

T-2343

United States General Accounting Office

GAO

Report to the Chairman, Committee on
Banking, Housing and Urban Affairs,
U.S. Senate, and the Chairman, Committee
on Banking, Finance and Urban Affairs,
House of Representatives

March 1991

DEPOSIT INSURANCE

A Strategy for Reform



GAO/GGD-91-26

GAO website

Contents

Executive Summary		2
<hr/>		
Chapter 1		22
Introduction	Background	22
	Information on Depository Institutions and Deposits	24
	Insurance Losses and Costs Increased Significantly	30
	During the 1980s	
	Why Reform Is Necessary	32
	Our Approach to the FIRREA Study	35
	Objectives, Scope, and Methodology	38
<hr/>		
Chapter 2		41
Deposit Insurance	Problem Number One: The Federal Bank Supervisory	42
Reform: An Overview	System Is Often Ineffective	
	Problem Number Two: Insufficient Bank Capital and	46
	Other Unhealthy Incentives Place BIF at Risk	
	Problem Number Three: Holding Company Regulation and	50
	Structure Need to Be Updated	
	Our Approach Stresses Incentives, Capital, and Effective	55
	Regulation	
<hr/>		
Chapter 3		59
Improving the Bank	Congress Should Establish a Regulatory "Tripwire"	60
Supervisory System	System to Improve Bank Supervision	
	Better Information on Banks, Accounting Rule Changes,	71
	and Strengthened Reviews of Internal Controls Are	
	Needed for an Effective System of Tripwires	
	A Commission of Regulators and Independent Experts Is	75
	Needed to Study the Adequacy of the Regulatory	
	System	
	Regulatory Improvements May Require Agency	77
	Restructuring	
	Congress Should Monitor the Adequacy of BIF Reserves	78
	Conclusions	80
	Recommendations	81

Contents

Chapter 4		83
Changes in Economic Incentives That Affect Owners, Managers, and Depositors		
	Bank Minimum Capital Requirements Must Be Strengthened	83
	Modifications Should Be Made to Deposit Insurance Premiums to Reflect Differences in Risk	95
	Incentives Affecting the Ability of Risky Banks to Attract Deposits Should Be Changed	96
	Conclusions	106
	Recommendations	106
<hr/>		
Chapter 5		108
Ensuring the Safe and Sound Evolution of the U.S. Financial System: Updating Holding Company Structure and Regulation		
	<i>Interstate Banking Restrictions Can Be Phased Out for Well-capitalized, Well-managed Banks</i>	109
	Improvements to Holding Company Regulation Are Necessary Even Without Glass-Steagall Reform	113
	Any Action to Expand Powers for Banking Organizations Must Meet Several Preconditions	123
	Conclusions	141
	Recommendations	142
<hr/>		
Appendixes		
	Appendix I: Information on Deposits and the Effects of Changing the Definition of an Insured Deposit	146
	Appendix II. The Implications of Federally Insuring BICs for Banks and BIF	166
	Appendix III: Foreign Deposits	171
	Appendix IV. Characteristics of the U.S. Financial Services Industry and the Top Firms in Each Component	181
	Appendix V: Major Contributors to This Report	187
<hr/>		
Related GAO Products		190
<hr/>		
Tables		
	Table 1.1: Assets Held by Depository Institutions, as of June 30, 1990	24
	Table 1.2: Asset Size of Depository Institutions, as of June 30, 1990	25
	Table 1.3: Uninsured Deposits and Non-deposit Liabilities of Commercial Banks, as of June 30, 1990	27

bear a significant liquidity risk associated with their use of short-term deposits to fund longer-term investments.

Another significant risk associated with depository institutions is that borrowers may not be able to repay their loans. Loan defaults can be attributed to various factors, including economic downturns and poor judgment and management practices. Interest rate volatility also poses substantial risk if depository institutions are forced to pay more for short-term deposits on which interest rates are adjusted frequently than they earn from loans and other investments with fixed, long-term returns.

In a healthy bank, the costs associated with these risks are reflected in prices charged for bank services and are, therefore, normally offset by earnings. Furthermore, if equity capital adequately reflects risk, (i.e., the greater a bank's risk the higher its capital level as a percentage of assets), then losses resulting from risk should be absorbed by bank owners. Deposit insurance protects depositors in failed banks if bank capital is not sufficient to absorb the losses.

The original limit of \$2,500 per insured account was quickly raised to \$5,000 in 1934 when thrift coverage was enacted. The limit has been raised six times since then. The current \$100,000 limit was set in the Depository Institutions Deregulation and Monetary Control Act of 1980.

Today, the deposit insurance program is administered by two federal agencies, the Federal Deposit Insurance Corporation (FDIC) and the National Credit Union Administration (NCUA). FDIC administers two separate funds—the Bank Insurance Fund (BIF), which insures deposits in commercial banks and some savings banks, and the Savings Account Insurance Fund (SAIF), which protects deposits in savings and loan associations and other thrift institutions.³ Accounts in credit unions are insured by NCUA's National Credit Union Share Insurance Fund (NCUSIF). In FIRREA and prior enactments, Congress has reaffirmed that federally insured deposits are backed explicitly by the full faith and credit of the U S government.

³SAIF is currently accepting premiums from thrifts, but expenses for the resolution of failed thrifts, except for those chartered after FIRREA was enacted, will be covered by the Resolution Trust Corporation, which is responsible for resolving thrift failures until August 9, 1992

Information on Depository Institutions and Deposits

As of June 30, 1990, there were about 29,000 depository institutions in the country. These institutions held roughly \$5 trillion in loans and other assets. Approximately two-thirds of the total—\$3.4 trillion—was held by about 12,500 commercial banks. (See table 1.1.)

Table 1.1: Assets Held by Depository Institutions, as of June 30, 1990

Dollars in billions

Type of institution	Number of institutions	Amount of assets	Percent of total depository institution assets
Commercial banks	12,502	\$3,360.0	66.7
BIF-insured savings banks	461	233.4	4.6
Other savings banks and thrifts*	2,878	1,251.7	24.8
Credit unions	13,102	195.3	3.9
Total	28,943	\$5,040.4	100.0

*Data are as of December 31, 1989, for SAIF-insured institutions and institutions in RTC conservatorships.

Source: GAO analysis of call report data.

Depository institutions vary greatly by size. Most are relatively small institutions—less than \$500 million in assets, while the largest commercial banks rank among the nation's largest and most complex multinational companies. The 57 depository institutions with assets over \$10 billion control roughly 30 percent of the assets in depository institutions. (See table 1.2.) The financial health of these large institutions is of particular concern because the failure of one or more of them may be great enough to affect the stability of the banking system.

Chapter 1
Introduction

Table 1.2: Asset Size of Depository Institutions, as of June 30, 1990

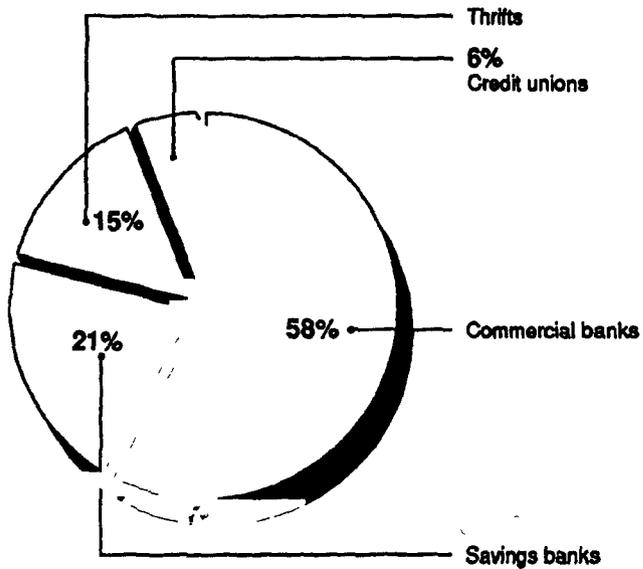
	Number of Institutions			Percent of deposit industry assets in categories
	Commercial banks	Savings banks and thrifts ^a	Credit unions	
Greater than \$50 billion	7	0	0	11.7
\$10-\$50 billion	38	12	0	19.2
\$1-\$10 billion	327	268	5	35.5
\$500 million-\$1 billion	245	245	23	7.0
\$50 million-less than \$500 million	5,124	1,967	752	21.2
Less than \$50 million	6,761	847	12,322	5.4

^aData for thrifts are as of December 31, 1989

Source: GAO analysis of call report data

Federal agencies estimate that as of June 30, 1990, the U.S. government insured just under \$3 trillion in deposits and credit union shares. Of this total, commercial banks held 58 percent, thrifts and BIF-insured savings banks held 36 percent, and credit unions held 6 percent. (See fig. 1.1.) Additional information on deposits is contained in appendix I.

Figure 1.1: Insured Deposits Held by Depository Institutions, as of June 30, 1990



Of savings banks total, \$405 billion was covered by SAIF, and \$203 billion was covered by BIF.

Source FDIC, OTS, and NCUA.

In addition to insured deposits, funding sources for depository institutions include domestic deposits over \$100,000, foreign deposits, various non-deposit liabilities and capital. Among depository institutions, commercial banks, particularly the largest 45, most frequently used uninsured deposit liabilities. (See table 1.3.)

Table 1.3: Uninsured Deposits and Non-deposit Liabilities of Commercial Banks, as of June 30, 1990

Dollars in billions

	Top 45	Industry total	Amount in top 45 banks as a percent of industry
Time deposits >\$100,000	\$139.0	\$392.1	35.5
Foreign deposits	291.8	330.0	88.4
Fed funds purchased	84.1	167.4	50.2
Repurchase agreements sold	38.5	100.7	38.2
Demand notes	14.6	28.6	51.0
Other borrowed money	75.3	121.8	61.8
Mortgage indebtedness	1.0	2.2	45.5
Acceptances outstanding	20.3	23.9	84.9
Other liabilities	61.3	91.9	66.7
Subordinated debt	15.0	19.7	76.1

Note: The top 45 are banks with assets in excess of \$10 billion.
Source: GAO analysis of call report data.

Sufficient Bank Capital, Effective Regulation, and Adequate BIF Financing Are Needed to Protect Taxpayers From Loss

Deposit insurance creates a very large contingent liability for the federal government as exemplified by the fact that the \$3 trillion in insured deposits greatly exceeds the entire 1991 federal budget. This exposure creates the potential for the federal government and taxpayers to sustain significant losses if numerous, high-cost bank failures occur.

The potential for losses to the taxpayer exists in part because the deposit insurance funds were never intended to be funded at a level that would create reserves sufficient to cover heavy losses from large numbers of bank failures. The program traditionally has been financed by relatively low, flat-rate premiums that, until the late 1980s, did not exceed 0.83 percent (8.3 basis points) of total domestic deposits.

Through the use of premium rebates, the FDIC was required to maintain the insurance fund at no less than 1.16 percent and no more than 1.40 percent of total insured deposits. Such premium rebates were given regularly until 1985. FIRREA established a designated minimum reserve ratio of 1.25 percent that could climb to a maximum 1.50 percent if FDIC determined that BIF faced significant losses. The Omnibus Budget Reconciliation Act of 1990 removed the 1.50 percent ceiling on the designated reserve ratio.

The insurance funds are protected by a regulatory system intended to reduce bank risk-taking and failures. This system includes regulation at

both federal and state levels. Federal and state laws define allowable activities for depository institutions, and federal and state regulatory authorities grant charters that can only be revoked by these same agencies. Discount loans from the Federal Reserve System, the nation's central bank, are also available to help banks deal with liquidity problems that otherwise could destabilize the banking system.⁴

The combination of federal and state chartering and regulatory agencies results in an administratively complex environment for managing deposit insurance risks. For example, within each industry component, rules differ between state and federally chartered institutions.⁵ All federally insured depository institutions are, however, examined by a federal agency.⁶ The Office of the Comptroller of the Currency (OCC), FDIC, and the Federal Reserve System employ a total of approximately 5,000 examiners and spend roughly \$500 million annually in supervising and regulating BIF-insured banks and savings banks.

How Insolvent Institutions Are Closed

Depending on the charter, OCC or a state banking authority has the power to close a banking institution. When banks fail, FDIC is almost always appointed receiver and has several options for handling the affairs of a failed institution. It can liquidate the bank, it can sell some or all of the failed bank to another bank, it can arrange a merger, or, in some cases, it can provide assistance to keep the bank open. FDIC can also set up a bridge bank that is operated under federal auspices in cases where a bank is too large to be resolved quickly.

⁴The Federal Reserve discount window, which together with deposit insurance and bank regulation comprises the "federal safety net," protects the deposit insurance funds and taxpayers from loss by maintaining systemic stability. The availability of borrowed reserves at the discount window permits individual depository institutions, as well as the depository system as a whole, to adjust to sizable fluctuations in deposits and loan demand. This provision of credit is intended to deal both with seasonal fluctuations in the demand for transaction balances at depository institutions and with liquidity problems. In addition to having access to the Federal Reserve, thrift institutions can borrow from Federal Home Loan banks, and credit unions from the Central Liquidity Facility administered by NCUA.

⁵For example, certain state-chartered banks are permitted to sell life insurance while most national banks are not.

⁶OCC charters and supervises 4,058 national banks with about \$2 trillion in assets. The Federal Reserve supervises 1,017 state-chartered banks with \$567 billion in assets that are members of the Federal Reserve system. FDIC supervises 7,420 state non-member banks, 18 federal savings banks, and 460 state savings banks with a total of \$1.1 trillion in assets. OTS supervises all federally insured federal and state savings associations. NCUA supervises all federally insured federal and state credit unions.

Since the 1960s, FDIC has handled most failed banks by selling some or all of the failed banks' assets through what are known as purchase and assumption (P&A) transactions. This type of transaction is significant because it generally protects all depositors—insured and uninsured—from loss. Such protection is afforded because all of the failed institutions' funding liabilities are assumed by another institution with FDIC assistance. Owners and stockholders are not generally protected in such transactions.

The decision about the type of failed bank resolution method FDIC will pursue depends, in most instances, on a cost test conducted by FDIC.⁷ FDIC uses the P&A method if it is a cheaper alternative than liquidation, which FDIC has generally found to be the case.⁸ FDIC can, however, disregard the cost test if it finds that protecting all of the bank's liability holders is essential to providing adequate banking services to the community.⁹ As a result of FDIC's preference to use the P&A, an estimated 99.6 percent of all deposits—insured and uninsured—were fully covered in bank failures from 1985 through 1989, although an estimated 32 percent of the uninsured deposits that remained in the banks when they were actually closed suffered losses.¹⁰ While FIRREA gave FDIC authority to vary the amounts of protection given to different classes of uninsured claimants, including uninsured depositors, FDIC does not have a general policy in P&A transactions about how different classes of uninsured claimants will be treated.

⁷Pursuant to Section 13(c) of the Federal Deposit Insurance Act, (FDIA), the cost test requires that assistance provided in connection with a failing or failed bank must not exceed the cost of a payoff and liquidation of the institution. The cost test does not require the FDIC to choose the least costly option among the nonpayoff options available but does require FDIC to estimate the ultimate cost to the public.

Application of the cost test has resulted in a higher probability that larger institutions will be handled in a way that pays general creditor claims in full. This occurs for several reasons, such as larger institutions tend to have larger relative franchise values, and the FDIC is likely to become involved earlier with publicly traded companies. With the passage of FIRREA, FDIC's maximum legal liability to uninsured depositors and creditors is that amount they would have received in a liquidation, regardless of the type of resolution option chosen. FDIC can prorate losses among uninsured depositors and creditors of a failed institution in connection with a P&A transaction.

⁸P&As and approaches that did not involve liquidation were used to resolve 708 of the 896 cases (79 percent) that FDIC handled from 1985 through 1989.

⁹Since 1980 FDIC has invoked what is known as the essentiality provision (section 13(c) of the FDIA) a total of four times. The most recent example involved the Bank of New England.

¹⁰Failed banks that were closed during this period had, at the time the regulators took action, an estimated \$85 billion in deposits of which about \$10 billion (12 percent) were uninsured. Of the uninsured deposits, \$711 million (68 percent) were also protected in full, and an estimated \$335 million (32 percent) suffered losses. In most instances, it is likely that there had been additional uninsured deposits in the banks that were withdrawn before the banks were closed.

Insurance Losses and Costs Increased Significantly During the 1980s

Without question, the deposit insurance program has been successful in instilling public confidence in the banking system. This has been particularly evident in the last two decades. Despite the energy price shocks and inflation of the 1970s, recessions, stock market drops, regional dislocations, and well-publicized problems in the thrift and banking industries that have occurred over the past decade, most people have not had to worry about whether their money was safe.

In the 1980s, however, losses in the credit union, thrift, and banking industries have demonstrated that insuring deposits can be very expensive. During this period depository institutions failed in record numbers. In the case of thrifts, insurance losses have spilled over to the taxpayer.

Turning first to credit unions, due principally to losses suffered during the severe recession in the early 1980s and despite the doubling of premiums in 1983, the level of reserves in NCUSIF never rose above about .3 percent of deposits. In 1984, Congress authorized all federally insured credit unions to deposit 1 percent of their insured shares in NCUSIF to recapitalize the fund. Since the recapitalization, industry losses have been within the fund's capacity.

Thrift losses mounted sharply throughout the 1980s and, despite a doubling of premiums and a special \$10.8 billion recapitalization program, bankrupted the Federal Savings and Loan Insurance Corporation (FSLIC), the agency responsible for insuring thrifts until 1989. From August 1989 through December 1990, a total of 531 thrifts with about \$271 billion in assets failed. The Office of Thrift Supervision estimates that another 179 thrifts will fail and that 356 institutions may lack sufficient financial resources to avoid insolvency. We estimate that, including financing costs, the thrift failures could ultimately cost the American taxpayers \$400 billion to \$500 billion.¹¹

Many reasons have been cited for the numerous thrift failures. Some of these have to do with changes in the financial markets that subjected all institutions, including specialized housing lenders, to intensified competition. Others include the periods of inflation, recession, and fluctuating interest rates that occurred in the economy. The thrift industry was

¹¹This estimate includes net cash outlays needed for FSLIC's assistance transactions and for institutions that RTC must resolve, RTC's administrative expenses through December 1996, when it is scheduled to be terminated; interest expense on bonds issued by the Financing Corporation, interest expense on bonds issued by the Resolution Funding Corporation to fund the resolution of insolvent thrifts, and monies for SAIF and potential post-RTC resolutions. Borrowing costs associated with the Treasury's contributions to the resolution effort are not included in the estimate.

damaged badly by high interest rates in the late 1970s and early 1980s; the high rates reduced the value of their fixed-rate mortgages that constituted the bulk of their assets. The industry also experienced asset quality problems. However, the problems reached the scale they did because thrifts did not have nearly sufficient capital to absorb risks, the system of thrift regulation and supervision was woefully inadequate, and the insurance funds did not have adequate reserves.

The safeguards protecting taxpayers broke down completely when thrift regulators were unable to close insolvent institutions because FSLIC did not have enough money. This encouraged owners and managers of insolvent or unhealthy thrifts to take even greater risks with insured deposits. We estimate that, on a present-value basis, the loss to taxpayers was equal to about 10 percent of the value of insured deposits that existed at the end of 1986 when the industry first began recording its precipitous decline. This level of loss is astonishing in a deposit insurance program once thought to involve relatively little risk to taxpayers. By way of contrast, the level of loss suffered during the Great Depression by depositors in commercial banks before the deposit insurance system was enacted is estimated to have been 1 percent of total deposits.¹²

Bank failures also occurred at record rates during the 1980s. In the years 1985 through 1989, almost 900 FDIC-insured banks with a total of \$109 billion in assets were closed or received financial assistance from FDIC. This figure includes 12 large banks that had more than \$1 billion in assets, a sharp increase in large bank failures over earlier periods. This is of particular concern because large bank failures pose a major threat to the solvency of the Fund. Failed bank resolutions during this 5-year period will cost FDIC an estimated \$17 billion. These insurance costs placed significant financial demands on the Bank Insurance Fund, which incurred a \$4.2 billion net loss in 1988, the first loss since FDIC's inception. BIF lost \$852 million in 1989 and an estimated \$4 billion more in 1990. The cumulative effect of these losses reduced BIF's reserve to about \$8.5 billion by the end of 1990. This reserve represents .43 percent of insured deposits, the lowest ever for the BIF or its predecessor. (See fig. 1.2.)

¹²For an explanation of depositor losses in the early 1930s, see p. 97