

Podcast Script

Episode 6: Deposit Insurance: Fund Management and Risk-Based Deposit Insurance Assessments

What This Episode Will Cover	<p>Diane:</p> <p>Hello again. My name is Diane Ellis. Welcome to Episode 6 of the FDIC’s ongoing podcast of <i>Crisis and Response: An FDIC History, 2008-2013</i>.</p> <p>In this episode, we’ll describe how the FDIC finances its mission to protect insured depositors and resolve failed banks through the Deposit Insurance Fund. We’ll also talk about the challenges to the Fund during the crisis and how the FDIC handled those challenges, and we will review the post-crisis reforms to strengthen the Fund.</p>
Introduce Pat and Fred	<p>Diane:</p> <p>Joining me today is Patrick Mitchell, Deputy Director for Risk Analysis and Pricing in the FDIC’s Division of Insurance and Research. Welcome Pat.</p> <p>Pat:</p> <p>Thanks Diane. It’s good to be here.</p> <p>Diane:</p> <p>Also with us again today is Fred Carns, Principal Advisor also in the FDIC’s Division of Insurance and Research. Welcome back, Fred.</p> <p>Fred:</p> <p>Thanks Diane.</p>
Background	<p>Diane:</p> <p>In the overview, Fred and I talked about how money that a depositor places in an FDIC-insured bank is protected by the FDIC up to the deposit insurance limit, no matter what state the economy is in or what may happen to the bank. When a bank fails and the FDIC takes it over, all insured depositors are protected. And for the 85 years that the FDIC has been in business, no depositor has ever lost a penny of insured deposits.</p> <p>So, Pat, what I would like you to explain is where the FDIC gets the money it needs to protect insured deposits and resolve failing banks. And what challenges did the FDIC face during the crisis to ensure that it could continue to successfully fulfill its mission?</p> <p>Pat:</p>

	<p>Well, Diane, unlike most government programs, federal deposit insurance does not rely on taxpayer funding. Over the FDIC’s entire history, the banking industry itself has been responsible for the costs of protecting insured depositors and resolving failed banks. The FDIC collects deposit insurance premiums from banks each quarter. The premiums are placed in the Deposit Insurance Fund, which we manage.</p> <p>Diane:</p> <p>So the FDIC’s revenue comes entirely from insurance premiums paid by banks themselves?</p> <p>Pat:</p> <p>From insurance premiums and from the interest earned by investing those premiums in U.S. government securities—when the money isn’t needed to protect insured depositors or close failed banks.</p> <p>Diane:</p> <p>So how big is the Fund now?</p> <p>Pat:</p> <p>At September 30, 2018, the Fund balance totaled over \$100 billion. I should note for our discussion that when we talk about the Fund balance, we’re talking about the net worth of the insurance fund, or assets minus liabilities. As the crisis unfolded, the FDIC first faced challenges in maintaining positive fund net worth. Eventually, the level of liquid assets—in other words, the cash and U.S. government securities held by the Fund—became a significant concern. We’ll talk later about the Fund’s liquidity challenges.</p> <p>Diane:</p> <p>\$100 billion sounds like a lot, but insured deposits are over \$7 trillion. Right?</p> <p>Pat:</p> <p>Right. In managing the Fund, we generally measure its size by comparing the Fund balance to total insured deposits. The \$100 billion fund balance at September 30th of this year amounts to 1.36 percent of insured deposits. We refer to this ratio of the Fund balance to insured deposits as the reserve ratio.</p>
<p>Impact of the Crisis on the Fund</p>	<p>Fred:</p> <p>So how large was the Fund at the start of the crisis? Was it prepared to handle the spike in bank failures as the crisis erupted?</p> <p>Pat:</p> <p>The short answer is no. The Fund balance was much smaller than it needed to be. Let me</p>

give some background. At the end of '07, the Fund balance totaled over \$52 billion. The reserve ratio, which was 1.22 percent at that time, had in fact been declining for a few years as fund balance growth failed to keep up with growth in insured deposits. That was because for about 10 years, the FDIC was severely restricted by law from charging most banks a premium. During that time, at least 90 percent of banks paid no premiums at all.

Diane:

That's right. But Congress eliminated those restrictions in a 2006 law. We implemented that law at the start of '07, charging every bank a premium. But the crisis struck before we could really begin to build the Fund.

Fred:

After no bank failures in all of '05 and '06, and only three in '07, failures began to climb in '08. And this put some strain on the insurance fund.

Pat:

The Fund balance began to decline in the second quarter of '08, with the reserve ratio falling below the 1.15 percent statutory minimum then in effect, due to the rise in failures and a large increase in loss reserves for expected failures.

Fred:

So the insurance fund is required to record losses before banks actually fail. Just as banks have to reserve for losses on troubled loans, the FDIC has to reserve for the losses it expects from anticipated bank failures. This loss reserve is a liability of the Fund, so an increase in the loss reserve reduces the Fund balance.

And with so many failures to come in the crisis, the Fund balance was going to face a lot more strain.

Pat:

That's right. The Fund balance and reserve ratio fell throughout the rest of '08 and '09, ultimately turning negative, as losses from actual and expected failures mounted. Twenty-five banks failed in '08, and failures climbed to 140 in '09 and 157 in 2010—the peak year for failures in this crisis.

Diane:

So, Pat, I recall us responding in a variety of different ways to the declining fund balance. Can you tell us more about that?

Pat:

Well, first, in the fall of '08, we proposed increasing premium rates – in fact, more than doubling the minimum rate. The rate increase went into effect at the start of '09.

Fred:

Then as bank failures accelerated in 2009, the FDIC considered imposing a one-time special assessment in an attempt to maintain a positive fund balance.

Pat:

Yes. The agency was concerned that a fund balance and reserve ratio near or below zero might create public confusion about our ability to move quickly to close failed banks and protect insured depositors.

Diane:

But that wasn't our only option.

Pat:

No, it wasn't. We could have used our legal authority to borrow from the Treasury. But borrowing from the Treasury would not have shored up the Fund balance—the Fund's net worth. A special assessment, on the other hand, bolstered the Fund balance by raising revenue. So the FDIC imposed a one-time special assessment in June '09, which raised \$5.5 billion.

Fred:

That didn't work, though, because the Fund still went negative.

Pat:

That's right. Unfortunately, the special assessment did not prevent the Fund balance from turning negative. In fact, the balance fell below zero just one quarter after we imposed the special assessment. The Fund ended '09 with a negative balance of almost \$21 billion and remained negative for seven quarters.

Diane:

But the negative fund balance by itself didn't prevent the FDIC from doing its job, and it didn't mean that the Fund lacked the liquid assets necessary to quickly resolve failed banks and pay insured depositors. Pat, as you mentioned earlier, the Fund balance equals its assets minus its liabilities. Among its assets are cash and Treasury securities that can be quickly converted to cash. And the Fund's principal liability at the time was the loss reserve for anticipated failures, which does not reduce cash until failures occur.

Fred:

But with so many failures occurring in 2009, we did become concerned that the Fund might not have enough liquidity, didn't we?

Pat:

We did. As failures continued throughout '09, the Fund's liquid assets declined sharply. By September, we projected that its liquidity needs would exceed its liquid assets in the first quarter of 2010, and the shortfall would grow throughout 2010 and '11. If not addressed, the potential squeeze on liquid assets threatened our ability to pay depositors promptly.

Diane:

So how did the FDIC raise the cash needed to replenish the Fund?

Pat:

Well, the FDIC adopted a novel approach. In November of 2009, the FDIC required banks to prepay over three years of quarterly assessments. We collected almost \$46 billion in prepaid assessments at the end of '09.

Fred:

That's something the FDIC's never done. Why did we take this approach, instead of raising assessments further or charging another special assessment?

Pat:

For two main reasons. First, the FDIC wanted to avoid increasing assessments when bank earnings and capital were already under stress.

Diane:

And under accounting rules, a special assessment would have an immediate hit on bank earnings and capital. That's not the case for prepaid assessments, where each bank books the prepayment as an asset with no immediate effect on capital and earnings.

Pat:

That's right. Banks would expense the prepayment only over time, as their quarterly assessments come due. The second main reason for raising liquidity through prepaid assessments was to avoid discouraging banks from extending credit and worsening the economic downturn. Bank lending was already on the decline, and higher assessment rates or additional special assessments could have discouraged banks from lending when the economy needed it most.

Fred:

The government had implemented unprecedented policies to support credit in the economy during the severe economic downturn. We didn't want to enact policies that would go against these efforts. And the FDIC knew that banks were holding significant amounts of

	<p>cash and other liquid assets, and expected that banks could draw on available liquid assets for the prepaid assessments without materially affecting their lending activities. Was there anything else that could have been done? Earlier you mentioned that we could have borrowed funds from the Treasury to increase fund liquidity.</p> <p>Pat:</p> <p>We could have turned to the Treasury. But we preferred to rely on prepaid assessments instead because that approach ensured the Fund remained directly industry funded.</p> <p>Fred:</p> <p>So, we really had to take some dramatic steps to manage the Fund during the crisis. What lessons did this offer for the post-crisis period? Did the FDIC change the way it managed the Fund?</p>
<p>Dodd-Frank and Post-Crisis Fund Management</p>	<p>Diane:</p> <p>That’s a good question. Let’s talk now about post-crisis reform. The FDIC did make significant changes to how it managed the Deposit Insurance Fund in response to the crisis, and we were able to do so because the Dodd-Frank Act included several provisions designed to strengthen the Fund.</p> <p>First, the Dodd-Frank Act increased the minimum reserve ratio—the minimum target for the Fund balance—from 1.15 percent to 1.35 percent. In 2010, when Dodd-Frank was enacted, the Fund balance was still negative, but fortunately, the new law gave the FDIC until 2020 to meet the 1.35 percent minimum.</p> <p>With the reserve ratio at 1.36 percent as of September, we’re two years ahead of the required deadline.</p> <p>Pat:</p> <p>And, Dodd-Frank eliminated an upper bound for the target reserve ratio, which therefore eliminated a cap on the size of the Fund. The FDIC now has sole discretion to determine the appropriate target for the Fund balance.</p> <p>Fred:</p> <p>How did the FDIC use this new authority to determine the target size for the Fund?</p> <p>Pat:</p> <p>The FDIC developed a comprehensive, long-term fund management plan in 2010. To develop the plan, the FDIC drew upon its experience during the banking crisis that began in ’08 as well as the earlier crisis of the 80s and early 90s. The long-term plan was designed to reduce volatility in insurance premiums and instead keep premium rates steady through economic cycles, while also maintaining a positive fund balance even during a banking crisis.</p>

	<p>Fred:</p> <p>So when times are good and few or no banks are failing, the plan would not call for reducing premium rates and letting the size of the Fund shrink.</p> <p>Pat:</p> <p>Exactly, because this would enable us to avoid having to sharply raise premium rates when the economy goes into a downturn and bank failures increase, which is the time when banks can least afford that cost. This is a key goal of the long-term fund management plan.</p> <p>To develop the plan, the FDIC sought industry input and also conducted an analysis of historical insurance fund data. The study concluded that it would have been feasible to maintain stable assessments in good times and stressful times while preventing the Fund from turning negative, but only if the reserve ratio was at least 2 percent at the onset of the recent crisis and the earlier crisis.</p> <p>Diane:</p> <p>And that's why the FDIC has set 2 percent as a long-term goal for the Fund.</p> <p>Pat:</p> <p>Right. The FDIC views that target as the minimum level needed to withstand future crises that are comparable in magnitude to the past crises. It's a long-term goal, one that the FDIC Board has reaffirmed each year since 2010. When the reserve ratio reaches 2 percent of insured deposits, premium rates will decrease, but all banks will continue to pay risk-based premiums into the Fund.</p>
<p>Risk-Based Pricing</p>	<p>Diane:</p> <p>Could you tell us a little bit more about what the crisis meant for risk-based premiums?</p> <p>Pat:</p> <p>Sure. As quick background: The FDIC switched from flat-rate to risk-based premiums in 1993. The FDIC views a system in which riskier banks pay more into the Fund than safer banks as a fairer system, and one more likely to promote incentives for banks to manage their risks prudently. The FDIC enhanced the system in '06 and for the first time adopted separate pricing methods for large and small banks, as the law permitted.</p> <p>Fred:</p> <p>Did the crisis cause the FDIC to make changes to risk-based pricing?</p> <p>Pat:</p> <p>Yes, and we made some adjustments to our risk-based pricing methods as early as April of '09.</p>

	<p>Diane:</p> <p>But the most significant changes to the pricing system took place after the worst of the crisis. Some of these changes were required by Dodd-Frank, and others were based on our experience and the data we had from banks that failed or came close to failing during the crisis.</p> <p>Pat:</p> <p>That’s right, Diane. The large number of failures in the crisis gave the FDIC a wealth of new data on the characteristics of banks that failed. With the new data and fresh experience, we were able to update risk-based pricing methods for both large and small banks.</p> <p>Diane:</p> <p>And the analysis that FDIC did to support the revised methods showed that the new methods, had they been in place before the crisis, would have better predicted banks that failed or got into serious trouble than the methods they replaced.</p>
<p>Conclusion</p>	<p>Diane:</p> <p>Well, this story does not receive the same attention as many other FDIC actions taken during the crisis. But without the FDIC’s ability and willingness to creatively use and adapt its powers to obtain critically needed financial resources, the agency’s ability to fulfill its longstanding mission would have been jeopardized.</p> <p>Pat:</p> <p>And our experience in managing the insurance fund during the crisis reinforced some key lessons. Perhaps most important of all, a federal deposit insurer needs to possess authority to steadily build insurance fund resources, especially when economic and industry conditions are benign. In that way, the insurance fund won’t have to turn to banks—or taxpayers—for more resources in times of economic stress, when the banks can least afford it and when bank lending is so crucial to economic recovery.</p> <p>Diane:</p> <p>Well thanks Pat and Fred for your insights today on the Deposit Insurance Fund. In our next podcast, we’ll discuss how the FDIC fulfilled its resolution and receivership responsibilities during the crisis.</p>

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