Feature Article:

Establishing Voluntary Excess Deposit Insurance: Results of the 2006 FDIC Study

Foreword

The Federal Deposit Insurance Corporation (FDIC) was required by the Federal Deposit Insurance Reform Conforming Amendments Act of 2005 (FDIRCAA) to study the feasibility and consequences of privatizing deposit insurance, establishing a voluntary deposit insurance system for deposits in excess of the maximum amount of FDIC insurance, and increasing the limit on deposit insurance coverage for municipalities and other units of general government. In February 2007, the FDIC sent its report to Congress. The results of the FDIC's findings on privatizing deposit insurance appeared in a previous issue of the ***FDIC Quarterly*** *(available at http://www.fdic.gov/bank/analytical/quarterly/index.html).*[1] *This article summarizes the FDIC's findings on establishing a voluntary deposit insurance system for excess deposits. The results of the FDIC's study on providing for increased coverage on municipal deposits will be presented in a future issue of the* ***FDIC Quarterly****.*

Introduction

In 2006, in response to the Federal Deposit Insurance Reform Conforming Amendments Act of 2005 (FDIRCAA), the FDIC studied the feasibility of establishing a voluntary deposit insurance system for deposits that exceed the maximum amount of FDIC insurance. This study concluded that market changes during the past two decades have lessened the demand for excess deposit insurance and provided depositors with other options to protect excess deposits. This article examines the factors that have shaped this new banking environment. It then looks at two approaches to offering excess deposit insurance and identifies key issues to be resolved should Congress authorize an FDIC role in the provision of excess deposit insurance.

A Changed Banking Environment

The banking environment has changed considerably since the early 1990s in response to a return to banking industry profitability, technological advances, and product developments in the private sector. As a result, the demand for various forms of excess insurance has diminished.

The Banking Industry's Return to Stability and Profitability

The return to industry stability and profitability after the turbulence of the late 1980s and early 1990s has reduced the demand for private excess deposit insurance. A number of private excess deposit insurance plans were implemented in the early 1990s, but many—such as the Depositsure program, offered by Centrex Underwriters Inc.—have been terminated. Joseph Carlson, president of Memphis-based Centrex, stated that the company expected a "blizzard of applications" for excess deposit insurance when the program was created in 1993. However, when profitability returned to the banking sector, Centrex found that the demand for the product fell below original expectations, and the Depositsure program ceased operation in 2001.[2] Another entrant into this market, Reliance National, a subsidiary of Reliance Group Holdings, reported being "flooded with inquiries" in the late 1980s. However, by the time the company developed a product, it discovered that "their timing was a bit off."[3]

Examples of firms currently providing excess deposit insurance are BancInsure, St. Paul Travelers, and Kansas Bankers Surety Company. BancInsure provides risk management and risk mitigation services for community banks and other financial institutions and offers excess deposit insurance bonds to banks that are

[1] Christine Bradley and Valentine V. Craig, "Privatizing Deposit Insurance: Results of the 2006 FDIC Study," *FDIC Quarterly* (Second Quarter 2007): p. 23–32.

[2] Celia Viggo Wexler, "For Private Deposit Insurers, The Windfall Never Came," *The American Banker* (July 10, 1996): p. 3.

[3] Ibid.

customers for the company's other insurance products (http://www.bancinsure.com). St. Paul Travelers offers excess coverage through a depository bond (http://www.travelers.com), as does Kansas Bankers Surety Company, a subsidiary of Wesco Financial Corporation. Kansas Bankers Surety offers these bonds not only to banks in Kansas but to banks in many other states (http://wescofinancial.com).

In addition, excess deposit insurance continues to be provided to state-chartered cooperatives and savings banks in Massachusetts by the Share Insurance Fund of the Co-Operative Central Bank (SIF) for cooperative banks and the Depositors Insurance Fund (DIF) for savings banks. The SIF and DIF are private, industry-owned excess deposit insurance funds, and both are backed solely by their own assets. Neither the Commonwealth of Massachusetts nor the U.S. government has any liability for these funds' obligations. Both funds insure deposits above the FDIC limit, in full, dollar for dollar, without restriction (http://coopcentralbank.com or http://difxs.com).

Technological Advances

Recent technological advances have changed the banking environment by giving customers options for depositing their money and protecting their deposits, reducing the need for excess deposit insurance. No longer must depositors physically visit a depository institution to do their banking. Depositors can shop for financial services and conduct banking business through the Internet. Rates and terms for deposit accounts offered locally and nationwide are available through commercial listing services, such as Bankrate.com (http://www.bankratemonitor.com).[4] The FDIC also has developed a Web-based application (http://www2.fdic.gov/edie) that provides information to depositors about how to keep more than $100,000 fully insured within one financial institution, using different categories of account ownership.

Recent Private Sector Product Developments

Products developed by the private sector have reduced the demand for excess coverage. Two of these initiatives have become particularly popular: deposit-placement services and deposit-sweep programs. In deposit-placement services, large deposits are split by private companies into smaller amounts and distributed to participating banks; as a result, the total deposit is insured by the FDIC. In deposit-sweep programs, a depository institution "sweeps" demand deposit accounts into nondeposit instruments, which may result in the avoidance of loss in the event of a bank failure.

Deposit-Placement Services. Deposit-placement services allow participating banks and thrifts to insure deposits that exceed the statutory insurance limit while retaining the bank-customer relationship with their depositors. To show how a deposit-placement service does this, let us assume that a customer deposits $500,000 into a participating bank or thrift. The bank originating the deposit retains $100,000 in an insured account and distributes the remaining $400,000 among four other participating institutions, resulting in the depositor having full FDIC coverage.[5] A deposit-placement service is a form of brokerage in which the risk associated with the increased coverage is passed to the FDIC. However, risk is minimized as deposits placed through this service are considered to be brokered deposits, and therefore only well-capitalized institutions can participate.[6]

In 2003, the FDIC responded to an inquiry from a deposit-placement service as to whether pass-through deposit insurance rules apply to funds placed with the service. The FDIC responded that deposit insurance would "pass through" from the agent (the deposit-placement service) to the owner of the funds provided that disclosure, record keeping, and other requirements were adhered to in the process.[7] Deposit-placement services became an alternative for customers seeking deposit insurance coverage of funds in excess of the statutory limit.

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[4] The FDIC provides tips for safe banking over the Internet at http://www.fdic.gov/bank/individual/online/safe.html, and maintains an online database where consumers can confirm that an institution is FDIC-insured (http://www2.fdic.gov/idasp/main_bankfind.asp).

[5] This example illustrates a one-way sell transaction. Deposit-placement services also offer reciprocal transactions in which the money that is transferred out of the originating bank ($400,000 in our example) is replaced with deposits from other participating institutions equaling (in our example) $400,000. As a result of a reciprocating transfer, the originating bank maintains its deposit base.

[6] 12 U.S.C. § 1831f(a) (2001). An adequately capitalized (but not well-capitalized) institution may apply to the FDIC for a waiver to accept brokered deposits ((12 U.S.C. § 1831f(c) (2001)).

[7] Joseph A. DiNuzzo, "Do 'Pass Through' Deposit Insurance Rules Apply to Funds Placed in the 'Certificate of Deposit Account Registry Service?'" *FDIC Law, Regulations, Related Acts* (2003), http://www.fdic.gov/regulations/laws/rules/4000-10220.html (accessed December 1, 2006).

Deposit-Sweep Programs. Many insured depository institutions offer customers the option of "sweeping" funds from a deposit account into an alternative investment vehicle. In a commercial sweep, the depositor has the option of sweeping funds held in a demand deposit into a variety of nondeposit instruments, including money market instruments, money market mutual funds, Eurodollar accounts, or international banking facilities. Commercial sweeps began to be used routinely in the 1980s. The primary motivation for developing this product was to allow commercial demand deposit customers to earn interest on their balances, but depositors may also believe their money is fully protected in the event of a bank failure. However, for several reasons, most sweeps may not actually increase a customer's chance of recovery if the institution fails.

Options for Federal Excess Deposit Insurance Coverage

If Congress were to decide that the FDIC should play a role in providing excess deposit insurance, the FDIC could adopt one of two strategies. First, it could offer excess insurance directly to banks on a voluntary basis, subject to an additional cost, and either retain the additional risk not covered by the participating banks' premiums or purchase reinsurance from a private sector reinsurer for the additional coverage. A second approach would be to continue to rely on the private sector for excess deposit insurance. However, to encourage private sector insurers to enter this market, the FDIC probably would have to act in some capacity as a reinsurer to private sector insurers.

FDIC Provision of Excess Deposit Insurance: Key Issues

The FDIC has considered how it might provide voluntary excess deposit insurance. Issues yet to be resolved include the availability of excess insurance, limits to the excess coverage to protect taxpayers and the insurance fund, and a price for the excess coverage. Congressional authorization would be required for the FDIC to play any role in providing excess voluntary deposit insurance.

Availability. The FDIC might limit the availability of excess deposit coverage to well-capitalized and well-managed institutions. For instance, it might institute term policies that would be cancelled if the institution failed to meet requisite capital standards or if the institution's CAMELS (capital adequacy, asset quality, management, earnings, liquidity and sensitivity to market risk) rating declined. A means of informing depositors about this change in status would need to be established to ensure that depositors received prompt and adequate notice.

Caps or Co-insurance. The FDIC might place a limit, or cap, on the amount of excess coverage it would insure. In addition, the depositor might share in any losses on the excess deposit. For example, only 80 percent of the excess deposit might be insured up to the designated cap. Of course, current law affects the recovery of excess (uninsured) deposits. First, after 1993 and the enactment of national depositor preference, uninsured depositors share *pro rata* with the FDIC in the liquidation of the failed bank.[8] As a result, if only part of an excess deposit is insured in a system using caps or co-insurance, depositors may not receive more coverage than they would under the current system, although excess coverage would give depositors the certainty of at least a minimum recovery.[9] Second, the FDIC Board may authorize the payment of advance dividends to uninsured depositors soon after a bank's closing. Advance dividends are based on an estimated recovery of the bank's assets and provide excess depositors an earlier return on the uninsured portion of their deposits.[10]

Pricing. A decision would need to be made as to whether participating institutions would pay a uniform premium. One possibility might be to assess a surcharge for accounts over the insurance limit on an increasing scale; that is, a higher premium per dollar of excess coverage. Another approach could be to assess a lower premium on the excess based on an institution's asset mix.

[8] 12 U.S.C. § 1821(d)(11) (2001).
[9] This outcome would depend on the percentage of the excess deposit insured and the rate of return on assets to uninsured depositors at a given failed institution.
[10] Federal Deposit Insurance Corporation (FDIC), *Managing the Crisis: The FDIC and RTC Experience, 1980–1994* (Washington, DC: FDIC, 1998): p. 249.

FDIC Provision of Excess Deposit Insurance: The Role of Reinsurance

The FDIC might guarantee its exposure in excess of the statutory limit with a private sector reinsurer. The FDIC would continue to provide deposit insurance coverage up to the statutory limit, but its risk on the excess could be transferred to a competitive market of private reinsurers.

The FDIC explored the feasibility of establishing a private reinsurance system for deposit insurance in 2001.[11] (The study focused on reinsurance of the FDIC's primary deposit insurance, not excess deposit insurance, but the findings are relevant here.) The Marsh & McLennan study found that reinsurers had only limited interest in engaging in reinsurance agreements with the FDIC on terms acceptable to the Corporation. Some reinsurers wished to limit their risk by either reinsuring only the strongest banks or charging prohibitively high premiums to banks which they determined to be involved in high-risk activities. Specifically, the Marsh & McLennan study reached the following conclusions:

- The capacity of the reinsurance market could theoretically exceed $5 billion.[12] However, that capacity would be available only if all the major insurance companies or reinsurance companies participated and only for transactions that had a very low probability of loss.
- Reinsurance companies would operate to their maximum capacity only if the FDIC paid a very substantial first loss. Even if the FDIC took the first losses, reinsurers would provide maximum capacity only when the transaction was rated the equivalent of Aa/AA or Aaa/AAA. Multiline insurers expressed interest in higher-risk transactions (lower-risk transactions would not generate premiums sufficient to support underwriting costs), but the capacity of this segment of the market was limited—between $200 million and $500 million.
- Reinsurers were not interested in sharing losses with the FDIC on a proportional basis, even if they received a proportional share of any premiums. Reinsurance companies advised the FDIC that if losses were shared on a proportional basis, their capacity would not exceed $100 million.
- Existing transactions would affect a reinsurance company's decision to participate in other transactions. If a reinsurer had an existing credit exposure with a particular bank—in the form of bank debt, credit default swaps, or insurance, for instance—the reinsurer would likely limit any further transactions with that client. For this reason, most reinsurers would prefer a transaction that excluded, or substantially limited, coverage of the 100 to 150 largest banks.
- Reinsurers generally preferred not to be exposed to losses from the failure of any single large bank.
- Reinsurers would be more likely to participate if transactions were bundled and structured with a three- to five-year term because reinsurers felt better able to evaluate risk on a portfolio basis than on an individual bank-by-bank pricing basis. Similarly, reinsurers were uncomfortable assessing risk beyond a five-year horizon.
- Reinsurers' pricing of the FDIC's risk would be a function of many factors, including the risk of the transaction, reinsurers' cost of capital, reinsurers' expense and profit provisions, and supply and demand. Reinsurers' prices would represent a free market charge without government support and, as such, could be expected to exceed prices that the FDIC would charge for the same portion of coverage.[13]

Privately Underwritten Excess Deposit Insurance

As mentioned earlier in this article, a small number of private secondary insurers currently provide coverage for excess deposits with either the bank or the depositor purchasing the coverage. However, most banks and depositors have not taken advantage of these services. As suggested by the results of the Marsh & McLennan study, for privately underwritten excess deposit insurance to be more attractive to potential providers and customers, the FDIC likely would have to assume some

[11] The FDIC engaged Marsh & McLennan to evaluate the feasibility of private sector reinsurance arrangements, specifically whether such arrangements could provide competitive-market pricing information that would assist the FDIC in setting deposit insurance premiums and in measuring risks to the deposit insurance funds. The final report was completed in December 2001. See Marsh & McLennan Companies, *Reinsurance Feasibility Study* (Washington D.C.: FDIC 2001).

[12] Figures are not inflation adjusted.

[13] Marsh & McLennan Companies (2001).

of the risk. The small number of private businesses currently offering excess deposit insurance reinforces the hypothesis that some public loss-sharing arrangement is necessary to invigorate this market.

FDIC Loss-Sharing Protocol. If the FDIC were to act as a reinsurer of privately underwritten excess deposit insurance, it would need to determine how much risk it would assume. The most critical issue would be the interplay between the amount of risk the FDIC would retain in such a program and the pricing of excess coverage. The FDIC's share of risk could be minimal—perhaps, in the extreme, as little as 1 percent of anticipated expected losses—but that retained component would have to protect the private insurers from extreme events.

Summary

A return to stability and prosperity for the banking industry has weakened demand for excess deposit insurance. In addition, technological advances and private sector initiatives have changed the banking environment and provided depositors with many options for protecting their deposits in excess of the statutory limit. Banks and depositors currently can purchase private excess deposit insurance from a limited number of providers, and new banking products and services—deposit-placement services and deposit-sweep programs—are alternatives to FDIC-provided excess deposit insurance.

If Congress were to decide that FDIC-provided excess insurance was appropriate, the FDIC would need to resolve availability, co-insurance, and pricing issues. It also would have to decide whether to retain the risk of the additional insurance or reinsure this exposure with private sector insurers. Alternatively, excess deposit insurance could be provided directly by private sector firms. However, depending on its scope, the price of privately provided excess deposit insurance likely would be prohibitive without an FDIC loss-sharing protocol. Private sector interest in providing excess deposit insurance, as reinsurers of FDIC exposure or as direct providers of excess deposit insurance, appears limited.

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The authors would like to thank Warren Heller of the FDIC Division of Insurance and Research and Alicia Amiel of the FDIC Library for their assistance in writing this article.

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