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An address by

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It is a pleasure to be here today to address the newly formed National Council of Savings Institutions. Your two predecessors, the National Association of Mutual Savings Banks and the National Savings and Loan League, made important contributions to financial legislation over the years; I know the Council will continue to provide leadership in the ever-changing financial services marketplace.

During the past six-to-nine months, the FDIC's principal focus has shifted from savings bank problems to commercial bank failures and various regulatory and legislative issues. I would like to spend most of my time today discussing the legislative package, S. 2103, submitted by the FDIC to Congress last month. I will then turn briefly to the net worth certificate program.

The FDIC's legislative package derives from the deposit insurance study we submitted to Congress last April. In that study we pointed out that while deposit insurance has worked extraordinarily well in maintaining depositor confidence in the banking system, it has also eroded discipline in the financial marketplace. Because _de facto_ 100% insurance coverage has been provided in connection with most bank failures, particularly the larger ones, depositors and other general creditors ordinarily have not been subjected to any risk of loss. Consequently, banks do not feel the same risk-restraining pressure from creditors as other firms. Our proposed legislation is designed to improve this situation and to strengthen the FDIC's ability to limit its exposure.

Most who have looked closely at deposit insurance have generally concluded that there are two ways to make the system work more fairly

and impose more discipline: (1) price insurance premiums according to bank risk and/or (2) expose large depositors and other creditors to greater risk of loss.

Risk-Related Assessment Credits

Our proposed legislation would allow us to vary the assessment rebate according to the risk a bank poses to the deposit insurance fund. Under the current scheme, all banks pay the same flat-rate premium and receive the same assessment rebate, irrespective of how well or how poorly they are operated. Relating the assessment rebate to risk would both reduce the inequity in the current system, under which low-risk banks subsidize the activities of high-risk banks, and discourage excessive risk-taking.

Despite overzealous claims in the academic literature, we recognize that an ideal risk-related premium system is simply not feasible at present. It would require unrealistic kinds and amounts of data and much more advanced risk quantification techniques than are currently available. We have proposed a more modest system based on sound, objective measures of risk.

Initially, there would be three risk classes of banks, based on such considerations as capital, asset quality and interest-rate risk. Normal-risk banks -- probably about 85% of all banks -- would receive the full rebate, which would be somewhat above the level authorized by law today. Riskier institutions would receive half the rebate, and those considered to be the most risky would receive none. The total rebate would remain the same as under current law, but the distribution of it among banks would vary according to their risk characteristics.

The cost difference between the best and worst banks would not be more than four or five basis points on deposits -- not trivial, but not enough to bring down an already weak bank. The FDIC would, over time, refine the criteria for measuring risk and, possibly, later request authority for greater variations in assessments.

We have also proposed that banks be charged for all above-normal costs of supervision, such as the more frequent examinations that problem banks require. Requiring problem banks to pay these costs -- instead of spreading them among all banks in the form of lower premium rebates as we do now -- would provide a small but important incentive for banks to correct their problems promptly. It would also be more equitable. These are not drastic proposals, but they represent steps in the right direction.

Market Discipline

One of the most effective ways to control excessive risk-taking is to expose banks to the discipline of the market, which has been undermined by the working of the deposit insurance system. A promising potential source of market discipline is depositors with balances in excess of the $100,000 insurance limit. Although we refer to them as "uninsured" depositors, in practice we have for years provided them with *de facto* 100% coverage in most bank failures, especially large ones.

This is a consequence of our preference for handling bank failures by merger. Prior to the failure and payoff of the $500 million Penn Square National Bank last year, no depositor or other general creditor had lost any money in the failure of an FDIC-insured bank of $100 million or more.

While the Penn Square failure has raised the threshold level, most large suppliers of funds undoubtedly still believe that the FDIC will not pay off deposits in a big bank. If these large creditors are to have sufficient incentive to monitor bank risk, then the risk exposure of uninsured depositors must be increased and equalized for banks of all sizes.

One way this could be done is for the FDIC to pay off insured depositors in all failed banks. However, a payoff of a large bank can create significant problems. Most notably, uninsured depositors and other creditors typically must wait several years before they receive payment of their claims. The bigger the bank, the more disruption this would cause.

To alleviate this problem, the FDIC is considering combining a payoff of insured deposits with a cash advance to uninsured depositors and other general creditors based on the present value of anticipated collections by the receivership. These liabilities could be transferred or sold to another bank so that banking services are not interrupted. If this type of transaction could be effected quickly, disruptions in the financial markets would be kept to a minimum. At the same time, uninsured depositors would be exposed to some risk of loss. As a result, bank customers would have a strong incentive to select the soundest institutions, not just the largest ones or those paying the highest interest rates.

In the FDIC's deposit insurance study, we discussed an alternative proposal for exposing larger depositors to the risk of loss through a coinsurance plan that would set coverage at 75% of balances above $100,000, even when a bank failure is handled through a merger. We have concluded the same result can be achieved, without statutory change, by combining

a payoff with the cash advance scheme I just discussed. Consequently, our legislative proposal does not include a coinsurance provision.

Our legislative package includes two provisions that will give the FDIC more flexibility in paying off banks or otherwise encouraging market discipline. We have proposed to define creditor preferences in bank failures so that certain contingent claimants, including loan participants and holders of standby letters of credit, would have a junior position relative to general creditors. This would simplify our costing procedures and, more importantly, would require a particular class of sophisticated bank customers to be more selective in its choice of banks.

In addition, we have proposed to expand the authority of a so-called Deposit Insurance National Bank (DINB), an institution used to pay off depositors of a closed bank. Under current law the authority of a DINB is very limited. It cannot take new deposits or make loans. Our proposal provides for a DINB with full banking powers. This would enable us to pay off a bank, make a cash advance to uninsured depositors and transfer deposits to a DINB, which could purchase assets of the failed bank and continue to operate and serve the bank's customers. As soon as practical, the DINB would be sold to another bank or in a public offering. This would give the FDIC an option for handling a failed bank in an orderly fashion where market conditions, uncertainties about the bank's assets and liabilities or other complexities make it virtually impossible to consummate a transaction over a weekend.

We believe our proposals would increase depositor discipline and introduce more private sector restraint on banks. Some argue -- correctly -- that increased use of fully insured brokered deposits will frustrate

our efforts to reduce de facto full insurance coverage. This is one of the reasons we are seeking comment on the desirability and means of reducing insurance coverage on brokered funds. Data recently collected on brokered deposits indicate that while their aggregate volume is modest today, a disproportionate share is concentrated in poorly rated banks.

Some contend that it simply will not be feasible to pay off a large bank, regardless of cash advance or DINB procedures. If that turns out to be the case, then we would consider urging Congress to impose a mandatory minimum capital requirement on depository institutions, a portion of which could be met by subordinated debt. This would be tantamount to "throwing in the towel" on depositor discipline and relying on capital markets to provide the necessary restraining influence on bank behavior.

Combining Deposit Insurance Funds

As most of you know, the FDIC's deposit insurance study urged combining the FDIC and FSLIC into a single insurance fund. We continue to believe that a combined fund would be stronger, would facilitate inter-industry acquisitions of troubled banks and thrifts and would provide for a more evenhanded treatment of depository institutions in an increasingly deregulated environment. Given the opposition to a merger that currently exists within both the banking and thrift industries, we have not proposed it in our draft legislation. We believe, however, it is essential for the FDIC and the FSLIC to move toward common capital and accounting standards and, to the extent feasible, common examination procedures. I should note that in these areas -- and a number of others, including deposit

brokering -- the FDIC and the FSLIC are working together more closely than ever.

The FDIC's Role

After hearing about our legislative and other proposals we have made, you may have some question about where the FDIC is heading, so let me make it clear. Deposit insurance is extremely important in our financial system, and we believe that providing adequate insurance coverage in an evenhanded manner should be the FDIC's principal role. That requires monitoring our risk and keeping it within reasonable bounds.

We do not believe the FDIC should divert its resources to consumer compliance, securities disclosure, antitrust enforcement and other matters that can be handled by other government agencies already performing similar functions. We have made recommendations along these lines to the Vice President's Task Group, and in our draft legislation we have proposed elimination of the requirement for FDIC approval of branch applications.

In order to control our risk exposure and obtain the information needed to properly handle failures, we must be able to examine any troubled FDIC-insured bank (and a small number of others) and to take appropriate enforcement actions. We currently have the requisite examination authority; the proposed legislation would give us the needed enforcement action authority. In implementing our authority, we seek workable, cooperative arrangements with other regulators. We are participating with the Federal Home Loan Bank Board in a joint examination program for federal savings banks, and we believe similar arrangements can be worked out with the states, the Federal Reserve and the Comptroller of the Currency for state member and national banks.

At the same time, we are cutting back substantially on examinations of nonproblem, insured nonmember banks. Our objective is to reallocate our resources to their most efficacious use -- that is, to larger institutions and problem situations. We will behave more like an insurer than a regulator.

Savings Bank Performance and Survival

Before concluding I would like to comment briefly on thrift performance and the net worth certificate program.

While it is true that commercial bank failures, deposit insurance reforms and other issues have been of more immediate concern to the FDIC lately than thrift performance, we still closely monitor savings banks and recognize that the industry's problems have not gone away. It is apparent that the easy earnings improvement has already occurred for many thrifts. The cost of funds at savings banks increased in the third quarter and aggregate earnings, while still positive, were down a bit, after several successive improving quarters. The strongest institutions have continued to show earnings improvement. If interest rates and deposit costs continue in the present range, we expect a slow upgrading of asset yields would increase interest margins and earnings over time -- but the key words are "if" and "slow".

What about our weakest institutions, the 25 or so that have outstanding net worth certificates? As we move into the second year of a three-year program, we -- the FDIC and the participating banks -- must plan for the future. Not all recipients of net worth assistance are in the same situation. A few are now operating close to break-even and may be able to

sell stock to improve their position. In other instances, it will take a combination of expense reduction, lower interest rates, a very receptive capital market and considerable good fortune to achieve a turn-around.

What other alternatives exist? Weak institutions might look to merge with a strong, potentially well-capitalized institution. I suspect there are some institutions on our net worth certificate list which would add value to another institution even though they do not have the strength to go stock on their own. A number of savings banks are doing quite well today. They have good earnings and surplus or the potential to convert to stock and be very well capitalized. It would not be too difficult, on paper, to pair off some strong and weak savings banks, factor in what the combined institution could raise by going stock and come up with pro forma earnings and capital numbers that would be very respectable. We even have some savings banks paying federal income tax that would get some immediate benefit by acquiring a weaker institution. Branch sales to strong institutions could also assist the recapitalization of weak savings banks.

The FDIC is not in the business of putting together unassisted mergers. Whether management and trustees at profitable mutuals have sufficient incentive to get bigger and go public, I do not know. We have seen thrifts convert to stock or start the process where additional capital is essential to survival. And we have seen a few cases where essentiality does not appear to have been the motive: where comparatively strong banks wanted to improve their situations and obtain the benefits that potentially go

with stock ownership. We will be very interested in monitoring what happens over the next year or so, particularly in New York now that legal hurdles to conversion are out of the way.

Title II of Garn-St Germain, which includes the net worth certificate program, expires in two years. Stock conversion or merger negotiations take time, and we believe it is important that savings banks participating in the net worth certificate program develop specific plans to strengthen their institutions. For that reason, we now require savings bank Title II applications (including renewal applications) to include a full discussion of merger plans, stock conversion plans or other pending actions to strengthen capital. We want to know what is being considered and, at least equally important, we want to see some hard thinking and concrete actions by boards of trustees and management.

Concluding Comment

Banks and thrifts are undergoing an enormous amount of change today -- in what they can do and in how they are to be regulated. Despite the turmoil over the past few years in financial markets, there is considerable reason for optimism. This has been a good year in many respects. The economy has moved ahead well, the inflation rate has been low and interest rates have been relatively stable. The majority of savings banks are operating in the black and their outlook is much improved over that of a year ago.

For some thrifts seriously weakened by losses in recent years, survival is not assured. Nearly all of their time and effort must, of necessity, be focused on enhancing earnings and capital or arranging a merger. The time frame for planning is comparatively short.

For the vast majority, near-term survival is not the issue, and the luxury of longer-range planning is available. An important element in your planning process is the future regulatory environment. Three major initiatives will likely be debated in the next session of Congress: expanded powers for banks and thrifts, deposit insurance reforms and reorganization of the regulatory system. All three are critically needed.

If I could leave only one message with you today, it would be to devote some time and serious thought to these legislative issues and work closely with the National Council on them. For better or worse, action or inaction on these items will affect your institution and industry for many years to come.