

## MIMIC: A proposal for deposit insurance reform

**James A. Wilcox**

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Kruttschnitt Professor of Financial Institutions, Haas School Of Business, U C Berkeley, Berkeley, CA 94720-1900, USA; tel: 510.642.2455; e-mail: jwilcox@haas.berkeley.edu

*James A. Wilcox is the Kruttschnitt Professor of Financial Institutions, Haas School Of Business, University of California.*

*As Kruttschnitt Professor of Financial Institutions, Dr Wilcox teaches banking, risk management in financial institutions, and business conditions analysis. Dr Wilcox is the former chief economist at the US Office of the Comptroller of the Currency.*

### ABSTRACT

*Here the author proposes the Mutual Insurance Model with Incentive Compatibility (MIMIC). MIMIC is a model for deposit insurance that mimics the incentives and practices of a private sector, mutual, insurance organisation. The main features of MIMIC are: fully risk-based premiums, payments by the Federal Deposit Insurance Corporation (FDIC) to the US Treasury Department (the Treasury) for its line of credit and 'catastrophe insurance', rebates to banks when the reserve ratio exceeds a risk-based ceiling, surcharges on banks when the reserve ratio dips below a risk-based floor, dilution fees on deposit growth to maintain reserve ratio and refunds to banks to maintain reserve ratio when their deposits shrink.*

### INTRODUCTION: AN OPPORTUNE TIME FOR REFORM

Policy reform often proceeds in the cauldron of crisis. In that cauldron, demand for immediate action to alleviate the symptoms

of a flawed financial system often boils up so rapidly and strongly that more fundamental flaws are not adequately addressed. In addressing reform of deposit insurance and other policies of the Federal Deposit Insurance Corporation (FDIC) in the USA, we need not, and should not wait for the heat to be turned up. Rather, conditions now allow reform to be pursued deliberately and thoughtfully.

Former FDIC Chairperson Donna Tanoue<sup>1,2</sup> has said that, because neither the banking industry nor the FDIC is facing any foreseeable crisis, now is an opportune time for reforming deposit insurance. Just as skilled banking management requires that policies and operations be set with an eye toward the future, skilled banking policymaking should be at least as forward looking. Recognising that the financial seas will not always be tranquil, policymakers can ready their vessels now for the possibility of rougher seas in the future.

Since the early 1990s, the financial health of the US banking system as a whole and that of the FDIC have rebounded. Earnings in the banking industry have been high and loan losses have been low. Bank capital as measured by the standard ratios has been replenished. As a consequence, losses charged to the FDIC's deposit insurance reserve funds have been low and the ratio of deposit insurance fund reserves to insured deposits has risen steadily.

Relatively recent experience, and some even more recent data, are reminders that financial stability is not a given. One needs only look back a few years to find serious financial turmoil in important economies in disparate parts of the world. The financial crises of 1997 and 1998 may have originated abroad and may have been felt most keenly within the regions surrounding their country of origin but, partly as a consequence of the operations of internationally active commercial banks, shocks that originate anywhere in today's interconnected, sophisticated, financial markets can reverberate around the globe on financial markets and on banking. The reverberations of such financial shocks on real economic activity and on policy at home can also affect the domestic banking industry.

More recently, the credit quality of loans held by US banks has slipped somewhat. Data from banking supervisors' Shared National Credits programme showed a doubling from 1998 to 2000 of the percentage of credits that were adversely rated. Though still well below their levels in the early 1990s, non-performing and charge-off rates for commercial loans have also risen in recent years. On the macroeconomic front, the consensus among economic forecasters is that economic growth during 2001 and 2002 will be considerably slower than the rates enjoyed before 2001. Thus, while the US banking industry and the FDIC are currently reporting strong results, there are no guarantees that recent results will continue indefinitely. These ongoing risks are the first reason that the opportune time to reform the FDIC is now, before there is any sizable deterioration in financial or economic conditions.

The second reason that this is an opportune time to pursue deposit insurance reform is that, at least for the near term, the enactment of the Gramm-Leach-Bliley Act (GLBA) in November 1999 removed much of the impetus for, and debate about,

financial modernisation. As a result, banking and its regulators find themselves in a period of considerable stability, in the sense that the legislative backdrop is more settled than it has been in some years.

A third reason that this is an opportune time for deposit insurance reform is that the banking industry and its regulators are now in a better position to handle some of the proposed remedies for the current flaws in deposit insurance. Advances in risk management analysis and techniques and the computational hardware and software required to make them practical now enable both the banking industry and its supervisors to adopt a considerably more forward-looking approach to risk assessment. And, indeed, both the industry and its supervisors appear now to be appropriately putting more emphasis on the conditions that might emerge in the future and the likelihoods and impacts of such conditions than they did in the past.

#### REFORM ISSUES

Along with its April 2001 recommendations, the FDIC<sup>3</sup> identified four problem areas in current deposit insurance policy.<sup>4</sup> The first area is pricing policy, which the FDIC argued creates inappropriate incentives and raises fairness issues. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) required the FDIC to charge risk-based deposit insurance premiums and established a designated reserve ratio for the insurance fund of 1.25 per cent of insured deposits. The FDIC's authority to charge risk-based premiums, however, was severely curtailed by the Deposit Insurance Funds Act of 1996 (DIFA). DIFA effectively restrained the FDIC from charging a bank any premium at all for deposit insurance once the reserve ratio exceeded 1.25 per cent of insured deposits, unless the bank was not well capitalised or exhibited financial, operational, or compliance weaknesses ranging from

moderately severe to unsatisfactory. DIFA also required that the FDIC charge all banks at least 23 basis points of domestic deposits if the reserve ratio is otherwise expected to be below 1.25 per cent of insured deposits for more than a year. Thus, deposit insurance premiums can shift up abruptly — independently of a bank's risk — when the reserve ratio falls below the designated reserve ratio.

In addition, current premium policy subsidises banks' risk taking at the margin. Even the few banks that pay positive premiums probably do not compensate the FDIC fully for the risks they impose on the fund. And, among the vast majority of banks that pay zero premiums, safer banks subsidise riskier banks via the latter's greater likelihood of drawing down the FDIC deposit insurance fund's (Fund) reserves and triggering increased premiums on all banks sooner.

Secondly, deposit insurance premiums are 'procyclical' in that the weaker the condition of the banking industry and thus the lower the Fund's reserve ratio, the higher deposit insurance premiums are likely to be. The third problem area is the legal requirement to operate separately the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF), which the FDIC strongly argued is inefficient. The final concern is whether and how the present \$100,000 insurance ceiling, which was set in 1980, should be changed.

Now that BIF and SAIF have similar, historically high ratios of reserves to insured deposits and serve industries that are in similarly strong conditions, two of the major stumbling blocks to their merger are no longer present. In addition, banks and thrifts are becoming increasingly alike and some individual depositories now have some of their deposits covered by BIF and some covered by SAIF. Since merging the two funds would enable the FDIC to achieve some operating efficiencies and per-

haps further diversify the risks of the separate funds, merging the SAIF and BIF seems straightforward, uncontroversial, and advisable.

Advocates of increasing the deposit insurance ceiling note that the overall price level in the economy has approximately doubled since 1980, when the coverage ceiling was last raised. They could also point out that nominal gross domestic product (GDP), wealth, and financial assets per capita have each risen even more than the overall price level. On the other side, the argument is made that raising the ceiling on insured accounts would weaken market discipline. Former Secretary of the Treasury Summers, Federal Reserve Board Chairman Greenspan and former Senate Banking Committee Chairman Gramm have all expressed opposition to raising the deposit insurance coverage ceiling to \$200,000 per account. In part, that perspective is likely to have been informed by the arguments of the Shadow Financial Regulatory Committee,<sup>5</sup> Seidman<sup>6</sup> and others that raising the ceiling from \$40,000 to \$100,000 contributed to the savings and loan crisis by reducing the market incentives to invest insured deposits appropriately. To the extent that a ceiling makes sense, and the author believes it does, inflation indexing would at least have the virtue of reducing the likelihood of sporadic, large, arbitrary adjustments of the nominal dollar ceiling.

#### **PRIMARY OBJECTIVE OF DEPOSIT INSURANCE REFORM: GET PRICES RIGHT**

The primary objective of deposit insurance reform should be to ensure that, consonant with its overarching goals of macroeconomic and banking stability, each of the financial services associated with deposit insurance is accurately and fully priced on the basis of risk. More thoroughgoing risk-based pricing will better align the

incentives of banks and of the FDIC with the broader goal of economic efficiency. The FDIC<sup>7</sup> presented a number of general indications about how risk-based premiums might be determined in practice. In addition to using examiner ratings and accounting ratios, the FDIC<sup>8</sup> pointed out that presumably, informative market prices are available for the debt and equity of some of the largest banking organisations in the USA.

Currently, deposit insurance premium policy consistently under-prices risk. Under current law and current conditions, the FDIC is, in effect, constrained to charge to almost all banks deposit insurance premiums of exactly zero. Although there are some risk adjustments in the FDIC's current premium schedule, they are only partial. For example, even if a bank is undercapitalised and has received the worst examiner rating, the bank's deposit insurance premium is still only 27 basis points of domestic deposits. Even this premium is unlikely to compensate the FDIC fully for the extra risks that riskier banks impose on the FDIC fund. An actuarially fair premium would probably be a significant multiple of the current premiums. This under-pricing of risks subsidises some banks' risk taking, and their resulting profits, at the expense of less risky banks. It may, in turn, subsidise riskier lending on the part of some riskier borrowers by keeping banks' costs artificially low.

But just as banks receive insurance services from the FDIC, the FDIC receives financial services from the US Treasury Department (Treasury). There are two major financial services that the Treasury provides to the FDIC. The first is a US\$30,000,000,000 line of credit. The second is the 'catastrophe' insurance policy that the current arrangement provides on a premium-free basis from the US Treasury to the FDIC. The full faith and credit of the Treasury stands behind the explicit

insurance provided by the FDIC. Below the author explains why Treasury is also likely to be at risk for extremely large losses in the banking industry. Since it is most likely that the Treasury would cover uninsured deposits only in dire circumstances, its coverage of such losses can be regarded as catastrophe insurance. At all times, under all circumstances, the FDIC under current arrangements pays a zero premium both for its line of credit and for its catastrophe insurance policy from the Treasury.

The under-pricing of financial services provided by the Treasury to the FDIC provides incentive for the FDIC and its insured banks to maintain a deposit insurance reserve fund that is too small and to charge premiums that are too low. The absence of risk-based premiums paid from the FDIC to the Treasury for Treasury-provided services constitutes a subsidy. And charging premiums that, on average, are too low, and maintaining a fund that, on average, is too small, raises the subsidy from the Treasury (and therefore implicitly from US taxpayers) to the FDIC, and therefore to some banks and to some bank customers.

A sometimes overlooked feature of premium policy is its repercussion on other aspects of deposit insurance. Improved pricing policy will point the way toward the appropriate policies for several important aspects of deposit insurance. The three areas in particular where pricing policy reverberates are: 1) on the reserve ratio, 2) on reserve rebates, and 3) on dilution fees, which might be levied on banks whose growth reduces the Fund's ratio of reserves to insured deposits. In turn, a coherent set of policies with regard to these three aspects of deposit insurance will facilitate improved premium policies.

The author will discuss two tracks that lead from the current situation to an improved deposit insurance programme; the first is a 'user fee' model and the

second is an 'as if' mutual model. Either of these models offers the prospect of better pricing than the current hybrid arrangement, which leaves unclear what the rights and responsibilities of banks are. Each model can bring considerable improvement to the pricing of deposit insurance in the form of fully risk-based premiums. In fact, there is no difference between these two models in the premiums that would be charged to banks. There are other differences, however, and the author will argue that the second model has a far greater chance of being implemented and then delivering the right prices.

#### THE USER FEE MODEL

In its 'options' paper, the FDIC<sup>9</sup> discussed the user fee model of deposit insurance. This model might also be referred to as a pure government guarantee programme. Under this programme, banks would pay risk-based user fees (or deposit insurance premiums or prices) to the Treasury. These premiums would be based not on banks' current conditions but, rather, would be based on forward-looking assessments of risks. Fully risk-based premiums would be sufficient over the long run to compensate the FDIC (and thus the Treasury in this model) for all the risks, large and small, that it chose to bear.<sup>10</sup> A fully risk-based premium would eliminate the subsidy that currently flows from riskier to safer banks. It would also eliminate the subsidy that currently flows from the Treasury through the FDIC to banks. Under this model, the Treasury would self-insure for catastrophes. Whatever payouts were made by the FDIC would come from the Treasury's general fund.

Deposit premiums would not be affected by the size of the FDIC's reserve fund. If a fund were to be retained, it would be little more than an artifact. Banks would incur no additional responsibilities when the fund balance was deemed to be 'too low';

nor would they have any extra claim on the fund when it was deemed to be 'too high'. Thus, neither the size of the fund nor its ratio to insured deposits would be economically relevant to banks. As a consequence, coverage extended to deposits, for example those added by growing, newly-chartered banks or swept in from uninsured, nonbank accounts, would impose no extra costs on other long-paying banks. Thus, under this model, there would be no need for a specifically identified deposit insurance fund.

If the current fund were to be abolished, however, something would have to be done with the proceeds of the fund. Currently BIF and SAIF reserves total about \$40,000,000,000. Abolishing the fund would require distributing the proceeds presumably either to banks and/or to the Treasury. A real drawback to not having a specifically identified deposit insurance fund might be that, when a banking crisis struck that required a large payout, the absence of a fund might hinder prompt closure of insolvent institutions. Advocates of maintaining a fund sometimes point to the Federal Savings and Loan Insurance Corporation (FSLIC) experience during the 1980s as an example where an insufficiently large fund precluded promptly closing insolvent institutions that then behaved in ways that were privately optimal but socially sub-optimal.<sup>11-13</sup>

An alternative would be not to abolish the Fund, but rather to just ignore its size, ie set premiums without regard to whether the Fund was deemed actuarially to be too high or too low.

In practice, however, the Fund is unlikely to be either abolished or ignored. First of all, the FDIC has always had a fund. Since its beginning in the early 1930s to the present, the FDIC has always maintained a fund. Secondly, abolishing the Fund requires distributing the proceeds. Given the sizable amount of funds at stake,

it seems unlikely that there would be agreement between the banks and Treasury as to who should get what fraction of the proceeds.

Banks will make strong claims on the Fund if abolition is undertaken. Among the factors they will point to are three: first, the Federal Reserve System and the Treasury were both repaid the 'seed money' that they contributed to the Fund soon after the FDIC was established in 1934. Indeed, in the late 1940s, both the Fed and the Treasury investments in the Fund were repaid — with interest — when the Fund was deemed adequately funded. Thus, the original 'venture capitalists' that seeded the Fund chose to cash out about 50 years ago. On that count, the Fed and the Treasury very much weakened their 'ownership' claims. Secondly, when the Fund was judged to have, in effect, no reserves in the early 1990s, banks were assessed for and paid special premiums in order to rebuild the Fund. These premiums were set without regard to the forward-looking risks imposed by those institutions. Thus, most of the explicit charges that banks paid to the FDIC during the 1990s were designed to and did 're-capitalise' the Fund. That would seem to strengthen the banks' case that they have a claim on the reserves that constitute the fund. Thirdly, the FDICIA requires that, if the ratio of deposit insurance fund reserves to insured deposits is otherwise expected to be below 1.25 per cent for over one year, the FDIC is obligated to charge banks a premium of at least 23 basis points of domestic deposits. Taken together, these factors provide the banks with considerable ammunition in their argument that they 'own' the Fund in the sense that banks are in the position of being the Fund's residual claimants.

Whether banks own the Fund in a legal sense is a somewhat different matter. The FDIC seems to have the authority to implement policies that would treat banks

as if they owned the Fund without taking a stand on the legal issue. Whether following such 'as if' policies would then enable banks to count the reserves of the Fund on their balance sheets would presumably have to be decided.

Nonetheless, the Treasury is unlikely to acquiesce readily to rebating the entire Fund to the banking industry. One reason that the Treasury might give is that the FDIC has never paid the Treasury for either the line of credit or the catastrophe insurance that the Treasury has provided to the FDIC.

Nor is it going to be easy to ignore the size of the Fund. For example, much of the current agitation for rebates from the Fund is based on its relatively high current size and ratio to insured deposits. Further, history shows that the size of the Fund consistently distorts the premiums that the FDIC charges banks for deposit insurance. First, when the size of the Fund was deemed adequate in every year from 1950–83, premiums were partially refunded. Secondly, as noted earlier, premiums were raised explicitly to re-capitalise the Fund in the 1990s when the Fund hit distressingly low levels. Thirdly, as also noted above, FDICIA requires that premiums be raised to repay the Fund for any extra losses that the Fund suffers under 'systemic risk exceptions'. And perhaps most dramatically, the Deposit Insurance Funding Act of 1966 requires, in practice, dramatic changes in premiums when the reserve ratio either exceeds or falls below 1.25 per cent of insured deposits. Thus, current debate, history and law all suggest that the size of the Fund importantly affects the premiums that the FDIC charges for deposit insurance.

In principle, this user fee or government guarantee programme might be the first choice for many. But, in practice, the author believes that it is unlikely to be implemented because it is unlikely that the Fund will be abolished and dispersed and,

given that the Fund will survive, it is unlikely that premiums would be immune from the size of the Fund. Therefore, the author offers a different solution. This solution also aims to achieve the same risk-based premiums as the user fee model. In addition to providing stronger economic incentives for both banks and the FDIC, it has the advantage of being more likely to be implemented.

#### **MIMIC: MUTUAL INSURANCE MODEL WITH INCENTIVE COMPATIBILITY**

To improve the prospects for moving closer to a deposit insurance system with rigorous, risk-based pricing, the author proposes MIMIC. MIMIC is a model for deposit insurance that mimics the incentives and practices of a private-sector, mutual, insurance organisation. The main features of MIMIC are:

- annual, fully risk-based premiums
- payments by the FDIC to Treasury for the line of credit and 'catastrophe insurance'
- rebates to banks when the reserve ratio exceeds a risk-based ceiling
- surcharges on banks when the reserve ratio dips below a risk-based floor
- dilution fees on deposit growth to maintain the reserve ratio
- refunds when deposits shrink to maintain the reserve ratio.

#### **RISK-BASED PREMIUMS**

Under MIMIC, banks would pay the same risk-based premiums that they would pay under the user fee model. While it is easy to talk about imposing risk-based deposit insurance premiums on banks, it is challenging to measure the risks that banks impose on the Fund. One can sympathise with the temptation to use readily available, objective data for determining deposit insurance premiums. Financial statements, however, often provide better indications

of what has been than of the likelihood of future events and the losses that future events would entail. For larger banks in particular, data and other information obtained through the supervisory process and from market prices and quantities may provide useful additional information.<sup>14-16</sup> Regardless, while measuring risk at individual banks may be challenging, it is surely possible to do better than charging nearly every bank the same zero premium.

Risk-based premiums will fluctuate over time as the risks that banks pose to the Fund fluctuate. Moving to risk-based premiums, which reflect forward-looking assessments of banks' prospects, may reduce the procyclicality in current premium policy, which tends to reflect recent, past performance. First, when banks' earnings reflect expected additional rewards to risk taking, risk-based premiums will tend to be higher when earnings are higher. And, secondly, banks' current earnings may be less correlated with forward-looking assessments of banks' prospects than they are with banks' recent past performance. If so, then risk-based premiums will be less procyclical than current premiums.

In addition, charging banks *ex ante* for the risks that they impose on the Fund has advantages over settling up *ex post*. First, a bank's cash outlays for premiums based on the risks it imposes on the Fund *ex ante* are likely to deter its risk-taking more than a less certain, *ex post* arrangement to charge for losses that the Fund suffers in the aggregate. Secondly, although on average the riskiest banks would be expected to be the banks that disappear into insolvency and that impose actual losses on the fund, those failed banks would not be around to pay any of the *ex post* settling up charges.

#### **PAYMENTS TO TREASURY**

The US Government (the Government) has come to recognise and to price some of the valuable financial services that it pro-

vides. Among the valuable, government-provided, financial guarantees that are already priced, however imperfectly, are federal flood insurance and the credit guarantees provided by the Federal Housing Administration (FHA) for some home mortgages and by the Small Business Association<sup>17</sup> (SBA) for some business loans. Many government-provided financial guarantees remain unpriced. Federal Reserve Board Chairman Alan Greenspan argued that the implicit guarantees that are provided by Treasury to housing-related government-sponsored enterprises (GSEs), which are not explicitly priced and have not directly drained funds from Treasury, are not costless.

The Treasury supplies two unpriced financial services to the FDIC. Currently, by law the Treasury extends a \$30,000,000,000 (presumably repayable) line of credit to the FDIC. The Treasury also backs the obligations of the FDIC with the full faith and credit of the Government. The backstop that the Treasury provides to the FDIC resembles the reinsurance that private insurance companies purchase. An example of a backstop being called upon took place as a result of the savings and loan crisis. The Treasury 'contribution' in the range of \$150,000,000,000 was required to cover the 'catastrophic' losses beyond those that the Savings and Loan Associations (S&Ls) and their insurer were called upon to pay.<sup>18</sup> Because the reinsurance provided by the Treasury to the FDIC is presumed to be called upon only to cover large losses beyond those that banks and the FDIC would be called upon to cover, this policy is referred to as 'catastrophe insurance'.

The Shadow Financial Regulatory Committee<sup>19</sup> and Kaufman<sup>20</sup> have suggested that deposit insurance no longer poses any risk to the Treasury, due to FDICIA provisions such as prompt corrective action and the requirement that large

losses would be funded, after the fact, by *ex post* fees on the remaining, solvent banks. Although the probability that the Treasury will have to fund deposit insurance losses may be extremely low, the Treasury remains at risk for low-probability, large-loss events.

Why does the Treasury remain at risk? First, the deposit insurance fund is not especially large relative to the size of the banking system or the size of the losses that it could potentially impose on the FDIC. Secondly, large enough losses can overwhelm not only the deposit insurance fund, but also overwhelm the ability (or desirability) of an industry to repay the Treasury after the fact, as demonstrated by the thrift crisis. Such large losses are likely to be associated with a severely weakened banking industry and perhaps similarly weakened financial sector. In that case, it is highly unlikely that it will be either economically sound or politically feasible to extract enough funds from the weakened banks to repay all the losses without further weakening them, putting them at a distinct competitive disadvantage relative to their non-bank competitors who will not be paying *ex post* fees, and disrupting bank credit flows to the detriment of the broader economy. Thus, the line of credit and catastrophe insurance provided by the Treasury remain in force and valuable. They need not remain unpriced.

Despite the value of the Treasury's ongoing backstops to the deposit insurance fund, at all times, under all circumstances, the FDIC has paid a zero premium for the costs and risks that its line of credit and its catastrophe insurance policy impose on the Treasury. This situation bears the same hallmarks of inefficiency that the FDIC pointed out in current deposit insurance premiums. The failure of the FDIC to pay risk-based prices (and pass the costs along to insured banks) for these financial services from the Treasury constitutes a public



subsidy to banks' risk taking. Absent a compelling economic argument to the contrary, these financial services should be priced according to the costs and risks associated with providing them. MIMIC calls for the FDIC to make two, separate, risk-based payments annually to the Treasury: one for the \$30,000,000,000 line of credit and one for catastrophe insurance.

There are at least two advantages of having the FDIC pay risk-based premiums for the line of credit and catastrophe insurance that it receives and presumably will continue to receive from the Treasury. First, it would remove the Treasury subsidy that flows through the FDIC to insured banks. The second advantage is more pragmatic. Charging the FDIC itself a risk-based premium for the line of credit and insurance that it receives would provide a clear and strong incentive for the FDIC to charge fully risk-based premiums for the deposit insurance that it offers.

In principle, the FDIC could charge banks fully risk-based premiums for deposit insurance even in the absence of a payment to the Treasury. But, so far, neither legislation nor FDIC policy has led to that. In fact, that the FDIC has been an approximately break-even operation even while getting free services from Treasury is consistent with the suggestion that banks have been consistently under-charged for deposit insurance.

It will also be challenging to measure the risk imposed on the Treasury by the FDIC so that risk-based fees for the line of credit and catastrophe insurance can be levied. Again, however, it should not be difficult to improve on the zero prices currently charged by the Treasury.

#### **RISK-BASED RESERVE RATIO, REBATES AND SURCHARGES**

Further mimicking private sector insurance arrangements, MIMIC calls for the FDIC to specify annually a risk-based target

range for its reserve ratio. The range would be re-calibrated from time to time as the FDIC's estimate of the risks facing the Fund changed. Some of the same practical difficulties will arise in setting the appropriate risk-based range for the reserve ratio as in setting risk-based premiums. At the same time, it seems very likely that it is possible to do better than, in effect, aim at a historical artifact like the current designated reserve ratio of 1.25 per cent.

The Fund's reserves serve as a 'deductible' in the catastrophe insurance policy. Thus, other things being equal, the premiums paid by the FDIC to the Treasury would vary inversely with the range established by the FDIC for its reserve ratio. Explicitly paying the Treasury for these services raises the incentive for banks and the FDIC to maintain a larger average reserve ratio than otherwise.

Choosing a range implies choosing a floor and a ceiling for the reserve ratio. To maintain the reserve ratio within its chosen range, under MIMIC the FDIC would impose surcharges on banks if the ratio dipped below the floor and analogously would provide rebates from the Fund to banks when the reserve ratio rose above the ceiling. These surcharges and rebates should and can be designed to preserve the annual premiums' risk-based incentives. Under MIMIC, banks will recognise that higher current premiums raise not only the reserve ratio but also the likelihood of future rebates. Thus, a risk-based range for the reserve ratio reduces the current incentive for banks to pressure the FDIC to set premiums and reserve ratios 'too low'.

These surcharges and rebates would be unrelated to the ongoing deposit insurance premiums paid by banks. Indeed, to preserve the correct incentives, banks should be made aware that the level of the Fund ratio would not affect their annual risk-based premiums. Of course, the total net

payment made by each bank to the FDIC would be affected by both the premium and the rebate (or surcharge). But, while the *ex ante* risk that a bank imposes on the FDIC affects the former, it would not affect the latter.

One way to determine the size of the rebate or surcharge allocable to each bank would be to base the rebate or surcharge on each bank's past average domestic deposits.<sup>21</sup> To preserve the correct incentives for banks, the rebate or surcharge should not be based on past premium payments. Once risk-based premiums have been in place for a time, past premium payments will reflect both the premium base (currently, domestic deposits) and the adjustment for risk. A policy that tied rebates and surcharges to risk, even past risk, may dull the incentives that risk-based premiums seek to sharpen.

#### DILUTION FEES AND REFUNDS

One notable feature of MIMIC is that it treats banks as if they have some of the rights and responsibilities that attend the members (or owners or residual claimants) of mutual organisations. At this stage of the debate, it does not seem necessary to decide whether banks would have a legal ownership claim. Nonetheless, while banks would have some of the prerogatives of 'ownership' of the federal deposit insurance system, it seems unlikely that they would have them all. For example, it seems very unlikely that there would be voting shares in any meaningful sense.<sup>22</sup> Rather, the FDIC would remain as the arm of the Federal Government charged with administering the deposit insurance system, including setting premiums and the target range for the reserve ratio.

At the same time, under MIMIC, banks would have a financial stake in the size of the Fund relative to insured deposits. Under MIMIC, as is now the case, growing banks dilute the Fund by lowering the

reserve ratio and raising the probability of surcharges to replenish the ratio. Thus, on this count, it seems appropriate to charge growing banks a dilution fee. This fee could be as simple as a one time charge equal to the current reserve ratio times the additional dollars of insured deposits. Even-handed policy would then also refund to banks whose insured deposits shrank an amount equal to the current reserve ratio times the decline in their insured deposits.

These dilution fees and refunds would apply not only to newly-chartered banks or to banks that suddenly have come to acquire billions of dollars of insured deposits. Instead, they would apply to all banks. After all, the dilution of the Fund and thus the expected cost imposed on other banks is about the same, regardless of which bank holds the extra dollar of insured deposits. To the extent that faster growing banks, for whatever reason, also impose more risk on the Fund, their annual premiums should reflect that risk. If the FDIC determines that, *ceteris paribus*, young and less-experienced banks are riskier, then it will have cause to impose higher deposit insurance premiums on them — just as casualty insurance companies impose higher insurance premiums on younger and less-experienced drivers.

#### MARKETS ON THE MARCH

Market-based and market-like pricing have been spreading around the globe for at least a decade. Entire countries have moved toward market-based systems. Closer at hand, US financial markets have increasingly priced and traded separately the distinct constituent parts of previously composite financial products (and services). Banks have been in the forefront of this 'unbundling' of composites into their more homogeneous components. As financial assets are unbundled, the resulting products more closely match individuals' market

demands and the resulting prices are likely to better reflect the costs and benefits of those products.

For many years, the Federal Reserve System bundled into the package of rights and responsibilities associated with being a member bank various financial services, such as cheque clearing and payments transfers, at no explicit, separate cost. Eventually — and ironically, given the economic orientation of the Federal Reserve System — Congress filled the pricing vacuum by mandating a pricing scheme for some of the financial services that the Fed supplies.

Some government-provided financial services remain bundled. In addition to deposit insurance, the FDIC provides valuable supervision and regulation at no explicit, separate cost. Moreover, some, but not all, insured banks receive these unpriced services. Just as it can address the pricing of deposit insurance *per se*, deposit insurance reform should eliminate the inefficient pricing of these services. One way to achieve more efficient pricing of the FDIC's supervision and regulation is to unbundle them from deposit insurance; that is, to separate the pricing of deposit insurance from that of FDIC supervision and regulation. Another way would be for the FDIC to allocate funds to various bank supervisory authorities, state as well as federal and including the FDIC's own Division of Supervision, on the basis of a common schedule that reflected the various costs of bank supervision and regulation.

Rather than letting Congress or an Administration take the initiative, banks and the FDIC should consider how to move toward a more rational pricing scheme for each of the financial services associated with the FDIC. Explicitly paying for each of these services may forestall other costs being imposed on banks by those who perceive banks as receiving government subsidies.

## CONCLUSIONS

MIMIC seeks to better align the banks' incentives and those of the FDIC with the interests of the government and thus of taxpayers. MIMIC calls for risk-adjusted deposit insurance premiums, as well as risk-adjusted prices for the individual services that the Treasury provides to the FDIC. As a result, MIMIC would reduce the current subsidies from safer to riskier banks and from the Treasury to the FDIC.

In order to strengthen the incentives of banks and the FDIC to get the prices right, MIMIC would have the FDIC treat banks as if they had some, but not all, of the rights and responsibilities of ownership of the deposit insurance system. Thus, MIMIC calls for the FDIC to maintain its reserve ratio within a risk-based range through the use of rebates and surcharges. It also advocates a dilution fee for deposit growth and, symmetrically, a refund when deposits decline. Taken together, these features of MIMIC move the deposit insurance system toward the policies and practices of private sector mutual insurance organisations.

The FDIC has stimulated a timely and valuable discussion of deposit insurance reform. Because of the size of their stake in the efficient operation of the deposit insurance system, banks should recognise their significant interest in achieving the right reforms.

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  - (21) Domestic deposits are the base upon which premiums are now levied.
  - (22) Unusual 'ownership' would be familiar, for example, to banks that are members of the Federal Reserve System. Member banks are required to purchase stock in their Federal Reserve Banks. While they participate in choosing the boards of directors and in other activities, they do not in practice have complete control over the Federal Reserve Banks.