Remarks By
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at
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Good afternoon, I'm happy and very honored to be making my third trip to mainland China.

The first time was nine years ago when President Clinton visited China for talks with President Jiang and other officials to promote economic cooperation and understanding between our countries.

At the time I was a senior executive with the New York Stock Exchange. We had been working with the Shanghai exchange, and I was part of the group that was sent to Shanghai in conjunction with the President's trip.

During our visit to the Shanghai stock exchange, I was impressed by the enthusiasm and energy I saw for China's growing capital markets. I was also impressed by the strong work ethic, entrepreneurial spirit and the eagerness to engage with your colleagues across the globe.

In short, I fell in love with China. I'll be visiting the Pudong financial district and the stock exchange again when I'm in Shanghai on Friday. I'm anxious to see the results of the change going on there and throughout China.

I fell in love with China for a second time a few years later and in a very personal way. I saw the kindness, warmth and very deep love for children when my husband Scott, and I adopted our daughter Colleen.

So I am delighted to be here again … this time working on banking issues that I believe are critical to developing a strong financial system in China … a system that brings stability, confidence and ultimately raises the standard of living for all Chinese people no matter where they live … in the city or in rural communities.

My agenda

I'll be meeting with government officials and bankers during my trip. We'll be talking about the U.S. experience in building a deposit insurance system that gives confidence in the banking system and the economy as a whole. We'll also be talking about how people save and spend their money, and about how they borrow it.

We have 8,600 banks in the United States. Many of these banks are in rural communities, where they serve as the gateway into the financial system.

As the primary regulator for the majority of these banks, I especially look forward to comparing notes with local officials and bankers.

The FDIC and the People's Bank of China have been consulting on banking issues for a number of years.

To formalize … and I hope expand … the relationship, Governor Zhou and I plan to sign a memorandum of understanding that will support this ongoing work as China moves forward on setting up a deposit insurance system.

Today, I'll start with a short history and description of deposit insurance in the United States. Based on this experience, I'll highlight the key features we think make for a successful system.

I also want to touch on rural finance. I know this is a recent focus for China's leaders. And it is an area of great interest to me because of growing up in rural Kansas, in the middle of America's heartland.

Finally, I'll talk about the U.S. efforts to provide basic banking services to low-income people.

A short history of U.S. deposit insurance

As China begins the establishment and development of its own deposit insurance system, I thought it might be of interest to recap the history of our own.

The FDIC was created in 1933 during the Great Depression, as one of a number of measures designed to restore confidence in the U.S. financial system and to protect small depositors.

After some twists and turns, the deposit insurance system that resulted covered 98 percent of depositors in commercial banks. The FDIC administered an insurance fund, and assessed banks a flat-rate premium on domestic deposits.

The FDIC was also given additional roles. It became the "receiver" for failed banks (meaning it took them over), and joined the Federal Reserve and the Comptroller of the Currency as a federal supervisor of commercial banks.

Following the Great Depression, there were very few bank failures for several decades. Deposit insurance ended bank runs, which threatened small banks in particular. These are the primary lenders to small businesses, which can be the engine of job creation and development throughout an economy.

Deposit insurance provided a solid foundation supporting sustainable growth in all areas of the U.S., both urban and rural.

It was not until the 1980s that wide-scale problems in the financial system began to emerge. By the end of the decade, problems in the thrift industry -- a type of bank that focuses on mortgage lending -- had exhausted their deposit insurance fund.

In 1989, Congress abolished that insurance fund and turned the responsibility for insuring deposits in thrifts over to the FDIC.

All was not well with the FDIC, however. By the late 1980s and early 1990s, the banking industry was also experiencing severe problems as a result of a series of regional recessions, losses from international lending and concentrations in commercial real estate. As a result, the bank deposit insurance fund came under severe stress.

Having already experienced the failure of one deposit insurer, and with the FDIC facing severe difficulties, Congress had to act. In 1991, Congress passed the FDIC Improvement Act, which was one of two important legislative changes that have shaped the deposit insurance system we have today.

The FDIC today

A key feature of the new law is known as “PCA” – or prompt corrective action.

This requires supervisors to take increasingly aggressive action to control risks and minimize losses as capital deteriorates.

Ultimately, a bank must either recapitalize or be closed when its capital falls below a minimum level. The FDIC can act independently to close the bank if the primary supervisor fails to do so.

Let me focus for a moment on “prompt, corrective action” because it’s such a key aspect of our system.

We learned valuable lessons during our thrift industry crisis.

We learned the importance of early intervention to deal with troubled banks.

We learned that a bank’s franchise value is preserved and the cost to the deposit insurance fund is reduced if regulators are not required to wait until all the capital is exhausted before closing a bank.

We also learned that supervisory discipline could be strengthened if early intervention is supported by clear, legal mandates.

Under current law, every bank’s capital strength is measured and ranked by its supervisors. These rankings are clearly defined and the supervisory actions required by the law are transparent.

These rankings range from “well capitalized” to “critically undercapitalized,” and trigger specific, and progressively severe, supervisory action as capital levels fall.

Also included are mandatory supervisory actions for banks that are “undercapitalized” … “significantly undercapitalized” … and “critically undercapitalized.”

These actions reduce the chances of regulatory forbearance -- another goal of prompt and corrective action. These undercapitalized banks are required to file Capital Restoration Plans, and are prohibited from paying capital distributions and management fees.

All these supervisory actions are mandatory. Still, regulators may also impose certain other measures to improve a troubled bank’s condition.

For example, regulators could require a bank to raise additional capital … restrict interest rates paid on deposits … limit asset growth … or require the termination of any activity that poses excessive risk.

While not having been tested in a banking crisis, our experience is that early intervention is most helpful in controlling regulatory forbearance … preserving the franchise value of troubled institutions … finding a suitable buyer … and minimizing losses to the insurance fund.

The FDIC now uses a least-cost strategy when resolving a failed bank.

In the past, critics said that deposit insurance protection was often extended beyond insured deposits, increasing the cost of resolving a bank failure and undermining market discipline. The effect of a least-cost strategy is that protection extends beyond insured depositors only if it is less-costly than any other means of resolution.

The second key legislative change was the Deposit Insurance Reform Act of 2006.

It allowed deposit insurance coverage to keep pace with inflation. Currently, most domestic deposits are insured up to $100,000; and deposits in retirement accounts up to $250,000. Foreign deposits, that is, deposits in foreign branches of U.S. banks, get no coverage.

The coverage limit generally refers to the amount that a single depositor can obtain at one institution. However, for joint accounts and trust arrangements, it is possible to obtain greater coverage.

The FDIC administers one deposit insurance fund, which currently stands at about $51 billion.

It also has a $30 billion backup line of credit from the U.S. Treasury to cover losses in excess of the fund balance, and has the ability to borrow from either the industry or the Treasury for working capital purposes.

As part of this reform, Congress gave the FDIC greater flexibility to manage the deposit insurance fund and to charge banks premiums based on risk.

The FDIC is required to maintain the fund within a range of 1.15 percent to 1.50 percent of insured deposits.

One of the criticisms of the old deposit insurance system had been the flat-rate premium system. Risky banks were being charged the same as safe banks, thus providing no incentive for banks to control their risk.

In 1993, the FDIC changed the assessment system — implementing risk-based premiums. The recent legislation enhanced this authority, and over the past year we've made significant changes to this system.

Features of Successful Deposit Insurance Programs

The benefit of a sound deposit insurance system is very simple: It lets people know that their money is safe. This prevents bank runs and helps to maintain the confidence of the banking public in the overall financial system.

However, designing an effective deposit insurance program is not so simple.

A variety of factors must be considered and many trade-offs must be weighed.

It is important to recognize that many different approaches may achieve the same objectives. But the specific design features that work best in a particular country will depend on the cultural, institutional and legal setting.

We have reviewed with our PBC colleagues the many varieties of explicit deposit insurance systems in place around the world, ranging from simple so-called "paybox" operations to very sophisticated risk minimizers.

In order to maximize the effectiveness of deposit insurance in promoting sound, stable banking and sustainable economic growth, it is very helpful to give deposit insurers powers beyond those of a simple "paybox."

A fully functioning safety net includes a deposit insurer that can help limit excessive risk-taking … promote sound and fair business practices … and be a player in crafting cost-effective resolutions for failed banks.

As I explained, the FDIC has extensive powers, including:

- setting standards for membership and examining insured institutions,
- terminating insurance,
- charging premiums based on risk,
- intervening early in the case of troubled institutions,
- selecting failure-resolution methods, and
- managing failed-bank receiverships.
- We also insure any bank that takes deposits, but regulate only certain institutions, with backup authority for the others.

Regardless of the design details, international experience suggests some broad features that are common to most successful deposit insurance programs.

First and foremost is a foundation built on a suitable legal framework … appropriate accounting rules … and a system of strong, prudential bank supervision.

Without these critical elements of financial infrastructure, deposit insurance alone rarely succeeds in maintaining public confidence, or sound, effective bank intermediation

Most successful deposit insurance programs include reliable funding sources for timely action in the event of bank failures. They also include: clear arrangements for information-sharing that allow the deposit insurer to monitor risk …to handle claims processing … and otherwise discharge their responsibilities.

If the deposit insurer’s authority to request and receive information is asserted clearly as part of its overall mandate … confusion, overlapping responsibilities, and costly disputes … can be avoided.

Another feature of many successful systems is an efficient, well-understood process for closing banks and promptly paying depositors and other claimants.

When this process is clearly communicated to all stakeholders in the banking system … especially to depositors … it promotes informed, rational public reaction during a bank closure or banking crisis.

Explicit rules for receivership management also provide transparency and added certainty about the resolution process, which involves revoking or transferring the bank’s charter, and satisfying claims by depositors and creditors.

These explicit rules can be extremely important for maintaining stability as a banking crisis threatens.

The orderly closing of a failed bank is one of the hallmarks of a nation’s financial stability.

Finally, public awareness of the overall deposit insurance program is a key ingredient for success. It strikes me that this is especially important for China given its vast rural economy and the goal of bringing more economic development and sustainable growth to these regions.

Rural finance

I have a special interest in the challenges China faces in bringing the prosperity of your big cities and industrial areas to your rural towns and villages. In my experience growing up in a small town in rural Kansas, deposit insurance was crucial to the financial peace of mind of farm communities.

By giving depositors the confidence to put their money into smaller, local banks, deposit insurance can help promote rural development.

This confidence benefits not only depositors, but also local banks by creating a more level playing field that allows institutions to compete effectively regardless of size or other characteristics.

Local banks tend to have more intimate knowledge of the credit needs of their communities. They are in a better position to know their customers and make credit decisions on the basis of individual qualifications.

In the United States, local community banks are crucial to the vitality and economic health of rural towns. They frequently are willing to step in and provide funding for economic development in areas that can be overlooked by larger institutions.

Economic inclusion and the importance of public awareness

An effective deposit insurance program goes hand-in-hand with efforts to educate the public about banking and finance, and to include those who have been underserved by the formal banking sector.

We still struggle in the U.S. with a significant number of people who have little or no connection to the formal, regulated banking system.

Not only must people know that their money will be safe in any bank, it is important to assure people that banks will treat them in a fair and equitable manner when applying for loans or conducting other financial business.

In the United States, fair lending, consumer protection and disclosure laws and regulations are in place to give people those assurances.

A strong system of both safety-and-soundness … and consumer protection regulation … is essential for a well-functioning banking industry.

The current problems in the U.S. subprime mortgage market demonstrate the need to have both types of regulation in place, and functioning well.

By way of background, the term “subprime” lending refers to loans made to people who have less-than-perfect credit histories.

These borrowers tend to have lower incomes and higher debt burdens. Conditions in U.S. housing markets resulted in a significant expansion of subprime mortgage lending in recent years.

Subprime lending has many benefits, such as increasing homeownership and helping people to smooth their spending through good times and bad.

However, in recent years, most subprime lending has been done by institutions other than banks which are not subject to the same level of safety & soundness and consumer protection regulation.

Through subprime lending, many households have taken on more debt than they can reasonably bear. Some did this as they strained to keep up with rising home prices. Others did this because they were victims of deceptive marketing and aggressive lending practices.

These unfortunate trends have led policymakers to seek ways to fill regulatory gaps between banks and non-banks that allowed such practices to get out of hand.

The FDIC and other regulators issued guidance to banks to encourage responsible lending. We’re also working with the wide range of other lenders and actors to find ways to help overburdened consumers improve their financial situations and to keep their homes.

The FDIC has also been very active in promoting economic inclusion and reaching out to those who do not use the formal banking system.

We are taking steps to ensure that our banks offer a range of basic services, including small- or micro-loans (that is, loans up to $1,000).

We’re also big promoters of financial literacy and education through a program we call “Money Smart.” So far, nearly one million people have taken the program. It is available in several languages, including Chinese.

We also work with community groups through a program we call the Alliance for Economic Inclusion to help banks find ways to serve their communities.

In addition, last year I created an Advisory Committee on Economic Inclusion. The panel members include academics, bankers, community advocacy groups and regulators who give advice and recommend new ideas for reaching out to those who are currently underserved.

Conclusion

Let me end by saying that I see this as a pivotal time for China’s financial system.

China has done extremely well in reforming and developing many parts of its economy. You have created more jobs and more wealth in 30 years than at any other time in your history. The next hurdle is transforming the banking sector.

I know there are deep-seated concerns about letting foreign banks get more involved in China.

Foreign banks can bring capital, new technology and new customers. Foreign regulators can bring new ideas. These can create new opportunities both for the Chinese people and for Americans.

I believe that a global economy like China’s needs a world-class banking system.

This is central to China’s long-term stability and competitiveness. But it begins with a stable and competitive domestic industry. And deposit insurance … to the mutual benefit of all … can be the keystone as China builds an advanced banking industry.

We have profound respect for what China has achieved, and for your efforts to transform your banking industry.

We’re honored that you’ve asked us to play a role and for the warm reception and friendship you have shown. I believe that we have much in common and much to learn from each other.

I hope that our visit to Beijing and to the interior provinces later in the week will help raise public awareness of the benefits that deposit insurance can bring to individual consumers, and to supporting broader economic growth and prosperity.

China’s ancient text – the “I Ching” – in English is called the “The Book of Changes.” As leaders it tells us to look ahead, to anticipate change, to see problems and to resolve them. In that spirit, I look forward to working with you to build a stronger China, and a stronger America.

Thank you very much.

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