# Remarks of
# Martin J. Gruenberg, Vice Chairman, Federal Deposit Insurance Corporation (FDIC) on The International Role of Deposit Insurance
**The Exchequer Club,**
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Good afternoon and thank you for inviting me to speak today. It is a great privilege to be here.

Many of you, I know, have been involved in financial services issues for a long time. I think we would all agree that the recent developments in the credit markets are rather extraordinary. Any one of a number of developments could be the topic of a speech – the collapse of underwriting standards in the subprime mortgage market, the transmission of that credit risk to investors around the world through the rapid growth of securitization, the role of the credit rating agencies in the assessment of the risk of securities backed by those mortgages, the exposure of some of our largest financial institutions to those securities, the liquidity issues created for financial institutions dependent on mortgage-backed securities for their funding, and the challenge of avoiding foreclosure for the hundreds of thousands of homeowners with subprime mortgages they cannot afford to pay. These are all critically important issues.

As the Vice Chairman of the FDIC, there has been a particular development in this still evolving credit market experience that has caught my attention and that I wanted to discuss with you today. The development is the heightened appreciation of the role of deposit insurance in maintaining financial stability during times of economic stress. The UK experience with Northern Rock, Britain's fifth largest mortgage lender that was the object of a bank run, illustrates, I think, the need for effective systems of deposit insurance to maintain public confidence in financial institutions, especially during times of economic uncertainty. It also illustrates the growing important international dimension of deposit insurance systems.

I would like to take this opportunity today to speak to you about the role of deposit insurance in maintaining financial stability, the expansion of explicit systems of deposit insurance to countries around the world, and the FDIC's efforts to bring about greater cooperation among those systems and to enhance their effectiveness.

## The U.S. Deposit Insurance System

The first national deposit insurance system in the world was the FDIC. It was created in 1933 during the Great Depression to restore public confidence in the U.S. financial system and to protect small depositors. At the time of its creation, the U.S. was in the midst of the largest financial crisis in its history. During the first few months of 1933, 4,000 U.S. banks suspended operations. Bank runs had become commonplace and President Roosevelt was forced to impose a national banking holiday. The issue of the moment was how to restore confidence in the banking system.

When the FDIC was created, there was no national system of deposit insurance in the world. President Roosevelt actually opposed its creation, even threatened to veto the legislation that was to create the FDIC. He was concerned about the moral hazard that can occur when protection extended to depositors makes them less diligent in the selection and monitoring of their banks, and makes banks less careful in their lending practices. Banking industry groups also opposed the FDIC's creation because they were concerned about the premiums their members might have to pay.

But the American public demanded a system of deposit insurance that would provide a safe place for people to put their money. The public had experienced widespread bank runs and did not want to have that experience again. Broad public support overcame the obstacles to the creation of the FDIC.

Without a doubt, the FDIC helped restore public confidence in the U.S. financial system. In 1934, the year after the FDIC was created, only nine banks failed compared to 4,000 bank closures during the nine months prior to its creation. Deposit insurance effectively ended bank runs in the U.S. The FDIC is widely viewed as one of the most successful legacies of that era, and remains highly relevant to the challenges facing the U.S. financial system today.

**The International Expansion of Deposit Insurance**

I would now like to discuss briefly the expansion of deposit insurance systems to other countries around the world since the creation of the FDIC.

At the start I should point out that I am talking about the expansion of explicit systems of deposit insurance. Experience indicates that all countries have some form of deposit insurance, explicit or implicit. When a financial crisis develops and bank depositors begin to withdraw their funds, governments typically take steps to protect depositors to stop banks runs and restore public confidence. The issue is whether the country has a defined, explicit system or not.

By definition, implicit deposit insurance systems create uncertainty about how depositors and other interested parties will be treated in the event of a bank failure. This uncertainty can undermine financial stability during times of stress. It can result in the government having to resort to blanket deposit insurance coverage, which tends to generate the most costly funding issues and the most severe form of moral hazard.

A well-designed, explicit deposit insurance system that is understood by the public is likely to be the most effective in helping to prevent bank runs, limiting the severity of financial crises and the resolution costs of bank failures, and contributing to overall financial stability.

The first country to create a deposit insurance system after the United States was India, which established its Deposit Insurance and Credit Guarantee Corporation in 1961. Interestingly, India first considered the notion of insuring bank deposits in1948 following a banking crisis in Bengal. The prospect was considered but held in abeyance for over a decade, until the failure of two large banks in 1960 led to the passage of India's Deposit Insurance Act creating the Deposit Insurance and Credit Guarantee Corporation the following year.1

The adoption of explicit deposit insurance systems around the world has steadily increased since the 1960s. By 1970 there were 10 countries with explicit deposit insurance systems, by 1980 there were 18, by 1990 there were 36, and by 2000 there were 70. Today, over 100 countries either have, or are considering or planning, deposit insurance schemes -- virtually every major economy in the world.2

Moreover, the pace of adoption of explicit deposit insurance systems around the world has accelerated in recent years, as many countries moved to establish systems after experiencing their own financial crises, or witnessing crises in other countries.

The Mexican peso crisis in the early 1990s served as an impetus to the adoption of deposit insurance systems in Central and South America. The Asian financial crisis in 1997 led to the establishment or strengthening of deposit insurance systems in Asia. A number of African countries established systems of deposit insurance to strengthen financial stability and depositor protection. In 1994, the European Union adopted a directive requiring the establishment of deposit guarantee schemes in its member countries. The fall of the Soviet Union led many countries in central and eastern Europe to establish systems of deposit insurance as part of their financial regulatory reform programs.

The FDIC has been engaged for many years in providing training and technical assistance to countries around the world seeking to establish or strengthen their systems of deposit insurance.

China, for example, has been working for some time to establish a deposit insurance system as part of efforts to strengthen its banking sector. The FDIC has on two occasions hosted groups of Chinese officials for four day training sessions on the establishment and operation of a deposit insurance system. In August the FDIC entered into a Memorandum of Understanding (MOU) with the People's Bank of China (PBC), which has taken the lead in establishing a deposit insurance system in China, to exchange information and technical assistance. We hope this will contribute to the successful establishment of a deposit insurance system in China.

In July, the FDIC hosted a four day training program on deposit insurance under the auspices of the International Association of Deposit Insurers that was attended by representatives of over 20 deposit insurance agencies from around the world. We anticipate offering that program on an annual basis.

Other countries with deposit insurance systems under study, planned or pending include South Africa, Thailand, Egypt, Bolivia, Costa Rica, and New Zealand.

**Key Features of Effective Deposit Insurance Systems**

Despite the variations in deposit insurance systems internationally, experience has shown that there are some general principles that can maximize the effectiveness of deposit insurance in promoting stable banking systems. The specific design features that work best will vary from country to country, but these key challenges always have to be addressed.

First, the deposit insurance system should function within a suitable legal framework with appropriate accounting rules, prudential bank supervision, and consumer protections.

Second, the deposit insurance system should be well understood by the public. Public awareness of the deposit insurance program is essential for its effectiveness.

Third, the deposit insurance coverage provided by the system must be adequate to provide assurance to most depositors.

Fourth, the process for closing banks and promptly paying depositors and other claimants must also be efficient and clearly understood.

Fifth, the deposit insurer must have access to information on insured institutions as necessary to monitor risk exposure.

Sixth, most successful deposit insurance programs include reliable funding sources for timely action in the event of bank failures.

Seventh, a deposit insurance system should establish standards for institutions to qualify for insurance such as capital, internal controls, and sound risk management.

Finally, the deposit insurance system should have strong corporate governance.

The Northern Rock experience in the UK suggested the importance of two key elements of an effective deposit insurance system. First, UK depositors were only fully covered up to 2000 pounds and then for 90 percent of the next 33,000 pounds. As a result, many if not most depositors stood to lose some money if a bank failed in the UK. Second, depositors were apparently concerned that their insured deposits would take up to six months to be paid due to the UK's deposit insurance funding scheme.

As a result, the UK extended full blanket coverage to all Northern Rock depositors. The UK subsequently increased full deposit insurance coverage nationally for all banks to 35,000 pounds.

Now the UK government is considering reform of its deposit insurance scheme. It has released a discussion paper and is soliciting responses to a series of questions it has raised regarding deposit insurance.3

These developments are a reminder that a well designed system of deposit insurance, coupled with an effective system of prudential bank regulation, are the most effective means of maintaining public confidence and financial stability during times of stress.

**The Role of IADI**

I would like to conclude by commenting on the International Association of Deposit Insurers (IADI) and the role it plays in strengthening the operation of deposit insurance systems around the world.

IADI was established just five years ago in 2002. It emerged from a Working Group on Deposit Insurance sponsored by the Financial Stability Forum of the Bank for International Settlements (BIS). The purpose of the Working Group was to develop guidance for effective deposit insurance systems. The FDIC was a member of that Working Group and joined in the effort, after the submission of the Working Group's report, to establish an International Association of Deposit Insurers to serve as an ongoing forum for deposit insurance agencies to exchange views, share experiences and expertise, and provide guidance, technical assistance, and training. As Ron mentioned in his introduction, the FDIC earlier this month assumed the leadership of IADI, and it is my privilege to carry out that responsibility on behalf of the FDIC.

IADI currently has 48 member agencies and twenty affiliated organizations with representation from Asia, Africa, Europe, North, Central and South America, and the Middle East. Major objectives will be to expand membership to all the deposit insurance systems of the world, expand and strengthen training and technical assistance to enhance the effectiveness of member agencies, and develop core principles for the effective operation of deposit insurance systems that will become widely accepted and implemented.

Next year will be the 75th anniversary of the creation of the FDIC, the world's first system of national deposit insurance. I think recent events underscore the wisdom of that decision, and the continuing relevance and importance of effective systems of deposit insurance in maintaining financial stability in today's global economy. The FDIC is strongly committed to playing a leadership role in strengthening the operation of deposit insurance systems around the world and facilitating greater communication and cooperation among them. We believe the International Association of Deposit Insurers has an important contribution to make to that effort.

Thank you very much.

1 Deposit Insurance and Credit Guarantee Corporation website; see http://www.dicgc.org.in/index.htm.

2 Gilliam G. H. Garcia, "Deposit Insurance: A Survey of Actual and Best Practices," International Monetary Fund Working Paper, 1999; Asli Demirguc-Kunt and Tolga Sobaci, "Deposit Insurance around the World," The World Bank Economic Review, Vol. 15, No. 3, 2001; Asli Demirgus-Kunt, Edward J. Kane, and Luc Laeven, "Determinants of Deposit-Insurance Adoption and Design," World Bank Policy Research Working Paper, February 2006; and IADI, www.iadi.org.

3 HM Treasury, Financial Services Authority, and the Bank of England, "Banking Reform – protecting depositors: a discussion paper," October 2007.

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