Remarks by
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Thank you for the opportunity to appear before this distinguished audience at the Outreach sponsored by the Bank of Italy and the Financial Stability Forum's Working Group on Deposit Insurance. These Outreach sessions evolved from the mandate that the Working Group received from the Financial Stability Forum. These sessions represent a unique opportunity for all of us who deal with deposit insurance issues on a daily basis to learn from one another.

The Working Group has afforded the FDIC another opportunity to work with our international colleagues who recognize the vital role that deposit insurance plays in promoting financial stability. I recall that, about a year ago, J.P. Sabourin and I talked about the tremendous potential of the Working Group as the first international group to focus on deposit insurance issues. In recognition of this effort, I made the decision when the Working Group was first established to dedicate FDIC economists to chair and, along with an economist and an analyst from the Canada Deposit Insurance Corporation, staff the Working Group's Research Committee.

The FDIC's Dr. George Hanc is the chair of the Research Committee. And what a resource he is! Dr. Hanc received his Ph.D. from Columbia University and has had a long and distinguished career in financial services. I am sure that you have found him as valuable as we do. I have not been able to attend these meetings as often as I would have like to have, but I always sent you my best – and my best was George. As the U.S. delegate to the Working Group, I am gratified by the significant progress that the Working Group has made in discussing issues of vital importance to all of us, issues ranging from funding to public awareness. And I commend Jean Pierre Sabourin, Chairman of the Working Group, for the tremendous leadership he has so ably provided.

Each of us brings here today the experiences of our own country. Although our experiences differ in many ways, the Working Group has discovered that countries share many common elements. In developing guidance on deposit insurance, the Working Group is drawing upon these common elements to develop a framework that can be used by countries for evaluating whether to establish a deposit insurance system or to modify an existing one.

Not surprisingly, the first critical element that the Working Group identified was the need for countries to articulate what objectives they wished to achieve in establishing or modifying a deposit insurance system. There is an old saying: if you don't know where you are going, any road will take you there. At the end of the journey, however, you might find yourself in a destination you would rather have avoided.

In the U.S., what are our objectives?

Historically, they include: Promoting public confidence in the banking system, and protecting unsophisticated depositors.

We want to ensure that we have a deposit insurance system that will serve the public well in the next moment of crisis – an adequately funded system that will be responsive to failures and a system that reduces the potential that taxpayers will have to pick up the bill to protect depositors.

Many of the countries represented here today have identified similar objectives.

Unless a deposit insurance system is structured with clearly defined objectives in mind, it will be difficult for the system to succeed. Whether these objectives can be achieved, however, will depend upon circumstances unique to each country. The Working Group has identified the need for each country working to establish or modify a system of deposit insurance to undertake a situational analysis to assess its prevailing conditions. Through such an analysis, policymakers can identify strengths and weaknesses and pinpoint what measures need to be implemented if the deposit insurance system is to meet its objectives.

My message here today is that – to remain effective – the same type of analysis must be done if we want to keep an established deposit insurance system operating effectively.

Why?

Financial systems are dynamic. Circumstances change. Further, long-held assumptions can shift as new information emerges, and time reveals weaknesses in our earlier thinking.

There is, therefore, a clear need for ongoing evaluation and validation of the effectiveness of the deposit insurance system, which may require changes after it becomes operational.

Call it a continuous-improvement process – a process that incorporates developments in the financial system and the lessons learned from experience – a process that allows for timely changes to the system.

In the United States, events in the 1980s led to an evaluation of the effectiveness of our system. Between 1980 and 1994 many more banks were closed or received FDIC financial assistance than in any period since the advent of federal deposit insurance. This put severe, though temporary, strains on the FDIC insurance fund. The result was to raise questions about the effectiveness of the deposit insurance system and to institute far-reaching legislative and regulatory changes: a risk-based premium system; prompt corrective action that requires supervisors to close an institution before its capital evaporates entirely; and a least-cost approach to resolving failures.

The banking crises of the 1980s and early 1990s forced the U.S. to reexamine – and restructure -- our deposit insurance system.

But, nearly a decade later, we are confronted with new challenges, challenges that led us to a reexamination of the deposit insurance system.

The FDIC began such a reexamination more than a year ago. Not because we faced a crisis. But because our financial system had transformed itself dramatically from what it had been less than a decade before.

When we looked, we found weaknesses – the unforeseen and unintended consequences from decisions made years ago.

Last year we began a process to review our system by issuing an Options Paper that discussed those weaknesses and offered possible solutions.

And earlier this month, after completing a lengthy review of the advantages and disadvantages of the possible solutions, and after extensive outreach efforts, the FDIC issued recommendations to the U.S. Congress for reforming our deposit insurance system.

Because they may be important to deposit insurers in other countries, I want to discuss two issues that arose out of our review.

The first issue concerns the funding of deposit insurance, particularly how different funding systems may serve to aggravate the business cycle. The second issue concerns the pricing of deposit insurance, particularly how different pricing systems can help to control moral hazard.

With respect to the first recommendation, the Working Group's paper on funding pointed out that, to be effective, a deposit insurance system should include the mechanisms necessary to ensure that adequate funds are available to reimburse depositors promptly. Funding arrangements will also affect when and by whom the costs of deposit insurance are borne. As you know, different countries have different funding arrangements—ex-ante in some countries, ex-post in others, and a combination of the two in still others.

In the case of the FDIC, funding is obtained on an ex-ante basis from premiums paid by insured depository institutions. This arrangement is supposed to build up the fund when the economy and the banking system are strong, so that funds will be available to meet failure costs when the economy turns down and the banks are under strain. Such a build-up is particularly important in the United States because bank failures are likely to come in waves, along with serious downturns in the economy.

Under our present system, however, banks are likely to be faced with steep increases in deposit insurance premiums in an economic downturn when their earnings are already depressed. Such premiums would divert billions of dollars out of the banking system and would raise the cost of gathering deposits at a time when credit would already be tight. This, in turn, could cause a further cutback in credit, resulting in a further slowdown of economic activity at precisely the wrong time in the business cycle. By contrast, when the economy and the banking system are strong, as at the present time, most banks are paying no premiums at all.

This anomaly results from existing legal restrictions on the size of the deposit insurance fund. Currently, the FDIC is required to maintain its deposit insurance fund at a statutorily designated reserve ratio of 1.25 percent of estimated insured deposits. As a result, when the fund is at or above its targeted level, the FDIC is constrained from charging premiums to well-capitalized institutions. Currently, over 90 percent of the institutions insured by the FDIC pay no premiums. When the fund is below 1.25 percent, on the other hand, premiums may have to be increased sharply in order to restore the fund rapidly to the 1.25 percent level.

We are recommending that the FDIC have greater flexibility in charging premiums over the business cycle to smooth premium swings over time. The FDIC should be permitted to charge premiums regardless of the size of the fund. To avoid enormous growth of the deposit insurance fund during long stretches of good years, it may be prudent to give rebates to insured institutions. Basing rebates on current deposit levels would exacerbate moral hazard – the faster you grow, the larger the rebate. Instead we recommend that these rebates be based on the past contributions of insured institutions to the fund.

The net effect of these recommended changes is that when the fund is below the target, premium payments would increase gradually to restore the fund to the target level. And when the fund is above the target, rebates will be paid to the banks in order to bring the fund gradually back to the target. The outcome of this process is that the deposit insurance fund would fluctuate within a targeted range over the business cycle. Stated briefly, we want to change our funding arrangements to make sure that they do not exacerbate the business cycle.

The second issue I would like to discuss concerns the pricing of deposit insurance to reflect differences in risk among insured institutions. Properly designed, risk-based premiums may discourage excessive risk-taking by insured institutions by increasing their premium assessments and therefore reducing moral hazard by linking their assessments to the risk that they pose. Ideally, risk-based deposit insurance premiums should be designed to reflect the expected loss posed by an individual institution to the deposit insurer, or to differentiate among institutions' risk-profiles in some manner.

Although there is wide agreement that relating deposit insurance premiums to the risk that an institution poses to the insurance fund is a good idea, risk measurement is a difficult task. The potential difficulties involved in the design and implementation of a risk-based premium system include: finding appropriate and acceptable methods of differentiating institutional risk; obtaining reliable and appropriate data; ensuring transparency; and examining the potential destabilizing effects of imposing high premiums on already troubled banks. In large part because of these difficulties, numerous countries have decided not to implement risk-based premiums.

In the United States, the FDIC is in the process of improving our risk-based premium system. We are aided in this task by our access to vast amounts of data from the institutions we insure. In addition, for large banks, market data represent additional information on which to base risk assessments. However, our ability to charge risk-based deposit insurance premiums to all insured institutions is constrained by the same restrictions on the size of the deposit insurance fund that I mentioned earlier. The effect of these restrictions is that currently most banks pay the same rate—zero—even though they differ considerably in their risk characteristics. As I noted earlier, the FDIC should be able to charge premiums on the basis of risk, regardless of the level of the fund.

So there you have it. As the Chairman of the FDIC and the U.S. delegate to the Working Group, I have had the unique opportunity to apply the principles articulated by the Working Group in the reform effort underway in the United States. I look forward to completion of the Working Group's efforts and believe that the guidance that will result will prove to be useful to all countries, regardless of the state of development of their deposit insurance system – to those starting up – and to those, like the U.S., who are reexamining their systems for changes and improvements.

As you know, the FDIC has a continuing commitment to working internationally, as our commitment to – and support of – the work of the Working Group shows.

In fact, in recent years the FDIC has been expanding its international activities.

Established in 1933, the federal deposit insurance program of the United States is the oldest continuous national deposit insurance program in the world. We have been through much: depressions and recessions . . . the failures of thousands of institutions . . . structural transformations of the banking industry.

As FDIC Chairman, I believe that we at the FDIC have an obligation to make our experience and expertise available to colleagues around the world – a world growing ever smaller and interdependent. Whatever affects one of our countries will – to a greater or lesser degree – affect all of us. For the United States, economic dislocations half the world away can have implications for our businesses and workers. It is in our interest – as well as the interest of all – to establish and promote close working relationships among the world’s deposit insurance authorities.

In the past few years, deposit insurance authorities around the globe have been working toward establishing an international framework that will benefit us all.

We’ve come a long way, indeed.

In September 1998, the FDIC hosted an international conference on deposit insurance issues. It was attended by representatives from 63 countries. Some of you here today came to Washington, D.C., for that conference. Then in 1999, the FDIC worked with the Financial Stability Institute to develop a deposit insurance program for developing countries, which was subsequently presented in Basel, Switzerland, in May 2000.

Also, in 2000, the FDIC dramatically increased the number of foreign visitors that we hosted through our International Visitors Program. In fact, today ends our first three-day training program for foreign visitors – 41 students from 18 countries are participating in the program in Washington. Highly experienced FDIC staff teach the students about bank supervisory structure, resolving bank failures and, yes, deposit insurance. The program is offered twice a year – the next program will be in October. And, last year we sent FDIC representatives on 20 technical-assistance missions to 12 countries – missions for which we were reimbursed. Among those countries were Korea, Indonesia, Bulgaria, Panama and Poland.

Your work is vitally important – not just to the people in your own country, but to people in every country. We recognize that, when we work together, we all benefit.

Thank you.

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