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Federal Deposit Insurance Corporation
Deposit Insurance: The Business Case for Reform
Financial Services Roundtable
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Good afternoon. It is a pleasure to be here today.

It is nice to see so many familiar faces. Many of you have been kind enough to invite me into your offices over the past several months. You have been gracious hosts, and for that, I am deeply grateful. Getting to know you, your business, and the challenges you face has been a priority of mine - and a priority of the FDIC's - this year. I often remind our staff that more than 70 percent of the money in the deposit insurance funds was paid by the top 100 banking organizations in America. You all help pay a good portion of our salaries at the FDIC, and for this reason alone, it makes sense for us to get better acquainted. I hope we can continue to do so.

I'd like to kick off our discussion today with a little business proposition. I'm a businessman at heart and I know this room is full of people who are ready to do deals. So let's take a minute and put together a deal.

I'm thinking about starting a new insurance company and after I've laid out our business model, I'll ask for you all to sign up as investors and principal shareholders. I think my new company will revolutionize how we provide insurance in America. Here's my idea:

- First, our new insurance company will be built around the novel concept that more than 90 percent of our customers will not pay any premiums and get the product for free - and will only be charged when they are least able to pay.

- Next, we will adopt rules to ensure we do not distinguish between our customers based on risk. In fact, we'll make sure the high-risk customers pay just about the same price as our low-risk customers.

- In yet another bold innovation, we will hold a static reserve that will bear no relation to our risk exposure. This will cut down on the complications of such 'old economy' insurance techniques like measuring risk exposure and holding dynamic reserves.

I think my idea is pretty innovative. How many want to invest? Show of hands?

Let me break it to you gently: You already have invested in this company. It is called the Federal Deposit Insurance Corporation, and - as I mentioned earlier - you've contributed more than 70 percent of our operating capital.

I've provided this illustration today because part of what I want to accomplish as FDIC Chairman is to give you a sense of the business environment we operate in. I realize we're not on the top ten list of things you worry about every day. I know this is true because I was a banker in Texas for 30 years. For 27 of those years deposit insurance meant very little to me. But for three years - during the worst years of the banking crisis - that FDIC sign on the door meant the difference between life and death for my business. I got up and polished it every morning. So I hope you'll remember - as I do - that financial stability is truly a precious commodity.

As my example illustrated earlier, we have some problems with how we provide deposit insurance in America. I'd like to spend a few minutes today sharing our views on how to fix them. We've got a plan, and it is called deposit insurance reform. It is moving in Congress and I need your help getting it passed this year.

Let me take a few minutes and run through the challenges we face in our business and outline how deposit insurance reform will help us address them. First of all, we cannot price our product in a way that makes sense. By law, we have to give away deposit insurance to more than 90 percent of the banks and thrifts in America. Such an inefficient pricing scheme only serves to increase the moral hazard concerns so often associated with deposit insurance. Using plain old business sense, if the FDIC is going to provide a guarantee to banks, then it ought to get something in return for it. This is no different than the philosophy you operate under every day as you run your business. I strongly believe deposit insurance - and financial stability - has value in America. And I believe the FDIC should have the flexibility to charge for the value we add.

Next, I believe we should be able to better distinguish between our customers based on the risks they pose to the financial system. By the mandate of law, our current risk-based premium system is crude and outdated. More than 90 percent of banks fit into our 'least risky' category. This isn't a true picture of the business environment we're underwriting. We need the flexibility to draw more reasonable distinctions between the institutions that use deposit insurance, and to price our product accordingly. And we have some hard data to go on. We know that institutions with a CAMELS rating of '2' are two and a half times more likely to fail than those with a '1' rating, for example. We should be able to make distinctions that are not arbitrary and that are truly reflective of our risk. As far as I am concerned, if you are a well-run institution with appropriate capital for your risk, you should be able to get your deposit insurance for a pittance. If you have a riskier business model, you should pay more. I know you have concerns about this, and we have committed to every bank in America that we will work constructively, with the industry, to design a pricing system that is both fair and that does not discriminate against institutions on the basis of their size. I give you my word that we will work with you to make sure the new risk-based premium system for deposit insurance is both effective and fair - indeed, I believe we are already doing just that.

Next, we have problems with the statutory reserve ratio - in fact, the statutory reserve ratio would not pass muster with any bank examiner in the land. We should - as a matter of principle - be able to agree that the FDIC should have a reserve ratio that bears some relationship to the actual risk on our balance sheet. Today, by law, we must keep at least 125 basis points worth of funds in reserve relative to the overall insured deposits in the system. This translates into about $41 billion dollars today. Over the course of the economic cycle, that number may need to be higher or lower - depending on the overall health and performance of the industry. Those will be debates for another day. But I think we can all agree that there is nothing 'magic' about 125 basis points - it is an arbitrary number and I'm not convinced an arbitrary reserve ratio is the best way to run an insurance company.

We have made our case in Congress for allowing the FDIC to manage the fund within a range. That way, the reserve ratio can build up over the course of economic upswings and fall in downturns. This will go a long way toward eliminating the pro-cyclical bias inherent in the current system - and, I might add, avoid the unpleasant task of increasing assessments on banks during the exact wrong time in the economic cycle.

Now, I'd be surprised if I didn't have your support on principles underlying our deposit insurance reform legislation in Congress. They are really not much different from the principles you use every day to run your own businesses. But the logical question for you is this: How much is all this going to cost me? Another question you might ask is: Didn't my bank pay its share back in the early 1990s? I have a couple of answers for you.

First, with respect to cost, I would simply say that the most certain route to increased costs is to kill this bill. We are teetering - as you all know - just at the 125 basis point threshold. It was at 123 basis points last spring. This morning, we announced it is right at 126 basis points. If reasonable deposit growth occurs in the fall, we'll likely dip back below 125 again. If it does, you will get a premium notice in the mail at the end of this year. What you owe will be based on your deposit base at a time when it will likely be swollen with the inflows of deposits from the stock market, from farm country and elsewhere. We don't have a choice in the matter. The law says charge premiums if the funds are likely to remain below 125 basis points for a year. Our Board of Directors will follow the law.

Do I think this makes sense? Absolutely not. The debate that will occur over premiums will be an artificial one. Our funds are adequate to withstand the current and expected failing bank trends. In my view, we can handle the foreseeable risk without needing significant additional funding from the industry. If we had the discretion, we would use it in this circumstance. I think this makes a clear case for providing us some flexibility to look at the broader economic factors at play and making a judgment call rather than collecting extra money from the industry at the wrong time in the economic cycle.

Finally, I know you've been told that deposit insurance reform is going to cost you a lot of money. I believe these arguments are overblown, and I'll tell you why. If it turns out additional funds are needed from the industry, we have crafted our recommendations to make sure that post-1996 entrants, and the institutions that have grown significantly since 1996, will pay first. If you paid the steep premiums - if you built the current fund - you will get an assessment credit that will offset your premiums. This, for many banks, will result in a premium holiday for a period of time relative to your prior contribution.

We've done a survey of your membership. We've calculated how long this premium holiday will last for every FDIC-insured member of the Roundtable. We'll make that available to you today. By giving you an initial break on FDIC premiums, I believe we've found a fair way to put everyone back on a level playing field. This system is also preferable to some other proposals that would require the FDIC to decide what is 'good growth' and 'bad growth', or that would penalize newer institutions for benefiting from the system in place when they were chartered.

We are also putting the finishing touches on another analysis. This study will show that you would fare better - under most plausible scenarios - with our plan than with the status quo. I have asked my staff to share this study with the Roundtable staff next week - and to continue to work with you to address any concerns you may have.

So, as I said, we've got some ideas for fixing our business model at the FDIC and ensuring we're more connected to what is happening in the broader economic marketplace. We believe these solutions are fair and that they will work. We also believe they are deserving of your support - I hope you will join us in helping get the new system through Congress by the end of the year. Passing deposit insurance reform will accomplish a major bit of housecleaning for us and will put us on solid footing to work with you - and our other stakeholders - on other matters of pressing interest to the banking sector.

Before I close, I want to touch on the question of the economy - certainly a topic all of us at the FDIC are watching very closely. While the economy is still struggling, most economists see us moving toward recovery later this year and into 2003 - and that's not much different from what we're seeing at the FDIC.

But in some sectors, however, it doesn't feel much like a recovery yet. Consumer confidence fell again in July. Corporate earnings and business investment have stabilized, but are not yet growing the way you'd expect in a recovery. Yet low interest rates, strong consumer spending, and the housing market have helped maintain some needed momentum.

This downturn has defied the norm in a number of ways. First, it can truly be called a 'corporate sector recession' because most of the bad news has been corporate news. We've seen the deflation of the stock market, a severe slump in business investment - particularly in technology equipment - and misconduct in corporate governance and accounting that has shaken investor confidence. Global competition and overcapacity have seriously crimped the pricing power of many U.S. businesses, leading them to focus on cost-cutting.

Indebtedness is up. Our research shows that net sales for the S&P 500 grew less than half as fast as interest expenses during the last five years. Interest expenses more than doubled in only five years even though long-term interest rates generally declined. Last year, a record 257 publicly traded companies filed for bankruptcy. This year there will likely be fewer, but we believe the total assets in bankruptcy will likely be higher than last year.

These trends in the corporate sector have had an impact, to be sure, on bank credit quality - particularly in large institutions that lend to large companies. Banks over $1 billion in total assets saw their C&I loan chargeoff ratio almost triple - from 0.6 percent of loans to 1.7 percent - in the two years ending last March.

Consumer spending held up better than usual in this recession; in fact, consumers have carried the economy along with the help of the tax cut, low interest rates, and opportunities for mortgage refinancing. With home values on the rise across most of the country and mortgage rates recently falling to 30-year lows, millions of homeowners have taken the opportunity to extract cash from their homes or roll consumer debt into their mortgage. According to Freddie Mac, 61 percent of mortgages refinanced in the first quarter of this year resulted in a loan amount at least 5 percent higher than before.

But as homeowners lever up, we see mortgage delinquencies rising as well. The Mortgage Bankers Association reported this week that some 4.8 percent of all home mortgages were past due at least 30 days in the second quarter. But for the less-stringent VA and FHA mortgage programs, delinquency rates rose to 8 percent and 12 percent, respectively.

Economists have expressed concerns that home price increases may not hold up in some previously fast-growing metro areas, and we can't expect mortgage rates to keep hitting historic lows forever. The bottom line is that households will eventually have to pay their mortgage and consumer debt out of current income. Together, the mortgage and consumer debt of households rose by 48 percent in the last 5 years while disposable income increased by only 29 percent.

While we must be realistic about these indicators, there is no reason to be overly pessimistic. We see a number of positive signs - particularly related to how the banking sector is weathering the storm.

First, we have to recognize that the industry has been living a charmed life since the recession started, because the benefits of a steeper yield curve have more than offset the costs of higher loan losses.

Here is how the numbers break down. The banking industry earned $38.8 billion in the first half of last year. In the first half of this year, provisions for loss rose by $5.6 billion from a year ago as the recession took its toll on credit quality. On their own, these losses could have reduced earnings by 15 percent from a year ago. But the lowest federal funds rate in over 40 years has helped make the yield curve almost as steep as it has been in 40 years. This helped banks raise net interest income in the first half by $12.8 billion - or more than twice as much as the increase in provisions for loss. The result was record first-half earnings of $45.3 billion. This shows how the interest rate environment has helped to cushion recession-related credit losses and keep bank earnings at high levels despite the recession.

It is also important to make the point that banks came into this recession in remarkably better shape than the last time. Back then, banks were weakened by the regional recessions that characterized the mid-to-late 1980s. They were still operating in an environment that was not fully deregulated. And most large financial institutions were preoccupied with shrinking their assets in order to comply with new regulatory capital standards.

This time, things are much different. In the years since the crisis, the banking sector has learned a number of valuable lessons - and those lessons are paying off this time around. The combination of capital, reserves, and income has climbed steadily over the past ten years to about 11 percent of total banking assets - leaving banks better able to deal with adversity than at any time in recent memory.

But increased reserving isn't the only lesson learned by banks. Earnings streams are more diversified, new financial products and services have come on board, more sophisticated risk measurement and risk management techniques have come online, and the strong merger trend over the last decade has left many large institutions less exposed to geographic risk than before. All this has allowed banks to take an aggressive approach to credit quality problems without seriously impacting their profitability. I hope this trend of 'lessons learned' will continue because the slump has shown us shortcomings in underwriting and pricing - in both traditional lending and subprime lending - that leave us some room for improvement in those areas.

Finally, I want to focus on another very important lesson learned by banks over the past ten years: the importance of good corporate governance and sound business planning. We've had no shortage of news recently about companies who got themselves in hot water in these departments - and I'd suggest that the broader marketplace has a lot to learn from the banking sector when it comes to governance and good business over the economic cycle.

Commercial banks were able to reverse the negative trends of the last crisis by taking some bitter medicine. Systems of governance were strengthened and clarified - including replacing management teams and negligent directors, reconfiguring board governance rules, and accepting greater regulatory scrutiny. It certainly wasn't a pleasant time to be a banker - I know because I was there. But the structural changes undergone by the banking industry in that downturn has, in my view, led to its strength in this one.

So you have a story to tell here and I urge you to tell it. You can be ambassadors for good governance and good business planning as you interact with your colleagues in the broader marketplace. We had a symposium recently in New York on risk management. Ken Thompson, of Wachovia, was our luncheon speaker. He forcefully made the point that the requirement for CEOs to personally attest to their financials was simply a codification of what he had always seen as his moral responsibility. As CEO, he stood behind his company - good or bad - and signing the paper was simply a formal attestation of that duty.

I know he is not the only one who feels this way. Most of you in this room could have delivered those remarks. Because it is precisely this sort of personal commitment that will ultimate restore the confidence of the rank-and-file investor, I urge you to tell your stories early and often. We all need your help on this, and we all will be better off as a result.

I will just mention in closing that we have been working hard to restructure and reorganize the FDIC to help us become more efficient and accomplish our mission more effectively. We are downsizing by about ten percent of our workforce - mostly through voluntary buyout packages - and we simplified our organizational chart around our three lines of business: supervision, insurance, and resolutions and receiverships. We required all of our managers in these areas to re-apply for their jobs. This led to a significant number of new managers at the Corporation who will - in my view - enhance our effectiveness as an organization. In total, I expect our corporate reorganization will save us more than $80 million per year. We will keep looking for efficiencies and ways to improve our operations. We welcome your scrutiny and your input - if you have thoughts, share them with me.

I appreciate the invitation to talk to you today and I've enjoyed getting to know so many of you over the past year or so. It was a pleasure meeting some of you at the Habitat for Humanity project I attended in North Carolina. I hope you will continue to sponsor such good work. And I hope you will continue to call on the FDIC as a resource. We will continue to make ourselves available to help in any way we can.

Thank you.

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