[Importance of the Deposit Insurance System]

Remarks by

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It's a pleasure to speak today with members of the Chicago Association of Commerce and Industry.

For example, your nearly 40 active committees address areas of importance to every business in Chicago.

You are working to help make meaningful changes to the area's tax structure, which your president, Sam Mitchell, has noted, is the most complex of any metropolitan area in the U.S. As an ex-CPA who worked in the area, you have your work cut out for you.

I think efforts like your's, underscore, that when anyone refers to Chicago as the "Second City", you would be fully justified in using that old Gary Cooper line: "When ya say that, stranger, smile!"

I would like to take this opportunity to tell you why I think our deposit insurance system is at a watershed period in its 55 year history, and why that is important to every one of you.

Yes, the insurance system problems are important to <u>every American</u> -- whether he or she has money in banks or not.

Last year was a challenging year for the FDIC, and its sister institution, the FSLIC, which guarantees savings and loan deposits. These challenges continue.

During the first six months of this year, we have handled 87 bank failures and 14 assistance transactions. At that pace we should end up with over 200 failings and assets, or just about the same number of total failed and assisted banks as last year.

Despite a record number of problems handled, the financial condition of the FDIC fund remains strong. The FDIC received a clean GAO audit for 1987, which showed the fund had a net worth of roughly $18.3 billion. Over $15 billion of that net worth is in cash-type reserves. That makes us about as <u>liquid</u> as they come in Washington, except maybe for the Fed, and they have the extraordinary advantage of being able to print money!

We expect 1988 to continue as a busy year. Based on current estimates of loss in 1988 -- including the cost of handling First Republic Bank of Dallas, Texas -- and the combined assistance of Texas American Bancshares and National Bancshares Corporation we announced yesterday -- we will experience some decrease in the net worth of the fund this year, probably somewhere in the neighborhood of 10 percent! That will be the first such loss in FDIC history.

That kind of news makes one reminisce about the good old days of the recent past. The nicest thing you could say about someone was that he was almost as rich as John Connally, and had almost as much religion as Jimmy Swaggert!

Notwithstanding our projected loss for 1988, we are able to deal with any banking problem we can foresee. With the number of banks on our problem list declining for two quarters now, our task could be a bit easier down the road. We forecast that bank failures will be significantly down next year. We should be back in the black in the 90's.

The tale of the FSLIC is, unfortunately, not as encouraging. The thrift industry used to be a simple business designed to encourage home construction providing low cost funding. Not much could go wrong, and as a result, it required minimal supervision. Increased competition and rising interest rates helped change that. In the early 1980s Congress deregulated much of the thrift industry, hoping this would be the answer to the their problems. But instead many thrifts ventured into risky real estate ventures and mail box brokered operations, and the problems have only become worse.

By the end of 1987, according to the GAO, there were over 500 insolvent thrifts with an aggregate negative net worth of $18 billion under GAAP accounting. Over one-third of the industry was unprofitable, with those thrifts losing $13.4 billion last year.

GAO concluded that the FSLIC had a negative net worth of $13.7 billion at year-end 1987. And, according to one congressional estimate, the problems are getting worse at a rate of over $30 million per day, or roughly a billion dollars a month.

Estimates of the cost of handling the thrift industry's problems by closing the solvent S&L's now range from $30 billion (FSLIC's) to over $80 billion!

So deposit insurance can cost billions of dollars, which ultimately must be paid -- or our government credit rating will be impaired.

Now you know why I think this insurance system is at a watershed, and needs a new look.

From a modest New Deal program started to bolster consumer confidence in a shaky banking system, the federal deposit insurance has grown to become an important factor in the safety and soundness of America's banking and S&L systems.

Deposit insurance was created as a reaction to severe problems the banking industry faced during the Depression.

The FDIC's beginning was modest in scope. But even then it was not without controversy. Small depositors and small banks supported the plan, while larger institutions stood against anything that would help put smaller banks on a more equal footing with them.

But the role and form of deposit insurance as conceived in the 1930's has changed dramatically as the structure of the banking system has evolved.

Deposit insurance has become a significant factor in the total U.S. financial system because it gives banks and thrifts our almost unlimited power to borrow on the credit of the United States. Bank owners are only required to put in 6 percent of a bank's resources, while thrift owners need contribute only 3 percent.

These insured institutions have "credit cards" guaranteed by the federally authorized insurance funds. Every institution can gather $100,000 deposits without the depositors worrying about the institution's credit. Of course, the government no longer regulates the interest rates paid by these institutions, so they are free to raise their rates to attract almost as much in deposit liabilities as they desire.

In addition, new kinds of financial enterprises that compete with banks, deregulation, new technologies, and geographic expansion, combine to make the banking business a different, and unfortunately, more risky business, than ever before.

Let's look at a few of the significant changes in the operation of the deposit insurance system as a result of the current environment. Significant differences from the original concept are apparent.

Let's look at the "too big to fail doctrine."

While the FDIC tries to protect all depositors, even those with more than $100,000 in deposits, we can not always find a way to give that protection to small banks under current law. So today, small banks complain they are discriminated against -- and they are sometimes correct. A system designed to help small banks ends up handicapping them.

Why, in recent years, has the FDIC has moved to protect depositors and creditors in failing large banks? Because we are only doing what the rest of the world does. No major industrial nation has allowed its large banks to fail since the Great Depression. The financial repercussions could be too far ranging. The international competitive ramifications alone make it unlikely this policy will be changed by any single country.

As the FDIC helps large banks in trouble, it changes the lender of last resort role. The Federal Reserve Board, becomes the lender of next to last resort. The Fed was conceived as a liquidity lender -- to stop runs on banks that were solvent -- not to save banks that were insolvent. No one thought in those days that insolvent banks would be "saved," even as far as depositors were concerned.

When the huge Texas banking operation First Republic went to the Fed window for funds to keep it afloat last winter, withdrawals at First Republic increased. Depositors and creditors were aware of the Fed's policy of taking the best collateral for its liquidity lending.

But, when the FDIC gave an unlimited guarantee to depositors and creditors at the Texas banks, and a loan of $1 billion, the run on those banks was stopped.

The FDIC has become the primary safety net for failing banks that need to be protected to assure a stable banking system. This is a role not even dreamed about by the creators of the FDIC.

Another change is the withdrawal of the safety net of insurance from bank holding companies as a result of current FDIC policies.

When the dictum that a bank is "too big to allow depositors or creditors to suffer" is applied, it is applicable to banks, but not to bank holding companies. This policy was not implemented when your Continental Illinois was rescued -- all creditors including holding companies were protected.

This spring, the FDIC guaranteed that all depositors and other general creditors of First Republic's banks would be fully protected, but these guarantees were NOT extended to the holding company creditors or shareholders.

This FDIC policy is critical when considering the many proposals that would allow new powers and activities to bank holding companies, or to the banks themselves.

FDIC and FSLIC loss experience, especially in the Southwest, has taught us that deposit insurance is a powerful tool, which if not properly controlled, has the potential to severely <u>damage</u> the financial system.

As I have said, deposit insurance effectively gives banks and thrifts the ability to borrow on the credit of the federal government. Because of this, the deposit insurance system must be carefully guarded.

Our deposit insurance system can be compared to a nuclear power plant. It can provide benefits. But at the same time, safety precautions are needed to keep it from going out of control.

A deposit insurance "meltdown" could damage the fabric of our whole economy. One has only to look at the savings and loan industry losses to see the magnitude of the financial problems of deposit insurance misused.

And, lest we become satisfied with our bank supervision as the answer, look at the losses the FDIC is incurring in Texas, despite supervision by the best federal and state bank regulators.

In Texas, all but two of the ten major banks have had to be rescued -- either by the FDIC or private resources.

We are dealing with our Chernobyl right now in the Southwest.

If one needs to be convinced that deposit insurance is important to the way we live, just think for a minute of what would be the effect on banking and consumer confidence -- not to mention Congressional mail office -- if the FDIC ceased issuing deposit insurance, or reduced it to $2500, as it originally began.

Today's banking environment requires a new look at deposit insurance in a world of deregulation in rates and territories, of expanded international financial markets, and of evolving computer based technologies.

Thus, the FDIC has undertaken a complete review of deposit insurance and its role and operation in the current banking environment. Our study on this subject, "A Deposit Insurance System for the '90s", will be completed before year-end.

Here are some of the fundamental guidelines to be followed in constructing a better deposit insurance system.

-- We must construct better Supervisory mechanisms to control risk This is key to the future of the system. If supervision doesn't work, the ability to borrow on the credit of the U.S. could mean far ranging disruption.

-- We must seek ways to increase the market's ability to control risk in today's environment Should we change coverage to include only short-term deposits, or the introduction of private coinsurance? Should we control rates paid on insurance deposits, or provide insurance only for individuals, and not for corporations?

We should look for structural changes that reduce risks in the system that uses deposit insurance. Suggestions have included the "narrow bank", that is one that invests only in "safe assets". Or should we have different types of insurance or structure for large funds and small banks?

Should we restructure the insurance system? Should there be a merger of the FDIC and FSLIC funds?

As we have said many times, we do not favor a merger under current conditions -- their obligations are just too big --

A better insurance system may include better coordination of the insurance funds.

So we believe it's clear we need an improved system for deposit insurance to be viable in the '90s.

This is a problem likely to be high on the agenda of our next President.

The new President -- Mr. D or Mr. B -- may want to act on this problem early in his honeymoon period, following the good advice, "Get the tough ones behind you in the first 100 days."

Well, I'm at a point in this speech that reminds me of a story that one of the presidential candidates recently told me.

He had just finished a long and rambling speech. Afterwards a woman came up to the speaker's table to shake his hand. "How did you like my speech?" he asked.

She answered, "I liked it fine. But it seems to me you missed several excellent opportunities."

The candidate was puzzled. "Several excellent opportunities to do what?

"To end your speech," she replied.

Not to be accused of missing good opportunities, I'd like to say

thank you for asking me to speak, and I would be pleased to respond to any questions.