Remarks by
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Good morning. A year ago, in front of this gathering, I announced that the FDIC would be undertaking a comprehensive review of the deposit insurance system. We looked at the deposit insurance system and found three fundamental problems that needed correcting.

Deposit insurance was crudely priced.
We were charging for deposit insurance at the wrong point in the business cycle.
And the value of insurance coverage was shrinking over time.
Now, the FDIC insures some $3 trillion in deposits. Operating a program of that magnitude has certain costs, and much of what I have to say relates to how those costs are allocated. We do not see deposit insurance reform as a revenue-raising exercise. Let me explain.

The cost of operating the insurance system should be spread out across insured institutions. However, today it is financed by the subset of the industry that existed prior to 1996. We should collect premiums in good times that cover losses in bad times. But now we collect most of the costs when times are bad. And, on the matter of insurance coverage for bank customers, the value of deposit insurance should be predictable and reliable -- and approximate the effects of inflation on American savings.

Yet changes in value have been large and sudden. We do not think this is the way FDIC insurance should work.

In a few weeks, the FDIC will issue our recommendations for reform. We believe these reforms are necessary to make our system stronger, more efficient, and better able to meet the future needs of Americans.

One need only look at the Bank Insurance Fund itself to see how these problems affect you. Despite the economic boom we've all enjoyed, the BIF reserve ratio has been treading water since 1997. And our preliminary data show it at 1.35 percent of insured deposits at the end of the year 2000 -- 10 basis points above the legal requirement.

That sounds like a big cushion. But it can disappear - and disappear rapidly in today's uncertain and fast-moving market economy. The insurance system then would revert to the way it collected premiums and recapitalized at the height of the S&L crisis.

It doesn't have to be that way. A year ago I spoke to you about the importance of reform and quoted the old adage: Fix the roof when the sun shines.

Well, in most ways the sun is still shining on our deposit insurance system. But we can see some clouds on the horizon. If they darken and grow - if they come together - the banking industry may end up paying premiums for deposit insurance like those premiums you paid in the early 1990s.

Looking out at the horizon, one concern we have is the condition of the banking industry - and what worsening conditions could mean in increasing bank failures. As it happens, today the FDIC is releasing our fourth-quarter and full-year earnings results for the commercial banking industry.

The numbers show a continuation of recent trends. Specifically, the vast majority of banks remain highly profitable, and their performance indicators remain strong. While bank earnings in 2000 were a mixed picture, more than two out of three banks reported higher earnings.

Some of the factors that have helped to sustain the string of record industry earnings -- low expenses for credit problems, strong growth in noninterest revenues, and a steady contribution from net interest income -- are still evident in the most recent data.

Times are still good. Nevertheless, signs of stress are emerging. A few large banks continue to struggle with asset-quality problems, and their difficulties are reflected in industry totals. As a result, for the first time in nine years, banking industry earnings did not set a new annual record in the year 2000. Commercial banks earned $71.2 billion in 2000, a decline of $380 million -- or one-half of 1 percent -- compared to their earnings in 1999.

Problems in commercial and industrial loans have been limited to a few large banks but the severity of these problems has been increasing. Growth in noninterest revenues, especially those that are sensitive to conditions in the stock and financial markets, lost some of its momentum in the past year. But banks have managed to sustain increases in net interest income in the face of declining net interest margins, thanks to rapid growth in interest-earning assets, particularly loans.

The recent slowdown in the economy casts doubt on banks' ability to sustain recent growth rates in the face of softening loan demand. The distant cloud is a reminder that good times don't last forever. When bad times return, more banks will naturally fail. If banks fail in greater numbers, the insurance fund will decline.

What could these dark clouds do to the insurance fund? Even in these good times, the BIF reserve ratio I just described has been basically unchanged since 1997. Therefore, in bad times, the BIF has no where to go but down.

Looking out over the horizon, a second concern we have - and one nearer and clearer - is the effects of the inflow of new deposits covered by the insurance program, without any corresponding payment for that coverage - the so-called "free-rider" problem. This inflow is not new. It has been occurring over the past five years. It was more pronounced than ever last year -- deposits grew at 6 percent - compared to a historical growth of 3 percent annually in recent years. And the inflow of deposits may continue - in various ways - as new products come on line.

While this deposit growth is a successful and legitimate activity, there is no denying that, over time, it could contribute to a large enough dilution of reserves to trigger premium payments by all banks.

Let me be clear: Under the current law, when the BIF falls below 1.25 percent, if it is not replenished within a year, the entire industry will be facing steep 23 basis point premiums. The entire industry.

So there you have it. Is this situation fair? Is it efficient? The possibility of upticks in bank failures from a cooling economy and the growth of deposits make the need for deposit insurance reform ever more pressing. If we find ourselves in a confluence of events - a slowing economy, expensive bank failures and significant deposit growth - the cushion in the BIF can disappear. And -- if 23 basis point premiums kick in -- the surviving institutions will end up paying for the high fliers.

What should we do?

By the end of March, the FDIC will release our recommendations for reform. It is a coordinated plan for improvement, and it will detail how our proposal may affect you in dollars and cents.

A year ago, I raised the issue of deposit insurance reform at this convention, and today I'd like to give you a preview of our recommendations, which should be viewed as a comprehensive package.

- First: Merge the BIF and the Savings Association Insurance Fund. We cannot rationalize the deposit insurance system without eliminating the incongruous requirement to maintain two separate funds.
- Second: Eliminate the "hard target" reserve ratio of 1.25 percent. Instead, we could maintain the reserve ratio within a more flexible target range.
- Third: Price insurance to be steadier -- less volatile -- over the business cycle.
- Fourth: Price insurance more closely to the risk an institution presents - rewarding the safest institutions over time.

- Fifth: Establish an adjustment or rebate to work in conjunction with this more flexible reserve ratio. Adjustment rules could provide for a gradual return to the midpoint of a range and some flexibility to adjust to changing conditions.
- Sixth: Index deposit insurance coverage levels to an appropriate base year of the Consumer Price Index.

First, merging the funds. That's no surprise. We've urged a merger for years. It is the only way to assure that you are not paying 23 basis points for deposit insurance while your competitor across the street is paying nothing.

Second, eliminating the "hard target" reserve ratio. The current situation is like an on/off switch. Premiums are very high - or they are zero for almost all banks. And that makes the down side of the business cycle worse. Eliminating the hard target would allow the insurance fund to absorb losses in bad times, so that earnings and capital are not drained from banks when they are needed the most -- and when bank lending is needed the most.

On pricing, if we are going to draw down the fund in bad times, it means that we must build it up in good times. And that means charging some premiums. Steadier premiums would allow you to plan and manage better. Which brings me to tying premiums more closely to risk.

Under our current system, the safer institutions subsidize those taking more risk. And that's not the way the system should work. If premiums were to be paid on a regular basis, risky banks could be required to shoulder more of the costs of deposit insurance - making the system fairer, and bringing in greater discipline. We're looking at risk-differentiation systems involving CAMELS ratings, financial ratios, and whether a bank is new or exceptionally fast-growing.

Now, we understand the concerns of those who suggest that there should be some sort of safety valve on the fund to prevent it from becoming too large. This could be done in a number of ways. One way would be to make an adjustment - call it a rebate. This adjustment could be larger, the larger the size of the fund. And the adjustment could be based on past contributions to the fund. One virtue of this approach would be that the institutions that have paid the most into the fund would get the most back.

Taken together, we believe our recommendations for pricing and funding will help manage the impact of new deposit growth in a fair and equitable way. How? Eliminating the hard target would remove the specter of 23 basis-point premiums, the most tangible threat from new deposits. In addition, regular risk-based premiums would mean that fast growers would pay for bringing new deposits into the system. Also, if there is an adjustment based on past contributions to the fund, those banks that build the fund would benefit. Over time, "new money" would replace "old money."

Lastly, let me talk about insurance coverage levels. We think indexing is a good idea because it can increase predictability for bankers and depositors, decrease instability, and lessen the potential for overreacting in times of stress with very large and sudden increases.

We're not alone. In a recent survey we commissioned from the Gallup Organization, 77 percent of the respondents agreed that the coverage limit should keep pace with inflation.

Indexing is the best way to make sure the limit does so. And we think using the CPI is appropriate. It captures inflation reasonably well. It is widely understood and accepted. And it is quickly available.

Of course, indexing raises the question of where to set the base - that is to say, with what year do we start? We know this is an important issue to community bankers. We know that getting the coverage level right helps you to better serve your customers, as depositors and as borrowers, by having more funding available to them.

This is fundamentally a public policy question that will be discussed at length in Congress. In short, our recommendations will make the deposit insurance system stronger. They will make the system fairer. And they will allow banks more flexibility to serve the credit needs of communities throughout the business cycle. In doing so, they will ensure that the system that has served the American public well in the past will continue to serve the American public well in the future.

The window of opportunity is still open for us to accomplish these ends. We need to act on that opportunity - and act now. If we act now, we will create a strong shelter for whatever storm may come.

Thank you.

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