Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

Barnett Sivon & Natter P.C.
ATTORNEYS at LAW
WASHINGTON, DC

What happened to the FDIC?*

Robert Barnett

July, 2010

Some unusual changes have taken place in deposit insurance over the past few years, and the recent use of an increase in an arcane part of the deposit insurance statute to help meet the PAYGO requirements in the Dodd-Frank bill make a quick review timely.

The most recent event was the change in the minimum level of the statutory range of the reserve ratio from 1.15 to 1.35, something that raised very few eyebrows. This change was part of the last minute method chosen by Dodd-Frank conferees to meet the budget requirement that new legislation be budget neutral after it became apparent that a more direct tax on banks did not seem capable of garnering enough Senate votes. The important point to be noted is that the purpose of the increase was not based in deposit insurance public policy, but to generate revenue for programs unrelated to deposit insurance. No hearings were held, no proposed change in the regulations was noticed for public comment, there is no evidence that the change was urged by the FDIC — the change happened because supporters of Dodd-Frank needed to persuade the budget mavins that the bill was budget neutral.

What does this change do? It says that in no case after 2010 may the reserve ratio of the Deposit Insurance Fund go lower than 1.35. The reserve ratio is the ratio of amounts in the DIF compared with total estimated amounts of insured deposits. The FDIC must designate a reserve ratio for the DIF each year, but that is simply a target. Now that target must always be above 1.35, but more important, whenever the ratio is less than1.35, the FDIC must immediately establish a plan to raise that ratio to an amount greater than 1.35. Therefore, the greater the minimum ratio, the larger must be the amounts in DIF since the deposit level seldom shrinks. DIF amounts increase primarily by increasing the assessments on banks.

In this case, the legislation appears to intend that the assessments needed

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

to meet the 1.35 level will come from banks over $10 billion in assets; the language that exempts smaller banks from the assessment is somewhat murky, however. This was part of the PAYGO amendment adopted, and like the rest of the amendment, did not receive the benefit of exposure to hearings or public comments.

Finally, and quietly, Congress accepted what must have been a recommendation from the FDIC and removed the cap on the permitted reserve ratio. Previously, the FDIC could not build the DIF to more than the amounts that would produce a ratio of 1.50; Dodd-Frank eliminates that cap. The FDIC can raise DIF to as high a level as it wishes.

Congress always had the power to do what it did in the bill, but generally has not used an increase in DIF reserve ratios to satisfy PAYGO. From a bank perspective, this is substantially no different from a bank tax, although that money will go into DIF and not the general fund. It can also allocate that tax as it chooses among various size banks since the restrictions in the FDI Act prohibiting that have been eliminated. In fact, it doesn't have to take an act of Congress to do any of that - the FDIC can set the reserve ratio wherever it pleases as long as it is above 1.35, and can favor one category of banks over another.

One might ask for what purposes DIF will be used in the future for the largest banking companies. Costs of resolutions of failed large systemic risk bank holding companies (those over $50 billion in assets) will be paid for through the Resolution Fund created under Dodd-Frank, and that fund is funded by separate assessments on those large institutions. Failure of any of those institutions will not be resolved through DIF, so DIF could be zero and it would not affect resolutions under Dodd-Frank.

There remains some question about how the FDI Act and this bill jointly resolve large depository institutions that are part of a systemically significant bank holding company. Even if those depository institutions are resolved under the FDI Act, the largest of them most likely will be handled under the systemic risk provisions of the FDI Act, different systemic risk provisions than are in Dodd-Frank. Losses from the FDI Act systemic risk resolutions do not come from DIF, but from a special assessment. DIF could be at zero and it would not impact resolution of the largest banks under the systemic risk provisions of the FDI Act. Only the smaller of the systemic risk depository institutions might be handled through the DIF programs, and that would depend upon the circumstances.

Nevertheless, notwithstanding all of that, DIF now can grow to a very, very large amount and be funded more than ever by large institutions, yet be used almost exclusively to cover failures of smaller institutions.

In another section of the bill, the maximum deposit insurance coverage was increased on a permanent basis to $250,000, and that increase was made retroactive to provide increased coverage to a few large depositors in one or two recent bank failures. The insured amount had been temporarily increased to $250,000 in the 2008 EESA without public notice. Again, these major changes were not exposed to public comment of any kind.

Retroactive coverage is extraordinary. It suggests that coverage in the future will depend less on how much persuasion large depositors have with the way the bank is managed, but how much political clout large depositors have. The argument against full deposit coverage on the grounds that large depositors will force management to operate a bank carefully now is less persuasive. As for moving coverage to $250,000 on a permanent basis — the general idea previously was that the FDIC covered most of the average deposits in banks. $250,000 seems a little high for that standard. Coverage is moving close to full coverage of all deposits, and the elimination of any semblance of customer monitoring of management practices.

The bill also, as part of its studied effort to penalize big banks for the financial crisis, changed the DIF assessment base from deposits to assets following 75 years of use of the previous base. Going forward, large banks as a group will have to pay around 60% of the assessments although they probably hold only about half of the insured deposits. It might even be as high as 70% under the new PAYGO amendments. Previously it had been split relatively evenly between large and small banks.

A quick diversion: this bill seems to exempt smaller banks from many restrictions and costs that are applied to larger banks (those over $10 billion or in some cases, over $50 billion). Those who support that say that the big banks were the ones that caused the problems and that they were bailed out with TARP money. Yet banks of all sizes received TARP funds, and big banks are paying back the TARP funds (including lots of interest) at a pace much faster than demanded under the law. Banks that are defaulting are smaller banks. Failures that cost DIF money have been of smaller banks;

none of the systemic risk size banks have cost the DIF anything during the 75 years of the existence of the FDIC, with the possible exception of Continental Illinois in 1984, 7 years before passage of FDICIA. Yet the bill bends over backward to give DIF assessment breaks to smaller banks.

But enough of that diversion. In addition to these developments, in 2008 the FDIC utilized its systemic risk authority for the first time to assist the acquisition of a systemically significant institution after receiving all of the statutory approvals (including the Secretary of the Treasury consulting with the President of the United States), but then never completed the transaction but instead approved the acquisition of the troubled institution by another depository institution a few days later.

About the same time as the aborted use of the systemic risk authority in an acquisition, the FDIC established a program that (a) guaranteed new senior uninsured debt of depository institutions or their holding companies, and (b) provided unlimited deposit insurance coverage for non-interest bearing deposit transaction accounts. To authorize creation of these programs, the FDIC said it had invoked the "systemic risk exception to the least cost test." While there may be good reasons for the FDIC to have adopted those programs, and most people would say they were effective and timely, it is difficult to understand the statutory basis for invocation of systemic risk.

As the author of that systemic risk language, Sen. Don Riegle, said in a section by section analysis he entered into the Congressional record

> "[This section] provides a narrow exception to least-cost resolution for those rare instances in which an institution's failure could threaten the entire financial system… [The exception requires an explanation of] how the FDIC's compliance with least-cost resolution in the case of a specific, named institution would have serious adverse effects on economic conditions or financial stability… The Secretary must then make a determination that the FDIC's compliance with least-cost resolution in the case of that institution would have serious adverse effects… ."

In other words, that section was designed to be applied in the case of a specific institution, not all institutions, according to Sen. Riegle. The language of the provision seems to support Chairman Riegle. There may be other reasons that the FDIC chose to invoke systemic risk provisions in its discussion of the establishment of these programs, but the minutes of the meeting at which those interesting decisions were made don't seem to have been published, nor have any accompanying memorandum that supported the use of systemic risk as the basis of the FDIC authority. It would be interesting to read the explanation of the statutor y basis for those programs, but at this distance, it is at a minimum, an aggressive interpretation.

In the resolution field, the FDIC has been innovative and active, becoming the first agency to commence a program that modified troubled mortgage loans in ways that to a great degree were ultimately included in the Treasury HAMP program and in many programs of proprietary modification programs. It is now being assigned for the first time the responsibility of resolving failed systemically significant non-bank financial companies, a task that generally has fallen to bankruptcy courts under different statutes.

The Board of Directors will now replace the Director of Thrift Supervision with the Director of the Consumer Financial Protection Bureau, and will have the responsibility to supervise state chartered thrifts.

Finally, in the discussion leading toward Basel III, the FDIC has been the protagonist for mandating significant leverage ratios in the face of opposition from other countries and some of its fellow U.S. regulators. Until the global economies had their serious downturn, the Corporation seemed to be winning that argument.

It would be difficult to tally up a scorecard for all of this, and equally unnecessary. But it is an interesting set of developments in deposit insurance during the past few years. At a minimum, the FDIC and its deposit insurance fund have become much more in play politically than they were during the first 75 years of the existence of the agency. Decisions on coverage of deposits for the average American have recently become a matter of secondary interest to those of using the fund to meet budget requirements, to punish large banks, and to be a lender of last resort. Interpretation of limits of authority under the FDIC Act has been aggressive. The Corporation has led the way on modification of troubled mortgages and in forcing consideration of the importance of leverage in capital considerations. The resolution fund has been established to handle the largest institutions, yet the smaller institutions whose failure will impact the DIF, pay less for coverage than the largest who seem not to cost the DIF anything.

Tallying this is difficult, but at a minimum, one must conclude that it isn't Franklin Roosevelt's FDIC anymore.

Robert Barnett is a partner with the law firm of Barnett Sivon & Natter, P.C.