Remarks by
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I would like to thank Laricke Blanchard for providing me with the opportunity to speak today before the Task Force on Financial Institutions Regulatory Issues of the Women in Housing and Finance. At the outset, I should note that the views I will present today are entirely my own and do not necessarily represent those of the Office of the Comptroller of the Currency.

A Proposal

The FDIC has initiated discussion of reform of deposit insurance and asked for comments and suggestions. Here I propose the Mutual Insurance Model with Incentive Compatibility (MIMIC), a model for deposit insurance that mimics the incentives and practices of a private-sector mutual insurance organization. Although I discuss MIMIC and its benefits and costs to banks in more detail later, here is a preview of its main features:

- Annual, fully risk-based premiums
- Payments to Treasury for the line of credit and "catastrophe insurance" provided to the FDIC
- Rebates to banks when the reserve ratio exceeds a risk-based ceiling
- Surcharges on banks when the reserve ratio dips below a risk-based floor
- Dilution fees on deposit growth to maintain reserve ratio
- Refunds when deposits shrink to maintain reserve ratio.

Opportune Time for Reform

Policy reform often proceeds in the cauldron of crisis. In that cauldron, demand for immediate action to alleviate the symptoms of a flawed financial system often boils up so rapidly and strongly that more fundamental flaws are not adequately addressed. In addressing FDIC reform, we need not, and should not, wait for the heat to be turned up. Rather, conditions now allow us to pursue reform deliberately and thoughtfully.

FDIC Chairperson Donna Tanoue has said that, because neither the banking industry nor the FDIC is facing any foreseeable crisis, now is an opportune time for reforming deposit insurance. Just as skilled banking management requires that policies and operations be set with an eye toward the future, skilled banking policymaking should be at least as forward-looking. Recognizing that the financial seas will not always be tranquil, policymakers can ready their vessels now for the possibility of rougher seas in the future.

Since the early 1990s, the financial health of the banking system as a whole and that of the FDIC have rebounded. Earnings in the banking industry have been high and loan losses have been low. Bank capital as measured by the standard ratios has been replenished. As a consequence, losses to the FDIC's deposit insurance funds have been low and the ratio of Fund reserves to insured deposits has risen steadily.

Relatively recent experience, and some even more recent data, remind us that financial stability is not a given. One needs only look back a few years to find serious financial turmoil in important economies in disparate parts of the world. The financial crises of 1997 and 1998 may have originated abroad and may have been felt most keenly within the regions surrounding their country of origin. But, partly as a consequence of the operations of internationally-active commercial banks, shocks that originate anyplace in today's interconnected, sophisticated, financial markets can reverberate around the globe in financial markets and in banking. The reverberations of such financial shocks on real economic activity and on policy at home can also affect the domestic banking industry.

More recently, the credit quality of loans held by U.S. banks has slipped somewhat. The latest data from banking supervisors' Shared National Credits program showed a doubling from 1998 to 2000 of the percentage of credits that were adversely rated. In recent years, non-performing and charge-off rates for commercial loans, though still well below their levels in the early 1990s, have also risen. On the macroeconomic front, the consensus among economic forecasters is that economic growth over the next year or two will be considerably slower than we have enjoyed in the immediate past. Thus, while the banking industry and the FDIC are currently reporting strong results, there are no guarantees that recent results will continue indefinitely. These ongoing risks are the first reason that the opportune time to reform the FDIC is now, before there is any sizeable deterioration in financial or economic conditions.

The second reason that this is an opportune time to pursue deposit insurance reform is that, at least for the near term, much of the impetus for, and debate about, financial modernization was addressed in late 1999 by the enactment of the Gramm-Leach-Bliley Act (GLBA). As a result, banking and its regulators find themselves in a period of considerable stability, in the sense that the legislative backdrop is more settled than it has been in some years.

A third reason that this is an opportune time for deposit insurance reform is that the banking industry and its regulators are now in a better position to handle some of the proposed remedies for the current flaws in deposit insurance. The development of risk management techniques and the computational apparatus to carry them out enable both the industry and regulators to adopt a considerably more forward-looking approach to risk assessment. And, indeed, both the industry and its supervisors now appear to be appropriately taking into account more, not just current conditions, but also the conditions that might emerge in the future and the likelihood of such conditions.

Reform Issues

In its recently released "options" paper, the FDIC identified four problem areas in current deposit insurance policy. The first area is pricing policy, which the FDIC argued creates inappropriate incentives and raises fairness issues. The Federal Deposit Insurance Corporation Improvement Act of 1991 required the FDIC to charge risk-based deposit insurance premiums and established a designated reserve ratio for the insurance fund of 1.25 percent. The FDIC's authority to charge risk-based premiums, however, was severely curtailed by the Deposit Insurance Funds Act of 1996 (DIFA). DIFA effectively restrained the FDIC from charging healthy banks anything at all for deposit insurance once the reserve ratio exceeded 1.25 percent. DIFA also required that the FDIC charge all banks at least 23 basis points if the reserve ratio is expected to be below 1.25 percent for more than a year. Thus, premiums can shift up abruptly--independently of a bank's risk--when the reserve ratio falls below the designated reserve ratio.

In addition, current premium policy subsidizes banks' risk-taking at the margin. Even the few banks that pay positive premiums probably do not compensate the FDIC fully for the risks they impose on the Fund. And, among the vast majority of banks that pay zero premiums, safer banks subsidize riskier banks via the latter's greater likelihood of drawing down the Fund's reserves and triggering increased premiums on all banks sooner.

Second, deposit insurance premiums are "procyclical" in that the weaker the condition of the banking industry and thus the lower the Fund's reserve ratio, the higher deposit insurance premiums are likely to be. The third problem area is the legal requirement to operate separately the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) funds, which the FDIC strongly argued is inefficient. The final concern is whether the present $100,000 insurance ceiling, which was set in 1980, should be raised.

I will comment only briefly on the two latter issues. Now that BIF and SAIF have similar, historically high ratios of reserves to insured deposits and serve industries that are in similarly strong condition, two of the major stumbling blocks to their merger are no longer present. Since merging the two Funds conceivably would enable the FDIC to achieve some operating efficiencies, I support the FDIC's recommendation to merge the Funds.

The ceiling on deposit insurance coverage is as much a political as an economic or analytical issue. Advocates of increasing the ceiling note that the overall price level in the economy has approximately doubled since 1980, when the coverage ceiling was last raised. On the other side, the argument is made that raising the ceiling then from $40,000 to $100,000 reduced the market incentives to invest insured deposits appropriately and contributed to the savings and loan crisis. Secretary of the Treasury Summers, Federal Reserve Board Chairman Greenspan and Senate Banking Committee Chairman Gramm have expressed opposition to raising the deposit insurance coverage ceiling to $200,000 per account. To the extent that a ceiling makes sense, and I believe it does, inflation-indexing would reduce the likelihood of large, arbitrary adjustments.

Primary Objective of Deposit Insurance Reform: Prices Right

The primary objective of deposit insurance reform should be to ensure that each of the financial services associated with deposit insurance is rigorously priced on the basis of risk. More thoroughgoing risk-based pricing will better align the incentives of banks and of the FDIC with the broader goal of efficiency.

The User Fee Model

In its options paper, the FDIC discussed a "user fee" model of deposit insurance, which might also be referred to as a pure government guarantee model. The thrust of this model is that banks would pay annual, risk-based, user fees, or premiums, for deposit insurance. Risk-based premiums would not be based solely on banks' current conditions but, rather, would be forward-looking. Fully risk-based premiums would be sufficient over the long run to compensate the government for all the risks, large and small, that it chose to bear. By moving toward risk-based premiums, subsidies from safer to riskier banks and the subsidies from Treasury through the FDIC to the banking industry would be reduced.

These premiums would not be affected by the size of the Fund. Banks would incur no additional responsibilities when the Fund balance was deemed to be " too low"; nor would they have any extra claim on the Fund when it was deemed to be "too high." Thus, the size of the Fund would be economically irrelevant to banks.

In principle, the user fee model might be very attractive if the U.S. were instituting a *de novo* deposit insurance program. But, we are not. I doubt that an agreement could be reached to abolish and disperse the Fund. And, if the Fund were to survive under the user fee model, it is hard to believe that premiums would solely reflect risk and be impervious to the size of the Fund. Thus, given past experience and present realities, the user fee model seems unlikely to achieve the objective of fully risk-based premiums for the future.

MIMIC: Mutual Insurance Model with Incentive Compatibility

To improve the prospects for a deposit insurance system with rigorous, risk-based pricing, I propose MIMIC, a model for deposit insurance that mimics the incentives and practices of a private-sector, mutual, insurance organization. The main features of MIMIC are:

- Annual, fully risk-based premiums
- Payments to Treasury for the line of credit and "catastrophe insurance" provided to the FDIC
- Rebates to banks when the reserve ratio exceeds a risk-based ceiling
- Surcharges on banks when the reserve ratio dips below a risk-based floor
- Dilution fees on deposit growth to maintain reserve ratio
- Refunds when deposits shrink to maintain reserve ratio.

I will go through each of these in turn.

Risk-based Premiums

Under MIMIC, banks would pay the same risk-based premiums that they would pay under the user fee model.

Moving to risk-based premiums, which reflect forward-looking assessments of banks' prospects, may reduce the procyclicality in current premium policy which tends to reflect recent past performance. First, when banks' earnings reflect expected additional rewards to risk-taking, risk-based premiums will tend to be higher when earnings are higher. And, second, banks' current earnings may be less correlated with forward-looking assessments of banks' prospects than they are with banks' recent past performance. If so, then risk-based premiums will be less procyclical than current premiums.

Risk-based premiums will fluctuate over time as the risks that banks pose to the Fund fluctuate. Risk-based premiums are not likely, however, to shift as abruptly as can happen under current law.

While it is easy to talk about imposing risk-based deposit insurance premiums on banks, it is challenging to approximate those risks. One can sympathize with the temptation to use readily available, objective data for determining deposit insurance premiums. However, financial statements are often better indications of what has been than of the likelihood of future events. For larger banks in particular, data and other information obtained through the supervisory process may provide useful additional information. Regardless, while measuring risk at individual banks may be challenging, we can surely do better than charging nearly every bank the same zero premium.

Payments to Treasury

The government has come to recognize and to price some of the valuable financial services that it provides. Valuable financial guarantees provided by the government ranging from loan guarantees on FHA home mortgages and on SBA business loans to flood insurance are already priced, however imperfectly. Many remain unpriced. Earlier this year, for example, Federal Reserve Board Chairman Alan Greenspan called attention to the resource costs of the implicit but unpriced guarantees provided by Treasury to housing-related GSEs.

The Treasury supplies two unpriced financial services to the FDIC. Currently, by law the Treasury extends a $30 billion (repayable) line of credit to the FDIC. Treasury also backs the obligations of the FDIC with the full faith and credit of the U.S. government. The backstop that Treasury provides to the FDIC resembles the re-insurance that private insurance companies purchase. An example of a backstop being called upon took place as a result of the savings and loan crisis. The Treasury "contribution" in the range of $150 billion covered the losses beyond those that the S&Ls and their insurer were called upon to pay. Because the re-insurance provided by the Treasury to the FDIC is presumed to be called upon only to cover large losses beyond those that banks and the FDIC would be called upon to cover, this policy is referred to as "catastrophe insurance."

Last week, the Shadow Financial Regulatory Committee suggested that deposit insurance no longer poses any risk to the Treasury, due to FDICIA provisions such as prompt corrective action and the requirement that large losses would be funded, after the fact, by ex-post fees on the remaining, solvent banks. I respectfully disagree with the Committee on this issue. Although the probability that Treasury will have to fund deposit insurance losses may be extremely low, Treasury remains at risk for low-probability, large-loss events. Thus, the line of credit and catastrophe insurance provided by Treasury remain valuable and necessary.

Why does Treasury remain at risk? First, the deposit insurance fund is not especially large relative to the size of the banking system or its potential losses imposed on the Fund. Second, large enough losses can overwhelm not only the deposit insurance fund, but also overwhelm the ability of an industry to repay Treasury after the fact, as demonstrated by the thrift crisis. Such large losses are likely to be associated with a severely weakened industry. In that case, it is highly unlikely that it will be either economically sound or politically feasible to extract enough funds from the weakened banks to repay all the losses without further weakening them, putting them at a distinct competitive disadvantage relative to their non-bank competitors who will not be paying ex-post fees, and disrupting bank credit flows.

Despite the value of Treasury's ongoing backstops to the deposit insurance fund, at all times, under all circumstances, the FDIC has paid a zero premium for the costs and risks that its line of credit and its catastrophe insurance policy impose on the Treasury. This situation bears the same hallmarks of inefficiency that the FDIC pointed out in current deposit insurance premiums. The failure of the FDIC to pay risk-based prices (and pass the costs along to insured banks) for these financial services from the Treasury constitutes a public subsidy to banks' risk-taking. Absent a compelling economic argument to the contrary, these financial services should be priced according to the costs and risks associated with providing them. MIMIC calls for the FDIC to make two, separate, risk-based payments annually to the Treasury: one for the $30 billion line of credit and one for catastrophe insurance.

In addition, I prefer charging banks *ex ante* for the risks that they impose on the Fund rather than settling up *ex post*, which the Shadow Committee recommended. First, a bank's cash outlays for premiums based on the risks it imposes on the Fund *ex ante* is likely to deter risk-taking more than a less-certain, *ex post* arrangement to charge for the Fund's losses. Second, although on average the riskiest banks would be expected to be the banks that disappeared into insolvency and that imposed actual losses on the Fund, they would not be around to pay any of the *ex post* settling up charges.

It will also be challenging to measure the risk imposed on the Treasury by the FDIC so that risk-based fees for the line of credit and catastrophe insurance can be levied. However, again, it should not be difficult to improve on the zero price currently charged by the Treasury.

Risk-based Reserve Ratio, Rebates, and Surcharges

Further mimicking private sector insurance arrangements, MIMIC calls for the FDIC to specify annually a risk-based target range for its reserve ratio. The range would be re-calibrated from time to time as the FDIC's estimate of the risks facing the Fund changed.

Choosing a range implies choosing a floor and a ceiling for the reserve ratio. To maintain the reserve ratio within its chosen range, under MIMIC the FDIC would impose surcharges on banks if the ratio dipped below the floor and analogously would provide rebates from the Fund to banks when the reserve ratio rose above the ceiling. These surcharges and rebates should and can be designed to preserve the annual premiums' risk-based incentives. Under MIMIC, banks will recognize that higher current premiums raise not only the reserve ratio but also the likelihood of future rebates. Thus, a risk-based range for the reserve ratio reduces the current incentive for banks to pressure the FDIC to set premiums and reserve ratios "too low."

The Fund's reserves serve as a "deductible" in the catastrophe insurance policy. Thus, other things equal, the premiums paid by the FDIC to the Treasury would vary inversely with the range established by the FDIC for its reserve ratio. Explicitly paying for these Treasury services raises the incentive for banks and the FDIC to maintain a larger average reserve ratio than otherwise.

Some of the same practical difficulties will arise in setting the appropriate risk-based range for the reserve ratio as in setting risk-based premiums. At the same time, it seems very likely that we can do better than, in effect, aim at a historical artifact like the current designated reserve ratio of 1.25 percent.

Dilution Fees and Refunds

One notable feature of MIMIC is that it confers upon banks some of the rights and responsibilities that attend the members (or owners or residual claimants) of mutual organizations. While banks would have some of the prerogatives of "ownership" of the federal deposit insurance system, they would not have them all. For example, it seems very unlikely that there would be voting shares in any meaningful sense. Rather, the FDIC would remain as the arm of the federal government charged with administering the deposit insurance system, including setting premiums and the target range for the reserve ratio.

At the same time, under MIMIC, banks would have a financial stake in the size of the Fund relative to insured deposits. Since growing banks dilute the Fund by lowering the reserve ratio and raising the probability of surcharges to replenish the ratio, it is appropriate to charge them a dilution fee. This fee could be as simple as a one-time charge equal to the current reserve ratio times the additional dollars of insured deposits. Even-handed policy would then also refund to banks whose insured deposits shrank an amount equal to the current reserve ratio times the decline in their insured deposits.

Markets on the March

Market-based and market-like pricing have been spreading around the globe for at least a decade. Entire countries have moved to market-based systems. Closer at hand, U.S. financial markets have increasingly priced and traded separately the distinct constituent parts of previously composite financial products (and services). Banks have been in the forefront of this "unbundling" of composites into their more homogeneous components. As financial assets are unbundled, the resulting products more closely match individuals' market demands and the resulting prices are likely to better reflect the costs and benefits of those products.

For many years, the Federal Reserve System bundled into the package of rights and responsibilities associated with being a member bank financial services, such as check clearing and payments transfers, at no explicit, separate cost. Eventually--and ironically, given the economic orientation of the Federal Reserve System--Congress filled the pricing vacuum by mandating a pricing scheme for some of the financial services that the Fed supplies.

Some government-provided financial services remain bundled. In addition to deposit insurance, the FDIC provides valuable supervision and regulation at no explicit, separate cost. Moreover, some, but not all, insured banks receive these unpriced services. Just as it can address the pricing of deposit insurance *per se*, deposit insurance reform should eliminate the inefficient pricing of these services. One way to achieve efficient prices for the FDIC's supervision and regulation is to unbundle them from deposit insurance; that is, to separate the pricing of deposit insurance from that of FDIC supervision and regulation.

Rather than letting Congress or an Administration take the initiative, banks and the FDIC should consider how to move toward a more rational pricing scheme for each of the financial services associated with the FDIC. Explicitly paying for each of these services may forestall other costs being imposed on banks by those who perceive banks as receiving government subsidies.

Conclusion

MIMIC calls for risk-adjusted deposit insurance premiums, as well as risk-adjusted prices for the individual services that the Treasury provides to the FDIC. As a result, MIMIC would reduce the current subsidies from safer to riskier banks and from the Treasury to the FDIC.

In order to strengthen the incentives of banks and the FDIC to get the prices right, MIMIC confers on banks some, but not all, of the rights and responsibilities of ownership of the deposit insurance system. Thus, MIMIC calls for the FDIC to maintain its reserve ratio within a risk-based range through the use of rebates and surcharges. It also advocates a dilution fee for deposit growth and, symmetrically, a refund when deposits decline. Taken together, these features of MIMIC move the deposit insurance system toward the policies and practices of private-sector mutual insurance organizations.

The FDIC has stimulated a timely and valuable discussion of deposit insurance reform. Because of the size of their stake in the efficient operation of the deposit insurance system, banks should recognize their significant interest in achieving the right reforms.