

**THE MYTHICAL FDIC FUND**  
**By William M. Isaac\***

[**Prologue:** The FDIC is debating whether to increase deposit insurance premiums in order to restore the deposit insurance “fund” to 1.15% of insured deposits or higher. I wrote a column for this newspaper on this subject the last time it was debated some seventeen years ago. I believe that column remains relevant to today’s public policy debate. So here goes . . . with a few edits and a postscript]:

When I became Chairman of the FDIC in 1981, the FDIC's financial statement showed a balance at the U.S. Treasury of some \$11 billion. I decided it would be a real treat to see all of that money, so I placed a call to Treasury Secretary Don Regan:

Isaac: Don, I'd like to come over to look at the money.  
Regan: What money?  
Isaac: You know . . . the \$11 billion the FDIC has in the vault at Treasury.  
Regan: Uh, well you see Bill, ah, that's a bit of a problem.  
Isaac: I know you're busy. I don't need to do it right away.  
Regan: Well . . . it's not a question of timing . . . I don't know quite how to put this, but we don't have the money.  
Isaac: Right . . . ha ha.  
Regan: No, really. The banks have been paying money to the FDIC, the FDIC has been turning the money over to the Treasury, and the Treasury has been spending it on missiles, school lunches, water projects, and the like. The money's gone.  
Isaac: But it says right here on this financial statement that we have over \$11 billion at the Treasury.  
Regan: In a sense, you do. You see, we owe that money to the FDIC, and we pay interest on it.

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Isaac: I know this might sound pretty far-fetched, but what would happen if we should need a few billion to handle a bank failure?

Regan: That's easy – we'd go right out and borrow it. You'd have the money in no time . . . same day service most days.

Isaac: Let me see if I've got this straight. The money the banks thought they were storing up for the past half century – sort of saving it for a rainy day – is gone. If a storm begins brewing and we need the money, Treasury will have to borrow it. Is that about it?

Regan: Yep.

Isaac: Just one more thing, while I've got you. Why do we bother pretending there's a fund?

Regan: I'm sorry, Bill, but the President's on the other line. I'll have to get back to you on that.

Once upon a time, there was indeed a segregated FDIC fund. During the Johnson Administration, someone had the bright idea to put the FDIC into the federal budget as a way to reduce the deficit. This was in the good old days when the FDIC always produced a surplus. Putting the FDIC on budget reduced the deficits being created by spending on the Great Society programs in tandem with the war in Vietnam.

The reality is that there is no FDIC fund. Anything the FDIC lays out to handle a bank failure must be borrowed by the Treasury, which adds to the federal deficit. The total amount of the current outlay is charged against the federal budget even if recoveries are expected in the future, as problem assets are collected by the FDIC. That's the case whether the FDIC's nominal balance at the Treasury is positive or negative.

The plain truth is that premiums paid by the banks to the FDIC today are a tax to compensate the government for putting its full faith and credit behind bank deposits. The nominal balance in the FDIC's account at Treasury is irrelevant, except that, over time, we want the banks to pay to the government more than the guarantee of deposits costs the government.

The operative words are "over time." It doesn't matter if the FDIC's nominal balance at Treasury is negative at any particular point. Over the long haul, we want it to be positive.

This leads me to wonder why official Washington seems so preoccupied with imposing on the banks FDIC tax increases at a time when the industry and the country can least afford them. I know of no responsible economist who would advocate a general tax increase in the midst of a recession. A tax increase on the banks is even worse than a general tax increase.

When we increase taxes on individuals, a dollar collected by the government is a dollar that doesn't get spent or invested in the private sector. But for every dollar we take out of the banks to put into the FDIC, we reduce by a multiple of ten or so the amount of loans banks can make. I can't imagine why we would want to do that at a time when we are seeking ways to encourage banks to increase their lending in order to stimulate the economy.

The deposit insurance tax rate on banks has increased three-fold since 1985, and there is serious talk of yet another substantial increase in 1992. It brings to mind the actions by the Federal Reserve in the 1930s to tighten the money supply in order to protect the gold standard, which helped turn a serious recession into the Great Depression. The nation is paying a pretty stiff price to maintain the myth of an FDIC fund. Let's not make it worse.

**[Postscript:** Bank regulation should always strive to be counter-cyclical, not pro-cyclical. We have it all backward today.

Fair value accounting, imposed by the Financial Accounting Standards Board (FASB) beginning in the early 1990s, is pro-cyclical and leads to exaggerated boom/bust cycles through its tendency to over-value assets when markets are strong and under-value assets when markets

are weak to non-existent. Today's problems have been aggravated significantly by the excessive asset write downs dictated by fair value accounting.

The Securities and Exchange Commission (SEC) took action against SunTrust Bank in 1999, alleging that it was manipulating earnings by setting aside what the SEC considered were excessive loan loss reserves during a period when SunTrust was not suffering significant loan losses. There is no doubt in my mind that the SEC's action had a negative effect on reserving by banks during the heady days of the late 1990s and early 2000s. Moreover, the earnings boost from the failure to increase reserves enabled banks to pay out more capital and/or expand their balance sheets. The one-two punch from FASB and the SEC has inflicted a great deal needless damage in the current credit cycle.

The Basel II capital models adopted by bank regulators are also pro-cyclical. The models mandate relatively little capital when we are in a prolonged period of low loan losses – when we would like to see banks exercising some restraint in lending. And they require relatively more capital when we are in the middle of difficult times – when we would really like to see banks lending more money. One can only hope that the regulators will rethink the wisdom of the Basel II approach to setting capital standards.

Deposit insurance is in the same category. A reasonable level of deposit insurance premiums should be paid in good times and bad, allowing the fictional fund to be “built” to a level that is likely to remain positive through the inevitable bad times. Premiums should not be increased at a time when we are trying to encourage banks to loan money to bolster the real estate markets and get the economy growing again.]