Remarks by
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One of the benefits of spending time here in the nation's capital is that one is constantly reminded of the continuing ties between the present and the past. From the windows of the Federal Deposit Insurance Corporation, for example, one can see both the lawn where President Lincoln walked -- and the far banks of the Potomac where Confederate flags flew. The building next door to the FDIC was the War Department then, and it is said that Lincoln would visit there to receive direct telegraphic reports from the battlefields. As commanding general of the army for many years after the Civil War, William Tecumseh Sherman had his office across the street in the Old State, War, and Navy Building.

Given the immediacy of the past in Washington, history is not just a subject taught in school here, it is in fact often the subject of conversation -- and sometimes in surprising ways, as a friend of mind found out when he was helping his son with his math homework. After much difficulty, my friend finally said in exasperation: "Son, you ought to be ashamed of yourself -- at your age, George Washington was a surveyor."

Without missing a beat, the young man looked into his father's eyes and said: "Yes, and at your age he was President of the United States."

Knowledge of the past provides us with a context for the present.

In that regard, much of the history of banking in this country is the story of the search for stability. As we all know, the FDIC was created in 1933 to restore and maintain public confidence in a banking system that had been shattered by failures. Interestingly, the Bank Administration Institute itself had its origin in the response to one of the catastrophes that periodically roiled the financial system before the FDIC was created -- the Banking Panic of 1907. In response to that panic, banks began creating internal auditing departments to help ensure their solvency. Bank auditors formed BAI -- known in the first quarter-century of its existence as the National Association of Bank Auditors and Comptrollers -- to exchange information that could be used as auditing standards for banks.

Banking panics were terrifying experiences that seemed to grow in force from one to the next, until nine thousand banks failed in the banking crisis of 1929-1933.

In speaking to bankers in New York City in 1938, FDIC Chairman Leo Crowley said: "Deposit insurance came into existence because more than $3.5 billion of depositors' funds were dissipated during the years between 1865 and 1933. No banking system with the weaknesses this record indicates can expect to maintain the confidence of bank depositors." Congress, he said, had two choices to restore public confidence: deposit insurance or nationalizing the banking system. The lawmakers opted to support private enterprise, he stressed, not to eliminate it.

In 1934, the year following the creation of the FDIC, nine insured banks failed.

Over three generations, federal deposit insurance has prevented banking problems from becoming banking panics, and in doing so it has stabilized an inherently unstable financial system. The nation has benefitted in three ways. First, federal deposit insurance has brought peace of mind to tens of millions of depositors, who no longer had reason to fear the failure of their banks. These were -- and are -- small depositors who are less likely to have the resources and expertise to assess the financial strength and policies of the banks with which they do business. Second, when banks suspend operations, the payments system is disrupted. By preventing bank panics, federal deposit insurance allows payments to clear among numerous parties in an orderly and efficient manner, thus preserving the integrity of the payments mechanism, without which no modern economy can function. Third, by insulating banks from panics, deposit insurance helps bring stability to the conduct of monetary and fiscal policies.

No one, however, repealed the business cycle. The failures of more than 1,400 U.S. banks from 1982 through 1994 -- apart from the 1,250 savings and loans that failed during the same period -- reminded us that guaranteeing savings can be a costly business, although it may be necessary to stabilize the banking system in times of stress.

We do not have to return to the 1930s -- or watch the film, It's a Wonderful Life, that is popular this time of year -- to understand how traumatic a run on a bank can be. In early 1991 -- just six years ago -- the New York Times described events at the Bank of New England in this way:

"Frantic depositors pulled nearly $1 billion out of the bank in two days; small savers trooped through the lobbies with their money in wallets, bulging envelopes and briefcases, and money managers yanked out multimillion-dollar deposits by remote control with computer and telex orders.

"Some local crooks even tried to get in on the action. The Federal Bureau of Investigation said it foiled a plan by six men who had hoped to rob an armored car they figured would be loaded with cash for all the withdrawals.

"Yet as soon as Washington stepped in, with the Federal Deposit Insurance Corporation taking over the bank on Sunday, the panic subsided," the Times concluded.

The Bank of New England case underscores how rapidly public confidence can evaporate. It also underscores the importance of deposit insurance in maintaining public confidence in the banking system. Bank of New England customers may have had doubts about their bank -- but their doubts were not contagious. A run on the Bank of New England did not spread into a general banking panic, with depositors at other banks demanding their funds, too.

We have evidence that throughout the banking crisis of the late 1980s and early 1990s, federal deposit insurance was the anchor for public confidence in the banking system. For example, in 1989 the American Banker commissioned Trans Data Corporation to survey 1,009 adults throughout the continental United States on confidence in banking. The survey found that 95 percent of the survey respondents said that it was important to them that there be a federal deposit insurance fund -- and nine out of 10 of the respondents expressed confidence in the current insurance system. When asked what they would do with their money if there were no deposit insurance, 36 percent said they would keep it at home. Twenty-one percent said they did not know what they would do. Only 18 percent said they would keep their funds in depository institutions.

In recent years, however, a question has arisen as to who can do the better job at guaranteeing bank deposits -- the government or the private sector? Indeed, the BAI has taken the position -- in a report on regulatory reform prepared for you by McKinsey & Co. -- that the FDIC should be "privatized."

Tonight I want to address (1) privatization of deposit insurance in general, (2) why the BAI/ McKinsey plan would not attain the results it desires, and (3) why the plan is based on a misconception regarding deposit insurance and the causes of moral hazard. I will then discuss how the FDIC is addressing the problem of excessive risk taking that can arise from the moral hazard of insurance.

Let's turn first to deposit insurance in general.

In giving us a context for the present, the history of private deposit insurance and other such arrangements that lack the "full faith and credit" of the federal government is not reassuring. In fact, it is the history of failure. Private and state-sponsored deposit insurance schemes have been tried -- and found wanting. As recently as 1982, there were 32 deposit insurance funds in operation. Only eight survived the crisis of the late 1980s and early 1990s -- and these survived because none of their significant members failed. Six operate today, but three are limited in scope and three cover state credit unions. Almost all the other funds collapsed because of the failure of one or more insured institutions. Most of the funds were state-sponsored, although the state did not usually provide any financial guarantees to the fund. These funds typically were mutual insurance funds with a board of directors drawn from the insured institutions.

Deposit insurance can prevent banking panics only if depositors have confidence in the insurance plan. To inspire confidence during a period of turmoil, deposit insurance must -- as far as the insured depositor is concerned -- be comprehensive. The problem with private plans developed thus far is the limited pool of resources on which they can draw, as compared to the unlimited pool of resources of the federal government. Private insured funds could be designed to handle isolated failures successfully, but they are likely to have difficulty handling catastrophes. Bank failures may come in waves, however, because the performance of the banking industry is closely tied to the performance of the economy. Further, during a crisis, a private insurance fund would have to seek financing from the banking industry or other private sources of funds when the whole industry -- and perhaps the economy -- are already in financial trouble. The price of a substitute for the "full faith and credit" of the federal government in inspiring public confidence would be prohibitively expensive. The serious question to grapple with in any privatization proposal is: How much less than the equivalent of a full faith and credit' guarantee by the federal government will the public accept -- and how much less would fully protect the banking system in times of crisis?

Let us turn now to the BAI/McKinsey plan.

The plan would privatize the FDIC and replace the line of credit from the U.S. Treasury with a private bank line. It is driven by a desire to free the banking industry from legal and regulatory constraints on its operations.

Any successful private deposit insurance fund, however, would have to monitor, if not regulate, bank activities. Virtually all insurance policies -- health, life, and liability -- contain restrictions and limitations on coverage, as well as conditions on approval, in order to control risks. A bank's loans and other activities determine the health of the bank. An insurance fund could not appraise the risk of insuring a bank's deposits without conducting its own bank examinations, and it could not limit the risks without restricting bank activities. Such a plan would simply substitute government regulation with private regulation by competitors.

The proposal raises the whole point of the proper constituency for any insurance fund. It makes quite clear that the BAI's proposed fund is to be run by banks for banks. However, deposit insurance is insurance for the depositor. If the operation of the fund were unsatisfactory, depositors have only one recourse -- to take their money out of the banks -- which could lead to the sort of bank runs that the FDIC was founded to prevent.

Fundamentally, the BAI/McKinsey plan rests on a misconception -- that moral hazard created by federal deposit insurance can be eliminated through privatization. Any deposit insurance fund -- any form of insurance, in fact -- faces the problem of moral hazard, regardless of its ownership or management. The problem of moral hazard occurs when insurance induces the insured to take more risk.

With deposit insurance, the insured party is the depositor. Insurance permits depositors to ignore the condition of their banks, so even fundamentally unsound banks may have little difficulty obtaining funds. Because insured depositors no longer have an incentive to monitor and discipline banks, bank managers may take more risks than they otherwise would. Deposit insurance can create opportunities for managers to make high risk/high return investments, without the market discipline of having to pay creditors to take that risk.

Historically the moral hazard problem created by federal deposit insurance has been mitigated by banking regulation and supervision and by insulating banks from competition -- one explanation for the low number of bank and thrift failures for almost 50 years following the creation of the deposit insurance system. Among the regulatory actions that reduce the risk arising from moral hazard are capital standards, examinations, and safety-and-soundness regulations.

Capital serves as a deductible for deposit insurance. Initial losses fall first on the equity investor, not the insurance fund. Capital standards give bank owners incentives to minimize risk. Only if losses exceed capital will they be borne by others. Because insured depositors do not need to look at the credit quality and other features of their banks, examinations act as their surrogate. Safety and soundness regulation is intended to be a substitute for market discipline. The 1980s -- particularly in connection with the savings and loan crisis -- reminded us that, without effective supervision, deposit insurance can simply become a public resource that risk takers can exploit. The challenge to the regulators is to develop safety and soundness regulation that comes as close as possible to market discipline. We are not there yet, but I remain hopeful.

Our objective must be to strike a balance that minimizes the moral hazard of deposit insurance, while providing stability to the banking system. As you know, to address the problem of moral hazard and to discourage excessive risk-taking, a number of reforms have been initiated in the past few years, including risk-based capital standards, as well as higher minimum standards for prompt corrective action; risk-related insurance premiums; the least-cost test for resolving bank failures, and national depositor preference.

The development of internationally-accepted risk-based capital standards is one of the most significant innovations in the history of banking regulation. The Basle Committee on Banking Supervision has laid out a framework for assessing an institution's capital adequacy by weighing its assets and off-balance sheet exposures on the basis of counterparty credit risk. Moreover, recognizing that international banks have been actively involved in trading securities and derivative products, the Committee has developed progressive standards through the use of standardized and internal models to measure the unique market risks of specific portfolios. As the first financial sector regulator to develop internationally accepted capital standards based on the unique risk of each bank, the Basle Committee is a pioneer in developing internationally accepted supervisory standards.

Higher minimum capital standards, as you know, are enforced through the policy of "prompt corrective action" when the capital of troubled institutions erodes. Under the system of prompt corrective action -- which went into effect at the end of 1992 -- federal regulators are required to begin a variety of supervisory actions if the capital of an institution falls below strictly defined minimums. The farther an institution falls below the minimums, the more severe the supervisory actions become. Those supervisory actions include -- but are not limited to -- imposing restrictions on dividend payments and other capital distributions, limiting management fees, curbing asset growth, and restricting activities that pose excessive risk to the institution. Early intervention allows bank regulators to preserve some of an institution's franchise value and, thereby, to limit losses to the insurance fund. More important, minimum capital standards and prompt corrective action are intended to curb excessive risk taking so that regulators will not have to intervene to close an institution.

The principle embedded in prompt corrective action is gradation of risk and of appropriate regulatory response: The less capital a bank has, the smaller the financial cushion for losses, and the greater the risk it poses to the insurance fund. The greater the risk, the more attention it should receive from regulators. The principle of gradation of risk and response is also reflected in our system of risk-related FDIC insurance premiums.

For almost 60 years, all insured institutions paid the same premiums to the fund, regardless of the risks they posed. Beginning in 1993, we divided banks and thrift institutions into nine groups, depending upon the risks they presented to their insurance funds. The greater the risk, the higher the premiums the institutions pay. Part of that risk calculation is based on capital and part on supervisory factors such as asset quality, loan underwriting standards, and management. Risk-related premiums promote safety and soundness -- and help to address the issue of moral hazard -- by giving institutions an economic incentive -- through lower deposit insurance premiums -- to improve their conditions and maintain lower risk profiles. We are analyzing whether other factors are relevant to risk -- and thereby whether the nine-block grid for setting deposit insurance premiums should be expanded -- as well as whether our current 27-basis point spread is sufficient to price the risks to the insurance funds posed by individual institutions.

One other requirement imposed in 1991 exposes uninsured depositors to greater loss than before. In resolving bank failures, the FDIC is required by law to accept the proposal from a potential purchaser that is the least costly to the deposit fund of all the proposals we receive. In more than half of the failures in 1992 -- 66 out of 120 -- uninsured depositors received less than 100 cents on each dollar above the $100,000. That was a significant increase in uninsured depositors experiencing losses from 1991, when fewer than 20 percent of the failures involved a loss for uninsured depositors. While the number of bank failures in 1992 was lower than in previous years, the number of uninsured depositors experiencing a loss was significantly greater.

Additionally, the passage of a national depositor preference law in 1993 gave creditors of banks other than depositors an extra incentive to be concerned about the condition of their institutions. In essence, depositor preference means that, if a bank fails, anyone with a non-deposit claim gets nothing until all depositors, including the FDIC as insurer, have been made whole.

Higher risk-based and minimum capital standards, risk-related deposit insurance premiums, the least-cost test for resolving bank failures, and national depositor preference are regulatory actions that address the risks to the insurance funds and the taxpayers that arise from the moral hazard that deposit insurance creates. Conceptually, they and other regulatory requirements are direct and indirect surrogates for the discipline that depositors would logically impose if they had access to the economist's dream: perfect information in a purely competitive market.

Private deposit insurance would have to have similar surrogates for market discipline. One has to ask whether a consortium or board of directors of private sector bankers who are in competition with each other would be able to manage a disciplined, unbiased system of regulation to offset the moral hazard of insuring bank deposits, regardless of whether the private insurance plan offered less than the "full faith and credit" guarantee of the federal government.

In conclusion, Congress created federal deposit insurance more than 60 years ago -- not to protect individual banks -- but to protect the depositor and to provide stability for the banking system. It was intended to be one of the few certainties in an uncertain financial world. It would promote the development of a modern and efficient payments system. It would foster economic growth.

The architects of the system were realists who, in the words of FDIC Chairman Leo Crowley, saw that "the virtues of our system of independent banking by private enterprise outweigh its weaknesses." Private enterprise meant the opportunity to fail as well as to succeed.

It is probably true that during the banking crisis of the 1980s and early 1990s, the FDIC indirectly protected the shareholders of failed banks more than could be justified today, although it is easier to understand that issue with 20-20 hindsight than in the midst of a full-blown crisis.

The innovations since that time that I have discussed, and others that the FDIC continues to evaluate, are intended to avoid that result in the future.

In 1934, Chairman Crowley stressed the point that federal deposit insurance was an asset for the industry when he addressed the American Bankers Association just 11 months after the FDIC's creation. He said: "The recent depression has proved that no group of banks in any geographical locality is isolated from the banking situation in the country as a whole. For this reason, it is important that the protection to depositors which an Insurance Fund makes possible be conducted on a national scale so that all may enjoy the same degree of protection."

In placing the full faith and credit of the federal government behind bank deposits, insurance meant that the banking industry and the economy would never again have to face runs and panics and the economic turmoil that resulted.

For banks today, federal deposit insurance remains an asset -- just as it is an asset for depositors of banks. The principal reason advanced by advocates of change is that the "subsidy" from deposit insurance and access to the payments system have prevented banks from being permitted to engage in a broad range of new activities. The premises of that argument -- that such a subsidy exists and that, if it exists, it cannot be removed without eliminating federal deposit insurance and special access to the payments system, should be examined and well understood. They are analytically separate issues from the question of whether the FDIC should be privatized, however.

Knowledge of the past provides us with a context for the present. I do not know whether it is true, as the philosopher said, that those who forget history are doomed to repeat it. It seems to me, however, that if an institution is created for a purpose -- and has lived up to all expectations -- it should not be changed without clear, sound, and well-understood reasons for doing so.

Thank you.

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