BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 25, 1991

To Presidents and Governors

From Donald Kohn

Subject: FDIC Borrowing from the Federal Reserve

Proposal

As you know the Treasury has proposed amendments to the FDIC Act and the Federal Reserve Act to enable the FDIC to borrow from the Federal Reserve. The borrowing is to serve as a temporary source of capital to BIF, in effect allowing it to bring forward future streams of premiums. (The proposed legislative language is attached, along with a copy of the letter from Robert Glauber to William Seidman outlining the plan for BIF recapitalization.)

The essential elements of the plan are: the borrowing would be up to $25 billion; it is to bear an interest rate comparable to the rate on similar maturity Treasury issues; it is to be repaid out of BIF premiums, whose cap would be raised to 30 basis points; in any case it is a full faith and credit obligation of the United States.

Implications

The proposed lending would have no effect on the size or risk profile of the Federal Reserve's balance sheet. Any funds advanced to BIF would be offset by reducing the System's portfolio of Treasury securities by an equal amount. In effect, one full faith and credit obligation would be replaced by another. As a consequence, there would be no effect on federal funds rates, reserves or money supply. Nor would it affect the Federal Reserve's income statement materially, since the rate charged on the loan would be close to the rates earned on our portfolio.

In addition, the BIF borrowing and spending, although on budget, would not affect the general level of interest rates. Such spending does not place new calls on national saving, and is essentially self financing as the funds are recycled through financial markets. Perhaps for this reason, spending for deposit insurance is exempt from the "pay as you go" provisions of the new budget agreement. Although the measured deficit would be increased over the near-term as BIF spent borrowed funds, surpluses would be created in future years as the higher premiums were received and used to repay debt. Over time, a net budget deficit and taxpayer obligations would arise if the premium payments were not sufficient to cover debt servicing. The budget shortfall would equal the amount of the needed reimbursement by the Treasury to the Federal Reserve (or equivalently, of the reduction in the Federal Reserve's payment to the Treasury to avoid potential decreases in our capital).

Nonetheless, the proposal could still create potential problems of precedent and perception for the Federal Reserve. For one, it involves the Federal Reserve directly funding the government; Congress has always severely limited (or more recently, forbidden) the direct placement of Treasury debt with the Federal Reserve, likely out of concern that it could compromise the independent conduct of monetary policy, and allow the Treasury to escape the discipline of selling its debt directly in the market. In the proposal there is no compromise of independence, but the sale of debt is indirect, through the Federal Reserve.

Another concern is that the proposal could lead to many other requests to provide Federal Reserve funding to a variety of borrowers, some of which may be less than fully backed by the government and less clearly linked to the central responsibilities of the Federal Reserve for the soundness of banks and the public's confidence in the financial system. Insistence on full faith and credit backing should limit the precedential nature of the proposal. Any linkage made with bank holdings of non-interest earning reserves over the years would also help in this regard. In addition, the precedent for Federal Reserve funding of government agencies has already been set. We provided capital for the original FDIC fund and in the past we have contemplated discount window assistance to government sponsored agencies, such as the Federal Home Loan Banks and the Federal Farm Credit System (lending to the Federal Intermediate Credit Banks is specifically authorized by the Federal Reserve Act). Still, the temptation to use the Federal Reserve to give worthy causes easy access to cheap credit may become less resistible by Congress once this additional step has been taken.

Finally, the rationale for using the Federal Reserve in this situation is far from clear. Direct lending by the Treasury to the FDIC would accomplish the same objectives, with the same costs and the same budget implications.

Possible System Response

Unless a clear adverse effect from this proposal on the operations of the Federal Reserve or its ability to conduct monetary policy can be demonstrated, it may be difficult to register a strong objection to it. The Federal Reserve's role in the initial capitalization of the FDIC, as well as our desire to remain deeply involved in the supervision and regulation of banks, also may argue for a "no objection" stance. Nonetheless, any such response could be accompanied by expressions of concern about potential precedents, and by questions as to whether this structure is necessary to accomplish the objective of recapitalizing BIF using the full backing of the government.

DEPARTMENT OF THE TREASURY
WASHINGTON

UNDER SECRETARY

March 18, 1991

Mr. L. William Seidman
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Dear Bill:

As you have requested, Treasury will include additional recapitalization authority for the FDIC in our proposed banking legislation, to be transmitted to Congress shortly. Based upon the approach proposed by you and supported by the FDIC Board, the following additional authority will be included in the legislation:

1. The FDIC will be authorized to borrow up to a maximum of $25 billion from the Federal Reserve banks.

2. The FDIC will pay interest on any such borrowings at a rate equal to the Treasury rate for borrowings of comparable maturity.

3. Any borrowing under this new authority will be secured by the FDIC's dedication of insurance premiums in amounts sufficient to service and retire the debt in accordance with its terms. Thus, any such borrowing will not be counted against the borrowing limitation of 12 U.S.C. 1825(c).

4. Annual premiums paid by Bank Insurance Fund (BIF) insured institutions will be capped at an aggregate of 30 basis points.

5. The FDIC's existing authority to borrow from the Treasury and the Federal Financing Bank will not be affected.

Very truly yours,

Bob

Robert R. Glauber

TITLE IV--BANK INSURANCE FUND RECAPITALIZATION

Subtitle A--Federal Deposit Insurance Corporation Borrowing

SEC. 401. FEDERAL DEPOSIT INSURANCE CORPORATION BORROWING.

Section 15 of the Federal Deposit Insurance Act (12 U.S.C. 1825) is amended--

(1) by inserting after subsection (d) the following new subsection:

"(e) Corporation Borrowings.--

"(1) Authority.--The Corporation shall have the authority to borrow funds from any Federal Reserve bank, provided that the Corporation shall have no more than $25,000,000,000 in borrowings outstanding at any one time from all Federal Reserve banks.

"(2) Limitations.--Any borrowing undertaken by the Corporation pursuant to paragraph (1) shall be undertaken only for the following purposes:

"(A) to maintain or improve the liquidity of the Bank Insurance Fund; or

"(B) to provide financial assistance with respect to any insured depository institution, or receivership or conservatorship of an insured depository institution, pursuant to section 11 or section [illegible]

(2) by amending subsection (c)(6) to read as follows:

"(6) Exceptions.--

"(A) With the prior approval of the Secretary of the Treasury, the Corporation may issue or incur up to $5,000,000,000 in the aggregate of additional liabilities in excess of the limitations of paragraph (5). The amount which the Corporation may borrow from the Secretary of the Treasury under section 14 shall be reduced by the amount of additional liabilities issued or incurred pursuant to this paragraph.

"(B) Obligations issued and funds received by the Corporation pursuant to section 15(e) shall not be subject to, and shall not be counted in calculating compliance with, the limitations of paragraph (5).

"(C) In calculating compliance with the limitations of paragraph (5), an amount equal to $5,000,000,000 less the amount of outstanding borrowing by the Corporation from the Secretary of the Treasury under section 14, or otherwise borrowed under subparagraph (A) included in net worth.".

SEC. 402. AMENDMENT TO THE FEDERAL RESERVE ACT.

Section 13 of the Federal Reserve Act (12 U.S.C. 342-347c) is amended by adding at the end thereof the following:

"Subject to such restrictions, limitations and regulations as the Board of Governors of the Federal Reserve System shall prescribe, any Federal Reserve bank is authorized to make advances to the Federal Deposit Insurance Corporation, upon its request. Such advances shall bear interest at the current market yield on outstanding marketable obligations of the United States of comparable maturities, as of the date of advance.".

Subtitle B--Federal Deposit Insurance Corporation Assessments

SEC. 411. MAXIMUM AGGREGATE ASSESSMENT.

Section 7(b)(1)(C) of the Federal Deposit Insurance Act (12 U.S.C.1817(b)(1)(C)) is amended--

(1) by amending clause (iii) to read as follows:

"(iii) Maximum Aggregate Assessment.--Notwithstanding clause (i), the maximum aggregate assessment charged to the members of the Bank Insurance Fund for any semiannual period, shall not exceed 0.15 percent of aggregate assessment base for such semiannual period."; and

(2) by inserting after clause (iii) the following:

"The Corporation shall have the authority to make such estimates and projections as may be appropriate for the purpose of computing assessment rates and aggregate [illegible] amounts, [illegible] estimates and projections shall not be subject to review by any court, nor shall any court have authority to stay or enjoin the Corporation from collecting assessments so computed. No action seeking repayment of an assessment collected by the Corporation may be brought later than 60 days after the date on which such assessment is due.".

SEC. 412. BANK INSURANCE FUND BORROWING ASSESSMENT.

Section 7(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1817(b)(1)) is further amended by inserting after subparagraph (F) the following new subparagraph:

"(G) Dedication of Bank Insurance Fund Assessments for the Repayment of Bank Insurance Fund Borrowing from the Federal Reserve Bank.--Subject to the provisions of this paragraph, if the Corporation has borrowed funds from a Federal Reserve bank as authorized by section 15(e), and so long as any such borrowing remains outstanding, the Board of Directors is authorized and directed--

"(i) to determine the amount of semiannual Bank Insurance Fund assessments received by the Corporation necessary to pay interest and principal on such borrowings pursuant to their terms; and

"(ii) to take whatever actions are necessary to dedicate that portion of the semiannual assessments received, determined pursuant to clause (i), to pay interest and principal on such borrowings pursuant to their terms. The amounts so dedicated shall not be available for any purpose other than payment of interest and principal of such borrowings.".