



United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-258440

December 13, 1994

The Honorable Henry B. Gonzalez
Chairman, Committee on Banking,
Finance and Urban Affairs
House of Representatives

Dear Mr. Chairman:

This correspondence is in partial response to your request that we review bank mutual fund activities. As part of that request you asked about the impact on the federal deposit insurance funds of the movement of money between deposits and mutual funds. Specifically, you requested that we evaluate whether the movement of money from deposits into mutual funds will significantly affect the assessment income of the federal deposit insurance funds. You also asked whether the Federal Deposit Insurance Corporation's (FDIC) projections for the federal deposit insurance funds take this movement of money into account and whether they should take it into account. We plan to address the other parts of your request for information about bank mutual fund activities in forthcoming reports.

BACKGROUND

FDIC administers two deposit insurance funds: the Bank Insurance Fund (BIF), which primarily covers the deposits of commercial banks, and the Savings Association Insurance Fund (SAIF), which primarily covers the deposits of thrifts. Each fund derives its income primarily from premiums levied on an assessment base that approximately corresponds to domestic deposits.¹ Any income not needed to pay for insurance losses and administrative expenses is added to the fund's reserves.

An important measure of the soundness of the deposit insurance funds is the reserve ratio. This ratio relates fund reserves (a measure of fund resources) to insured

¹The funds also receive income from earning assets contained in the funds.

deposits (a measure of potential exposure to loss).² At the end of 1993, the ratio of BIF's reserves (\$13.1 billion) to insured deposits (\$1,905 billion) was 0.69 percent. The SAIF reserve ratio at the end of 1993 was 0.17 percent (\$1.2 billion in reserves and \$696 billion in insured deposits). Key financial characteristics of BIF and SAIF are summarized in tables 1 and 2, respectively.

Table 1: Key Financial Characteristics of the Bank Insurance Fund, as of December 31, 1993
(Dollars in millions)

Reserves (January 1993)	-\$100.6
+ Premium income	\$5,784.3
+ Other income	\$646.5
- Expenses	\$886.0
- Provision for losses ^a	-\$7,677.4
= Reserves (end of year)	\$13,121.7
Reserve ratio ^b	0.69%

Note: Numbers may not add due to rounding.

^aProvision for insurance losses includes estimated losses for troubled institutions likely to require resolution and the estimated losses for bank resolutions that occurred during the year for which an estimated loss was not established prior to resolution. It also includes loss adjustments for bank resolutions that occurred in prior years. The negative provision in 1993 reflects a reduction in the estimated losses for troubled institutions likely to require resolution, and in the estimated losses for bank resolutions that occurred in the current and prior years.

^bFDIC estimated insured deposits for 1993 to be \$1,905 billion.

Source: FDIC's 1993 and 1992 Financial Statements (GAO/AIMD-94-135, Jun 24, 1994).

²Insured deposits are estimated by FDIC from information collected quarterly on deposits reported by insured institutions. Reserves are the numerator and insured deposits are the denominator of the ratio.

Table 2: Key Financial Characteristics of the Savings Association Insurance Fund, as of December 31, 1993
(Dollars in millions)

Reserves (January 1993)	\$279.0
+ Premium income	\$897.7
+ Other income	\$25.8
- Expenses	\$30.3
- Provision for losses	\$16.5
= Reserves (end of year)	\$1,155.7
Reserve ratio ^a	0.17%

^aFDIC estimated insured deposits to be \$696 billion for 1993.

Source: GAO/AIMD-94-135.

Currently, each of the insurance funds is under a mandate, contained in the Federal Deposit Insurance Act (FDI Act), to increase its reserve ratio. Under the FDI Act, FDIC must develop a plan for BIF to achieve a designated reserve ratio equal to at least 1.25 percent of insured deposits no later than 15 years after the implementation date of the recapitalization schedule.³ Pursuant to the FDI Act, if the SAIF ratio is below the designated reserve ratio of 1.25 percent, the FDIC shall set assessments to increase the reserve ratio to the designated level within a reasonable period. After January 1, 1998, the FDI Act requires SAIF to achieve the designated reserve ratio according to a 15-year schedule.⁴ Every 6 months, FDIC reviews the outlook for BIF and SAIF; FDIC is to adjust its premium structure for each fund on the basis of the fund's revenue and expenditure outlook.

Customers choose among mutual funds and bank deposits on the basis of such factors as expected rates of return, risk, and

³FDIC published its first recapitalization schedule in September 1992: it included projections for BIF to be recapitalized by the end of 2006.

⁴FDIC may extend the date specified in the schedule to a later date that it determines will, over time, maximize the amount of semiannual assessments received by SAIF, net of insurance losses incurred by SAIF.

convenience. From 1990 to 1993, bond and equity mutual fund assets more than doubled, growing from \$602 billion to \$1,427 billion; money market mutual fund assets grew from \$498 billion to \$559 billion. During the same period, deposits at banks and thrifts declined from \$3,637 billion to \$3,528 billion.⁵

RESULTS IN BRIEF

Although the source of the money flowing into mutual funds cannot be readily traced, analysts believe funds that would otherwise be deposited in banks or thrifts constitute a major source of mutual fund assets. The movement of savings from deposits has reduced the assessment bases--and hence the assessment incomes--of BIF and SAIF from what they otherwise would have been.⁶ The extent to which any reduction will occur in the future depends upon the amount of money placed in mutual funds or other investments that otherwise would be deposited in banks or thrifts.

A movement of savings from bank and thrift deposits into mutual funds does not necessarily mean that the financial condition of BIF or SAIF is adversely affected.⁷ Our analysis of FDIC projections showed that slower rates of growth (including negative rates of growth) in the assessment bases contributed to shortening the timetables for recapitalizing BIF and SAIF.⁸

⁵Deposits include demand, savings, time, and money market accounts in banks and thrifts.

⁶In 1992, the average assessment base for BIF was \$2,429 billion; in 1993 and 1994, the average assessment base fell to \$2,377 billion and \$2,365 billion, respectively. For SAIF, the average assessment base in 1992 was \$800 billion; in 1993 and 1994, it fell to \$744 billion and \$715 billion, respectively.

⁷Our analysis does not consider what impact a reduction in deposit funding would have on projected FDIC loss ratios for the funds. It is possible if deposits were replaced by other sources of funding that were collateralized (e.g., Federal Home Loan Bank advances) that projected loss ratios in failed institutions would rise and adversely affect the funds' projected reserve ratios.

⁸In its September 1993 recapitalization projections, FDIC estimated that BIF would reach the designated reserve ratio in 1998. As of September 1994, FDIC estimated BIF would reach this ratio in 1995. In its September 1993 projections, FDIC also estimated that the designated reserve ratio for SAIF would be reached in 2012. In the September 1994 projections, FDIC estimated SAIF would achieve its designated reserve ratio in

Recapitalization is estimated to occur sooner, in part, because slower growth in the assessment bases would reduce the level of deposits that BIF and SAIF are projected to insure but would not reduce the funds' projected reserves by the same proportion.⁹

FDIC officials said the agency's projections of the reserve ratio did not explicitly take into account the impact of mutual funds on deposits. Rather, the agency took a more general approach--projecting the overall trend in deposits for each insurance fund as well as many other factors such as projected insurance losses.

It is appropriate for FDIC to focus on the overall trends in deposit growth. However, the willingness of consumers to move funds between deposits and mutual funds introduces a source of volatility into deposit growth projections and thus to insurance fund reserve ratio calculations.

MUTUAL FUND GROWTH HAS NOT ADVERSELY AFFECTED
DEPOSIT INSURANCE FUND RECAPITALIZATION SCHEDULES

Before the late 1980s, growth in deposits appeared both stable and predictable. Generally, there was a fairly stable relationship between deposits and the level of economic activity. For example, over the period 1970 through 1988 nominal gross domestic product (GDP)--a measure of economic activity--averaged about 9-percent growth per year. During that time, commercial bank deposits also grew at an average annual rate of about 9 percent per year, and thrift deposits grew by 10 percent per year. Although GDP has continued to grow, annual deposit growth in banks and thrifts combined averaged -1 percent from 1990 to 1993.¹⁰

2002.

⁹Recapitalization would be delayed by a decline in insured deposits if BIF or SAIF did not have positive reserves.

¹⁰A sharp break in the link between the level of economic activity and deposits was first felt by thrifts, where the failure of many institutions led to a shrinkage of the industry. From 1990 to 1993, deposits at SAIF-member depository institutions declined by almost 6 percent per year. Deposit growth at banks has slowed too, despite the shift of deposits from thrifts to banks associated with the resolution of thrift industry problems. Deposits at BIF-member institutions increased on average about 1 percent per year from 1990 to 1993, although there was a slight decline from 1991 to 1992. From 1990 to 1993, nominal GDP increased at an average annual rate of 5 percent.

The growth of mutual funds undoubtedly contributed to the fact that the amount of money placed in bank and thrift deposits did not keep up with growth in the economy. However, other factors, such as efforts by banks to build capital by restricting growth, higher deposit insurance premiums, and the resolution of the thrift crisis, also contributed to the decline in deposit growth.¹¹ The extent to which future growth of mutual funds will affect the level of bank and thrift deposits depends largely on how consumers view the returns and risks of mutual funds compared with deposits and other investment opportunities.

In its March 1994 recapitalization schedule, FDIC reduced its estimate of the rates of growth in bank and thrift deposits from its previous estimates of deposit growth. It assumed no growth in bank deposits for 1994 followed by a 2-percent growth rate thereafter.¹² For thrifts, FDIC projected a 2 percent annual decline in deposits for 1994 onward. These projections remained unchanged in FDIC's September 1994 recapitalization schedule. Despite the reductions from prior year growth estimates, FDIC projected earlier this year that BIF and SAIF would reach their designated reserve ratio (1.25 percent) sooner than previously anticipated: BIF in 1995 and SAIF in 2002.

FDIC attributed much of the improvement in the outlook for the insurance funds to the assumption of fewer failures because banks and thrifts have been more profitable than expected. However, slower deposit growth rates also contributed, to a modest degree, to shortening the timetable for meeting the designated ratio.

Slower deposit growth, without any other changes--such as changes in failure rates, reduces both components of the reserve ratio--reserves and insured deposits--compared to what they would otherwise be. However, because the reserve component reflects factors in addition to premium income, the reduction is

¹¹To build capital ratios, many banks either restricted asset growth or let their portfolios shrink, reducing their funding needs. Higher deposit insurance premiums increased the cost of raising funds through deposits, and resolution of the thrift crisis sharply reduced the number of institutions competing for deposits.

¹²Although this rate of growth is higher than growth rates experienced since 1990, it is less than half the rate of increase in GDP projected in the 1995 budget.

proportionately greater on insured deposits (the denominator), hence the improvement in the ratio.¹³

INSTABILITY IN DEPOSIT FLOWS
CAN ALTER RESERVE RATIO PROJECTIONS

As noted previously, FDIC reviews its projections for reaching the designated reserve ratio every 6 months. FDIC officials said that during their review they look at the overall trend in deposit growth as well as a number of other factors, including projected insurance losses. They do not explicitly take into account the impact of mutual funds on the flow of savings into deposits. Although we agree that it is appropriate to look at the overall trend in deposit growth when reviewing the recapitalization schedule and setting premiums, the growth of mutual funds introduces a relatively new element of uncertainty into reserve ratio calculations.

For example, if interest rates paid by banks on insured deposits become more attractive relative to the expected risk-adjusted rates of return available on mutual funds, there could be an outflow of money from mutual funds into deposits. This, in turn, would reduce the insurance funds' reserve ratios, if nothing else affecting the ratios changed, by increasing the denominator of the ratio proportionately more than the numerator. To illustrate this, we calculated what would happen to the BIF reserve ratio if the growth rate of deposits were to increase from 2 percent to 4 percent after 1994--as might occur if interest rates on deposits increased relative to the expected risk-adjusted rates of return on mutual funds.¹⁴ Under FDIC's current projections, the assessment rate for BIF will decline to an average of 12 basis

¹³Everything else being equal, slower deposit growth (such as results from the movement of deposits to mutual funds) reduces insured deposits (the denominator of the reserve ratio) and results in a proportionate reduction in premium income (a component of the numerator). However, the overall effect on the funds' reserves (the numerator) depends on what happens to all of its components, including other income the funds earn on their reserves, or whether beginning of year reserves are projected to be drawn down by bank or thrift failures. As long as the numerator of each fund--which is composed of premium income, income on earning assets, and reserves--declines more slowly than the decline in insured deposits, the fund's reserve ratio will improve.

¹⁴The example uses the assumptions underlying the BIF projections but would also apply to SAIF.

points in 1995 and 5 basis points in 1996. In our higher growth rate scenario, premiums would have to be set about 2 basis points higher than currently projected to maintain the BIF reserve ratio at 1.25 percent.

SCOPE AND METHODOLOGY

To answer the questions of whether FDIC takes account of the movement of funds from deposits to mutual funds and whether they should, we reviewed the March 1994 and September 1994 semiannual projections for BIF and SAIF made by FDIC and spoke with FDIC officials. FDIC's projections for BIF and SAIF were based on a number of factors, including assumptions regarding the number and cost of bank failures, asset and deposit growth, and the ratio of insured deposits to the deposit assessment base. To understand the impact on the federal deposit insurance funds of a change in the flow of deposits into banks and thrifts, we calculated what would happen to the projected reserve ratio if we changed FDIC's assumptions regarding the growth and mix of deposits. Our analysis, however, did not consider any other potential changes in FDIC assumptions, which could also affect BIF and SAIF.

AGENCY COMMENTS

On October 28, 1994, the Director, Division of Research and Statistics, FDIC provided comments on a draft of this correspondence. He indicated that the FDIC agreed with the analysis in this letter.

- - - - -

We are sending copies of this correspondence to the Chairman of FDIC and other interested parties. We will also make copies available to others upon request.

Rose M. Kushmeider, Senior Economist, and Stephen C. Swaim, Assistant Director, were the major contributors to this correspondence. If you have any questions about the material in this report, please contact me at (202) 512-8678.

Sincerely yours,



Thomas J. McCool
Associate Director, Financial
Institutions and Markets Issues

(233419)