ANOTHER WASHINGTON MONUMENT:
FIRREA REMEMBERED
Remarks by Donna Tanoue
Chairman
Federal Deposit Insurance Corporation
Before the
Exchequer Club
Washington, D.C.
July 21, 1999

The public today can take deposit insurance for granted. That is a very good thing, because when the public begins to worry about deposit insurance, we should all be concerned. The last time there was widespread concern about the adequacy of deposit insurance was during the savings and loan crisis and the insolvency of the Federal Savings and Loan Insurance Corporation, or FSLIC. The nation was facing its largest financial crisis since the Great Depression. The legislative response to that crisis, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, known as FIRREA, was signed into law almost 10 years ago.

On this day ten years ago, many of you were working on that legislation. While I was not here, I understand that the efforts to deal with the crisis resulted in long days, lost weekends, and even an ulcer or two for some of you.

A number of issues were hotly debated -- issues that ranged from the powers and responsibilities of the agency that would cleanup the S&L crisis – the Resolution Trust Corporation, or RTC – to issues such as whether S&Ls would be allowed to display our seal if the thrift deposit insurance system were placed under the FDIC.

The pain and aggravation were worth it. FIRREA would turn out to be one of the more significant laws in the history of the nation's financial industry. Why?

First, in ending a crisis, FIRREA began to clear the decks for the extraordinary economic boom we have enjoyed in the 'Nineties. Second, by restoring stability, FIRREA laid the groundwork for financial modernization legislation that is now before the Congress.

I would like to talk about what we learned from that crisis – lessons embodied in FIRREA. There were a lot of lessons to be sure – so I will focus on three of them of special importance to the FDIC as deposit insurer. The first lesson is the critical importance of capital. The second is the critical importance of acting quickly – both to resolve troubled institutions and to get their assets back into the private sector. And the third is the critical importance of having an independent and strong deposit insurer.

First, let's look at capital – the main line of defense in a healthy banking system. Regulatory capital in the 'Eighties was widely, and accurately, regarded as often nothing

more than a shell game to cover up weaknesses, but the emphasis on capital reflected in FIRREA has contributed, in part, to the strong capital levels we see in the industry today. At the end of 1988, the thrift industry's equity capital amounted to 4.11% of industry assets. At the end of 1998, the thrift industry had an equity-to-assets ratio of 8.68%. Over the same period, banks also saw a dramatic increase in their equity capital ratio – from 6.28% to 8.5%. As a result of the emphasis on capital over the past decade, the industry is better positioned to handle a downturn in the economy.

The second lesson from FIRREA was the critical importance of acting quickly and decisively. The deposit insurer for the S&Ls in the 1980s, the FSLIC, suffered from a number of defects, but among the most serious was a lack of funding. As a result, the FSLIC was unable to close large numbers of insolvent S&Ls, which were allowed to continue operating in the hope that riskier investments would pay off over time.

S&L regulators lowered capital standards, eased other regulatory rules, and tried forbearance to keep troubled S&Ls alive until they grew out of their problems. Obviously, that strategy did not work. Ultimately, industry losses were many times what they would have been had problems been addressed promptly – and a large portion of those losses had to be picked up by you and me, the taxpayers.

Although other factors affected the quality of regulation, the availability of the financial resources needed to close insolvent institutions was central to the regulators' ability to act on and control problems.

Once S&Ls failed, they had to be resolved, but closing failed institutions promptly is only half the solution.

At the time of FIRREA, the cleanup of collapsed S&Ls seemed so enormous that people thought it would take forever. You'll recall that the RTC was an agency started from scratch with the help of staff from the FDIC.

Bill Seidman, former FDIC and RTC Chairman, in 1990 noted that if the RTC sold $1 million in assets a day every day of the year, it would take three years to sell $1 billion in assets. With an inventory of about $40 billion in difficult-to-sell assets, at that rate it would take 120 years to sell them all. And the inventory was still growing. The only viable course of action was to sell large pools of assets, if the RTC were to complete its job during its legal lifetime.

Through creating a national sales office, securitization, and other innovations, the RTC succeeded. All told, the RTC resolved 747 institutions. At the time they were taken over, these institutions had assets totaling $402 billion. In fact, the RTC did its job so well that Congress authorized an early termination, and the agency ceased to exist on December 31, 1995. Of the $402 billion in assets the RTC had taken over, only $7.7 billion remained at that point in 1995. The FDIC assumed responsibility for the disposition of these remaining assets – and absorbed much of the remaining RTC staff.

From the RTC experience, we learned how critical it is to liquidate the assets of failed institutions – to get them back into the hands of the private sector – as quickly as possible, so that they can be managed most effectively. Otherwise, these assets act as a drag on economic activity and expansion, as has been the experience outside the U. S.

The third lesson from FIRREA was how critically important it is to have an independent, well-capitalized deposit insurer. In effect, deposit insurance makes a bank failure a nonevent for the average household customer. Because the government provides an absolute guarantee, people do not have to worry about the safety of their savings. Because they don't have to worry, they don't have to rush to the bank to get their money out in response to the news – or rumor – that their institution may be troubled financially. How important is that guarantee?

In the 1980s and early 1990s, nine percent of the banks in the United States – nearly one-out-of-10 – either failed altogether or received financial assistance from the FDIC to stay open. And during the same period, nearly 1,300 savings and loan associations failed. But did we see widespread panic and bank runs? Remarkably, none at all – because of the government's guarantee.

What are the benefits from deposit insurance? Depositors are protected, and because deposit insurance prevents a banking problem from becoming a banking panic, the payment system continues to operate. In other words, everyone – not just depositors -- benefits.

FIRREA reaffirmed the government's guarantee for savings and loan depositors, and assured that more than $150 billion of taxpayer and industry money would be available to make good on that promise.

In recent years, we've seen financial crises in Asia and Latin America – crises that, in part, have led 21 countries to adopt explicit deposit insurance programs since May of 1995. Today, 68 countries have such systems. Clearly, the benefits of deposit insurance are appreciated worldwide.

Deposit insurance, however, doesn't alone ensure stability in the financial marketplace. It addresses only one potential problem, albeit a problem that can cripple, or even bring down, a financial system: that problem is the evaporation of public confidence in banking. At the same time, stability also requires both effective economic policies and effective prudential supervision.

Today we have strong insurance funds – funds at record levels -- but they could be stronger still. How?

As a result of the changes brought about by FIRREA – as well as by communications and information technology and the marketplace -- the banking and thrift industries are now very similar.

This fact was dramatically illustrated earlier this week when the largest bank trade group, the American Bankers Association, and the largest thrift trade group, America's Community Bankers, announced they are exploring a merger. Why are the institutions more similar?

On the asset side, residential mortgage loans constitute a significant business at many banks, and commercial loans can account for a portion of the lending portfolios of thrifts. On the liabilities side, the array of deposit accounts available in the two types of institutions is essentially identical. And from the point of view of the insured depositor, there is virtually no difference between banks and thrifts. All the depositors care about is that their money is insured.

The distinctions between the Savings Association Insurance Fund and the Bank Insurance Fund have also become blurred. Having two insurance funds – one for banks and the other for thrifts – does not reflect what is going on in the marketplace. In fact, today, the Bank Insurance Fund does not simply insure just banks and the Savings Association Insurance Fund does not simply insure just thrifts. Both funds insure both types of institutions. How did this come about?

At the inception of SAIF, virtually all SAIF-insured deposits were held by SAIF-member thrifts. As a result of mergers and consolidations among banks and thrifts, commercial banks hold more than one-third of all SAIF deposits – 35.2% to be precise. One hundred and five commercial banks are SAIF members. And, notably, 24 of the 50 largest holders of SAIF deposits are BIF members – including giants with a nationwide presence such as First Union and Nationsbank, as well as banks such as AmSouth, SouthTrust Bank, and Regions Bank of Birmingham, Alabama; Banc One Texas of Dallas; and Norwest and U.S. Bank of Minneapolis. The SAIF has become a true hybrid fund.

Moreover, in the other direction, 360 savings institutions are BIF members. Currently, 846 banks and thrifts – representing 58 percent of the assets of all FDIC-insured institutions -- receive two assessment notices each quarter—one for their SAIF deposits and one for their BIF deposits.

Merging the funds would be a logical response to the decreasing distinctions between banks and thrifts and the increasing overlap between them.

Two other major considerations also support a merger.

One, as long as there are two deposit insurance funds with assessment rates independently determined, the prospect of a premium differential exists. When deposit insurance is offered at two different prices, banks and thrifts will gravitate to the lower price. As we have seen in the past, this can produce inefficiency and waste, as institutions expend time and resources trying to take advantage of the lowest price for deposit insurance.

Two, a merger of the funds would also ensure that risks to the deposit insurance system are as diversified as possible. The more concentrated the risks—by numbers of institutions, by geography, by types of products—the more concentrated are the dangers, and the greater is the likelihood that trouble in a single institution or in a small group of institutions will cause more widespread problems. This is especially the case with the creation of what is known as megabanks. As megamergers increase, the health of the funds increasingly depends on the health of the 25 largest institutions. I cannot overstate the importance of this point. By diversifying risks, a merger of the funds would make our strong deposit insurance system even stronger.

Ten years ago, the House and Senate were meeting in conference to iron out the differences between their respective versions of FIRREA. Today, the House and Senate are preparing to begin another conference, this one on financial modernization legislation. This legislation will serve as the financial blueprint for the next generation. Are the lessons of FIRREA being heeded in this important work?

I am glad to tell you that from the perspective of the FDIC, both bills recognize the FIRREA experience. At virtually every turn, leaders from the House and Senate -- from both sides of the aisle -- have approached issues from the standpoint of safety and soundness concerns. Provisions ensuring strong capital are in both measures, and provisions that will give the FDIC important tools in protecting the funds are also in both bills, as well.

It would be a shame, after all this, if one important piece is not included: the merger of the two nearly identical funds that protect the nation’s depositors. Keeping the funds separate serves no safety and soundness purpose. Merging them only adds to the strength of the system. The timing is right, the funds are well capitalized, and major banking legislation is pending.

The train is leaving the station and a funds merger should be on it.

Last Updated 07/13/1999