Remarks by
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I'm here today to talk with you about the deposit insurance funds -- and about three issues involving deposit insurance: The first issue is preparing computer systems for the Year 2000 date change. The second is emerging risk. And the third is refinements that we are considering in the risk-based premium system.

I am pleased to report to you that the Savings Association Insurance Fund has a record balance of $9.7 billion, and the Bank Insurance Fund has a record balance of $29.1 billion.

Today, 92 percent of the members of the Savings Association Insurance Fund are in the best capitalized and best managed category of institutions in our risk-based premium system. That means that 1,354 institutions pay no premiums into the SAIF for insurance coverage.

Today, 95 percent of the members of the Bank Insurance Fund are in the best or "1A" category. That means that 8,808 institutions pay no premiums into the BIF for insurance coverage.

In recognition of the strong financial condition of the banking industry, the FDIC Board of Directors a few weeks ago voted to maintain the current assessment rates for both funds during the first half of next year -- welcome news for all of you, I'm sure.

With that background on the funds, let me first address the Year 2000 date change.

The FDIC and other regulators are working hard to ensure that financial institutions are minimizing the potential for Y2K disruptions. As you all know, examiners have made on-site assessments of progress toward Y2K readiness at every bank and savings institution in the country. And we are currently visiting banks and savings institutions a second time.

In turn, the banking industry is taking aggressive steps to make sure your computer systems will function properly after January 1, 2000. Most bankers have taken the challenge of Y2K as seriously as the regulators have. And it is widely reported that the banking industry is one of the leaders in preparing computer systems for the date change.

As of July 31, 1998, 94 percent of all FDIC-insured institutions were making satisfactory progress toward achieving Year 2000 readiness, five percent were rated "needs improvement", and less than half of one percent -- 37 institutions out of 10,092 -- were rated "unsatisfactory". Nevertheless, more must be done: the critical steps of testing systems and contingency planning.

In our current assessments, examiners have found some manageable deficiencies. Among them were poor documentation of test plans and poor preparation of contingency plans.

When presented with our findings, bankers for the most part have addressed the problems willingly. But don't wait until the examiners arrive -- you will save time and effort if you look for problems yourselves.

Some questions have arisen about the services that banks -- indeed all of us -- rely on: the utilities and the telecommunications companies, for example. In particular, will these industries be in shape to provide the needed service come January 1, 2000?

On December 3rd, there will be a Trade Association Summit Meeting of representatives from these "infrastructure" industries in Washington to discuss their readiness. The meeting will be hosted by the Financial Institutions Sector Group of the President's Council on Year 2000 Conversion, and underwritten by the FDIC and the Fed. The focus of the meeting will be on Year 2000 issues relevant to financial institutions -- current developments with respect to Year 2000 readiness of the domestic infrastructure, specifically the telecommunications and energy sectors. The audience for this summit will be the financial industry trade groups, who will, I'm sure, share the information disseminated at the meeting with their members.

The FDIC is addressing another potential problem that might arise from the date change. There are no uniform industry requirements for data retention for insured financial institutions. Current disaster recovery plans may be insufficient in addressing specific Y2K data problems.

One step the FDIC is contemplating to address this problem is requiring minimum data backup and retention of a small number of key financial data by all insured financial entities. Doing so would provide a financial institution the basis for mission critical data reconstruction. And it would enable the FDIC to meet its deposit insurance obligations and ultimately resolve institutions, if that becomes necessary. It should be noted that the retention plan is being considered as an interim procedure with a limited life expectancy of just a few months.

The second issue I want to discuss with you is emerging risks. The warning signs are clear: Stressed economies in Asia, Eastern Europe, and Latin America. Reduced demand for our exports. And low agricultural prices that are stressing farm income. We are taking these trends seriously. And we are telling our examiners to keep them in mind.

Another emerging risk we are taking seriously is the risk arising from subprime lending. Like any other form of lending, subprime lending can be done safely with appropriate controls and diversification. However, as you know, some institutions have recently gotten in trouble with subprime lending because of a lack of controls and a concentration of lending.

We know of about 160 institutions that are, to some extent, involved in subprime lending at either the bank level or through a subsidiary. About 17 percent of the banks on our problem institution list and 7 percent of the banks rated A3" have some involvement in subprime lending -- although in many cases it is not the sole or even principal cause of their problems.

Eighteen months ago we issued guidance to the industry on subprime lending. And the FDIC is working with the other regulators on additional guidance to assure that subprime lending is handled in a safe and sound manner.

Thirdly, I wanted to talk with you about refinements we are making in our risk-based premium system. As you know, the reasoning behind our system of risk-based premiums is simple -- and fair: The greater the risk that an institution poses to the deposit insurance funds, the higher the premium it should have to pay. Of course, the smaller the risk an institution poses, the lower the premium it should have to pay. Not only is this fair, there are also policy considerations to risk-adjusted deposit insurance premiums.

Risk-based assessments provide a financial institution with a modest financial incentive to avoid taking on undue risk. And they thereby lessen the moral hazard that is created when we provide a safety net for our banking system. How sensitive to risk should deposit insurance premiums be? As sensitive as practical.

Despite concerns about increasing risk in banking, there has been no increase in the percentage of institutions classified into the riskier categories of our premium system. I have asked the FDIC staff to look into a number of possible explanations, including this one:

Are supervisors identifying institutions whose condition is good, but whose practices make them "outliers" in terms of underwriting, concentration of risk, or undisciplined growth?

If these institutions are being identified, they should be asked to pay -- through deposit insurance premiums -- for the risks they pose to the rest of you.

The FDIC is talking with the other regulators to find ways to refine existing procedures to assure that we consider risky practices fully and consistently.

Today, I will update you on the preliminary approaches that the FDIC staff is exploring to reconcile risk-adjusted premiums and the greater risks that "outlier" institutions may be taking on. Specifically, the FDIC is asking the question:

Are there any insured institutions rated 1 or 2 under the CAMELS rating system that warrant a rise in their premiums because their banking practices or strategies jeopardize their financial condition or stability?

The FDIC would ask that question for the banks we supervise. And we would ask our colleagues at the other agencies -- the Federal Reserve, the Comptroller of the Currency, and the Office of Thrift Supervision -- that question for the institutions they supervise.

If the answer is "yes", we might reclassify the institution from an "A" to a "B" in our premium matrix. Or, we might recommend further onsite review, or take no action, depending upon the unique situation at each individual institution. No premium increase would be made unless deficiencies in risk management had been discussed with the management of an institution.

We are also looking at ways to screen institutions so that we can zero in on those most in need of review. One possibility we are exploring is to look first at institutions that have composite CAMELS ratings of 1 or 2 -- and a management component rating of 3 or worse. Today, there are 333 banks and savings institutions with those ratings out of 10,700 institutions we insure. Of the 333, 278 are banks and 55 are thrifts.

If we were to use this screen, each one of these institutions would receive a closer look from its primary regulator. Based on what was found, we would decide whether premiums should be raised -- institution by institution. This fine-tuning of premiums would contribute to our common goal of avoiding an excess buildup of risk in the banking system.

I want to stress this morning that we have not made any decisions on these possibilities. Much would depend on the outcome of discussions with our colleagues at the other banking regulatory agencies, with whom we are beginning to discuss these approaches. Of course, just as I am raising this possible approach with you today, we would inform you and your colleagues of our thinking as it continues to evolve. And we would give insured institutions advance notice of any changes we would make. The earliest any changes could take place would be the spring of next year. Of course, we may not find any institution that we need to shift to another category. And we are prepared to accept that result.

In closing, on a number of fronts -- three of which I've talked about today -- the FDIC -- and you -- face a challenging time. As we deal with those challenges together, my door will always be open to you.

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