Remarks by
Donna Tanoue
Chairman
Federal Deposit Insurance Corporation
Before The
Government Affairs Conference
America's Community Bankers
Washington, D.C.
April 4, 2001

Good morning.

As many of you know, tomorrow the FDIC is planning to issue our formal deposit insurance reform recommendations. We will send the recommendations to Congress and begin the next stage of discussions with lawmakers and bankers alike on how best to make the necessary changes to the US deposit insurance system.

The reform measures we are recommending will ensure that the system continues to serve the country well -- and to see that it remains one of the world's strongest and most respected, particularly in times of economic stress. It is a very important fact that when hundreds of banks and thrifts failed in the 1980s and early 1990s, deposit insurance acted as the anchor for public confidence in the banking system.

The reform effort could not come at a better time, either -- positioned as we are between a past of unprecedented prosperity and an uncertain future. We need to address the weaknesses in our system now, while the industry is strong and healthy and can make the necessary adjustments without a great deal of pain.

The FDIC has six core recommendations:

- *eliminate the fixed 1.25% reserve ratio target*
- *price insurance to be risk-adjusted, but less volatile*
- *establish an adjustment or rebate to shrink the fund when it gets too big*
- *base that rebate on past contributions to the fund*
- *index insurance coverage to reflect inflation, and*
- *merge the BIF and SAIF*

Tomorrow, you will hear about the details and figures of our reform proposal. And, as you consider our reforms, I'd like you to ask yourselves the following questions.

I know that, for most of you -- a staggering 92 percent of insured institutions, in fact -- the key question is, What is an improvement over paying "zero" for deposit insurance, as you do today?

Let me tell you what the improvements are.

First, if we don't make changes to the system, someday you may see your premiums jump from zero to 23 basis points. If your insurance fund falls below the 1.25% reserve ratio, and is not replenished within a year, insured institutions would face an average 23 basis point premium until the fund is recapitalized.

For the fund to drop like that, it is probable that the economy would be in a slump and your earnings, already down. And those 23 basis points would be a blunt instrument that does not differentiate among banks that paid into the insurance funds over the years and those that did not. In addition, it would not differentiate among institutions that took significant risks in the marketplace and those that did not.

Here's something else -- something you know too well - More institutions are joining the banking system and discovering the benefits of a zero deposit insurance premium. The well publicized sweeping of brokerage accounts into insured deposits is an example of incentives at work - I refer to the incentives that a zero premium can provide.

Large institutions are sweeping billions of dollars from uninsured accounts without paying premiums for the significant additional coverage. This puts the fund at greater risk and could contribute to a dilution of the fund reserves large enough to trigger premium payments by all.

Let me stop a minute and talk about the prospects for new premiums, since there has been a great deal of confusion and speculation over this.

The FDIC is NOT projecting that the reserve ratio will fall below 1.25 any time soon. Certainly, we all are aware of scenarios involving combinations of the strong deposit growth that I just mentioned and high insurance losses that could drive the reserve level below the target. This has been true for some time.

While this is possible, we do not foresee it today. The industry is strong, deposit insurance losses over the near term are expected to remain low, and while deposit growth has picked up, it is not approaching a rate that would cause such a sharp decline in the reserve ratio.

That said, a second question I'd like you to ask yourselves is, *What is really happening to the reserve ratios?*

They have been treading water since at least 1997. The preliminary data for year-end 2000 show BIF at 1.35 percent. The preliminary year-end reserve ratio for SAIF is a little better, at 1.44 percent.

I know many bankers think those ratios are high -- 10 points of cushion for the BIF and 19 for SAIF. But let me share some trends that could make the cushions look a lot smaller in the future.

First, the Deposit Growth Rate -- The reserve ratios are sensitive to the growth rate of insured deposits. I mentioned that some large institutions are bringing in deposits. Others are figuring this out, too. And it's not only the BIF -- we know that some are being set up with SAIF as well. And this does have an affect on the reserve ratio.

Holding everything else constant, for example, $100 billion in new BIF-insured deposits would reduce that cushion by about 6 basis points.

Second, the Failure Rate -- Failure rates rise in tough economic times. But even in the good years we've had lately, we've seen some of our most expensive failures. If reserve ratios are steady in the good times, they will almost certainly go south in the bad times.

The BIF cushion as of year-end 2000 was about $2.2 billion. And the SAIF cushion was $1.5 billion. A slowing economy, unanticipated and expensive bank failures of the type we have seen in recent years, deposit growth - these factors could combine under unfavorable, but far from unimaginable, circumstances to eliminate either cushion in the future.

This is why the FDIC recommends a price structure that eliminates the so-called "free rider" problem of free deposit insurance.

A third question to ask yourself is, Do you care about volatile premiums?

That's essentially what we have today. It's like an on-and-off switch -- and when it's on, it will be during the worst possible time for banks and thrifts to have another big bill to pay.

A year of 23 basis points for a bank with $100 million in deposits would cost $230,000. It would be more than 10% of pre-tax revenue. The effect would be disproportionately large for community banks' earnings, since they rely more on deposits to fund their assets than do larger banks.

That's why we recommend low, steady premiums from even the best institutions. We propose to reduce premium volatility by getting rid of the fixed 1.25% target, allowing the fund level to rise and fall gradually.

A fourth question: Do you care about risk-based pricing?

Of course you do. You use it in your own business when you lend money at different rates depending on the riskiness of the borrower. It's just as important to pricing deposit insurance as it is pricing your loans.

Under our current system, you are going to write the check for the high flyers because when premiums do kick in, the healthiest institutions - the survivors -- will subsidize everyone else.

That's why we recommend that insurance pricing be more sensitive to the risks posed by each institution to the fund.

Let me hasten to add that our pricing reforms are not designed to increase the assessment burden on the industry and raise additional revenue for the insurance fund. That is not the goal. Rather, our reforms are intended to spread the assessment burden more evenly over time and more fairly across institutions.

So -- if we are going to collect premiums and let the fund level fluctuate, we recognize that there is the potential for the fund level to drop too low or get too high. Therefore, we recommend that a surcharge be added to premiums when the fund is too low and that rebates be paid back to the industry when the fund is too high.

We will also recommend that the rebates be based on past contributions to the fund. This will allow old money to be replaced with new money in the fund. And institutions that have paid no premiums into the fund will not get rebates while they build up their contributions to the fund over time.

We think bankers and depositors will be better off with the implementation of the FDIC reforms. In some ways, the answers to these questions tell the story:

- *What is an improvement over paying "zero" for deposit insurance?*
- *What is really happening to the reserve ratio?*
- *Do you care about volatile premiums?*
- *Do you care about risk-based pricing?*

One final point -- We have heard from many bankers that they are particularly upset by the effects of fast growing institutions on the insurance funds. Our reform proposal addresses this in three ways: removing the 1.25% rigid target would prevent deposit growth from triggering steep premiums for everyone; collecting risk-based premiums from all institutions would require fast growers to pay their fair share; and rebates based on past contributions would prevent the system from inadvertently rewarding banks only because they are bigger.

However, it is important to note that this trend in fast growth and large scale sweeping of funds into insured deposits is probably here to stay -- and it is "banking," too. So, we should charge for it -- but we should not impose a penalty for it.

Singling out specific types of institutions for special fees or costs, as some have proposed, has the effect of being arbitrary -- since every new deposit dollar from every insured institution dilutes the fund. It also creates a system that is susceptible to gaming -- as business-organization decisions are made only to get around the extra fees.

This is an example of why the FDIC cannot endorse a piecemeal approach to reforming the system. Only a comprehensive approach to pricing can maintain fairness and prevent the unintended consequences of only doing half the job.

And, as you heard Charlie Cook say this morning about the challenges of a 50/50 split in the Senate, progress on this reform effort is going to require consensus-building. We believe that a consensus can be developed around our approach. We will have to work together -- regulators, lawmakers and bankers -- to make this happen.

Thank you.

***

Last Updated 04/05/2001