



The FDIC Should Have Borrowed From Treasury to Replenish the DIF

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The state of California just announced its plan to withhold an additional 10% in state income taxes from the wages earned by workers. It is not a tax increase. Individuals who get a refund on their 2009 taxes will get a bigger refund in 2010 while individuals who must pay state taxes will owe less. This California Plan essentially represents an interest-free loan from wage earners to the state.

Yesterday, the FDIC approved a similar plan to replenish the Deposit Insurance Fund (DIF). Specifically, on December 30, 2009 banks will prepay their deposit insurance premiums through 2012. The estimated \$45 billion in funds raised by the prepayment plan are needed to provide cash to the FDIC to handle anticipated bank failures. Each insured bank will record its payment as an asset, a prepaid expense. As quarterly premiums are levied in the future, it will reduce its prepaid expense by the amount of the quarterly assessment. If a bank's quarterly assessments increase, perhaps because the bank is downgraded under the CAMELS system or it relies on additional brokered deposits, the prepaid expense will disappear before the end of 2012, and the bank must make subsequent premium payments earlier than expected. If a bank's quarterly assessments decrease over time, the bank will have prepaid its insurance beyond 2012. The prepayment plan essentially represents an interest-free loan from banks to the FDIC with the true final maturity unknown.

Strangely enough, the prepayment plan has been widely praised by bankers and regulators because it avoids another immediate special assessment and does not carry the stigma associated with borrowing from Treasury – the other alternatives. Because banks cannot afford a \$45 billion hit to earnings in the current environment, they generally did not favor a special assessment even though it could again have been based on total assets less tier 1 capital, as was the special assessment.

What about the stigma associated with Treasury borrowing? The FDIC is authorized to borrow \$100 billion from Treasury at its discretion and can obtain an additional \$400 billion with Congressional approval. In her October 14th testimony before the Senate Subcommittee on Financial Institutions, FDIC Chairman Bair stated that the “Prepayment of assessments ensures that the deposit insurance system remains directly industry-funded and it preserves Treasury borrowing for emergency situations.” She further stated that “The FDIC’s proposal requiring prepayment of assessments is really about how and when the industry fulfills its obligation to the

insurance fund.” The stigma appears to be the possible perception that taxpayers and not banks will pay for deposit insurance. The banking industry clearly wants to avoid headlines that read something like “Taxpayers Bailout Community Banks.” Finally, the prepayment plan does keep the Treasury credit line open for emergencies.

What seems to be missed, however, is that borrowing \$45 billion from Treasury is the least burdensome economic alternative for banks. Compared to the prepayment plan, banks would make annual principal and interest payments on the debt that are well below their up-front payment and thus have more funds to invest. They would achieve higher subsequent earnings over time and exhibit stronger liquidity. To put this in focus, banks paid over \$9 billion in FDIC deposit insurance assessments during the second quarter of 2009 while they reported almost \$4 billion in losses in the aggregate. Banks would be stronger financially with no prepayment.

Let’s address the potential political costs. Banks and the FDIC regularly emphasize that deposit insurance is self funded by assessments on insured institutions. No insured depositor has ever suffered a loss on insured deposits. Neither of these claims would change under either the prepayment plan or Treasury borrowing. Importantly, we seem to have forgotten that the FDIC borrowed \$15 billion from Treasury in the early 1990s such that borrowing from the Treasury would not be precedent breaking as is widely suggested today. Steven Sebastian, the FDIC’s auditor representing the Government Accountability Office (GAO), noted that the earlier loan arose during the savings and loan crisis and was repaid within 18 months.¹ This loan was repaid by assessments on insured institutions and had a relatively short maturity because conditions improved faster than originally expected. Had the FDIC borrowed from Treasury, the same result might have occurred depending on how quickly the economy improves. In any event, if the FDIC ever borrows from Treasury, repayment will come from assessments on insured banks.

The existence of a stigma associated with Treasury borrowing is more difficult to assess given recent experiences. It is true that most firms issuing preferred stock under the Troubled Asset Relief Program (TARP) have experienced hits to their reputations as the public perception is that they have been ‘bailed out’ by taxpayers. While TARP Special Inspector General Neil Barofsky recently reported that 17% of the loans under TARP had been repaid, it is widely recognized that some recipients will never fully repay their obligations and taxpayers may never receive a full return on the allocated funds. Unfortunately, the Capital Purchase Program (CPP) which focuses on healthy banks has been lumped with other funding for AIG, GM, GMAC and Chrysler where the likelihood of full repayment is small. So the damage is done under TARP. Still, some banks have clearly not suffered reputation hits. For example, one year ago PNC used its \$7.7 billion in

¹ See “GAO: More Stress Ahead For FDIC,” National Journal Insider Interviews by Michelle Williams, June 11, 2009.

CPP funds to help it acquire National City Bank and appears to have weathered any criticism well.

The same stigma does not appear to apply to firms that issued FDIC-insured debt. The following table lists large institutions that benefited from the FDIC guarantee of debt issued under the Temporary Liquidity Guarantee Program (TLGP). At the end of October, the FDIC had guaranteed almost \$304 billion in debt. Financial stalwarts, such as Goldman Sachs, Morgan Stanley and JPMorgan Chase borrowed almost \$86 billion of the total. While there may be public outrage over these firms' compensation plans for senior managers, little has been said about their guaranteed borrowing. Bank of America and Wells Fargo borrowed another \$44 billion and \$9.5 billion, respectively in this guaranteed form. It doesn't appear that these firms have suffered any loss of reputation from these borrowings. Only the \$65 billion provided to Citigroup and the \$7.4 billion provided GMAC appear to be at real risk. But these firms have reputation issues because of their weak overall financial condition. All of these firms have simply lowered their overall funding costs by taking advantage of this cheap debt. Most do not seem to be operating with damaged reputations due to the guarantees.

The FDIC is on the hook for the entire \$304 billion in the event of default. Had the FDIC borrowed \$45 billion from Treasury to aid the DIF and banks – arguably the principal responsibility and mission of the FDIC - it would have been a relatively small exposure. If there is any stigma, it would seem to apply directly to the FDIC and only indirectly to banks. Given the experience with FDIC-insured debt, any potential stigma might have been mitigated if it was successfully communicated that banks ultimately service all FDIC debt to Treasury through future assessments. Treasury borrowing was successful in the early 1990s and would have been again.

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FDIC-Insured Debt Issued Under the Temporary Liquidity Guarantee Program
Outstanding on October 31, 2009 (Millions of Dollars)

<i>Issuer</i>	<i>Amount</i>
Goldman Sachs	\$ 21,614
Morgan Stanley	<u>23,769</u>
‘Old’ Investment Banks	\$ 45,383
Bank of America	44,000
Citigroup/Citigroup Funding/Citibank	64,600
JPMorgan Chase	40,435
HSBC USA Inc.	2,675
PNC Funding Corp.	3,900
Regions Bank	3,750
State Street	2,450
U.S. Bancorp	2,680
Wells Fargo	<u>9,500</u>
Large Banks	\$173,990
American Express	5,900
GMAC	7,400
GE Capital Corp.	54,846
John Deere Capital Corp.	2,000
MetLife Inc.	<u>397</u>
Other Large Financial Institutions	\$ 70,543
Banco Bilbao Vizcaya	470
Bank of New York Mellon	603
Bank of the West	1,000
Huntington National Bank	600
KeyCorp	938
SunTrust	576
Union Bank	1,000
Zions	<u>255</u>
	\$ 5,442
Others	<u>\$ 8,253</u>
Total	\$303,611

Source: SNL Financial provided by FinPro