

Visioning on Deposit Insurance*

Presentation by Martin J. Gruenberg
Vice Chairman of Federal Deposit Insurance Corporation

Good afternoon. I am very pleased to be here today to celebrate the tenth anniversary of the Korea Deposit Insurance Corporation and to discuss issues regarding the improvement of deposit insurance systems with the distinguished heads of other deposit insurance agencies. The program states that the purpose of this session is to share the challenges facing our organizations and the visions we are developing for them. In this regard I would like to commend Mr. Choi and his staff at the KDIC for guiding their agency through some very difficult times over the past decade and for forging ahead to make improvements in their deposit insurance system. During the past ten years the KDIC has successfully moved from a temporary blanket coverage system to a limited coverage system; has been given authority to investigate banks that received public funds; and, most recently has been given authority to examine troubled insured financial institutions.

We at the FDIC have also faced challenges during our existence, especially during the late 1980s and early 1990s when an unprecedented number of U.S. banks failed. Following that crisis, deposit insurance laws changed markedly in the United States. In particular, our system for

* The use of this document as posting on CDIC (Taiwan) website was authorized by Korea Deposit Insurance Corporation.

assessing banks a premium for deposit insurance was changed from a flat-rate system to one that was risk-based. Additionally, a target reserve ratio was established for our fund. We spent the past decade implementing and refining these adjustments.

In light of the guidance produced by the Working Group on Deposit Insurance for the Financial Stability Forum in 2001, the FDIC undertook a review of the changes we had implemented over the previous decade to see how well they were working and to determine whether further improvements could be made. Our review culminated in a report, *Keeping the Promise: Recommendations for Deposit Insurance Reform*. In that report, the FDIC laid out its vision for refining our deposit insurance system. After working closely with our legislative and executive branches of government, we were successful in getting legislation passed in February of this year that, we believe, will help us to improve the operation of our deposit insurance system. Some of the changes—such as the merger of our two separate funds for banks and thrifts—are largely unique to the U.S. system. What I would like to discuss in the remainder of my time here today are a few of the changes we are making that may provide insights for other deposit insurers as they consider how to improve their systems.

In particular, I would like to focus on the use of a reserve range as a tool to gauge the adequacy of our deposit insurance fund, rather than a specific (or hard) target reserve ratio. Following passage of the Federal Deposit Insurance Corporation Improvement Act in 1991, a target reserve

ratio—termed a designated reserve ratio or DRR—was established for our deposit insurance funds. I'm sure many of you are familiar with our DRR of 1.25 percent of insured deposits, which guided our premium setting for the past decade. Now we are in the process of developing an assessment system with somewhat more flexibility, which we anticipate will accomplish two things. First, the new system should reduce some of the potential for large swings in assessment rates that existed under the previous system and thus help to reduce volatility in the premiums bank pay. Second, the new system should help us ensure that banks are properly charged for the risk they pose to the system.

Let me briefly explain. Our old system operated in a pro-cyclical fashion, in that the FDIC could be required to raise assessment rates during economic downturns. If a downturn were to increase the FDIC's insurance losses and push the reserve ratio below the 1.25 percent target, we could be forced to increase premiums at a time when banks are already under stress due to deteriorating economic conditions. In other words, banks could be forced to pay the most at a time when they are least able to afford it.

Similarly, under the old system the FDIC could be required to lower assessment rates during an economic expansion. To the extent that an expansion is associated with fewer bank failures the fund could grow beyond its target ratio. In that event, a decrease in premiums could be necessary to prevent the fund from growing beyond the 1.25 percent target.

In both upturns and downturns, the old system tended to exacerbate the swings of the business cycle instead of moderating them.

Under the new system, the FDIC will be able to allow the deposit insurance fund to fluctuate within a reserve ratio range of 1.15 to 1.50 percent of insured deposits. Additionally, there is no requirement that the reserve ratio meet a target DRR. The FDIC must simply keep the reserve ratio within the designated range: If the fund falls below 1.15 percent, a restoration plan must be implemented; and if the fund grows beyond 1.50 percent the FDIC must pay dividends to the banks equal to 100 percent of the premiums collected.

This ability to allow the fund to fluctuate within a range should result in more stable assessment rates and more predictability for banks, thus helping them to control their costs. In other words, the fund's reserve ratio, not the assessment rate, will adjust to changes in economic conditions—falling when times are difficult and rising when they are better. As in the children's fable, the FDIC will become more like the ant and less like the grasshopper—better able to cope in times of necessity by the preparations we are able to undertake in times of plenty.

A second benefit the FDIC anticipates from the recent deposit insurance reform legislation is to be able to charge all banks at all times for the risk they pose to the system. Under the old structure, the FDIC was prevented from charging well-capitalized and well-managed institutions a premium when the DRR is above its target ratio of 1.25 percent. Under the

new legislation, the FDIC will be able to charge a bank a premium for deposit insurance that reflects the risk it poses to the deposit insurance system regardless of the reserve ratio of the fund.

Our goal first and foremost will be to price premiums fairly. And any system that we adopt will be open and transparent. The industry, with the help of the general public, will have an opportunity to weigh in on any changes we propose.

Key to implementing this change will be to devise ever-more-accurate systems for measuring the risk a bank poses to the system. As a result of much discussion with bankers, trade group representatives and other regulators, as well as our own analysis, the FDIC is looking at several pricing methodologies. For example, we are considering whether a different pricing system for the largest banks and thrifts may be appropriate, given the scope and complexity of operations at these institutions.

The FDIC Board will meet in July to adopt a proposed regulation for comment on alternatives for pricing deposit insurance premiums, and we expect to adopt final implementing regulations on all aspects of deposit insurance reform by November 5th.

These reforms have been the subject of much discussion and debate, and I expect this dialogue to continue as we move forward with implementation. The FDIC welcomes any input from the members of this

distinguished audience as we develop the policies and regulations that will make our deposit insurance reform a reality.

I hope that my comments have given you an idea of some of the work that is currently underway at the FDIC. As I stated in the beginning, these changes are largely the result of a self-assessment process that the FDIC implemented a number of years ago. Like the KDIC, we have found the practice of regular self-assessment to be of great value, and we strive to maintain a corporate culture that fosters openness to new ideas and incremental reforms that can steadily enhance the effectiveness of our deposit insurance system.

I thank Mr. Choi for this opportunity both to share the experiences of the FDIC and to learn about the work of others. Once again, I want to congratulate Mr. Choi and all of our KDIC colleagues on the occasion of their tenth anniversary. Our two institutions have forged a strong working relationship that has proven to be most productive and rewarding, and we look forward to building on this solid foundation as we go forward. Together, we can do much to promote stability in our rapidly evolving financial world. Thank you.