and \$100,000 in 1980. If coverage had been indexed using 1974/\$40,000 as a base, the current level would be between \$115,000 and \$130,000; if indexed using 1980/\$100,000 as a base, the current level would be approximately \$200,000. Clearly, an adjustment accounting for inflation since 1974 is reasonable but such an increase would not justify an unacceptable premium increase. Former FDIC Chairman Helfer believes this is a “better approach” than increasing coverage to \$200,000. However, she indicated that, “Whatever the correct number, it is the principle of indexing that is important.”²⁰

¹⁹ Helfer, Dec. 4, 2000, p. 12

²⁰ Helfer, p. 14

Indexing on a going-forward basis would certainly not justify any premium increase and would have the clear advantage that the FDIC identified in its Options Paper – insulation from political cross currents and maintaining “the same relative importance of deposit insurance in the economy over time...”²¹ Indexing using the current level also avoids the debate over what year and level should be the basis for indexing. For better or worse, depository institutions and the economy have adjusted to the current level of coverage. Indexing would maintain that balance rather than seeking to recalibrate it based on a level that had been appropriate in the past.

To simplify and reduce the cost of implementation, as well as to promote consumer understanding, we recommend that any increases be provided only in \$10,000 increments. Some ACB members are especially concerned that frequent small adjustments would be more costly than any benefit they might realize from increased deposit funding.

Should Coverage for Retirement Accounts be Increased?

Congress has provided substantial tax incentives to encourage individuals to accumulate retirement savings. These individual savings are replacing resources that employers previously provided through defined benefit pension plans. This shift in retirement funding has increased the burden on individuals to manage their own assets. As individuals respond to tax incentives, their retirement assets often exceed the current \$100,000 coverage limit by substantial amounts. Since planners generally recommend that individuals shift these savings into more secure and stable investments as they approach retirement, ACB believes that Congress should substantially increase deposit insurance for retirement savings that meet the tax requirements established under the Internal Revenue Code. Congress could provide increased coverage as part of deposit insurance reform, or in conjunction with enhancements to retirement savings incentives or social security reform.

Should Coverage for Municipal Deposits be Increased?

ACB members hold differing views on increased coverage for municipal deposits. This generally reflects differences in state and local practices. For example, in Minnesota local governments have joined together to form mutual funds for their liquidity needs, effectively bypassing insured depository institutions. New Jersey has a centralized and relatively straightforward system for collateralizing public deposits that makes it unnecessary for banks to match specific collateral with specific deposits. In other states banks are still able to compete for these deposits, but must follow complicated collateralization requirements. Bankers in those states believe they would benefit from increased deposit insurance for municipal deposits. Similarly, minority institutions also believe they would benefit from increased deposit insurance for these deposits. However, policy makers must avoid imposing an across-the-board premium for increased coverage that would not benefit all institutions.

Should the FDIC Make Excess or Co-Insurance Available as an Option?

ACB does not support optional deposit insurance or co-insurance for amounts over the general coverage limit (whether the current \$100,000 limit or some higher amount). ACB members believe that this could lead to confusion among depositors, with some banks offering more FDIC insurance than others. It would add an unnecessary complication to a system that the public understands fairly well, at least in broad outline. Other ACB members have commented that competitive pressure would eventually result in all institutions offering “optional” coverage. Finally, institutions that wish to provide additional protection for special cases can collateralize individual deposits or seek privately funded overline insurance. While private insurance could never substitute for basic FDIC coverage – no conceivable private firm could have the capacity – carefully targeted overline insurance is feasible and currently available.

²¹ FDIC Options Paper, p. 44.

Should The Rules for Determining Coverage be Further Simplified?

In recent years, the FDIC has taken careful steps to simplify rules for coverage. ACB generally supported these changes, but we do not support further substantial changes in coverage rules. The Options Paper suggests that, “The most straightforward option would be to...eliminate the separate insurance coverage that is currently provided for accounts held in separate rights and capacities...”²² (Note our view expressed above about the separate coverage of retirement accounts.) Any changes might simplify coverage computations, but would also tend to reduce the amount of coverage available. This would make it more difficult for institutions to attract deposits. In addition, further changes could actually complicate the work of new-accounts representatives in community banks. Too-frequent rounds of “simplification” would be costly to implement and provide too many opportunities for mistakes and misunderstandings.

Conclusion

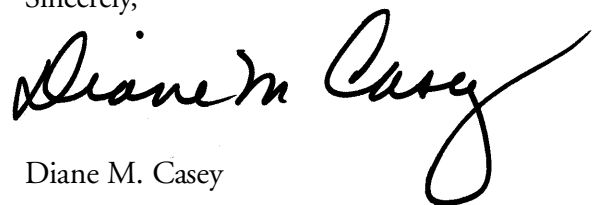
ACB appreciates the opportunity to comment on this important matter. We believe that it could lead to substantial improvements in the deposit insurance system.

These are ACB’s key recommendations:

- BIF and SAIF should be merged without delay;
- Congress should set a ceiling on the merged fund and provide for rebates;
- If other important reforms are provided, the FDIC should have expanded authority to impose modest risk-based premiums;
- Highly rated institutions should continue to be exempt from premiums so long as the fund is above its statutory minimum level;
- If the fund falls below that level, the FDIC should have the flexibility to recapitalize it over a reasonable period;
- Institutions that grow at excessive rates should pay a special premium to maintain the integrity of the fund;
- The FDIC’s current role should be maintained; deposit insurance must not be privatized;
- Congress should provide increased coverage by indexing coverage from the 1974 level of \$40,000, without imposing significant additional premiums;
- Congress should substantially increase coverage levels for retirement savings.

If you have any questions, please contact Steve Verdier at (202) 857-3132.

Sincerely,



Diane M. Casey

²² FDIC Option Paper, p 46.

FDIC Deposit Insurance Options Paper

Introduction

This options paper is part of a comprehensive review of the U.S. deposit insurance system by the Federal Deposit Insurance Corporation (FDIC). We are undertaking this review to assure the ability of the system to meet its responsibilities over the next decade. Industry consolidation, expanded activities, global-ization and the use of technology have advanced the business of banking and the products and services offered to American depositors. The FDIC wants to ensure that the deposit insurance system continues to protect depositors and contributes to its full extent to the stability of the banking system.

The United States has the oldest federal deposit insurance system in the world, established in 1934 to put an end to the devastating bank runs that shut down businesses and contributed to the Great Depression. The system proved to be a success; following its introduction, deposit insurance restored public confidence in the banking system. For the next three generations, the system served its purpose by helping prevent banking problems from becoming banking panics. In the 1980s, when hundreds of banks and thrifts failed, deposit insurance acted as the anchor for public confidence in the banking system.

In good times and bad times, deposit insurance provides a safe and certain place for people to put their money. By eliminating the disruption caused by bank runs, deposit insurance contributes to the foundation necessary for a robust banking system and by extension, a dynamic financial system. In turn the general economy benefits from the stabilizing influence of deposit insurance.

The success of the U.S. system of federal deposit insurance is particularly evident in contrasting the U.S. experience during the 1980s crisis with recent crises in Asian and Latin American countries that lacked explicit deposit insurance systems. During the U.S. crisis, there were no depositor runs on banks, and bank failures were resolved through a well-established, orderly process. This was not the case for countries

without explicit deposit insurance, and it is perhaps sufficient to note that more than 30 countries chose to implement new, explicit deposit insurance systems during the 1990s. The benefits of deposit insurance are appreciated worldwide, and the U.S. system has become a model for the rest of the world.

Nevertheless, the 1980s crisis in the U.S. also provides a sobering reminder that a flawed deposit insurance system can be extremely costly. U.S. taxpayers were billed for more than \$130 billion to clean up the savings and loan crisis following the demise of the Federal Savings and Loan Insurance Corporation (FSLIC). This demonstrates that deposit insurance raises complicated issues and requires a careful balancing of competing public policy concerns.

Today, the bank and thrift industries have never been healthier. Bank capital levels are at an all time high, profitability has climbed for the ninth year in a row, and the insurance funds have substantial combined reserves of \$42 billion. There will never be a better time to address the latent flaws in the system. Reforms now will also help us maintain the proper incentives for risk and reward to insured institutions, as well as fairness among institutions that present different levels of risk to the system.

The FDIC has identified three fundamental areas for review: the processes for pricing risks, funding insurance losses, and setting coverage limits. This options paper describes various ways in which we might make improvements to the deposit insurance system. The options are intended to prompt analysis and comment from individuals and organizations that have an interest in the issue

The Need for Reform

With the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), Congress passed a number of significant reforms to shore up the deposit insurance system. These included prompt corrective action, least-cost resolutions,

scaling back of too-big-to-fail, the introduction of risk-based premiums, and a mandate to maintain adequate insurance funds. With the Deposit Insurance Funds Act of 1996 (DIFA), Congress ensured that members of the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) would not face significant and arbitrary differences in deposit insurance pricing.

Despite these significant improvements, the current deposit insurance system has several features that work against the effective and equitable functioning of the system:

- The continued existence of two separate insurance funds based on an anachronistic distinction;
- The current pricing system that creates inappropriate incentives and raises fairness issues;
- The requirement that banks are required to fund insurance losses when they can least afford it; and
- Uncertainty for depositors as to the future real value of FDIC coverage.

Over the past decade the FDIC has stated its view that the two insurance funds the FDIC administers should be merged. The distinction between the funds is increasingly arbitrary; a combined fund would be stronger and more efficient; and the time to merge them is when they are both healthy. These arguments are laid out in detail in Attachment A. This options paper will not address this flaw, other than to state the FDIC's position that a merger of the funds is good public policy either on a stand-alone basis or as the prerequisite for any other changes to the deposit insurance system.

The second and third of these problems result from the conflicting mandates of the FDICIA: to price deposit insurance premiums according to the risk posed by individual institutions, and to maintain a target level of reserves within the insurance funds. The tension between the dual mandates of risk-based pricing and a fixed fund level became far more explicit in 1996 as DIFA severely limited the FDIC's ability to price according to risk.

Because of current restrictions on pricing deposit insurance, most banks and thrifts pay no insurance premiums when they are doing well, but pay high premiums when the industry is weak and banks are failing. This does not make sense for the banks or for the communities they serve. It is possible that, in difficult times, deposit insurance premiums could reduce the pre-tax net income of insured institutions by almost \$9 billion. Based on current average capital and loan-to-assets ratios for all insured institutions, this reduction in income could lead to a contraction in lending of more than \$65 billion at the precise time in the business cycle when loans are most needed.

The current process for setting deposit insurance coverage limits has brought the issue before Congress on a somewhat arbitrary and ad hoc basis. This has resulted in significant fluctuation in the real value of insurance for depositors. The current coverage limit of \$100,000 has declined in real value by half since it was established in 1980. This raises the question of whether Congress wishes to continue providing the same level of insurance protection for consumers in real terms, or to allow the coverage level to erode in value by maintaining the status quo. The current deposit insurance arrangements lead to several questions:

How Should the FDIC Price Risk?

Through a combination of legislative changes, regulatory choices and economic events, the pricing and funding of deposit insurance evolved during the 1980s and 1990s into something fundamentally different from what existed during the first 50 years of the FDIC's history. Banks that are paying for deposit insurance at the end of the 1990s are those that have run afoul of capital regulations or the supervisory process. This is a significant departure from past practice. Pricing of deposit insurance has evolved into a penalty system for the few, rather than a priced service for all.

Thus, a decade that began with a legislative mandate for risk-based insurance premiums ended with the FDIC providing a free guarantee of almost three trillion dollars in bank and thrift liabilities. As a result, the moral hazard problems

FDICIA intended to address with risk-based deposit insurance may have become more firmly entrenched than ever. (Moral hazard problems are discussed in more detail in Section IV, "Coverage Limits.") A striking feature of a zero premium is that not only may the rate paid by vastly disparate banks be identical, but the dollar amount as well: a bank with \$100 billion in deposits and a complex risk profile can be billed the same amount for its insurance as the smallest and most conservatively run community bank. Presumably, the rationale behind a statutory zero premium is that, as long as a fund is above its target level, it does not need additional funds. However, aside from raising money for the insurance funds, premiums also serve to align economic incentives. When a valuable product is offered at zero cost, it leads to that product being overused, causing distortions throughout the marketplace and, in the case of deposit insurance, potentially exacerbating moral hazard.

If deposit insurance were priced according to risk, it is likely that every bank in the U.S. with insured deposits would pay something for deposit insurance, for the same reason that every bank pays at least some spread over Treasuries for unsecured debt. However, since shortly after the BIF was recapitalized in May 1995, its members that are in the best-rated, 1A-assessment category have not been required to pay deposit insurance premiums. Members of the SAIF that are rated 1A have paid no premiums since January 1997.¹

At year-end 1999, only 7 percent of all banks and thrifts paid premiums into the deposit insurance funds. Ninety-three percent, or more than 9,500 institutions, do not pay premiums. This stands in stark contrast to the first 50 years of the federal deposit insurance program, when every insured institution paid an annual rate of 3.3 to 8.3 cents for every \$100 of insured deposits.

Despite the uniform assessment ratings given to these 1A institutions, they do not all present uniform risks to the deposit insurance funds. The current premium matrix does not recognize institutions that, by objective measures and historical experience, have a higher risk profile, unless the institution fails to maintain the minimum level of capitalization to be considered "well-capitalized" as defined for prompt corrective action purposes or is subject to heightened supervision.² In a less favorable economic environment, many of these 1A-rated institutions would deteriorate faster than others, yet that higher degree of risk is not built into the current assessment scheme.

How Should New Deposits be Treated?

Most banks and thrifts established since the recapitalization of the insurance funds have never paid for deposit insurance. Through March 2000 this included 844 new banks and thrifts whose insured deposits totaled more than \$44 billion. The responsibility for maintaining the \$550 million needed to capitalize these deposits at a 1.25 percent DRR falls on the other members of the deposit insurance system.

Similarly, institutions that are rated 1A can grow their insured deposits without paying assessments. This zero marginal cost of insurance clearly differs from the private insurance industry, in which higher coverage amounts entail higher charges. With the marginal cost of deposit insurance at zero, the same issues of fairness arise that occur under the new bank scenario: all insured institutions eventually are assessed to cover deposit growth at the fastest-growing, 1A-rated institutions. In a deteriorating financial environment, it will be necessary to raise assessment rates earlier or by a greater amount to make up for the dilution of the reserve ratio attributable to unfunded insured-deposit growth. Under some circumstances, insured-deposit

¹ More details on the risk categories in the current premium system are presented in Attachment C.

² Federal supervisors rate insured institutions on six factors: Capital; Asset Quality; Management; Earnings; Liquidity; and Sensitivity to market risk (CAMELS). Institutions receive an overall rating ranging from 1 to 5, with 1 being the best rating.

The original decision by the FDIC to lump CAMELS 1- and 2-rated institutions into the same risk category for premium purposes was largely codified into law in 1996 by the DIFA. Federal Deposit Insurance Funds Act, Pub. L. No. 104-208, §§ 2708(b) and 2708(c) (1996) (codified at 12 U.S.C. §§ 1817(b)(2)(A)(iii) and (v)). As a result, the FDIC is largely prohibited from distinguishing between CAMELS 1- and 2-rated institutions for determining premiums.

growth could occur rapidly, accelerating the need to raise assessment rates for all insured institutions. This could happen even in a favorable economic environment in which deposit-insurance losses remain low. In early 2000, an investment company announced plans to convert some of its customers' funds into FDIC-insured accounts. Reports in the media suggested that as much as \$100 billion could be converted in this manner in a relatively short period of time. Sudden growth of this magnitude at 1A-rated banks, with no corresponding growth in the fund balance, would dilute the fund's reserve ratio. In this example, the BIF reserve ratio would fall by 5 basis points. With a reserve ratio of 1.35 percent as of March 31, 2000, such a decline would leave the fund's reserve ratio above the statutory minimum of 1.25 percent, but the industry would be closer to mandatory rate increases for all insured institutions, depending on insured-deposit growth and insurance losses. From March 31, 2000, through June 30, 2000, insured deposits at the banks affiliated with the investment company grew by \$12 billion.

There is also the possibility of a large shift of household assets into insured deposit accounts in the event of financial market volatility. There is currently more than \$11 trillion outstanding in U.S. equity holdings (including mutual fund shares) alone. In a protracted bear market, some of these funds could be transferred to insured deposits. And it is still too early to gauge the probable impact of electronic banking on insured deposit growth. Obviously, the likelihood of deposit inflows from these examples, as from a myriad of other possibilities in an era of financial modernization, cannot be known. The question is whether the current deposit insurance system is capable of addressing the issues raised by these possibilities.

Conversely, institutions that shrink their deposits are not compensated for the indirect benefit they confer on other members of the system. Most BIF members have paid no premiums since 1995, and most SAIF members have paid none since 1996,

but all insured institutions paid very high rates in the earlier 1990s. The issue of deposit growth and shrinkage becomes important in any discussion of rebates (other than the refunding of current assessment income). Any such program would require legislation, but the question of who is entitled to how much is complicated by the existence of institutions whose deposit growth or shrinkage was atypical. For example, aggregate BIF-insured deposits grew by 10.5 percent from year-end 1995 to year-end 1999, during which time one bank grew its insured deposits (without any acquisitions) from \$19 million to \$1.2 billion (up 6,140 percent), and another bank reduced its insured deposits from \$763 million to \$423 million (down 45 percent). Of these two banks today, the one with a lower level of insured deposits paid considerably higher total assessments in the 1990s.

How Should Losses be Funded?

In reaching a point where the FDIC does not collect assessment revenue from most institutions during good times, we have clearly departed from any concept of spreading insurance losses over time by collecting revenue on an ex ante or long-run expected loss basis. In contrast, prior to 1989 it could be argued that Congress intended the FDIC to operate under a form of long-term expected loss pricing. During the period 1933-1989, when premiums were set by statute and never departed from a range of between 3 and 8.3 basis points per annum, accumulated premiums and the investment income on those balances enabled the system to roughly pay for itself. The system in place today, in contrast, amounts essentially to charging nothing in times of prosperity, and a lot in times of adversity, thereby potentially magnifying swings in the banking cycle.

The current "cushion" in the BIF, the amount by which the fund exceeds 1.25 percent, is \$2.3 billion.³ If insurance losses not covered by the systemic risk exception were to exceed this amount—as they did in each year from 1988

³ Despite growth of the fund during the first quarter of 2000, this cushion fell from \$2.5 billion at year-end 1999 because of insured-deposit growth in the first quarter.

through 1992⁴—and the fund fell below 1.25 percent and was expected to remain there for a year or more, the FDIC would be forced to raise average assessment rates to a minimum of 23 basis points. Therefore, all banks would be forced to pay substantially higher premiums at a time when many banks were under stress. On a strict pay-as-you-go basis, banks would have had to pay approximately 62 basis points in 1991.

If the FDIC had more latitude in setting rates when the reserve ratio falls short of the DRR, the recapitalization period could be extended with rates less than 23 basis points. This would help to avoid a credit crunch and to moderate the negative impact of deposit insurance premiums on real economic activity.

How Should the Coverage Levels be Determined?

The current process for setting deposit insurance coverage limits has brought the issue before Congress on a somewhat arbitrary and ad hoc basis. This has resulted in significant fluctuation in the real value of insurance for depositors. Deposit insurance has a simple, but important purpose: to provide a safe place for depositors to keep their money, as a way to prevent bank runs and maintain the stability of the banking and financial system.

Since 1934, the basic coverage amount has increased five times, from \$5,000 to \$100,000. Most of the increases more or less reflected cost-of-living adjustments, but the most recent increase is an exception. The 1980 jump from \$40,000 to \$100,000 had more to do with attracting deposits to insured institutions in a competitive market of very high interest rates. Today, 20 years later, \$100,000 of deposit insurance has lost about half its value, based on the Consumer Price Index.

The next several decades will be a time in which the population is aging, retirement costs are increasing, and the supply of federally-backed investment vehicles, such as Treasury notes and bonds, may decline. Thus, a long-term perspective

may argue for allowing for the coverage limit to keep up with changes in the price level, household wealth, or other measures relevant to households.

However, there are trade-offs to consider. Higher coverage limits can increase moral hazard. The 1980 increase is widely viewed as contributing to the high cost of the savings and loan crisis. Also, the impact of higher coverage limits on insured deposit growth is difficult to predict, and the likely distribution of benefits is subject to debate.

Overview of Options Paper

This remainder of this paper organizes the discussion into three major areas: pricing risk, funding insurance losses, and coverage levels.

Section II of this paper discusses the pricing of deposit insurance for individual banks. If deposit insurance is viewed as a service that banks use, the question is how this service should be priced. One answer is that the price should reflect the risk that the bank presents to the deposit insurance system. This expected loss approach to pricing is consistent with the best practices that have developed in the banking industry in recent years.

The next question is what information should serve as the basis for pricing. Supervisory ratings are appealing because they are based on quality information and reflect the judgment of experienced supervisors; however, too great a reliance on ratings raises concerns about consistency and subjectivity. This suggests the appeal of more objective information, which could include non-public information (such as credit exposures), Call Report information, and market information. Finally, the FDIC could generate pricing information through risk-sharing contracts with market participants.

Section III deals with how deposit insurance losses are funded from an aggregate perspective. The funding of FDIC losses has evolved over the years from a system that featured steady premiums with a fluctuating reserve ratio to a system that

⁴ Annual losses ranged from \$2.7 billion to \$6.9 billion during this five-year period. These are actual losses and not loss provisions, which were even higher but were partially recovered when many projected failures did not occur.

targets a specific reserve ratio and results in volatile premiums. The mandate to maintain a particular ratio can lead to steep premiums during bad times and calls for rebates during good times.

One general approach is a user fee system in which banks have no claim on past premiums. Under such an approach, the question is whether premiums will be relatively stable and consistent with expected loss pricing, or whether premiums will be more closely tied to current losses or the reserve ratio in order to guard against premiums that are too high or too low.

A mutual approach would differ from the user fee system in that banks would have some claim on past premiums. This could take the form of rebates when the insurance fund is viewed as too large; this raises the question of how to allocate these rebates. Alternatively, banks could hold claims on the insurance fund, similar to mutual fund shares. This could address concerns about free rider and pricing problems. Under mutual arrangements, the cash flow between a bank and the insurance fund could have two components: one to price risk at the margin and the other to reflect the bank's claim on the fund.

Section IV discusses the appropriate extent of deposit insurance coverage. The section begins with a review of the history of coverage levels in nominal and real terms. This is followed by

preliminary estimates of how an increase in the coverage limit would be expected to increase the amount of insured deposits. This depends on the behavior of households and businesses, and further study would allow more confidence in these estimates.

It is widely recognized that there is a tradeoff between the stability that deposit insurance brings and the potential for distortion of the market process. Coverage levels speak directly to that tradeoff: higher coverage may provide greater stability during difficult times, while lower coverage may enhance market discipline and minimize distortion. The section addresses this tradeoff with a discussion of moral hazard, implicit protection, and industry structure.

The options in the coverage section include continuing the existing system of ad hoc statutory adjustments; indexing for inflationary adjustments; or simplifying the current system to limit a particular level of coverage to one account per person. Other ideas for changes to coverage include extending higher coverage to municipal and other public deposits; this raises issues similar to those posed by brokered deposits. The section ends with excess coverage options including increased use of private coverage, new excess coverage through the FDIC, FDIC-backed private insurance, or coinsurance systems.

Source: FDIC Deposit Insurance Options Paper, August 2000, Introduction, pages 1-7.

Origins and Purposes of Deposit Insurance Funds: A Brief History

The states were the first to establish state deposit insurance programs. The first was proposed in New York in 1829 by Governor Martin Van Buren.¹ From 1829 to 1917, 14 states had established deposit insurance programs for their state-chartered banks. These programs had two purposes: to protect communities from the economic disruptions caused by bank failures and to protect depositors against losses.

While the states had taken the lead, a number of members of Congress were interested in establishing a federal deposit insurance system. The first bill was introduced in 1866.² Between 1886 and the establishment of the FDIC in 1933, 150 proposals for deposit insurance or guaranty were introduced in the Congress.³

The stock market crash of 1929 and the ensuing banking crisis in the early 1930s provided the necessary impetus for Congress to create a system of federal deposit insurance. In the four years after the crash about 9,000 banks closed, resulting in losses to depositors of over \$1.3 billion.⁴ Conditions deteriorated further during the winter of 1932-33. By March 4, 1933, the date of President Roosevelt's inauguration, every state in the union had declared a bank holiday. One of Roosevelt's first official acts was to declare a nationwide bank holiday to begin on March 6th.⁵ Congress then passed the Emergency Banking Act, which legalized the national bank holiday and set standards for reopening banks.⁶

Having passed the emergency legislation, Congress turned its attention to the issue of deposit insurance. The House had passed a deposit insurance bill in 1932, but the Senate had adjourned without acting on it.⁷ The chief

proponent of federal deposit insurance was House Banking Committee Chairman Henry Steagall who faced strong opposition from the Roosevelt Administration, most of the banking industry, and Chairman of the Senate Banking Committee, Carter Glass.⁸

Opponents of federal deposit insurance pointed to the failure of the state deposit insurance programs and argued that a federal program would not work. They said it would remove penalties for bad management, that it would be too expensive, and would be an unwise intrusion by the federal government into the private sector.

In May of 1933, both Senator Glass and Representative Steagall introduced bills including deposit insurance provisions. Senator Glass apparently yielded to public opinion indicating that voters wanted deposit insurance. After a heated but short conference, a compromise was reached with the House conferees agreeing to accept the two controversial provisions of the Senate bill. They required Federal Reserve System membership for insured banks and made deposit insurance a temporary program.⁹ Both houses passed the conference report on June 13, 1933 and the President signed the bill on June 16, 1933.¹⁰

The 1933 Act created the Federal Deposit Insurance Corporation by amending the Federal Reserve Act.¹¹ Capital to establish the FDIC was to come from the Treasury and the 12 Federal Reserve Banks. Treasury contributed \$150 million and each of the Reserve Banks was required to buy stock in an amount equal to half of its surplus as of January 1, 1933.¹²

¹ *Political Science Quarterly*, June 1960, p. 182.

² *Ibid.* p. 186.

³ FDIC, *The First 50 Years*, 1984 – p. 31.

⁴ *Ibid.* p. 36.

⁵ *Ibid.* p. 38.

⁶ *Ibid.*

⁷ *Ibid.* p. 40.

⁸ *Ibid.*

⁹ *Ibid.* p. 43.

¹⁰ *Ibid.*

¹¹ *Ibid.*

¹² *Ibid.* p.44

The temporary plan limited deposit insurance protection to \$2,500 for each depositor.¹³ Banks admitted to the plan were to be assessed an amount equal to one-half of one percent of insurable deposits.¹⁴

The permanent plan set forth by the 1933 Act was replaced by the Banking Act of 1935 which made several major changes in the deposit insurance program. The 1935 Act adjusted the annual assessment rate to a one-twelfth of one percent annual assessment rate on total deposits.¹⁵ The Act also continued the coverage of \$5,000 per account, rather than the increased sliding scale version of the “original” permanent plan.¹⁶

The \$5,000 per account limit remained until 1950, when it was raised to \$10,000. It was increased to \$15,000 in 1966, to \$20,000 in 1969, to \$40,000 in 1974, and to \$100,000 in 1980.¹⁷

Representative Steagall outlined the purposes of the deposit insurance program as follows: . . . the purpose of this legislation is to protect the people of the United States in the right to have banks in which their deposits will be safe. They have a right to expect of Congress the establishment and maintenance of a system of banks in the United States where citizens may place their hard earnings with reasonable expectation of being able to get them out again upon demand This bill seeks to establish a mutual insurance system supported and maintained by the banks themselves, in their own interests as well as for the benefit of their depositors We cannot have a normal use of bank credit in the United States until people are willing to put their deposits in banks. Deposits

constitute the basis for bank credit, and bankers can never be free to extend credit accommodations for the support of trade and commerce until they are permitted to retire at night without fear of mobs at their doors the next morning demanding cash for their deposits.¹⁸

As indicated, President Roosevelt and Senate Banking Committee Chairman Carter Glass both initially opposed federal deposit insurance. Roosevelt felt that the use of tax revenues to finance such a system was unacceptable. However, because of the weakened condition of the banking industry, policy makers recognized that at least some of the initial capitalization would have to come from government sources.

During Senate debate, Senator Glass repeatedly emphasized that this was to be an insurance fund, but not a government guarantee. He stated: “I am not standing here as an advocate. For 35 years in the other House, and up to this time in the Senate, I have opposed guaranteeing deposits, but this is not a Government guaranty of deposits The Government is only involved in an initial subscription to the capital of a corporation that we think will pay a dividend to the Government on its investment. It is not a Government guaranty.”¹⁹

The financial crisis of the 1920s and the 1930s also led to the current regulatory system for thrifts. The National Housing Act of 1934 established the Federal Savings and Loan Insurance Corporation (FSLIC) as a permanent government corporation and placed it under the supervision and authority of the Federal Home Loan Bank Board.²⁰

¹³ *Ibid.*

¹⁴ *Ibid.*

¹⁵ Banking Act of 1935, Conference Report No. 742

¹⁶ *Ibid.*

¹⁷ FDIC, First Fifty Years, p. 69.

¹⁸ Congressional Record, 1933; Conference Report No. 742, p. 3037.

¹⁹ *Ibid.* p. 3727.

²⁰ “A Guide to The Federal Home Loan Bank System” p. 47.

The differences between a bank and thrift charter allowed the Act's supporters to argue that the creation of FSLIC was more related to housing policy than monetary or economic policy. The threat to thrifts was not deposit losses, but rather that a lack of public confidence might prevent an adequate inflow of new funds to maintain home lending.

In a statement to the Senate Banking Committee on May 16, 1934, Bank Board Chairman John Fahey argued that FSLIC was a matter of equity for thrifts: "The advent of deposit insurance for banks has resulted in substantial deflection of wage earners' savings from investment in building and loan associations to deposit in banks where they will be insured. Not only principles of fair treatment, but the economic necessity of keeping funds from flowing out of institutions where they are needed and into institutions where they will presently be unused calls for the erection of a system of insurance for building and loan associations comparable to that presently in operation for the protection of bank depositors."²¹

Despite this concern, the thrift industry initially resisted the new deposit insurance. Federally chartered thrifts were required to carry it, but coverage was optional for state-chartered thrifts, most of which refused to sign up.²² It was not until 1951 that FSLIC-insured thrifts outnumbered non-FSLIC-insured thrifts.

Under the 1934 Act, savings accounts in FSLIC-insured thrifts were guaranteed up to \$5,000. Due to the different nature of the account, in event of a failure, a depositor was entitled to receive 10 percent of his or her account in cash immediately, 50 percent of the remainder within one year and the balance within three years of the default.²³

The 1934 Act established the FSLIC premium rate at one-fourth of one percent of total deposits.²⁴ That Act also permitted a special assessment, also at the one-fourth of one percent rate. Both assessments were reduced to one-eighth of one percent in 1935.²⁵

In 1950, the regular premium was reduced to 1/12 of one percent.²⁶ Although on the books since 1934, the special assessment was not imposed by FSLIC until 1985. The one-eighth of one percent was levied quarterly from 1985 through 1988.

The limits of FSLIC insurance coverage increased concurrently with FDIC insurance, from \$5,000 in 1934 to \$100,000 in 1980.²⁷

²¹ Congressional Record, May 16, 1934, p. 33.

²² *Ibid.* p.47.

²³ *Ibid.*

²⁴ *Ibid.* p.48

²⁵ *Ibid.*

²⁶ *Ibid.*

²⁷ *Ibid.*

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