Remarks by
Ricki Tigert
Chairman
Federal Deposit Insurance Corporation

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This is my first official address to an ABA group since I became FDIC Chairman, an occasion that I have looked forward to eagerly.

I have worked with bankers for most of my professional life -- in my private legal practice, at the Treasury during the Reagan Administration, and at the Federal Reserve -- and have always been impressed with the healthy skepticism that marks your profession.

Even so, I was surprised at the answer I received when I asked a friend who used to work at the ABA what this audience tonight would be like.

He replied: "Bankers are a hard sell."

"What do you mean by that?" I asked.

"Well," he replied, "how many banks failed in the three years before the FDIC was created?"

"Several thousand" I answered.

"Yes," he said, "and how many banks failed in 1934, the year after the FDIC was created?"

"Nine," I answered.

"True," he said, "and what did the ABA say about deposit insurance after witnessing its amazing effect?"

"Tell me," I said.

Pulling a yellowed sheet of paper from his desk, he said: "an official ABA committee concluded, and I quote, 'there is no question but that the law guaranteeing deposits has reestablished the confidence of many thousands of small depositors throughout

the United States. This has given a certain stability to the banking situation that might not otherwise have existed under all the conditions that have prevailed. That such confidence is not warranted does not change its effect.'"

That was certainly a candid assessment -- or rather, self-assessment.

The FDIC has indeed sought throughout its long history to assure the stability of, and confidence in, the banking industry. In achieving record earnings and record capital levels the last two years, the banking industry has done much to assure stability, too. I am here tonight to talk about a related issue -- the number one issue on most bankers' minds when it comes to the FDIC: What is going to happen to Bank Insurance Fund premiums next year.

It will come as no surprise to you that, if current trends hold, we can expect the Bank Insurance Fund to reach the reserve ratio of 1.25 percent of insured deposits in the third quarter of next year -- or perhaps even late in the second quarter -- thus achieving the recapitalization that the FDIC Improvement Act mandated three years ago, well ahead of what anyone was predicting at that time.

Over the last several weeks, I have reviewed and weighed detailed statistical analyses of the condition of the industry and the Bank Insurance Fund, as well as projections for both the industry and BIF over the coming year. Those numbers lead me to conclude that BIF premiums will decline, and will decline significantly, for the vast majority of banks. Out of necessity, BIF premiums have been a major operating expense for banks over the last three years, but the time is at hand when, for the best-capitalized and best-managed institutions, that will no longer be the case.

I want to underscore, however, that a number of complexities, practical and legal, remain, and that these complexities will enter into the FDIC's consideration of BIF premium reductions. I want to give you an overview of several of those complexities this evening.

One complexity arises from our inability to fine-tune our assessment process in advance, and even as we go along. That is to say, we cannot predict the moment, the hour, the day, even the week when the BIF becomes recapitalized, and then immediately shift to a lower premium. Further, no one will break the ribbon stretched across the finish line -- no one will wave a checkered flag -- when the race has been won.

As you know, the Fund has two major sources of income: assessments and investments. At the end of the third quarter, the BIF balance stood at $19.4 billion, up from $13.1 at year end

1993. The increase in the BIF balance during 1994 was due primarily to assessment revenues of $4.2 billion in 1994 and to a reduction in the liability of the BIF for the cost of projected bank failures of $1.5 billion. This reduction in liability means we are shifting back into the Fund money that was earlier reserved to resolve bank failures that never happened.

I want to note here as an aside that we are working with the General Accounting Office, our auditors, to continue to improve the failure model they use so that it reflects current reality more accurately.

The Bank Insurance Fund's investments in U.S. Treasury obligations at the end of the third quarter stood at $13.3 billion, compared to $5.3 billion at year-end 1993. This represents the BIF's liquidity. As the assets of failed banks are disposed of, BIF liquidity will increase. Interest from BIF investments -- now more than $50 million a month -- will be an important and growing component of BIF's future operating results. Of course, that income will vary as interest rates change. For now, however, it is easy to see that the name of the game is assessments.

If insured deposits neither grow nor shrink, and if our failure projections are on the mark so that BIF experiences no large losses, and if operating expenses are estimated accurately, and if other factors have been taken into account precisely, we expect the Fund will cross the finish line -- the 1.25 ratio -- late in the second quarter or early in the third quarter of 1995.

Uncertainty, however, is a given.

Consider one example: Historical experience suggests that insured deposits tend to rise when interest rates rise and stabilize when interest rates fall. Total insured deposits fell in 1992 and 1993, with low interest rates. Total insured deposits continued to fall, however, in the first three quarters of 1994, even as interest rates increased. We are seeing an anomaly in the way we thought the world worked. Of course, if the current trend of declining insured deposits reverses, then it will take a bit longer to reach the 1.25 percent reserve ratio.

As I noted before, a large loss could significantly affect our progress, and large losses quite often come as surprises.

A second complexity, a legal complexity, comes into play here. We must set the basis for new assessments through the rulemaking process. That requirement limits our flexibility. For example, to allow for an adequate comment period, a proposed rule setting the basis for new assessments -- and perhaps proposing a range of new assessments -- must be published early next year.
Given these complexities, our assessments are likely to

overshoot the 1.25 target. What can we do to deal with that? Again, complexities enter in.

A third complexity is divining what the law tells us to do once the Bank Insurance Fund reaches 1.25. The Federal Deposit Insurance Corporation Improvement Act sets no maximum ratio. Rather, it says that, in setting rates to reach the 1.25 ratio, we must take account of a number of factors: operating expenses, case resolution expenditures and income, the effect of assessments on members' earnings and capital, and any other factors that the Board deems appropriate. Moreover, the Act states explicitly that the FDIC Board may increase the reserve ratio to such higher percentage as the Board determines to be justified for a particular year by circumstances raising a significant risk of substantial future losses to the Fund. I read this language to mean that while Congress did not contemplate a higher ratio, it told us to play it as we see it.

Today, I don't see "circumstances raising a significant risk of substantial future losses to the Fund" in the current financial statements of the industry. On the contrary.

Next week we expect to announce that, in the third quarter, commercial banks set a record for earnings. Asset quality measures, reserve coverage ratios, and equity capital ratios all show improvement -- again. According to the financial statements, banking is stronger today than it has been for decades.

Of course, the numbers for the early 1980s showed that, by some measures, the banking industry was strong then, too.

I also recall an interesting story that a friend of mine who came to Washington in the late 1970s to work as a banking reporter recently told me. His second or third week on the job, he learned that the FDIC rebated part of the insurance premium to the banks. He asked his bureau chief, a financial writer with more than 25 years of experience in journalism, if that was a good idea.

The bureau chief replied: "The FDIC has nine billion dollars in its insurance fund -- the way that banks are regulated today, it is inconceivable that anything could happen that would cost that much money."

Consider the reasoning behind those congressionally mandated rebates: the Fund had exceeded a billion dollars in the late 1940s, and people thought that it was inconceivable that anything could happen that would cost that much money.

Unfortunately, the 1980s proved that reasoning wrong.

A fourth complexity is closely related to the third: The law does tell the FDIC what to do if the Fund ratio drops significantly below 1.25. In general, we have a year to make up the short-fall by adjusting premiums. If we cannot, we are required to set a premium for the industry that at least averages 23 basis points until the Fund is replenished -- that is to say, what we have now. That requirement also reduces the FDIC's flexibility in fine-tuning the assessment rate. It raises the prospect -- if we are not careful -- of assessment rates bouncing up and down like a tennis ball at Wimbledon. So we need to be careful.

Taking into account an unforeseen hit on the Fund and the requirement that a minimum 23 basis point premium be imposed if it drops below the 1.25 ratio for a year, it is reasonable to ask whether the Bank Insurance Fund needs to have a cushion above the 1.25 ratio. Put simply: Do we need a cushion to soften the impact from an unforeseen blow?

Do we need a cushion to assure that banks don't get hit with a 23 basis points premium -- again and again? And how much would be enough? I am not here tonight with the answer -- although you can be sure I am studying it closely. I have, however, brought some numbers that I find thought-provoking. Based on our historical loss experience, we have determined that a cushion of one basis point above the 1.25 percent ratio mandated by FDICIA -- that is to say, a 1.26 percent ratio -- would cover routine losses, and by that I mean losses of less than one basis point annually. In 40 of the 60 years the FDIC has existed, losses totalled less than one basis point of insured deposits. With the yields on our investments today -- and no surprises in losses and other costs -- we could build that cushion from investment income alone in less than a quarter.

A fifth complexity arises in the situation where the Fund has collected assessment revenue beyond its needs, even with a cushion for unforeseen losses. What happens then? Can we return assessment income to BIF members, and, if so, by what means?

Under the law, the Board is not required to provide assessment credits or rebates -- and, in fact, FDICIA repealed the specific authority under which FDIC provided rebates in previous years and replaced it with a risk-based premium system. Even so, do we still have general legal authority to provide rebates? Can we roll balances forward for institutions, or otherwise provide assessment credit? These questions remain.

A sixth complexity also arises from the statute. Without question, the law contemplates that the FDIC will use insurance premiums as a risk management tool: The greater the risk an institution presents to the Fund, the greater its premium should be. Conversely, while virtue may be its own reward, a risk-based

premium system adds a financial incentive for avoiding temptation and maintaining sound controls and management as well. We need to follow this approach going forward -- not only because the statute contemplates a continuing risk-based assessment system, but also because it reflects the potential risks to the Bank Insurance Fund. Just as an insurance company in the private sector sets premiums to cover risk, so, too, should we. It is just good business judgment.

Given the condition of banks currently, what does this approach mean? For most banks -- the great majority of banks -- it means great news. According to our most recent numbers, 90.7 percent of the institutions insured by BIF -- 9,816 out of 10,828 institutions -- are at the top of our nine assessment categories. That is to say, more than nine-out-of-ten of these institutions are in the best-capitalized and best-managed group. By contrast, two years ago, only 77.2 percent of the institutions insured by BIF fell into the top group.

On the other hand, 162 institutions now fall into the "adequately capitalized" category -- 50 of these in the lowest of the three supervisory groups.

In addition, capital levels at 36 institutions are less than adequate.

Clearly, risk-differentials will continue for banks as they deviate from the best-capitalized and best-managed group -- the only question is at what levels do they provide a real incentive for improvement? The FDIC will have to make a judgment about this issue and will be asking you for your comments before we do.

Finally, a complexity that has cast a shadow over consideration of BIF issues is the related -- though not connected -- issue of recapitalizing the Savings Association Insurance Fund. At present, I can say only two things about this issue.

The FDIC staff is exploring the effects on the thrift industry of a differential between BIF and SAIF premiums once BIF is replenished. Legally, however, the BIF premiums are required to be set independently of the SAIF.

As I said earlier, we expect to address BIF premium reductions through the rulemaking process beginning in January. The complexities I have discussed this evening are likely to be reflected in one way or another in the proposal we expect to issue for comment then.

I want to urge all of you here tonight -- and your colleagues in the industry -- to comment on that proposal -- not only on the immediate question of what the premiums should be, but also on the related issues I have outlined.

We share the goal of making BIF funding and management as fair, efficient, and stable as possible. You cannot plan and prepare for the future without some measure of certainty about costs. Moreover, I am mindful that sound banks must be able to compete in today's highly competitive marketplace, and that higher marginal costs make that difficult. I am sensitive to these issues and willing to work with you to achieve our common goals of a sound insurance fund and a deposit insurance structure that rewards the best capitalized and best managed institutions with the lowest possible insurance rates.

If we work together, the day is not far off when bankers again will view deposit insurance -- not as an operating cost -- but as a source of strength that builds consumer confidence. And that's not all bad!

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