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It is indeed a pleasure to speak to such a distinguished meeting of economists, analysts, and bankers. The conference includes even promoters of a "narrow little technical bill" to privatize deposit insurance and banking regulation. We are certainly a diverse and tolerant group here today. It is also -- and always -- a pleasure to be in Chicago -- which, for five years, was the home away from home for most of the headquarters staff of the Federal Deposit Insurance Corporation. Literally.

The celebrations earlier this week of Victory in Europe reminded me of that fact. In the spring of 1942, soon after the entry of the United States into the Second World War, hundreds of FDIC employees in Washington were told that -- within two months -- they would be transferred to Chicago for the duration of the war. The transfer was part of a program to free up office space in Washington for use by the military. The Pentagon was still a year from completion and government offices tied to the war effort were springing up all over town. The Field Building -- at 135 LaSalle Street, in the Loop -- was to become the Chicago home of the FDIC during the war.

As one writer described it: "One by one, FDIC employees did sell homes and pull children out of school. Spouses quit their jobs to keep the family together for the rest of the war -- however long that would be. Together, they said good-bye to friends and relatives in Washington and made new lives for themselves in Chicago."

It was a big change.

FDIC employees made the move, however, because necessity demanded it.

Much of what government does is a response to necessity -- meeting immediate needs -- from building roads to recapitalizing deposit insurance funds. If reporters write history on the run, governmental policy-makers make history on the run -- necessity demands it.

From the standpoint of government officials, occasions such as this conference provide an opportunity to engage economists, bankers and others in examining the longer-term questions we face -- without having to assign staff to the job. At the FDIC we welcome any thoughtful contribution, and I am joined here today by several of my FDIC colleagues eager to hear the contributions. Today I will talk about two developments that have occurred in recent years.

The first is the subject of this timely conference: financial innovation and its effect on the banking industry. The second development has been the subject of this conference in past years: the deposit insurance system. When looked at in tandem, financial innovation and deposit insurance reform certainly do raise some thought-provoking questions about the changing nature of the industry the FDIC insures and the role of deposit insurance in the overall safety net.

As this conference highlights, financial innovation is changing the way commercial banks and thrifts do business. As time passes, it becomes clearer that banking is an information-based business. Telecommunications is changing the delivery of financial products: brick-and-mortar and geographic proximity mean less. The explosive growth in computing power has provided increasingly sophisticated analytical tools for risk management -- and even greater need for risk management -- as if that were possible after the thrift and banking crises we recently experienced. As Alan Greenspan said earlier today, financial institutions have been able to lose money the old fashioned way, too -- where inadequate systems for assessing risks have been in place.

Globalization of financial markets brings greater competition and interconnectedness. The pricing of financial instruments and services results more and more from competitive market forces rather than nonmarket arrangements.

Within the banking industry, these changes are having the greatest impact on larger institutions. Many large banks are moving away from traditional balance sheet products toward risk management products and services. Several large money-center banks have or are changing their business strategies to reflect the convergence of credit markets and capital markets. With respect to derivative contracts, fewer than seven hundred banks report any use. These banks hold almost three quarters of the banking industry's assets. In fact, the 15 most active banks account for 95 percent of the reported notional amounts of derivative instruments in the banking industry.

The picture is similar with respect to securities activities. There are 36 bank holding companies with section 20 subsidiaries; all but three are over $10 billion in assets. With respect to globalization, 175 U.S. banks have active foreign branches; 99 percent of the assets in these banks are in banks over one billion dollars in size. Likewise, most securitization of assets, other than residential mortgages, is done by larger banks.

Large banks are more active in the sale of mutual funds: 71 percent of banks over $1 billion report fee income from fund sales, while 28 percent of banks under $1 billion report such fees.

While the business of banking has been changing over the past decade, so has the business of deposit insurance. The FDIC Improvement Act, or FDICIA -- and the events that led to its passage -- are well-known to this audience. Much of the impetus for FDICIA was to address concerns that a de facto too-big-to-fail policy had resulted in an over-extended deposit insurance safety net. There was a widely-held view that the connection between deposit insurance and large banks had wandered off course. FDICIA was designed to correct this by putting more market discipline into the banking system and by drawing a distinction between the deposit insurance safety net and the broader, but less explicit, systemic safety net that includes supervision and backup liquidity.

The legislative measures to address too-big-to-fail included the provisions dealing with prompt corrective action, least-cost resolutions, and systemic risk. Prompt corrective action, which includes mandatory supervisory sanctions and restrictions on the use of the discount window, forces shareholders and potential investors to decide at an earlier stage whether to shore up a troubled bank. This and other factors have had the effect of encouraging banks to maintain higher capital levels in order to avoid such a day of reckoning. The systemic risk exception clarified the FDIC's role in the safety net. It takes the decision to incur additional costs to protect other creditors out of the FDIC's hands alone by requiring the concurrence of the Treasury and the Federal Reserve Board. It also requires that the cost of such a decision be recouped through a special assessment on the industry based on liabilities rather than deposits; this places a greater share of the burden on larger institutions. It represents an explicit narrowing of the FDIC's role in the overall safety net.

The most recent legislative change that has had a major impact on deposit insurance is the establishment in 1993 of national depositor preference. Depositor preference alters the priority of claims when a bank is placed into receivership so that depositors stand ahead of unsecured general creditors. Thus, depositor preference is a mechanism that makes it unlikely that the FDIC would lose money in a least-cost resolution involving a bank that relied heavily on nondeposit funding -- but we cannot ignore that it brings with it a number of very real negatives.

For instance, since all general creditors are now subordinate to those depositors protected by depositor preference, the costs to banks of using unsecured non-deposit liabilities and other general credit obligations such as qualifying financial contracts may increase. Some of these obligations are used by banks to hedge their interest rate or currency risk. Increasing these costs may discourage banks from using these instruments. Also providing a preference for uninsured depositors reduces the incentives they have for selecting a depository institution carefully. As it happens, the banks that have low levels of deposit funding tend to be large banks. For example, banks over $10 billion in asset size on average fund 55 percent of their assets with domestic deposits. In contrast, for banks under $10 billion in size, the comparable figure is 86 percent.

Thus, financial innovation and deposit insurance reform share a common feature: their impact is most pronounced on larger institutions.

This means that a greater share of innovative financial activity is being conducted in institutions that are less reliant on the explicit deposit insurance safety net and more subject to market discipline.

Let me illustrate this by classifying the commercial banking industry, which includes 10,450 banks with $4.0 trillion in assets, into three groups based on derivatives use and funding base and I will raise a few questions along the way. While the lines I draw leave room for ambiguity as to where certain banks belong, the divisions are based on simple measures and help to shed light on the changing nature of the industry.

The first group consists of banks that report no off-balance sheet derivatives. These nearly 9,900 banks hold $1.1 trillion in assets or 27 percent of the assets of the commercial banking industry. The average size of these banks is $110 million in assets. These banks fund 87 percent of their assets with domestic deposits on average.

The second group of banks are those that report some off-balance sheet derivatives and that fund more than one-half of their asset base with domestic deposits. These 525 banks hold $1.7 trillion in assets, or 42 percent of the industry. The average size of these banks is $3.2 billion in assets. On average, these banks fund 79 percent of their assets with domestic deposits.

The third group are those banks that report off-balance sheet derivatives and fund less than half of their assets with domestic deposits. These 69 banks hold $1.2 trillion in assets, or 31 percent of industry assets, just under 90 percent of the derivatives, and just over 90 percent of the trading account assets in the industry. The average size of these banks is $18 billion in assets. These banks fund 27 percent of their assets with domestic deposits.

Let me ask you: Does this grouping of the commercial banking industry help us think about how deposit insurance should be administered in an era of rapid financial innovation? The vast majority of banks are small, rely on deposit funding, do not use off-balance sheet derivatives, and do not have trading activity or foreign operations. These banks for the most part are not publicly traded - thus, they are not subject to a significant amount of discipline by the capital markets. Because they support the intermediation of funds from small transaction and savings accounts to borrowers not served by the national capital markets, are not these banks the reason we have deposit insurance? Are there other reasons?

The third group of banks, by contrast, is much different in nature. The global marketplace is their arena. Their customers can choose to go directly to the market for their financial services. The performance of these banks is continually monitored and assessed by global capital markets.

Domestic deposit funding is but one of a variety of funding options available to these banks. Their role in the payments system is critical, and liquidity problems for these banks are likely to result in liquidity problems in the broader financial markets. All developed countries have such banks, and the governments of these countries support these banks with backup liquidity and supervision, regardless of whether a significant deposit insurance system is in place. What role does deposit insurance have for these banks? Is the FDIC's role in protecting against systemic risk and disruption significant for these banks -- as well as for smaller banks?

The middle group of banks is a hybrid of the other two. These banks can be large, but their role in the global marketplace is less prominent than the third group of banks. Their customers are likely to be mid-sized firms with some limited access to national capital markets. Many, but not all, of these banks are publicly traded. Domestic deposit funding is critical to their operation and thus deposit insurance is important for them. These banks find that they must adapt to rapid market developments to compete, but they are not likely to be on the leading edge of financial innovation. What role does deposit insurance play for them? Does it assure a significant, stable funding source? How important is that for their operations?

The grouping of banks that I have just described raises some other important questions. First, as the nature of commercial banking changes, does the potential grow for financial innovation and deposit insurance to be intertwined in ways that limit market discipline?

If so, how should policymakers and regulators respond to current trends so as to minimize risks to the deposit insurance funds, without stifling financial innovation, and while assuring a stable financial system? In this context, it is essential to remember that, for bank failures, the FDIC has been the "lender of last resort." Further, what are the implications of a substantial and growing segment of the banking industry that has a rapidly evolving risk profile, but a risk profile that is shifting from the deposit insurance funds toward the market? From the perspective of protecting the deposit insurance funds, should we find the fact that newer and rapidly growing activities are taking place in banks that rely less on insured deposits comforting -- or less comforting? From the broader perspective of the entire financial system, if deposit insurance is not the back-up stabilizing mechanism for these banks, what is? In the event of a financial crisis, could the government address a financial crisis through ad hoc measures? Is that feasible over the longer term?

Another question concerns the FDIC's role as receiver for institutions with a bank or thrift charter. One could conceive of a situation in which an insolvent bank does not pose a systemic risk and whose funding structure poses virtually no risk to the deposit insurance fund. Does it make sense for the FDIC to be the receiver for this institution? If so, what protection, if any, should be provided beyond insured deposits?

The groupings I have presented raise a question about the coming evolution of the banking industry. Are we witnessing a bifurcation of the industry, with one group of larger institutions transforming themselves into broad financial service providers while other smaller banks retain their important traditional roles in their communities? Or, are the transformed institutions leading the way to a financial frontier that the entire industry will likely inhabit someday?

On a more concrete topic, risk-based pricing of deposit insurance has been a dramatic change in the way the FDIC fulfills its insurance responsibility. Do our current risk-based schedules adequately reflect the risks to the insurance funds posed by the best-capitalized institutions with the highest supervisory ratings? If not, what would? Further, the current risk-based premium system is an administered system that in effect does little more than penalize the current minority of institutions whose capital levels and supervisory ratings fall below acceptable standards.

This may be an entirely appropriate role for a risk-based deposit insurance system. Nevertheless, it does not, in all likelihood, replicate the pricing that a market-driven system would provide. As financial markets evolve and we gain a greater appreciation for the ability of market-based pricing systems to produce and disseminate valuable information, does the appeal of taking steps toward a market-driven system increase? As I said earlier, I would welcome feedback from the thoughtful and experienced audience gathered here today on any or all of these questions.

Deposit insurance was put in place to stabilize a fragmented banking structure by providing explicit, but limited, protection to bank depositors. Over time, deposit insurance has provided de facto protection to the system as a whole. Where do we go from here? Where will necessity take us?

I grew up in Tennessee -- a state where necessity is no stranger. Many years ago, a woman in Tennessee went to see the governor to try to talk him into releasing her husband from prison.

The governor gave her a meeting.

"Well," he said, opening the meeting up, "what is your husband in prison for?"

The woman replied: "For stealing a ham."

"That doesn't sound too bad," said the governor, "tell me, is he a good husband?"

"No," replied the woman, "not at all. In fact, he never notices me at all."

"Well," said the governor, "is he a good worker?"

"No," said the woman, "he is as lazy as a man can be."

The governor then asked: "Is he a good father?"

"No," answered the woman, "he just yells at the children all day."

"Ma'am," the governor asked, "why would you want a man like that out of prison?"

"Governor," she replied, "we're about out of ham."

Wherever necessity takes us, we will be going, but we must understand necessity has both reaches and limits.

Again, it was a pleasure speaking with you.

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