Remarks
By
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The
Lawyers Council
Of
The
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Thank you.

It is a pleasure to be here today with so much high-powered legal talent, including the FDIC's own Bill Kroener. Bill has been a valuable counsel to the FDIC over many years of great change in banking.

I'm here today to make the case for deposit insurance reform. I know it's hard to talk about paying new insurance premiums -- a new bill to pay that comes right out of the bottom line. But the truth is that there has never been a better time to talk about these kinds of reforms. The banking industry's return on assets -- a basic yardstick of industry profitability -- has been above 1 percent for eight years now -- and it never reached that height before in the 68-year history of the FDIC.

But good times don't last forever, as we were reminded last year when several large banks experienced earnings setbacks, and the industry's net income declined slightly from 1999's record level. And 22 of the top 25 banking companies reported an increase in nonperforming assets during the first half of this year -- primarily in syndicated lending.

The best reason to fix the flaws in our deposit insurance system now, while conditions are good, is that the earnings problems that bad times bring won't be made even worse by the imposition of large deposit insurance premiums.

The truth is that the current system could exacerbate an economic downturn by raising premiums at the worst possible time -- pulling funds from banks and limiting credit availability when it is needed most. It would take a toll on the safety and soundness of the banking industry because a premium increase would hit when banks are less healthy and losses are depleting the insurance funds. All these reasons argue for taking action now.

But there's one more bottom-line reason to support reform now. Banks, like all other businesses, will always be concerned about their profitability. Our proposal will make this one piece of bank expenses and therefore, earnings, more predictable without increasing expenses in the longer term. And we all know that the market values costs that are more predictable and easier to manage -- leading to less volatile earnings.

I also want to talk with you about making good public policy, and about the potential costs and benefits of deposit insurance reform - to your institutions in particular.

First, public policy.

As you know, last month we made a number of recommendations to Congress that would improve our deposit insurance system - recommendations to address the flaws in our system.

One question is, What do we do to prevent premiums from hitting your bottom line at the worst possible time?

The first problem to address is the way insurance premiums are charged Today, 92 percent of the industry gets federal deposit insurance for free. As a result, some brokerage firms have recently moved a large amount of funds - very quickly - into insured deposit accounts at their affiliate banks. That was a good business decision for them.

However, other banks can rightly say that they are subsidizing insurance costs for these and other fast-growing banks.

Free insurance distorts market discipline. And at a time when financial regulators around the world are coalescing around the idea that government should create incentives for the industry to manage risk appropriately - the Basel proposal, for example - the U.S. deposit insurance system is out of step.

All insured institutions should pay for insurance - and they should pay based on risk. That is to say, their probability of failure.

So how would the FDIC differentiate based on risk? In the example detailed in our recommendations, the FDIC used a statistical failure-prediction model as the basis for a scorecard that assigns depository institutions into risk categories. The scorecard example, which uses examination ratings and financial ratios, appears to work well for the great majority of depository institutions and could form a sound basis for risk differentiation for the thousands of small banks whose historical experience underlies the analysis.

This approach will be modified in order to assign large, complex institutions to appropriate risk classes for deposit insurance. The risk characteristics of large, complex

institutions do not fit neatly into the same statistical profiles, as do small banks. Moreover, there is information available on larger institutions that is not available for their smaller counterparts: Many of these institutions have continuous on-site supervision, are monitored by ratings agencies, and have debt and equity whose prices may reflect useful market signals about risk.

While the scoring system must accommodate these inherent differences, the FDIC does not believe it is appropriate to otherwise differentiate systematically among institutions on the basis of asset size alone in setting premiums. So, if small banks currently rated 1A -- our top insurance category -- were divided into three risk groups, large banks rated 1A should be similarly divided. In this analysis of our 1A banks, we expect about 50 percent to pay 1 basis point, 30 percent to pay 3 basis points, and 20 percent to pay 6 -- before rebates.

Rebates would be given, in conjunction with premiums, to prevent the deposit insurance fund from growing too large. We recommend gradual rebates to the industry based on past contributions to the fund.

If the example rebate system we provide in our report were in effect today, almost half of the 92 percent of banks currently in our top insurance category would pay 1 basis point for risk -- and the typical bank in this group would receive more in rebates than they would pay in premiums. To put this in perspective, the percentage of banks that would fall into the 1 basis point category roughly corresponds to the percentage of large banks with a credit rating of "A" or better. The top half of the largest 50 banking companies presently have at least an "A" rating.

So, using our example, the typical bank in this room today can expect to get back more than you pay in to the fund in today's economy. And, in today's economy, the aggregate rebate to the industry would be 1.4 basis points -- to be distributed among banks based on past contributions to the fund.

If current economic conditions continue, rebates could increase, and the percentage of banks whose rebates exceed their payments could also increase.

On the other hand, if conditions decline, banks would not be paying as much under the system we recommend. Today, average premiums for most banks would jump from zero to 23 basis points if the Bank Insurance Fund were to drop so low that lower premiums would not get its reserve ratio back to 1.25 percent within a year. If that were to happen, the law requires that we charge average premiums of at least 23 basis points.

New deposit growth combined with an increase in bank failures could cause such a drop fairly quickly-which, again, would result in high premiums limiting credit availability.

This is the second problem with the current system that we want to address-the unnecessary volatility of premiums.

Small - but steady premiums - over time would make it unlikely for premiums to climb so high during bad times.

So what does that mean for institutions such as yours specifically?

Let's look at some potential costs.

As long as the law requires us to charge 23 basis points during a downturn, we would have to do it. But if that spike could be evened out over the course of time, it would be best for everyone. In the simulations we ran using the sample pricing system in our report, a "typical" institution in the best-rated category would pay about 10 or 11 basis points in a significant downturn, rather than 23 basis points today.

Consider an institution with $50 billion in assets.

At 11 basis points, it would pay about $30 million in assessments.

And at 23 basis points, it would pay more than $60 million.

Similarly, a bank with $150 billion in assets would pay about $90 million versus $190 million -- $100 million difference.

And, given the numbers, if I were with a major institution, I would want to think about that.

But dollars-and-cents isn't the only cost-benefit to weigh in considering reform. There may also be new opportunities for the industry.

One opportunity is reinsurance. Our recommendations paper last month did not address every deposit insurance reform issue, but we believe that some of these issues merit further analysis. One of these is private sector risk-management practices, including reinsurance. In our role as insurer, we are essentially a financial institution with a portfolio of credit risks. As a result, we believe we can improve the way we manage the deposit insurance funds by drawing on private-sector risk-management practices.

We believe that the market can help us better manage risk by helping us to better price risk and assess the exposure of the insurance fund. In particular, we are looking at ways that the FDIC may enter into risk-sharing arrangements with market participants. We already have the statutory authority to do so. The Federal Deposit Insurance Corporation Improvement Act authorized the FDIC to transfer up to 10 percent of its risk exposure to market participants. Total insured deposits currently are slightly over $3 trillion, so the FDIC could conceivably transfer the exposure on $300 billion of insured deposits. Of course, if we proceed, we would start on a smaller scale with pilot projects to test different risk-sharing arrangements.

Our purpose would be to better price risk and assess fund exposure, not to lay our risk off. We recognize that the market can provide valuable pricing information because it incorporates the judgments of many individuals about events that will affect the dollars that they themselves have at risk. Market information alone is not perfect. But, combined with our supervisory information, it can be a valuable tool.

This approach has a great deal of appeal, partly because of advances that the financial industry has made in the past few years in assessing and transferring credit risk. We are exploring some of the tools currently used in the marketplace. Commercial and investments banks, insurance firms, and large commercial firms-represented by many of you in this room-use a variety of instruments to transfer risks, including swaps, structured securities, and reinsurance arrangements. These may serve as a starting point for thinking about instruments the FDIC could use to help us evaluate our risk exposure.

We have hired Marsh & McLennan to help us evaluate the possibility of reinsurance. They have put together a prospectus for us and have begun talking to reinsurers to gauge interest in selling reinsurance on our entire portfolio or some portion of it. The price we would pay for reinsurance would give us valuable information about the price we should charge the banks that we insure and the risk exposure of the insurance fund.

Reinsurance is not the only possibility, however. Perhaps the most straightforward example would be a contract in which the company to which we shift the risk agrees to pay some percentage of the FDIC's loss if a particular institution were to fail within a specified period. In return, the company would receive either an up front payment or periodic payments from the FDIC.

There might be many variations on this approach. Contracts could cover pools of insured institutions rather than individual institutions. This might give us market judgments about emerging trends or the riskiness of banks with certain characteristics, such as a concentration in consumer credit.

Again, we could come up with other variations. Many of you, I am sure, have the expertise to devise and evaluate different approaches. We've used risk-sharing arrangements over the years in the liquidation and resolution area. Our experience has taught us that well-designed and well-executed public-private partnerships can enhance the FDIC's ability to perform key functions-particularly when the functions are similar, if not identical, to tasks performed by the private sector. Assessing risk is one such function.

So there you have it. Deposit insurance reform is an opportunity. An opportunity to fix problems, but also, perhaps, an opportunity for members of the industry to explore for-profit participation in the system.

The problems won't go away. They must - sooner or later - be addressed. We have argued for addressing them sooner. Because we have an opportunity, an opportunity

that arises from the relatively good economic times we are still enjoying. Who can say how long they'll continue to last? Please think about all the opportunities I've talked about today. It is in our interests to act upon them.

Thank you.

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