Remarks
By
Donna Tanoue
Chairman
Federal Deposit Insurance Corporation
Before
America's Community Bankers
Seattle, Washington
October 30, 2000

There is an old saying: "If it isn't broken, don't fix it," but we learned in the 1980s that when it comes to federal deposit insurance, it would have been far better to address the problems of the FSLIC (Federal Savings and Loan Insurance Corporation) before it was broke. That lesson was an expensive one for the taxpayers and for you.

Many of you paid for the mistakes of your defunct counterparts throughout the 1980s and long into the 1990s: billions and billions of dollars through assessments to the FSLIC and through assessments to build up the Savings Association Insurance Fund (SAIF). And in paying off Financing Corporation (FICO) bonds, you're still paying for those mistakes today.

The 1980s were a tough time. During the thrift crisis, a third of the savings institutions in the country were wiped out, so the thrift industry represented here today is - for the most part - an industry of survivors, survivors who had to struggle to contribute significant premium income throughout the crisis years and were then required to capitalize a new insurance fund, paying more than half of industry income in 1996.

Those experiences give you a unique perspective. No one knows the value of federal deposit insurance more than you do. When the 1980s began, 590 thrifts were insured by state-sponsored programs in Maryland, North Carolina, Ohio, and Pennsylvania. By the close of the decade, all those programs had either collapsed or were abandoned. As one after the other fell, the absolute certainty of federal insurance limited the damage. At the same time, no one knows better than you do the consequences of neglecting the latent flaws in a deposit insurance system. No thrift executive who lived through the demise of the FSLIC would ever want to have that kind of experience again.

Since last spring, the FDIC has engaged in a comprehensive review of the deposit insurance system, with an eye to reform, that is to say, to addressing its latent flaws. I've talked with your counterparts in the commercial banking industry about this effort, but, because you have a unique perspective - forged and tempered in the heat of crisis -- I welcome the opportunity to discuss it with you today and to talk about why reform is needed from a public policy perspective.

One reason reform is needed is so that we can merge the bank and thrift insurance funds. We continue to endorse this as a fundamental safety and soundness goal. I think

we all agree about that. Today, I want to talk to you about additional reasons for reform: why it is needed in terms of fairness, why it is needed in terms of benefiting the economy, and why it is needed in terms of benefiting the depositor.

First, fairness.

The current system allows fast-growing institutions to increase their insured deposits without paying assessments into the insurance fund. That is patently unfair to the vast majority of institutions that paid into the fund to capitalize it. Without fairness, any system eventually would come under pressure, break down, or require major redesign in the long run. What do I mean when I say fast growing? Consider the example of one particular federal savings bank insured by SAIF. At mid-year 1996, it had insured deposits of about $250 million. As of last June 30, it reported insured deposits of over $3.1 billion. It increased insured deposits by 10 fold and didn't pay a penny for the additional exposure. That's not fair, but that's not all.

Most newly chartered institutions pay nothing at all into the insurance funds. Nothing. And if one of these newly chartered institutions fails, there is the possibility that FDIC money will be spent resolving the failure, without the institutions ever paying one thin dime into the fund.

That's patently unfair to the rest of you.

What degree of unfairness are we talking about here?

Consider a thrift that 15 years ago held about $500 million in assets and has grown into a $1 billion institution today. Assuming a typical thrift balance sheet, in those 15 years, it has paid somewhere in the neighborhood of $20 million to meet its deposit insurance obligations, including payments to the Financing Corporation. On the other hand, the fast-growing savings bank I mentioned earlier is only four years old, but it has $3 billion in insured deposits and paid a total of $2 million to date for its deposit insurance obligations, including payments to the Financing Corporation.

Fairness - to the vast majority of institutions - also means that we should price deposit insurance so that premiums better reflect risk. Just like private sector insurers do. Those of you who lived through the 1980s - survived the 1980s - know what it is like to pay for the mistakes of high flying institutions. I want to emphasize this point.

When banks pay little in good times and a lot in bad times - after the failures have occurred - more and more of the cost burden is shifted to the survivors. Does this make sense? Or does it make more sense for institutions to pay steady premiums over time?

In addition, while the survivors paid for the thrift failures of the 1980s, the U.S. taxpayer paid more. You have an interest - and I have an interest - in seeing that that doesn't happen again. And, as you know, Congress shares our interest. That is why it passed legislation nearly 10 years ago that made sure that the bank and thrift industries would

be required to pay dearly before the taxpayer would be on the line again when we have to deal with a wave of failures.

As you know, the FDIC has a call on your capital to recapitalize the fund.

What can we do now to increase the likelihood that we will never have to make that capital call? A move that could have a severe impact on your institutions, your communities, and some of your stockholders.

Which leads me to my second point, reform to benefit the economy.

Under the current system, the cost to thrifts of funding their insurance can spike quickly from, in effect, zero to at least 23 basis points in a severe economic downturn. If that happens, deposit insurance premiums could reduce the pre-tax net income of all FDIC-insured institutions by almost $9 billion - and that, in turn, could lead to a lending contraction of more than $65 billion, and this contraction would likely come at the worst possible time: during an economic downturn. The industry pays most when it can afford it the least, thus hindering the industry's ability to fuel a recovery by granting credit.

Given that it defeats a key purpose of insurance - to spread losses more evenly over time - does this volatility make sense?

Let's turn to my third point: reform to benefit the depositor. That means coverage. I want to stress that, with the exception of our long-standing support of merging the BIF and the SAIF, the FDIC has not endorsed anything - although we are looking hard at the issues.

It has to be clear to anyone who takes the trouble to look that the current process for setting coverage limits is arbitrary and ad hoc, and that leaves consumers uncertain as to their future investment alternatives.

Coverage issues need to be analyzed, in conjunction with pricing and fund size, if we are to make the deposit insurance system more effective in serving as a safe harbor for savers, and that means facing the question of whether coverage should be indexed. In other words, do we want to hardwire indexation into the law - as we have in other federal programs on which Americans rely -- such as Social Security benefits and retirement benefits?

The demand for insured deposits may soon increase. The supply of federally insured investments, such as Treasury notes and bonds, is on the decline, and a likely place for those investors to go would be banks. In addition, the population is aging, and the need for a zero-risk place to put funds may be increasing. The current weakness in the equity markets is increasing investor interest in debt instruments, including insured certificates of deposit.

I know a question that might be on your mind is how much deposit insurance reform would cost you. It doesn't necessarily have to cost you more in the long run. A better system means that the industry will pay less, and whatever it does pay, safer banks will pay a smaller share.

One proposal that we are examining is taking a "mutual fund" approach to managing the fund. That approach, in turn, could allow thrifts that built up the fund to get credit for that. And, in the good years, a mutual fund approach could allow rebates, dividends and/or a new asset on your books -- a claim on the deposit insurance fund.

I'm not here today to ask you to open your wallets -- Congress already did that. Rather, I'm here to ask you to keep an open mind.

Many years ago, a newspaper editor in Baltimore, Maryland, wrote: "Every problem has a solution that is simple, easy - and wrong." If we want a better system, deposit insurance reform won't be simple and it won't be easy, but I promise you this. The FDIC will continue to work toward the right solution in just the way that we have worked toward it so far: transparently - in the sunshine -- and inclusively.

If we knew in the 1980s what we know now, wouldn't we have tried to address the latent flaws in the FSLIC? Knowing what we know now, shouldn't we do what we can to address the latent flaws in our current system?

Why now? Because there are signs that our window of opportunity for deposit insurance reform may be closing.

What signs? We are seeing debt burdens rising among low- and middle-income households. We are seeing a rapid escalation of home prices dwarfing income growth. We are seeing more cities at risk for overbuilding commercial real estate. We are seeing rising corporate default risks across industries. We are seeing stock market jitters.

And, I don't need to remind any of you that these challenges are being faced in an environment where net interest margins continue to be squeezed by increasingly competitive deposit markets and a relatively flat yield curve.

Add to these signs the fact that a growing number of institutions have significant exposures in subprime and high LTV mortgages. Over the past 18 months, we have seen some of these institutions fail suddenly and with extraordinarily high loss rates - in excess of 50 percent.

What does all this mean for the SAIF?

The balance in the SAIF above the 1.25% target at midyear was a little less than $1.5 billion. Given a high-loss scenario, the sudden failure of a single, medium-sized SAIF-insured institution could completely wipe out that $1.5 billion cushion.

The reserve ratio could drop well below the 1.25 legal level in a relatively short period of time. The more severe the scenario, the higher the premiums.

If all this sounds like a prediction of gloom and doom, it is not. It is a reminder that we must be prepared for more challenging times ahead. I've said before that the time to fix our roof is when the sun is shining. If you pitch in, the work can be done before the next storm hits.

Last Updated 10/30/2000