Remarks by
Donna Tanoue
Chairman
Federal Deposit Insurance Corporation
Before the
Annual Convention
Of the
Independent Community Bankers of America
San Antonio
March 7, 2000

There is an old adage that makes a lot of sense: Fix your roof when the sun shines. The sun is shining on our deposit insurance system. The funds are well capitalized, almost all banks pay nothing for their insurance premiums, and losses to the fund for the immediate future are projected to be small.

While reaching for the sunblock, however, we need to think about what we can do to ensure that the funds can weather the next storm - because another storm will come eventually.

Why is that important?

From the public's point of view, federal deposit insurance is a simple matter. Bank customers in the United States know that their bank deposits are insured. They can rest assured that their insured savings are safe.

Because depositors do not have to worry about the safety of their money, they do not feel compelled to rush to the bank in response to the news - or rumor - that their bank is troubled financially. And in preventing banking panics, deposit insurance helps to keep the payments system operating.

In recent years, we have seen financial crises in Asia and Latin America - crises that, in part, have led at least 31 countries to institute new explicit deposit insurance programs during the 1990s. Today, 68 countries have such systems. The benefits of deposit insurance are appreciated worldwide.

Deposit insurance is a simple idea - with profound results.

You in the industry -- and we at the FDIC - know, however, that deposit insurance raises complicated issues -- and it requires a balancing of competing concerns. First and most important, the deposit insurance system must help maintain public confidence while shielding taxpayers from the costs that can arise from deposit insurance. Second, deposit insurance should help the industry through bad times - that is what insurance companies do. Next, deposit insurance must not alter the rational development of the industry over time. Finally, the system must be fair. These concerns are fairly easy to state, but difficult to address.

We at the FDIC are undertaking a comprehensive review of our deposit insurance system. I want to take a hard look at certain issues, including: (1) Does the deposit insurance system create the right incentives? (2) Is the system fair? (3) What is the right coverage level?

The country - the economy - the financial system - have changed significantly in the almost 70 years since federal deposit insurance was created.

The security that deposit insurance provides the individual - and the stability that it provides the financial system and the economy - have not changed.

But its effect -- and even its role - are arguably different in our world than they were a lifetime ago.

Given the changes underway in our financial system, where hundreds of billions of dollars can shift almost overnight, and where many Americans do their personal business on-line, a reexamination of deposit insurance has never been more timely.

Let's look at some current issues in deposit insurance this morning - issues that will be a part of our reexamination - beginning with the one that lies at the heart of running an insurance operation, which is how we price deposit insurance.

On pricing, we need to look, in particular, at whether the current system unnecessarily allows some banks to create more exposure for the insurance funds without cost to the banks themselves. If the level of overall insured funds grows to the point that the reserve ratio falls below 1.25 percent, all banks must pay premiums. And we need to look at whether the relatively blunt one-size-fits-all approach to risk-based premiums is appropriate.

At present, new institutions can enter the deposit insurance system without contributing a penny to it. And most existing institutions can grow their deposits without incurring any additional costs for deposit insurance.

The Bank Insurance Fund was fully capitalized in 1995. The Savings Association Insurance Fund was fully capitalized in 1996. Since they were fully capitalized, 814 new banks and thrifts have been chartered. Insured deposits held by this group of institutions as of year end 1999 totaled almost $44 billion. Given this amount of growth in coverage, the amount of money required to maintain the reserve ratio of the funds at 1.25 percent would be about $550 million.

Moreover, some institutions have grown rapidly since the capitalization of the insurance funds or may grow rapidly in the future. In many cases, rapid growth simply reflects an institution's success in competing for new business. But, as recent experience suggests, rapid growth may also indicate greater risk to the insurance funds.

Since the Bank Insurance Fund was fully capitalized, the fastest-growing 25 percent of BIF-insured institutions added approximately $178 billion to their BIF-insured deposits. These additions to insured deposits represent a significant financial impact on the deposit insurance system.

Deposit growth also arises from new opportunities created by ongoing market developments. We are all aware of the potential for significant expansion of banking activities by large insurance companies, as well as other commercial firms that own unitary thrift charters. And a recent announcement by a Wall Street investment firm that it plans to sweep uninvested funds from its Cash Management Accounts into insured deposit accounts is especially significant. This means there is a potential - according to press reports -- for $100 billion to be added to BIF-insured accounts, which could produce, over time, a 6-basis point decline in the BIF reserve ratio. If other companies initiate similar programs, the BIF ratio could easily be reduced well below its current level.

Also, one of the more noticeable changes in the consumer end of the financial system is the growth of mutual funds. In 1980, equity mutual funds totaled a little over $60 billion. Now the figure is approximately $4 trillion. While this growth may not be surprising given the combination of demographics and extraordinary economic expansion, it is not inconceivable to think that this trend may slow, or even reverse itself, if the equity markets weaken. Investors could shift significant portions of their wealth from equities to money market funds or insured deposits. Given the numbers involved, the potential impact on the insurance funds could be substantial.

There is a flip side to the deposits generated by newly chartered or rapidly growing institutions. Many existing institutions, particularly community banks in agricultural and rural areas, are facing significant and steady declines in deposit funding. The reasons for this are familiar to all of you: pressures on the agricultural system, changing demographics, and the growing acceptance of savings and investment alternatives.

Many of the banks facing deposit declines are the very same banks that were called upon to make significant contributions to recapitalize the insurance funds. As their deposits shrink, so does the portion of the insurance funds needed to support the exposure created by these banks. The current system doesn't reflect this reality.

Another concern I have with the existing system is that it is insufficiently forward-looking. The premium system should address excessive risk-taking before it affects the condition of insured institutions and the deposit insurance funds. Pricing risk after-the-fact limits our ability to create the right incentives and to provide fairness.

The current risk-based premium system, created in 1993, is based primarily on capital ratios and supervisory ratings. This represents a significant improvement over a flat-rate system, but under current law there are limits on the ability of such a system to be fully forward-looking.

To begin to address this issue, the FDIC, working with the other federal regulatory agencies, recently adopted premium-system enhancements to screen for risk profiles similar to those institutions that recently became troubled or failed.

This approach is aimed at identifying outlier institutions in the best-rated category. In the most recent assessment cycle, about two percent of the best-rated institutions were flagged by the screens and only a handful face the prospect of higher premiums.

These enhancements represent just a first step. The FDIC needs greater flexibility to look to additional indicators of risk to the funds. This would help us to develop a system that not only is more forward-looking, but also more discriminating with respect to different risk profiles. It is difficult to conceive of a private insurer charging the same premium to more than 90 percent of its clients.

As we consider changes in the premium system, we must also keep in mind that consolidation is changing the structure of the banking industry and, therefore, the risks confronting the deposit insurance system.

The FDIC increasingly faces a small number of large risk exposures that are difficult to diversify. Problems at one or more of the largest banks would put to a severe test the resources of the deposit insurance system.

This is a serious concern. Obviously the best strategy is to take steps to avoid cases where FDIC intervention is necessary. Prompt corrective action is designed to do this by triggering intervention at an earlier stage.

In addition, the regulatory community is working on measures to address the risks from large, complex banking organizations. The risk-based capital rules are under review, there is a greater push for transparency, and Congress has asked for a study on the use of mandatory subordinated debt.

It is not clear where these efforts will lead, but it is likely that some of these initiatives will result in requirements that apply only to large banks. In other words, the regulatory approach will follow the segmentation of the industry.

We need to consider whether we should do the same with respect to deposit insurance. This possibility was explicitly acknowledged by Congress in the section of FDICIA that established the risk-based premium system. The language says the FDIC may "establish separate risk-based assessment systems for large and small members of each deposit insurance fund." The FDIC has chosen not to exercise this authority, but the changes underway in the industry call for us to take another look at the possibilities here. It may be possible or even necessary to move away from the one-size-fits-all approach in order to avoid placing unnecessary burdens on smaller banks while appropriately pricing the risks from larger institutions.

One possibility is to look to the market to help price large bank exposure. Market information is inherently forward-looking and represents the collective judgment of informed participants with money at stake. The market continuously differentiates among institutions on the basis of risk, and it may be possible to incorporate some of this information into the deposit insurance pricing system.

Talk of more sensitive risk-based premiums leads to concerns that this will drain resources from the industry and put them in insurance funds that already are above their statutory targets. This is our second issue this morning, the adequacy of the insurance funds and the possibility of excess funds. This is another area that would benefit from both an exchange of views with the industry and more sophisticated analysis.

The United States is unique among countries in that for more than half a century it has maintained significant deposit insurance funds. Why have we done this?

The presence of a strong fund makes it less likely that banking problems will meet with delay, thereby increasing the costs. Second, a strong fund -- built up during good times -- is a way of paying for deposit insurance when the industry can best afford it.

Finally, a system without a strong fund is essentially a pay-as-you-go system in which only the good banks that survive pay for the mistakes of others.

How large should the funds be? Big enough to do the job. To a significant degree the answer will be a matter of judgment. Bank failures occur infrequently and irregularly - and sometimes in large numbers. Deposit insurance is not like life insurance - it is not amenable to precise actuarial calculations.

And even if it were, the "right" size for the funds would not be constant. It would be adjusted on an ongoing basis to reflect changes in economic conditions, structural changes in the industry, and other developments, just as we expect bank capital to be adjusted for such factors.

To help sort out the issues I have raised with you this morning, we need to do two things. The first is to clarify the public policy purposes that are served by a deposit insurance fund. The second is to improve the analysis of fund exposure. This in many ways mirrors the efforts underway within the industry to monitor and measure risk. We want to talk with you about these issues in the months ahead.

In closing, a number of proposals for changing our deposit insurance system have been made, including one by this organization that the level of insurance coverage be doubled from $100,000 to $200,000.

Certainly, in terms of purchasing power, $100,000 isn't what it was in 1980 when the current level of coverage was set. Had the coverage limit been indexed to inflation, it

would now be about $197,000. The twenty years since 1980 is the longest period in the history of the FDIC that we have gone without raising the coverage limit.

We are inclined to think that raising the coverage limit to $200,000 may not substantially elevate the risk exposure of the funds, in part because depositors already have the ability to structure their accounts to achieve far higher coverage.

However, we currently are unable to project even the initial impact of a higher coverage limit with any degree of reliability. A survey of the industry would help in this area. Some questions we need to explore include: Will more dollars move from big banks to small banks, or vice versa? Will dollars simply cross the street from one small bank to another? Will there be a significant inflow of funds from outside the banking industry?

There still will be uncertainty as to the ultimate impact of a higher limit, because it is difficult to predict whether depositors will significantly change their behavior in reaction to a change in the coverage rules.

Some observers have pointed to the raising of the coverage limit in 1980 as an important cause of the banking and thrift crises that followed. Of course, many factors contributed to the severe problems of that decade. Nonetheless, we must be mindful of incentives and the potential for unintended consequences whenever we consider significant changes to the deposit insurance system. In the end, the question of higher coverage limits boils down to what we consider to be good public policy. Let me describe how I propose that we make progress on this and other issues in the coming months.

I will invite the leadership of the Independent Community Bankers of America - and the other major trade associations -- to a roundtable discussion of deposit insurance reform to be held in April.

And we will work with other organizations that have views on deposit insurance reform - consumer groups, state bankers associations, and others.

We will follow the roundtable with outreach meetings that I will invite bank chief executive officers to attend in late May and in June.

We want to hear from you and your colleagues about your views on how deposit insurance can best allow you to serve your communities - as well as any other issues you might wish to raise.

Finally, I am asking the staff of the FDIC to consider these and other issues -- considering the feedback from the roundtable, the meetings with the industry and other interested parties, and studies that have been performed to date. The FDIC will then in mid-July publish for comment a set of policy options. That set of policy options will be the initial step in our comprehensive reexamination of deposit insurance. We will then by year end produce a set of recommendations for change.

Over the past 70 years, federal deposit insurance has become a characteristic of American life. The FDIC's icon of insurance - our symbol of confidence - greets bank customers whenever they walk into thousands of institutions that serve the public.

At the FDIC, we are proud of the certainty and stability that we have provided the nation for three generations of Americans. By refining some of the elements in our system - by eliminating inequities - and by addressing unintended consequences in our system, we can improve the service we provide the public.

The sun is shining.

And we have work to do.

Last Updated 03/07/2000