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FDIC Proposal Threatens the Nascent Economic Recovery

The Federal Deposit Insurance Corporation (FDIC) proposal that banks prepay their FDIC insurance premiums would be a major policy mistake. It has the potential to stall the nascent economic recovery and add to the growing list of bank failures.

In an effort to replace its depleted Deposit Insurance Fund (DIF), the FDIC proposes that banks prepay the next three years of their FDIC premiums. The prepayments would be due by the end of this year and would total an estimated $45 billion.

The FDIC staff claims that the $45 billion dollar prepayment won't adversely affect either bank capital or liquidity. Such claims are spurious.

The premium banks have to pay on their deposits is essentially a tax on bank deposits. In this sense it is similar to the reserve requirement the Fed places on bank deposits. As with an increase in reserve requirements, increasing the insurance premium reduces the multiple expansion of credit in the banking system. A major increase in reserve requirements is a powerful means of restricting the money supply.

Technically, bank capital would remain unchanged by the proposed increase. According to Generally Accepted Accounting Principles (GAAP), banks will be able to book the prepaid expense as an asset which will offset the cash payment. However, the monetary impact isn't dictated by GAAP. It's dictated by the payment of cash.

The same is true for bank liquidity. The FDIC staff assumes that banks have a lot of liquidity due to the large amount of excess reserves held at the Fed. However, a recent study by two of the Fed's staff members points out that the excess reserves are a direct result of the Fed's new monetary policy procedures. Therefore, these deposits do not represent excess liquidity as the FDIC staff assumes.

If the FDIC carries out its proposal, it would tend to have a significantly negative impact on liquidity in the fourth quarter. The timing of this policy would be the exact opposite of what most policymakers would like to see. Near-term it would strain liquidity and accelerate the number of bank failures, thereby further depleting the DIF. Longer-term, the elimination of cash payments of FDIC premiums for the next three years would then have a offsetting positive impact on liquidity and the economy.

There are several alternatives to the FDIC proposal. Congress has arranged for the FDIC to have a $500 billion line of credit from the US Treasury. Utilizing this line would minimize the disruptive monetary impact on the banking system. The FDIC would be able to raise its insurance premium to repay any such borrowing once the economic recovery is firmly in place and bank balance sheets are stronger than they are at this point in the cycle.

It is also conceivable that the Federal Reserve could offset the monetary restraint from the FDIC proposal. They could do this by initially lowering reserve requirements to offset the prepayment, then gradually raising reserve requirements when the insurance premium is no longer due.

Alternatively, the Fed could increase bank reserves sufficiently to offset the impact of the prepayment. This is essentially what the Fed did in the second quarter of this year when the FDIC instituted a special insurance premium totaling an estimated $8 billion. According to the

Federal Reserve Bank of St. Louis, the Fed increased bank reserves (after allowance for excess reserves) by about $20 billion this past spring. This was $12 billion more than the FDIC's special premium.

Relying on the Fed to offset the FDIC proposal is problematic. The Fed manages monetary policy by setting a fed funds rate, not by setting the level of bank reserves. This means that the Fed's attention is more likely to be on the level of interest rates instead of what is happening to bank reserves.

The bottom line is that the FDIC's proposal threatens to inadvertently produce a more restrictive monetary policy than the Fed, the FDIC or anyone else would want to see. I respectfully urge the FDIC to reconsider this proposal.

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