Remarks by
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Thank you and good morning.

In a recent discussion on the future of the deposit insurance funds, a colleague at the FDIC recalled the "Butterfly Effect" -- the illustration of chaos theory that begins with the question: "Does the Flap of a Butterfly's Wings in Brazil set off a Tornado in Texas?"

Twenty years ago, Edward Lorenz first asked that question in a paper that discussed the instability of our global climate due to the escalation of very small, almost unnoticeable, local disturbances, such as the changing of individual clouds -- or even the flap of a butterfly's wings in Brazil setting off a tornado in Texas. In recent years, the term "Butterfly Effect" has also been used to illustrate how complex relationships tie the different parts of a system together and make each part of the system vulnerable to events in another part. It is, if you will, an update on the old story of "for the want of a nail, the kingdom was lost."

I hope we don't miss finding the best public policy solutions to these issues for want of effort by all who have an interest in assuring a sound financial system.

The people in this room today represent a significant and important part of the banking industry -- and the banking system. The two are not synonymous. Savings and loan associations may not be part of the industry -- yet -- though some are trying -- but they are part of banking system. In more ways than one, when they have a problem, its effects ripple through the rest of the system.

The Bank Insurance Fund is in good condition and its prospects appear favorable. In contrast -- despite the general good health of the thrift industry -- the Savings Association Insurance Fund is not in good condition and its prospects are not favorable because it is significantly undercapitalized.

As you know, beginning later this year, a substantial disparity between the deposit insurance premiums paid by BIF members and SAIF members is likely to occur. Indeed, the proposals issued by the FDIC Board at the end of January, if adopted as final, would result in a premium differential of 19.5 basis points. The disparity is mandated by current statutory provisions.

The FDIC cannot avoid bringing the disparity into being. Only Congress can change the laws that will soon require the FDIC to promulgate significantly different assessments for the two deposit insurance funds. Like the tip of an iceberg, the premium disparity is the visible manifestation of significant differences in the approaches to recapitalization of the two funds.

Three factors are relevant.

One, the SAIF is significantly underfunded. At year-end 1994, the SAIF had a balance of $1.9 billion -- or 28 cents in reserves for every $100 in insured deposits. This amounts to six percent of the assets of SAIF-insured "problem" institutions. The $21.8 billion BIF, in contrast, amounts to 52 percent of the assets of BIF-insured problem institutions. At the current pace, and under reasonably optimistic assumptions, the SAIF would not reach the minimum reserve ratio of 1.25 percent until at least the year 2002.

Two, SAIF assessments have been -- and continue to be -- diverted to purposes other than the fund. In short -- from 1989 to 1994, $7 billion -- approximately 95 percent of SAIF assessments during that time -- was diverted from the SAIF to pay off obligations from thrift failures in the 1980s.

Of the $9.3 billion in SAIF assessment revenue received from 1989 to 1994, a total of $7 billion was diverted: $1.1 billion was diverted to the Resolution Funding Corporation (REFCORP); $2 billion was diverted to the FSLIC Resolution Fund (FRF), and $3.9 billion was diverted to the Financial Corporation (FICO).

By far the largest of the drains on SAIF assessment income, the FICO was established by Congress in 1987 in an attempt to recapitalize the defunct Federal Savings and Loan Insurance Corporation.

From 1987 to 1989, the FICO issued approximately $8.1 billion in bonds. SAIF assessment revenue currently amounts to just over $1.7 billion a year and FICO interest payments run $779 million a year, or about 45 percent of all SAIF assessments.

Without these three diversions, the SAIF would have reached its designated reserve ratio -- and would have been fully capitalized -- in 1994 -- before the BIF. The REFCORP and FRF no longer have claims on SAIF assessments, but -- as things now stand -- the FICO claim will remain as an impediment to SAIF funding for 24 years to come.

If you have ever tried to fill a bucket with a hole in it, you understand what I mean.

Of the potential premium differential, at least 11 basis points is attributable to the FICO obligation. The existence of the differential could provoke further shrinkage in the SAIF assessment base and a shortfall of assessment revenue to pay the FICO obligation, which would lead to default on the bonds. Although FICO bonds are not obligations of the FDIC, interest on the bonds is a significant drain on the SAIF.

Three, for the first time, the SAIF will assume responsibility for resolving failed thrifts after June 30 of this year. Given the underfunding of the SAIF, significant insurance losses in the near-term could render the SAIF insolvent and put the taxpayer at risk. One large or several sizable thrift failures could bankrupt the fund.

The outlook for the SAIF is further complicated by the fact that the law limits SAIF assessments that can be used for FICO payments to assessments on insured institutions that are both savings associations and SAIF members. Because assessment revenue from these institutions cannot be used to meet debt service on FICO bonds, more than 32 percent of SAIF-insured deposits were unavailable to meet FICO payments in 1994. This 32 percent is owned by banks -- by many of you in this room -- directly or indirectly. This portion was up from 25 percent at the end of 1993. This shift contributed significantly to a 7.9 percent decline in 1994 in the SAIF assessment base available to service FICO, even though the overall insured deposit base of the SAIF declined by only 1.1 percent in 1994.

At current assessment rates, an assessment base of $325 billion is required to generate revenue sufficient to service the FICO interest payments.

The FICO-available base at year-end 1994 stood at $486 billion. The difference of $161 billion can be thought of as a cushion which protects against a default on the FICO bonds. If there is minimal shrinkage in the FICO assessment base -- 2 percent -- a FICO shortfall occurs in 2005.

If shrinkage increases -- for whatever reason -- the shortfall occurs earlier -- as early as 1997 or even 1996 under some assumptions.

As you know, Great Western Financial Corporation, the parent company of a SAIF-member federal savings bank with offices in California and Florida, announced that it had submitted applications for two national bank charters. Under the applications these commercial banks would share Great Western's existing branch locations.

By mid-March, five other SAIF-insured institutions announced that they were considering similar actions to shift deposits from the SAIF to the BIF. Just this week, one institution filed the necessary applications.

If these efforts in converting SAIF-insured deposits to BIF-insured deposits are successful, others are likely to follow. Even if they are not successful, others are likely to follow in other forms. The six institutions have approximately $80 billion in SAIF deposits -- and that represents 50 percent of the FICO-cushion I mentioned earlier.

For these reasons, the SAIF assessment base could shrink significantly -- and relatively soon. Removal of substantial deposits from the SAIF would result in a significantly smaller base from which to generate the fixed FICO assessment.

To establish parity between the BIF and the SAIF today would require about $15.1 billion, or about 25 percent of the total equity capital of SAIF members. Of this total, $6.7 billion would be needed to increase the SAIF from its year-end 1994 balance of approximately $1.9 billion to $8.7 billion, the amount that currently would achieve the designated reserve ratio required by Congress of 1.25. The remaining $8.4 billion of the $15.1 billion is the amount that would be necessary at current interest rates to defease the FICO obligation.

Requiring these amounts to be collected entirely through SAIF insurance premiums raises difficult questions. What will be the effect on the ability of SAIF members to raise new capital, to prosper, and to compete effectively? Will erosion of the SAIF assessment base and changes in its composition jeopardize the ability of the FICO to meet its obligations? Should some of the burden be shared? And by whom?

There is no magic answer to these questions. Any of the solutions so far proposed would require action by Congress. There is no way for the FDIC to resolve this issue through the exercise of its regulatory authority.

Making Oaker and Sasser institutions assessable and denying the six applications to set up BIF-insured institutions will not save the FICO bonds. They will default -- we project by the year 2005 under current conditions -- earlier if the FICO assessment base continues to shrink.

I do not have to tell you that there is considerable disagreement over precisely what action should be taken to address the SAIF problem and whether it should be taken this year or later. The most frequently mentioned sources of money to address SAIF's needs include the U.S. Treasury, the thrift industry, and the banking industry.

Others have been mentioned, too, as having an interest in resolving the problems. None of the possible sources of funding is happy about the prospect of footing the bill for capitalizing the SAIF and funding the FICO interest payments.

On Friday, March 17, the FDIC Board of Directors held an unprecedented public hearing on the agency's proposals to reduce deposit insurance premiums for most banks while keeping insurance rates unchanged for savings associations. Although written comments are not due until April 17, we have received more than 1,300 comment letters to date. One message came through loud and clear from bankers testifying at the hearing, a message about customer confidence during a crisis: The "FDIC-insured" sign on the door is like a prized brand name to customers -- the logo on the door of a financial institution represents confidence -- and the integrity of that logo must be preserved. We should allow nothing to tarnish it.

Further, the majority of the witnesses at the hearing strongly agreed that, in weighing proposals to address the SAIF problem, we must seek a real and permanent solution, not one that simply defers the issue to a later time while leaving in place the conditions that are the source of the problem.

In that regard, the FDIC has taken the position that any solution should be judged by how well it accomplishes three goals.

First, it should eliminate to the extent possible the portion of the SAIF premium attributable to the FICO assessments and it should reduce the premium disparity between BIF and SAIF member institutions. This disparity encourages SAIF members to engage in legal and regulatory maneuvering to avoid SAIF assessments and in my view renders infeasible the existing mechanism to fund the FICO. This standard leaves open the question of what level of premium disparity between BIF and

SAIF members would be small enough to eliminate the incentive for SAIF members to flee the SAIF. It is true the FDIC could lower SAIF premiums to 18 basis points on average until 1/1/98, to help deal with the disparity, but the FICO would probably default next year if we did that.

Second, it should result in the SAIF being capitalized relatively quickly, perhaps no later than 1998. The longer we allow the SAIF to be undercapitalized, the greater the possibility that unanticipated losses will deplete the fund. Under moderate failure assumptions, the SAIF capitalizes in 2002. If failures climb dramatically, they can prevent SAIF capitalization altogether, and even threaten that insurance fund's solvency. It is true the thrift industry is healthy, and we are not currently predicting such losses in the near term, but seven years -- or more -- is a long time.

Third, a solution should address the immediate problem that on July 1, the SAIF will take over from the RTC the responsibility of handling thrift failures. Unfortunately, the SAIF will assume this responsibility in a vulnerable and grossly undercapitalized condition.

In addition, we need to be concerned about the means to achieve these goals. In that regard, we must consider the precedent that is being set for the use of deposit insurance funds. To ensure sufficient insurance reserves to meet future losses and to protect the FDIC's independence, deposit insurance funds should be used for deposit insurance purposes. Ideally, the converse should also be true that deposit insurance expenses should not be paid out of public funds, although the savings and loan crisis is evidence of an unfortunate breach of the latter principle, and the diversions from the SAIF for other purposes prove the rule about the former.

We also must carefully consider the fairness of the solution to all concerned.

The many options that have been proposed to address the SAIF issue can be grouped in this way: One, no action; two, options using public funds; three, options involving a special assessment on the SAIF assessment base; four, options that would use investment income of the insurance funds to pay the FICO assessments; five, options using no public funds, including merging the funds and sharing the FICO assessments between BIF members and SAIF members; and six, options that combine two or more of these approaches.

I want to briefly comment on a few of the ideas behind some of these options.

First, it has been estimated that there will be between $10 billion and $14 billion in Resolution Trust Corporation funds that have been appropriated but not spent -- so-called excess RTC funds. It has been suggested that these funds be used either to pay the FICO assessments or to capitalize the SAIF, or some or all of both.

There are substantial public-policy concerns with the precedent set by using public funds to capitalize the SAIF. Independence is vital to the effective functioning of the deposit insurance system. The exercise of safety-and-soundness powers, the pricing of risk for insurance purposes, and closing and disposing of insolvent institutions all are accomplished most effectively when they are insulated from the political process. Capitalization of the SAIF with appropriated money could create a climate in which the FDIC's exercise of its insurance responsibilities would be influenced by policy concerns outside the scope of the FDIC's mission. In addition, there are clear budgetary implications of such a choice -- but fewer budgetary issues if funds are made available to cover unpredicted losses to the SAIF.

Second, a number of thrift executives have advocated a special, one-time assessment -- levied against the SAIF assessment base -- to capitalize the SAIF. This special assessment could amount to some or all of the $6.7 billion needed as of year-end 1994 to capitalize the SAIF. In order to collect the full $6.7 billion, a special assessment of about 70 basis points would have to be levied over and above the current average assessment of about 24 basis points.

Based on year-end 1994 financial reports, a 94 basis point one-time assessment would lead to three SAIF member with total assets of $500 million becoming critically undercapitalized and another 103 SAIF members would be downgraded one notch from current capital categories.

Third, another proposal asks banks to share the FICO obligation. Spread over the two funds, that would cost 2.5 basis points, a fifty-fifty sharing would cost the BIF 1.5 basis points and the SAIF 5.5 basis points. There are implications again for using deposit insurance funds for non-deposit purposes, as the SAIF found.

Fourth, there is the proposal to merge BIF and SAIF, with the existing premium rates being maintained until the combined fund reaches the 1.25 ratio. Merging the funds would set a very unfortunate precedent for the use of the resources of the deposit insurance funds. Existing law requires that BIF resources be used to cover only BIF expenses; merging the funds would violate that principle. There is a danger in overriding the law governing the use of insurance fund resources solely for the sake of expediency. Once an insurance fund's resources is used for purposes other than protecting the depositors of that fund, where do you draw the line?

In the end, I agree with former FDIC chairman Bill Isaac, who wrote in the American Banker this week that you have no moral obligation to solve this problem.

The question in the end is what is in the best interest of your bank, your customers, and the financial system.

I believe you have an interest in assuring stability to the deposit insurance funds and in assuring that "insured by the FDIC" continues to be a strong force for stability to the system.

I hope you will help us find a fair solution -- with or without your wallets.

Thank you.

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