

Two Deposit Insurance Funds Are Not Necessarily Better than One

by James B. Thomson

The Great Depression opened an era of increased federal government intervention into private markets. It brought striking changes to the financial sector, where legislation like the Glass–Steagall Act of 1933 sought to compartmentalize financial firms and markets into distinct sets of activities (commercial banking, housing finance, investment banking, and insurance). This fragmentation was mirrored in government agencies, where a separate regulatory infrastructure was established for each segment of the financial system. The change also meant setting up two different insurance funds for depository institutions: one for those engaged primarily in housing finance (savings and loans) and another for commercial banks.¹

Three eventful decades have now blurred the distinctions between financial markets and financial firms. Rising inflation in the 1970s and rapid advances in information and computing technology contributed to a rapid pace of market innovations that effectively dismantled the Glass–Steagall barriers, many of which were formally lifted by the Financial Modernization Act of 1999. For depository institutions, the 1980s thrift debacle and U.S. regional banking problems brought on the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, which reduced or eliminated differences in federal regulatory structures for commercial banks and savings associations but still retained a separate chartering agency for each.

With the passage of the Financial Modernization Act, the FDIC began reforming our system of federal deposit guarantees. Recently, the FDIC posted a

“Deposit Insurance Options” paper on its Web site for public comment.² Among the possible reforms described there is a merger of its Bank Insurance Fund and its Savings Association Insurance Fund (BIF and SAIF). This *Economic Commentary* explores that possibility with an examination of the primary arguments for maintaining separate bank and thrift deposit insurance funds. While each of these arguments may have seemed valid in the past, none is defensible today. Moreover, evidence that merging the two funds would reduce taxpayers’ exposure to loss indicates that this deposit insurance reform is long overdue.³

■ Promoting Home Finance

The idea of separate deposit insurance funds for banks and savings associations took root in the regulatory and legislative environment of the 1930s. Commercial banking and home finance, traditionally viewed as distinct financial activities, were treated as such when the regulatory infrastructure for depository institutions was revamped. Commercial banks and savings banks were to be insured by the Federal Deposit Insurance Corporation, a federal government agency newly created by the Glass–Steagall Act. The FDIC would be independent from the U.S. Treasury (and its chartering agency, the Office of the Comptroller of the Currency) as well as from the Federal Reserve System, adding yet another player to the already fragmented federal regulatory system for banks. In contrast, the Federal Savings and Loan Insurance Corporation, created by the National Housing Act of 1934 to insure deposits in thrifts, would be a subsidiary of the Federal Home Loan Bank System.⁴ The System had been established in 1932 as

Does the United States need to maintain two separate insurance funds for banks and thrifts? This *Economic Commentary* examines the arguments in support of a recent reform proposal for merging them.

a regulatory infrastructure for savings and loan associations under the Federal Home Loan Bank Board.

Congress created a parallel regulatory infrastructure for housing finance lenders to promote home building and ownership. Unlike the agencies for regulating banks, the Federal Home Loan Bank Board had a mandate to promote the industry it regulated.⁵ Promoting the housing finance industry, however, might conflict with the Bank Board’s regulatory safety and soundness mandate and would certainly conflict with a deposit guarantor’s duty to protect the depositor and the taxpayer from loss. By creating a separate deposit insurance fund for thrifts that is subservient to the Federal Home Loan Bank Board, Congress strengthened the thrift regulator’s ability to pursue its industry-promotion objective.

By passing the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) in 1989 and the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in 1991, Congress rejected the idea that a federal regulatory agency should be charged with promoting the industry it regulates.⁶ FIRREA dismantled the single regulatory structure for housing finance. While it stopped short of merging thrift and

banking industry regulators, it placed the federal thrift chartering and supervisory agency under the U.S. Treasury Department (where the equivalent banking agency is housed) and created a new deposit insurance fund for thrifts within the FDIC. Moreover, Congress' intention that the FDICIA would "align the incentives of institutions' owners, managers, and regulators more closely with the interests of the deposit insurance funds" is further evidence that it no longer viewed the federal thrift regulatory structure as an appropriate tool for promoting the housing finance industry.⁷ Hence, maintaining a separate Savings Association Insurance Fund cannot be justified on these grounds. Finally, recent research questions the need for a separate agency to promote housing finance.⁸

■ Regulatory Competition

Economists generally consider competition an effective discipline for both private firms and public agencies. In the area of bank regulation, competition between the three federal regulatory agencies and between federal and state regulators has been said to confer two important benefits: Regulatory competition checks overzealous regulators by mitigating their tendency to stifle innovation and restrict new entrants. Moreover, competition encourages regulatory agencies to innovate, thus increasing their effectiveness and lightening the burden of regulation costs borne by their clients.⁹ Of course, the benefits of regulatory competition must be weighed against the higher administrative costs of maintaining multiple agencies and the potential for competition in laxity.¹⁰

In the area of deposit insurance, regulatory competition would help align insurers' incentives with those of uninsured depositors and taxpayers. The funds would have incentives to intervene in the affairs of troubled depository institutions more quickly and to handle receiverships in the most efficient, cost-effective manner. An insurance fund's weakness—in the form of unbooked losses—would be exposed as its solvent members sought the safety of the rival fund. For regulatory competition to yield benefits for deposit insurance, certain conditions must be met: First, the funds must be housed in separate, independent agencies. Second, insured depository institutions must have the right to switch funds when it is in

their interest to do so.¹¹ Neither of these conditions is met in the current configuration of BIF and SAIF; so it is unlikely that any competitive benefits now offset the costs of maintaining two separate FDIC deposit insurance funds.

■ Cross-Industry Subsidies

Unlike most private insurance arrangements, federal deposit insurance does not use actuarial principles to determine the size of its reserve. Instead, the BIF and the SAIF attempt to maintain a ratio of fund reserves to insured deposits of 125 basis points, a target established by the FIRREA. The level of premiums assessed, therefore, depends on the fund's level in relation to the target reserve ratio. All else being equal, institutions pay higher deposit insurance premiums when their FDIC fund's reserve-to-insured-deposit ratio is below 125 basis points than when the target is met or exceeded. Hence, operating both the BIF and the SAIF results in a form of limited cross-guarantee of fund members' losses associated with closing failed banks and thrifts.¹² In other words, losses resulting from institutions that close today are covered by higher future premiums paid by a fund's surviving members.

Initially, concern about merging the BIF and the SAIF may have arisen because future premium assessments were used to underwrite current losses to the reserve. This created the possibility that BIF institutions could be taxed through higher premiums to help clean up the massive red-ink spill that once affected much of the thrift industry. When the SAIF was created, upward of \$200 billion in losses were associated with resolving closed thrifts, so keeping the funds separate may have served to assuage banks' legitimate concerns about using their deposit insurance fund to underwrite some of the Federal Savings and Loan Insurance Corporation's losses. Furthermore, the rapid expansion of insured liabilities that resulted from admitting even the remaining solvent thrifts into the banks' insurance fund would have further lowered an already inadequate reserve-to-insured-deposit ratio and so required higher BIF deposit-guarantee assessments in the future.

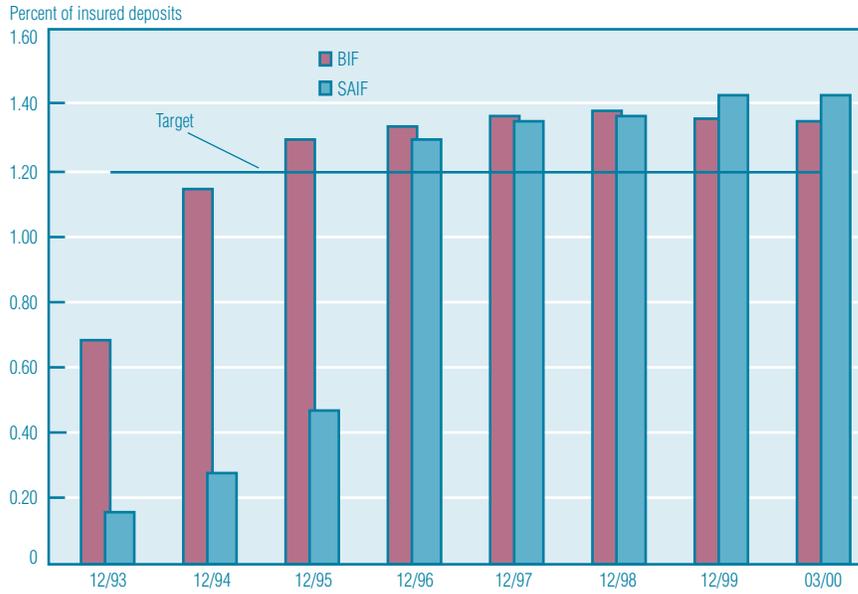
Now that the resolution of the thrift debacle is complete, no reason remains to keep operating separate FDIC funds to protect banks from past losses in the

housing finance industry. Moreover, as figure 1 shows, both the BIF and the SAIF have exceeded the target ratio of 125 basis points since 1996. Hence, merging the funds would not dilute the BIF's reserve or raise its members' premiums. In fact, the SAIF's reserve-to-insured-deposit ratio currently exceeds that of the BIF.

A more relevant concern today is the possibility that, through the two funds' cross-guarantee, a merger could expose banks and housing finance lenders to risks they would not normally bear. This might be because these two types of depository institutions operate in distinct markets. It may also reflect a conscious choice to avoid certain types of exposure, either because of risk-management concerns or because an activity brings returns that are too low to warrant the degree of exposure it entails.

Several reasons invalidate this rationale for maintaining separate funds. First, financial market integration has effectively removed economic distinctions between depository institutions and the risks they face, making it difficult to argue that banks and savings associations operate in distinct markets with widely different types of risk exposure. For instance, roughly 48 percent of bank loans are related to real estate (24 percent to home mortgages alone), and more than 12 percent of loans made by thrifts are commercial and industrial loans or consumer loans. In fact, the banking industry currently has, in absolute terms, nearly 1.6 times more dollars invested in home mortgages than thrifts have.¹³ Consequently, it is hard to see how merging the BIF with the SAIF would expose banks and thrifts to new risks or to risks they purposely seek to avoid.

Probably the most damning evidence against the cross-industry subsidy argument for maintaining separate funds is the composition of the funds themselves. Nearly 40 percent of deposits insured by the SAIF are made in commercial banks. Savings association deposits account for 9 percent of BIF accounts. In addition, restrictions on moving deposits between the BIF and the SAIF and the ongoing consolidation of the depository institution sector have caused some banks and thrifts to have deposits insured by both funds. BIF members currently own

TABLE 1: INSURANCE FUND RESERVES

SOURCE: Federal Deposit Insurance Corporation, *FDIC Quarterly Banking Profile*, 2000 quarter 1.

nearly 39 percent of deposits insured by the SAIF.¹⁴ In practice, therefore, distinctions as to whose deposits each fund guarantees are no longer meaningful.

■ Taxpayer Exposure

One compelling argument for merging the BIF and the SAIF is that doing so could reduce taxpayers' exposure to loss. A recent study shows that a single fund created from the merger would have a lower probability of insolvency than either the BIF or the SAIF.¹⁵ The most conservative estimate shows insolvency probabilities of 7.0 percent for the BIF and 10.3 percent for the SAIF, but only 6.5 percent for the merged fund. Similar results could be achieved by simply increasing each fund's target ratio of reserves to insured deposits; this would mean increasing deposit insurance premiums for members of the BIF and the SAIF until the new target is achieved.

■ Conclusion

As with any proposed reform, both the costs and the benefits of merging the BIF and the SAIF must be considered. A fund merger would lower the FDIC's administrative costs by eliminating inefficiencies associated with operating two funds, such as keeping duplicate sets of books. It would also reduce the paperwork costs of deposit insurance for banks and thrifts that have deposits insured by both funds. However, these

administrative cost savings might not suffice to offset potential benefits from retaining separate industry funds.

A careful review of the arguments for keeping separate deposit insurance funds for banks and thrifts rather than a single fund suggests that the benefits of separation are at best elusive and most likely nonexistent, given the structure of today's financial markets. Finally, recent evidence shows that a fund merger would lower taxpayer risk associated with federal deposit guarantees. So merging the BIF and the SAIF is a deposit insurance reform that merits consideration.

■ Footnotes

1. Credit unions also have access to federal guarantees through the National Credit Union Share Insurance Fund. However, unlike banks and savings institutions, state-chartered credit unions have the option of private deposit insurance through American Share Insurance.

2. The paper can be found at <www.fdic.gov>.

3. For previous analyses of the merger of the FDIC's twin insurance funds, see two articles by William P. Osterberg and James B. Thomson, "SAIF Policy Options," Federal Reserve Bank of

Cleveland, *Economic Commentary*, June 1995; and "Making the SAIF Safe for Taxpayers," Federal Reserve Bank of Cleveland, *Economic Commentary*, November 1, 1993.

4. When federal deposit insurance was created, most savings banks and all federal savings and loans were organized as mutual institutions. Therefore, deposit accounts at these institutions were technically "equity shares," much as they are in credit unions today.

5. At that time, the Federal Home Loan Bank System consisted of 12 Banks (similar in charter and organization to the 12 Federal Reserve Banks), the Federal Savings and Loan Insurance Corporation (similar to the FDIC), the Home Owners Loan Corporation, the Federal Home Loan Bank Board (analogous to the Federal Reserve Board) to oversee the System, and charter federal savings and loans (equivalent to the Office of the Comptroller of the Currency). The Federal Home Loan Bank Board and its successor, the Federal Housing Finance Board, include all Federal Home Loan Bank member institutions in their definition of the Federal Home Loan Bank System. For a contemporary discussion of the System and its mandate to promote housing, see J.E. McDonough, "The Federal Home Loan Bank System," *American Economic Review*, vol. 24, no. 4 (December 1934), pp. 668–85.

6. One exception is government-sponsored enterprises, where the Federal Housing Finance Board is charged with regulating and promoting Federal Home Loan Banks.

7. See Richard Scott Carnell, "A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991," *Annual Review of Banking Law*, vol. 12 (1993), pp. 317–21.

8. A recent study finds no evidence that savings associations' commitment to housing is any different than that of commercial banks. See Elizabeth Laderman and Wayne Passmore, "Do Savings Associations Have a Special Commitment to Housing?" *Journal of Financial Services Research*, vol. 17, no. 1 (February 2000), pp. 41–64.

9. See George J. Benston, Robert A. Eisenbeis, Paul M. Horvitz, Edward J. Kane, and George G. Kaufman, eds., *Perspectives on Safe and Sound Banking: Past, Present, and Future*, Cambridge, Mass: MIT Press, 1986, chapter 11; and James B. Thomson, "A Market-Based Approach to Reforming Bank Regulation and Federal Deposit Insurance," in *Research in Financial Services: Private and Public Policy*, vol. 4, Greenwich, Conn.: JAI Press Inc., 1992, pp. 93–109.

10. The bank regulatory agencies' performance relative to the single federal thrift regulatory agency during the 1980s suggests that competition in laxity was not a problem and that the competitive environment may have improved regulators' performance.

11. This does not rule out the possibility of charging entry and exit fees to discourage active switching and remove depository institutions' incentives to run on their insurance fund.

12. These cross-guarantees are limited because BIF and SAIF members do not pledge their full capital and credit to cover closed institutions' losses in excess of a fund's insurance reserve. When the Federal Savings and Loan Insurance Corporation collapsed, its losses of \$125 billion or more became the liability of the U.S. taxpayer.

13. See Federal Deposit Insurance Corporation, *FDIC Quarterly Banking Profile*, 2000 quarter 1.

14. Members of the smaller SAIF fund hold more than 2 percent of all deposits insured by the BIF.

15. See Robert Oshinsky, "Merging the BIF and the SAIF: Would a Merger Improve the Funds' Viability?" Federal Deposit Insurance Corporation, Division of Research and Statistics Staff Paper, 1999.

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