Remarks
of
Martin J. Gruenberg, Vice Chairman,
Federal Deposit Insurance Corporation (FDIC)
at the 2007 Annual Meeting
of the
European Forum of Deposit Insurers, Istanbul, Turkey
November 26, 2007
The International Role of Deposit Insurance

Good evening and thank you for inviting me to speak today. It is a great privilege and honor for me to be here on behalf of both the International Association of Deposit Insurers (IADI) and the Federal Deposit Insurance Corporation (FDIC). I would like to begin by thanking Ahmet Ertürk, Chairman of the Savings Deposit Insurance Fund (TMSF), and his outstanding staff, for hosting this meeting and for their gracious hospitality. I would also like to thank Roberto Moretti, Chairman of the European Forum of Deposit Insurers (EFDI), and Dirk Cupei, EFDI's Vice Chairman, for inviting me to participate today.

The Chinese have a famous curse with which you may be familiar, "May you live in interesting times." For those of us concerned with the stability of financial systems and financial markets, I think these times would certainly qualify.

The collapse of underwriting standards in the subprime mortgage market in the United States, 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 global financial institutions to those securities, and the liquidity issues created for financial institutions dependent on mortgage-backed securities for their funding all raise serious issues for national and global financial stability.

As the Vice Chairman of the FDIC and the newly elected President of IADI, there has been a particular development in this still evolving credit market experience that has not surprisingly caught my attention and that I wanted to discuss with you this evening. 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, is only the most recent illustration of 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 in particular how IADI and EFDI can work together to bring about greater cooperation among those systems and to enhance their effectiveness.

The U.S. Deposit Insurance System

If I may, allow me to start with the deposit insurance system with which I am most familiar, the FDIC. 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.

While the banking crisis brought on by the Great Depression resulted in the creation of the FDIC, the FDIC as we know it today is in large measure the result of the crisis experienced by the United States in its savings and loan industry in the 1980's. That crisis resulted in the failure of approximately one-third of the savings and loan institutions in the United States, the collapse of the federal deposit insurance fund established for the savings and loans, and the expenditure of approximately $140 billion by U.S. taxpayers to make good on the insured deposits in the failed savings and loan institutions. It was the worst financial crisis in the United States since the Great Depression. The result was the enactment of fundamental reforms by the Congress in 1989 and 1991 in the system of banking regulation and deposit insurance in the United States. These reforms included the establishment of a system of prompt corrective action which mandates by law intervention by regulators in failing institutions as their capital declines; the extension of responsibility to the FDIC for the management of the deposit insurance funds for both the banking and savings and loan industries; and the provision of expanded authorities for the FDIC including authority to approve and withdraw deposit insurance coverage, independent enforcement authority over a failing institution, authority to close and resolve a failed institution independent of the bankruptcy courts, and authority to charge risk-based premiums for deposit insurance.

The point I want to make is that the U.S. system of deposit insurance, like that of most deposit insurance systems around the world, is the product of and a response to our unique history and experience. It has been a difficult history marked by two major financial crises. Deposit insurance systems can take many forms, and in my view it is a matter for each country to determine what system is most appropriate for its circumstances and needs. However, I do hold the view that an explicit system of deposit insurance, with defined and publicly understood terms and conditions, is preferable to an implicit system of deposit insurance.

The International Expansion 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 national 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 in 1948 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.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.

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

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 should be adequate to provide assurance to most depositors.

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

Fifth, the deposit insurer should 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.

Experience has shown, I believe, 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), the role it plays in strengthening the operation of deposit insurance systems around the world, and the potential for increased cooperation between IADI and EFDI.

IADI, like EFDI, 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. After the submission of the Working Group's report, the decision was made 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. Earlier this month I was privileged to be elected President of IADI and serve as Chairman of its Executive Council. This is, in fact, my first speech in that capacity.

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

European countries, including France, Germany, Hungary, and Italy were members of the original Working Group on Deposit Insurance that resulted in the creation of IADI. I will tell you quite candidly that in order for IADI to be a fully credible representative of deposit insurance agencies, strengthened cooperation with EFDI and participation by more European countries in IADI is, in my view, essential. I personally do not see any inconsistency between the existence of an International Association of Deposit Insurers and a European Forum of Deposit Insurers. It is certainly clear to me that there are issues specific to Europe that make valuable and necessary the existence of EFDI. But I also believe very strongly that, for the sake of global financial stability, there is a very strong interest in the existence of an International Association of Deposit Insurers whose purpose is to facilitate communication, cooperation, the sharing of experience and expertise, the provision of training and technical assistance, and the development of core principles for the operation of effective deposit insurance systems that that would benefit all deposit insurance agencies in the world.

Given the global nature of financial risk, it is imperative in my view for all deposit insurance systems in the world to benefit from each other's experience and expertise. In some measure, it seems to me, we all have an obligation, as well as a self-interest, to be actively engaged internationally. It is my perception that deposit insurers have been underrepresented in international fora dealing with issues of global financial stability. Recent events and the ongoing expansion of explicit systems of deposit insurance around the world suggest that now is an opportune time for deposit insurers to play a more active role in international organizations concerned with global financial stability. In order to accomplish this, IADI and EFDI should work together to give deposit insurers a meaningful, effective voice in the international financial policymaking arena. I can tell you, as President of IADI, I will have no higher priority than strengthening cooperation between IADI and EFDI in whatever ways we find mutually appropriate. In my view, we share a mutual self interest and a public responsibility to pursue that objective.

Thank you very much.

***

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

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.

Last Updated 01/07/2008