

FEDERAL DEPOSIT INSURANCE CORPORATION

ROUNDTABLE ON DEPOSIT INSURANCE REFORM

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C.

Tuesday, April 25, 2000
9:30 a.m.

Federal Deposit Insurance Corporation

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The FDIC has made minor edits to this transcript for purposes of brevity and clarity.

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A G E N D A

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1 P R O C E E D I N G S

2 9:35 a.m.

3 CHAIRMAN TANOUE: Okay. Why don't we get started?

4 Good morning, everyone. I'm Donna Tanoue, Chairman of
5 the FDIC, and I'm pleased to welcome everyone to this Roundtable
6 on Deposit Insurance Reform.

7 Now, you know at the FDIC, we always say that one
8 should fix their roof when the sun is shining, but it's awfully
9 wet out there today, but we're going to start anyway.

10 You know, our goal today is really to take a fresh
11 look at deposit insurance reform, and this morning, we'd like to
12 start out by really honing in on three issues.

13 The first is how to price deposit insurance, and the
14 second issue is really how to maintain the insurance funds at
15 appropriate levels, and the third issue is how to provide the
16 right level of insurance coverage.

17 And to that end, we're seeking a diversity, although
18 there are a lot of blue suits here today, a diversity of opinion,
19 and I'd like to underscore that the FDIC has not adopted or
20 endorsed any single approach to deposit insurance reform, and what
21 I'd underscore, at the outset is that we are open-minded, and
22 that's what we're here for today, to listen and to really obtain
23 the value of your views and perspectives.

24 And today's roundtable is really a first step, a first
25 step in the process, and we're here to gain comments and
26 perspective from those of you who are so enormously knowledgeable
27 about the issues and also have a real stake and interest in the
28 outcome.

29 I am personally looking forward to hearing some very
30 insightful analysis and some thoughtful recommendations and really
31 to hearing a very spirited and lively discussion.

1 Following this roundtable, the FDIC plans to continue
2 our discussions with you, and we plan to go, as you know, around
3 the country to seek input, and what we're shooting for is to
4 develop a set of policy options some time in July.

5 Now, this morning, I've asked Art Murton, who is the
6 Director of our Division of Insurance at the FDIC, to help lead
7 the discussion or maybe I should say to help moderate the
8 discussions, and for those of you who don't know him, Art
9 characterizes himself, and I quote here, "as a recovering
10 economist". But for most of his adult life, he has been involved
11 with deposit insurance issues.

12 We also have up here Roger Watson, who is the Director
13 of our Research Division, and he is someone that I characterize as
14 really embodying the heart and soul of the FDIC, and he's
15 extremely knowledgeable in the issues as well.

16 And I also want to take a few moments to recognize a
17 very special person, and that is our Vice Chairman Skip Hove. For
18 those of you with long memories or short memories, good memories,
19 it was under Skip's leadership that the FDIC held its first
20 Symposium on Deposit Insurance Reform two years ago, and that
21 symposium laid the groundwork really for today's roundtable
22 discussion and where we go from here.

23 I'd like to thank Skip for his tremendous vision and
24 for participating also in today's discussion as well, and with
25 that, let's begin, and I'll turn it over to Art to really open it
26 up.

27 MR. MURTON: Thank you, Chairman Tanoue.

28 My role as moderator today is to make sure that we
29 cover the topics in the time that we have, and that everyone gets
30 the opportunity to weigh in.

31 As the Chairman said, we'd like this to be an open

1 discussion with give and take. So, I would just like to ask that
2 the participants try to keep their remarks brief, so that the
3 discussion can keep moving.

4 If everyone is able to do that, I wouldn't expect any
5 heavy-handed regulatory intervention would be necessary.

6 (Laughter)

7 MR. MURTON: With that, I'll cover a couple of
8 logistics. We're going to try to take Q&A from the audience at
9 the end of each session, time permitting, and as your materials
10 indicate, tomorrow morning, this session will be web-cast, and the
11 relevant information is in the package.

12 What I'd like to do now is just go around the table
13 and have the participants introduce themselves, and I'd like to
14 start at this end of the table.

15 MR. SMITH: My name's Jim Smith. I'm First Vice
16 President with the American Bankers Association, and I'm also
17 President and CEO of the Union State Bank and Trust in Clinton,
18 Missouri, \$150 million bank in rural Missouri, about 70 miles
19 outside of Kansas City.

20 MR. FITZGERALD: I'm Bill Fitzgerald, Chairman at
21 American Community Bankers, also Chairman at Commercial Federal
22 Bank, headquartered in Omaha, Nebraska, about 13 and a half
23 billion.

24 MR. NORTH: I'm Nolan North, Chairman of the Board of
25 the Association for Financial Professionals, and I am Vice
26 President and Assistant Treasurer of T. Rowe Price.

27 MR. CARNS: I'm Fred Carns, with the Division of
28 Insurance at the FDIC.

29 MR. SHEEHAN: I'm Tom Sheehan. I am President of the
30 Independent Community Bankers Association. I am also Chairman,
31 President and CEO of Grafton State Bank. We're a \$120 million

1 community bank located just north of Milwaukee, Wisconsin.

2 MR. McELDOWNEY: I'm Ken McEldowney. I'm wearing two
3 hats today. It seems like everyone's wearing two hats. I'm
4 President of Consumer Federation of America, and I'm also
5 Executive Director of Consumer Action, a San Francisco-based
6 consumer education advocacy group that works through a national
7 network of more than 5,000 community-based organizations.

8 MR. GREEN: I'm Roy Green. I only have one hat,
9 that's the Legislative Representative for Financial Services at
10 AARP.

11 MR. CARNELL: I'm Rick Carnell, Associate Professor of
12 Law at Fordham University in New York.

13 MR. THOMAS: I'm Ken Thomas, Lecturer of Finance at
14 The Wharton School.

15 MR. MURTON: Okay. Thank you.

16 What I would like to do now is start the Session on
17 Pricing, and to kick it off, I'd like to ask Fred Carns to provide
18 a little background material on some of the pricing issues.

19 Session on Pricing

20 MR. CARNS: Thank you, Art.

21 Pricing is the first topic. Let's take a look first
22 at a brief history of FDIC premiums.

23 When the FDIC began operations in 1934, the assessment
24 rate was set by statute at 1/12th of one percent of assessable
25 deposits or eight and a third basis points.

26 The Fund eventually grew to about a billion dollars in
27 1950, and the FDI Act of 1950 established the refund system at
28 that time. The FDIC refunded 60 percent of the excess of current
29 assessment income above its operating costs and insurance losses,
30 and the refund took the form of a credit against future
31 assessments.

1 This system essentially remained in place with minor
2 changes until 1980, with effective premiums after the refunds
3 averaging around three and a half basis points.

4 In 1980, bank failures were rising, and insurance
5 losses began to mount, and the refunds were reduced over time and
6 finally discontinued in 1983.

7 As the banking crisis later took hold, eight and a
8 third basis points proved to be insufficient, and Congress
9 authorized a series of increases in the rate, which continued
10 until premiums became 23 basis points in 1991. That was the year
11 that FDICIA was passed, among other reforms, which introduced
12 deposit risk-based premiums for deposit insurance, and the average
13 premium at that time remained at 23 basis points until the BIF was
14 recapitalized in 1995 and the SAIF in 1995.

15 1996 was the year that the Deposit Insurance Funds Act
16 became law, and the constraints on pricing contained in this Act
17 formed the basis for much of our discussion here this morning.

18 The Deposit Insurance Funds Act imposes a premium of
19 zero for most institutions that are well-capitalized. Under the
20 Act, whenever the insurance fund is above its target or designated
21 reserve ratio, the FDIC has limited flexibility to charge anything
22 to a well-capitalized institution, unless it has a composite
23 CAMELS rating of 3, 4 or 5.

24 The result today, given the strong condition of most
25 institutions, is that more than 93 percent of the industry pays
26 nothing for deposit insurance, and you can focus on the red
27 portion of the pie charts here.

28 We see from this slide that when the risk-based
29 premium system was originally established, 75 percent of the
30 industry was in the best-rated category. Today, again, it's over
31 93 percent.

1 We want to consider the concerns raised by the '96
2 constraint in combination with the other factors of our system,
3 and these concerns relate, first, to whether the system promotes
4 cost-sharing for deposit insurance in a fair and equitable manner;
5 second, whether the system is sufficiently forward-looking; and,
6 third, whether it can respond appropriately to emerging risks and
7 changes in the industry structure.

8 These concerns manifest themselves in several ways.
9 For purposes of our discussion, we've grouped some examples under
10 two headings, Deposit Growth and Risk Differentiation.

11 Let's start with deposit growth. The general point to
12 make about our present system is that institutions can grow their
13 insured deposits without paying any extra premiums.

14 In today's environment, given the increasing size of
15 the largest institutions and the blending of financial services
16 within holding companies as well as technological developments,
17 rapid increases in aggregate deposit levels are increasingly
18 possible, and this raises the prospect that actions by one or a
19 few firms could trigger premiums for the entire industry.

20 We're all aware of recent press reports regarding
21 plans of an investment banking firm to sweep funds from cash
22 management accounts into insured deposits, perhaps as much as a
23 \$100 billion. Were this to occur all at once, it would reduce the
24 BIF year-end reserve ratio from 1.37 to 1.31.

25 It's worth considering that the SAIF is equally
26 subject to these forces, although the example we're considering
27 involves a BIF-insured institution. Another investment banking
28 firm or insurance company could choose a SAIF-insured depository,
29 and a \$100 billion increase in insured deposits for the SAIF would
30 reduce that ratio from 1.45 to 1.27.

31 Less dramatically perhaps, we can look at the top 25

1 percent of institutions in terms of insured deposit growth since
2 the funds were capitalized. The fastest growers have increased
3 their deposits by \$178 billion without paying any additional
4 assessments.

5 Meanwhile, 814 new banks have been chartered over this
6 period, and they now hold \$44 billion and have never paid anything
7 to the insurance funds.

8 The de novo or new bank issue takes on additional
9 significance when we look to our historical experience. Both in
10 the '80s and recently, we've seen a number of well-rated
11 institutions suddenly develop problems and sometimes fail.

12 Given the increasing number of new banks, it's
13 probably just a matter of time before the industry will be paying
14 for failures through the insurance funds for institutions that
15 haven't contributed to the BIF or SAIF.

16 The flip side of charging zero for deposit growth is
17 that there are several institutions that are shrinking, losing
18 core deposits, reducing the exposure that's attributable to them.

19 These institutions get nothing back from the insurance funds.
20 Many of them were asked to pay substantially in the past to
21 capitalize the funds, and, so, we think we need to take a look at
22 the fairness of the system in this area.

23 The second set of examples we've chosen to illustrate
24 we group under risk differentiation, and, here, we ask the
25 question whether we should use additional information to allow
26 finer distinctions, whether we can make the system more forward-
27 looking and more responsive to structural changes.

28 Let's first look at an example using reported year-end
29 information. These are actual numbers reported by insured
30 institutions in the best-rated category. They all pay the same
31 zero premium.

1 We show here the top 10 percent and the bottom 10
2 percent for a number of performance factors. There are clearly
3 significant differences among these two groups of institutions,
4 but, again, these are all in the best-rated category.

5 You can see particularly commercial loan growth and
6 volatile liability growth, very significant differences.

7 What about the responsiveness of the pricing system to
8 changes in industry structure? 20 years ago, the smallest
9 institutions held half of all core deposits. Today, the situation
10 is reversed. If you look at the red bars, the largest
11 institutions now hold over 50 percent of core deposits.

12 This is the familiar barbell structure to the industry
13 that we've all discussed in the past with many small institutions
14 on one end and a few institutions with considerable assets on the
15 other, and this reflects what we all know, that risk to the funds
16 is becoming more concentrated in the largest institutions.

17 But what's also significant is that the largest
18 institutions have substantially different characteristics than the
19 other institutions in the industry.

20 For example, the largest banks have different
21 asset/liability structures than the rest of the industry, and this
22 means that there's information available for these institutions
23 that is not available for smaller institutions.

24 Some of this information obviously is market
25 information, which is inherently forward-looking. Here, we show a
26 chart with yield spreads over comparable maturity Treasuries for
27 bank holding companies' subordinated debt from 1997 to the
28 present.

29 The red line is the mean spread for all 800some
30 institutions that issued sub-debt over this period, and the bars
31 above and below show the dispersion, the 90th and 10th percentile,

1 respectively, for spread over Treasuries.

2 You can see pretty clearly from this diagram that with
3 the Russian default in the Fall of '98, the mean spread increased
4 substantially and so did the dispersion, and this has not been
5 reversed.

6 The market is pricing risk in the largest institutions
7 differently than it was prior to 1998, and the FDIC is not.

8 I would like to hear your views on this as well as the
9 other issues we've highlighted in our agenda with respect to
10 pricing.

11 MR. MURTON: Thanks, Fred.

12 I'd like to open up the discussion, maybe start with
13 the deposit growth issue that Fred talked about, whether it comes
14 from de novo institutions or rapidly-growing risky institutions or
15 just new entrants into the industry.

16 I'd like to start it off and somewhat arbitrarily,
17 I'll call on the first person who was here this morning, and
18 that's Bill Fitzgerald from the ACB.

19 MR. FITZGERALD: Okay. It seems to me the analysis
20 that you thought people probably had done with reference the
21 dollars that you have today in the FDIC fund versus total assets
22 that are out there is one analysis, and then your issue is what
23 happens if the \$100 million comes in, what happens with the de
24 novo shops, and it seems to me the de novo -- obviously they start
25 off with nothing to begin with, and, so, if there's a three-to-
26 five-year risk premium on some premium for them as they grow that
27 base, that would be a way to take a look at that.

28 I think the change in operation in any of the current
29 banks, if in fact they would elect to transfer in funds as was
30 referred to, then my reaction is not currently covered under your
31 analysis, and therefore there has to be a way to rate this growth,

1 and there has to be a premium attached to that until that growth
2 is determined what the risk it brings to the fund.

3 And, so, it seems to me there ought to be a way to
4 price that as well. That would be a change of operation,
5 transferring the funds out of the institutions or other forms of
6 products, into an insured product, and therefore there should be
7 pricing.

8 So, I think there has to be some way to analyze that
9 and therefore protect the fund from those that are in it today.

10 Obviously the regulators today have the risk rating
11 that was referred to, the CAMEL rating, and certainly that needs
12 to continue to be looked at to make sure that all of the
13 institutions currently regulated fall within the guidelines that
14 you perceive the current reserves are covering, and if you're
15 falling out of that because of riskier-type lending you're getting
16 into or new markets that you're in that are untried or untested,
17 then obviously it seems to me you've got to kick in some added
18 premium to that institution to protect your total fund.

19 So, some way, there has to be a way to measure that.

20 MR. SMITH: Art, I think, you know, obviously if
21 there's going to be a significant influx in money coming into the
22 fund that has to be insured, I think that we can figure out a way
23 to charge for that or cover that.

24 I think, also, de novo institutions, obviously you
25 need to look at the risk at the time the charter is requested and
26 those type of things can be handled from the regulatory
27 standpoint.

28 I think, also, you could see if there's going to be
29 any rebates back, that institutions that have not paid into the
30 fund during the time to build the fund up would not maybe be
31 eligible for rebates.

1 MR. MURTON: Okay.

2 MR. SHEEHAN: Well, I don't think there's any real
3 objection on the part of most of our de novo banks to pay
4 something to get into the game, and it certainly would seem to be
5 somewhat unfair to not have to pay something.

6 I've talked to a few of our banks that have been
7 recently chartered, and they would not object to that. I mean, I
8 think it's all part of the process.

9 Again, that has to be determined in some manner that
10 would be fair to those institutions. Obviously it's difficult
11 when you're starting a new bank to have to have the additional
12 burden of deposit insurance premiums over the short-term, but
13 maybe there's a way that this can be balanced so that there is
14 some entry-level costs to getting into the fund, and certainly if
15 a company is coming into the fund like an investment banker that's
16 transferring huge amounts of money from other accounts into the
17 fund, that has to be dealt with because it's part of the problem
18 with something that's free.

19 I mean, when anything is free, you're going to sell a
20 lot of it, you know. So, I mean, I think that's --

21 (Laughter)

22 MR. SHEEHAN: -- part of the problem.

23 MR. MURTON: So, I am hearing that charging for growth
24 is a reasonable approach to take.

25 I guess one question that raises is, if that growth is
26 coming from existing deposits within the industry, how do you deal
27 with the sort of ratcheting up of the fund balance relative to the
28 overall deposit base?

29 MR. FITZGERALD: Don't you think that ties in with the
30 reserve premium itself?

31 In other words, the reserves that you have, what do

1 they cover today, and are they at 1.41? Are they sufficient to
2 cover a 10-or-15-percent growth in the insured institutions today
3 or do they just cover what the current base is?

4 MR. MURTON: Ken?

5 MR. THOMAS: Yes, Art. The one graph that really
6 bothers me up here is the fact that 93 percent are in the 1-A
7 category, and that's not a problem, but when we look at that other
8 graph, where you had the two extremes, we see that as a
9 significant differentiation, and, so, clearly, there should be
10 different charges, different -- on the concept of risk-based
11 premium.

12 What I proposed is not just increasing the existing
13 matrix but adding like a third level on most in the form of
14 special assessments to specific categories, such as, for example,
15 all de novos would have at least a three-basis-point special
16 assessment for the first three years. All rapidly-growing
17 institutions, at least a three-basis-point special assessment.
18 Those with targeted profiles, such as sub-prime lending. We would
19 have then, of course, too-big-to-fail, ought to have a special
20 assessment for those 20-25 banks in the range of three to eight
21 basis points, but an entire third dimension on top of the existing
22 two-dimensional graph of special assessments. That would be one
23 way I would look at it.

24 MR. MURTON: Yes, Ken?

25 MR. McELDOWNEY: I guess one of the questions I would
26 have, perhaps need more study, is whether or not a pure risk-based
27 model is appropriate.

28 I think it's well agreed that all banks benefit from
29 the deposit insurance program, and I think if you just have
30 something that's risk based, I think it has some real problems in
31 the long-term sense, and I think certainly when Fred was doing it,

1 it sort of illustrates the type of problems you can end up with.

2 And I think certainly in a prosperous time like now, it's
3 one thing. I think that if in fact you start ending up with some
4 problem banks, more than even now, and you suddenly have to
5 increase the premiums, and it's totally risk-based, it seems like
6 it would put even more pressure on the problem banks.

7 So, to me, it seems like one way of looking at it is
8 to study whether or not you can have -- certainly continue to do
9 premiums to a certain extent based on risk -- but also have some
10 base premiums that would apply to all banks and all deposits,
11 whether or not it was not risk-based.

12 MR. MURTON: Rick?

13 MR. CARNELL: A couple of points.

14 First, although the law requires the risk-based
15 system, we don't have a risk-based system right now, and we
16 haven't had a risk-based system since the enactment of this law;
17 that is, the differentiation between the highest and lowest rates
18 is nowhere close to the differentiation in actual risk.

19 If I remember correctly, the highest premium that the
20 FDIC has ever charged under the risk-based system is in the low 30
21 basis points.

22 Now, there's no way, no way that even 100 basis points
23 would approximate the risk posed to the FDIC by a CAMEL 4 or 5
24 rated under-capitalized institution.

25 If you think of what a commercial financial guarantee
26 insurer would charge to insure such an institution, it would be
27 many, many times larger than the FDIC charges.

28 So, I think that should be kept in perspective, that
29 we don't have a risk-based system. We have only the beginning of
30 a risk-based system and a somewhat abortive beginning since 1976.

31 Second, let's keep in mind the political constraints

1 on pricing by the FDIC. In other words, whatever the theory of
2 the law, and the law requires an actuarially-fair risk-based
3 premium, the FDIC does not have the same practical freedom as a
4 private business. In principle, it should, but the reality is that
5 a government agency, and in particular a government monopolist,
6 does not have the same freedom as a private business to
7 differentiate based on cost and risk.

8 Nobody would dispute that a private business can
9 charge people different prices based on differences in costs and
10 differences in risk, yet when a government agency tries to do
11 exactly the same thing, people are up in arms, and they're making
12 unrelated policy arguments.

13 So, I think it's very important to keep in perspective
14 the current system.

15 Third, I appreciate Ken Thomas's suggestions on ways
16 the system could become more sensitive to risk, but I would want
17 to take strong exception to the suggestion of charging people for
18 too-big-to-fail risk; that is, charging an explicit premium.

19 To do that would be a recognition of too-big-to-fail
20 policies which Congress took strong action in 1991 to do away
21 with, and I think there's other ways to deal with that, but the
22 problem is that if you charge someone an explicit premium for
23 supposedly being too-big-to-fail, that creates a kind of moral
24 entitlement to being treated as too-big-to-fail when worse comes
25 to worse, and I think that in that sense, the cure is making the
26 problem much worse.

27 The way to deal with too-big-to-fail, I would suggest,
28 would be to require large institutions to have subordinated debt
29 outstanding at the holding company level, which would create --
30 and we could go into that, but it -- I think that that idea is
31 getting a lot of attention.

1 That would be probably the single biggest step we
2 could take to improve market discipline on large institutions,
3 both because they will face a market price in the pricing of their
4 debt, but also because if the debt starts spiking, that will send
5 a signal to regulators and other policy-makers.

6 I would also note that there's other things that could
7 be done. The Federal Reserve Board's regulation on interbank
8 liabilities, which is supposed to prevent a Continental-Illinois-
9 type domino effect, is deplorably weak and imposes no quantitative
10 limits on exposure to inadequately-capitalized institution, also
11 exposure to government-sponsored enterprises.

12 One last point is that I very much agree with the
13 points raised earlier about the equity and desirability of
14 imposing some charge based on rapidly-growing institutions, such
15 as an institution that moves a \$100 billion of money into a new or
16 grown FDIC-insured institution.

17 I would just note that if we're trying to single out
18 that kind of conduct, that we're going to create significant
19 potential for evasion. So, I would note that if we want a rule
20 that can't be evaded, can't be gamed, then have a rule that
21 applies across the board.

22 For example, if you had a rule that required all FDIC-
23 insured -- and I'm not necessarily proposing this but pointing it
24 out as a rule that couldn't be evaded -- required all FDIC-insured
25 institutions to keep on deposit in the insurance fund an amount
26 equal to one-half of one percent of their deposits, let that count
27 as an asset of the institution for GAAP purposes, assuming that
28 that's okay with FASB, but the key thing would be that they would
29 have this on deposit in the fund, so that as they grew or shrank,
30 this would grow or shrink.

31 Now, I have waited until now to point out that there

1 is an analogy here to the Credit Union Fund, and I would not
2 suggest that this amount would count as capital for regulatory
3 purposes, but I think it's worth -- the key thing is that if
4 you're not going to have an across-the-board rule, then you are
5 opening the potential for significant gamesmanship by the fast-
6 growers.

7 MR. MURTON: Thank you. We might want to come back to
8 that issue on the credit union.

9 Could I call on Roy? I think -- and then we'll come
10 back to Jim.

11 MR. GREEN: Yes. I probably come at this from a
12 slightly different perspective. We've immediately delved into
13 some of the risk and baseline pricing mechanisms.

14 It's important to, I think from our membership's point
15 of view, recall -- in fact, I was looking before I came over this
16 morning at Helen Boosalis's comments a couple of years ago, at the
17 fundamental importance of confidence, both in the generation of
18 people who are 65 and over who do have memories of depressions and
19 major economic dislocations, and those who are younger, who have
20 perhaps seen the more promising times, particularly recently.

21 The point being here is with the change in the
22 financial industry that's occurring, I think we have to be very
23 careful in the strategies for pricing the services and the risk
24 that we do not in any way alter the fundamental confidence that
25 seniors have in what the FDIC supports and what it can afford in
26 terms of the dynamics of the economy.

27 MR. MURTON: Thank you. Jim?

28 MR. SMITH: I would disagree in the fact that I think
29 we do have a risk-based system because on the grid, 3, 4 and 5
30 rated banks do pay, and they are assessed a risk.

31 Given the history of the last four or five years, it

1 would seem to me when we say we have 93 percent of the banks that
2 aren't paying any premiums, but given the history of the problem
3 banks the last four or five years, I don't find that uncommon, and
4 given the problem list today, I still think that's adequate.

5 And I would also say that there's a risk-based system
6 because for anybody that's ever had a battery of field examiners
7 come in and look at your shop and give you a rating at the end of
8 the time, I can tell you there's a risk-based system because they
9 are looking at your bank. They are making decisions of whether
10 your bank is taking risk in any particular area, and that is being
11 reported back to the FDIC.

12 I think that's a true test, that we in fact do have a
13 risk-based system with people looking at our bank on an annual
14 basis.

15 CHAIRMAN TANOUE: But what about the category of
16 institutions -- the more than 90-percent that fall in that 1-A
17 box? Would the bankers want to see greater differentiation in
18 terms of risk, in terms of those institutions?

19 MR. SMITH: I don't really think so, because everybody
20 runs their shop differently. What some bank will have eight or
21 nine percent capital, maybe lower reserves, one bank will have
22 high loan loss reserves and lower capital. So, everybody runs
23 their bank a little bit differently, and I think the requirements
24 that we have and the field examination that we have today is a
25 very fair assessment of how that shop looks and passes that
26 assessment on to the regulatory authorities as to the
27 determination of the rating system.

28 MR. MURTON: Could I just respond to that?

29 One of the concerns I think we've heard is that the
30 subjectivity of the way we might choose to differentiate has been
31 a concern.

1 Certainly I think it's fair to say that within the 1-A
2 category, there are one-rated institutions that are what you might
3 call recession-proof, and then at the other end, there's some two-
4 rated institutions that are going to experience severe
5 difficulties perhaps during difficult times, and they're being
6 asked to pay the same amount, and the question is wouldn't you
7 want to distinguish between those, and is the concern that we
8 couldn't do that in a way that was fair?

9 MR. SMITH: I think it's going to be difficult to
10 decide between a one-rated institution and a two-rated institution
11 because I think if you force the banks to only go to a one-rated
12 system to get that, you're going to really impair the market
13 opportunities in those communities.

14 I think risk-proof -- risk recession-proof
15 institutions may make some different decisions than maybe an
16 institution that's out there really trying to make their market
17 work in their community and do the things, and I would hate to see
18 the differentiation just simply because I don't think we can run
19 our shops in our communities saying we're only going to be a one-
20 rated bank.

21 MR. CARNELL: Could I get a clarification? When you
22 say one, you mean CAMEL-1?

23 MR. SMITH: CAMEL-1, yes.

24 MR. CARNELL: Okay.

25 MR. SMITH: CAMEL-1.

26 MR. MURTON: Yes, Rick?

27 MR. CARNELL: I'd like to make a point or two here.

28 The first is that strong risk differentiation in the
29 system -- and I'm not referring to between CAMEL-1 and CAMEL-2.
30 I'm inclined to agree with you, James, that that's not the place
31 to draw the line.

1 But strong differentiation between healthy banks and
2 unhealthy banks is pro-stability and pro-confidence, and I think
3 it's that way in a couple of respects.

4 First, insofar as people have -- as depositors and
5 others have -- a sense that there are significant safeguards in
6 place, that promotes confidence. But beyond that, the economic
7 and reputational incentives created by significant differentiation
8 in deposit insurance premiums also promote stability because they
9 promote market-driven adjustments in asset portfolios and
10 behavior, and we saw that, I believe, after the enactment of
11 FDICIA -- about the time the FDIC created the interim risk-based
12 system.

13 The FDIC created a system where it was possible for
14 most banks to be in the 1-A category. I think that was done
15 consciously, and the result of that was that everybody wanted to
16 be 1-A, and institutions that might have resisted increasing
17 capital if it was in response to a sort of fiat demand from the
18 agency were willing to do it, so that they could have the carrot
19 of being in the 1-A category, which was valuable both in reduced
20 premiums but also, since that's where a lot of other people were
21 going to be, if there was a reputational advantage for being
22 there.

23 So, by creating or, I should say, reinforcing market-
24 type incentives to be healthy, I believe the risk-based premium
25 system promotes stability and confidence.

26 MR. MURTON: Nolan?

27 MR. NORTH: If I could come at this pricing issue from
28 a little different perspective, please.

29 I'm here representing the large depositors in the
30 banks, arguably the customers of the FDIC, and I would draw your
31 attention to the chart that Fred had up there highlighting the

1 premiums being paid in the '91 to '95 time frame, when the
2 assessment rate was at 23 bps, and it was in that same time frame,
3 I would point out, that many banks developed a customer invoice
4 system that we call the "account analysis" which allowed banks to
5 provide explicit pricing on each service or line item, as it were,
6 to pass that cost, i.e. price, on through to their customers.

7 Every such bank, therefore, at the same time developed
8 a line item to pass on to -- to pass through to -- their business
9 customers the FDIC assessment, and we, the business customer, was
10 then charged based on our total ledger balances, minus 16 and two-
11 thirds.

12 So, those of us that had tens of millions of dollars
13 on deposit in our banks were paying an assessment based on the
14 entire ledger balance, minus 16 and two-thirds, and it was our
15 position, and our research would support, that it was largely
16 based on these corporate pass-through costs in that period that
17 brought the BIF out of red and put it past the 125 bps points that
18 it is today.

19 It's our estimate that at least 40 percent of the
20 money in BIF came through from business customers of banks, and we
21 have therefore been subsidizing the other customers in the bank in
22 providing this money to BIF.

23 Now, from that standpoint then, we think we have a say
24 in what the pricing should be in this discussion, and we come at
25 it from a little different standpoint.

26 We have a fairly simple analysis which says the
27 insurance premium ought to be based on that which is insured, and
28 that which is insured is \$100,000 of collected balances, and
29 therefore the pricing that we are talking about this morning, the
30 insurance premium, the assessment, ought to be based on a per-
31 customer basis on that \$100,000 that is insured. Point 1.

1 Point 2. This discussion of new entrants into the
2 banking system. You should be flattered that you have so many
3 people wanting to participate with you, and I'm not sure my
4 association has much of a position on that topic, but my personal
5 view would be we're talking about this one entrant bringing
6 perhaps a \$100 billion into the system, and I would make the view
7 that size of deposits does not equal risk to the system and
8 therefore would move towards Mr. Thomas's suggestion that there be
9 different types of special assessments for different types of
10 activities.

11 And in the too-big-to-fail analysis, if we are focused
12 on that which is insured, which is a \$100,000 of collected
13 balances, then the equation changes dramatically of what is the
14 risk to the system.

15 MR. MURTON: Thank you. Tom?

16 MR. SHEEHAN: My only comment on that would be that
17 there must be in some manner a growth component and history has
18 shown us, I believe, that rapid growth in any institution can
19 create a significant amount of risk because if you're not growing
20 locally, and you're not attracting deposits locally, and you're
21 garnering these deposits nationally, at prices that are obviously
22 higher than what local deposits are paying, you have to do
23 something with that money.

24 I mean, the market works pretty well, and, so, a
25 straight arbitrage is not going to be adequate. So, you're going
26 to have to find investments that are going to be adequate to give
27 you at least some sort of a margin, and if you're rapidly growing
28 for whatever reason, and I think this happened previously, history
29 does tend to repeat itself, but in the early '80s, there were a
30 number of institutions that were growing very, very rapidly using
31 deposits they attracted nationally.

1 I think there was risk that was inherent in that
2 growth, and if we can figure out some way to price that growth
3 component, I think that would mitigate some of this rapid growth
4 that occurs, to the disadvantage of a lot of the smaller banking
5 institutions in the Midwest and other parts of the country that
6 are struggling for deposits and are having difficulty garnering
7 deposits.

8 These are being drained. They need to be replaced
9 with other borrowings. I mean, it creates kind of a domino effect
10 for a lot of our smaller banks. So, I think if you price that
11 growth and make it a component so that you put a little element of
12 concern in that deposit growth, I think you might help solve
13 several problems, especially in the Midwest.

14 MR. MURTON: Thank you, Tom. Ken?

15 MR. THOMAS: Yes. On this very basic issue of whether
16 or not we have a risk-based system, I tend to agree -- I
17 definitely agree with Jim that we do.

18 I mean, if we go back to '34, from the fixed system
19 that we used to have, we have a risk system. The system today we
20 have is not broken. It just needs to be improved. So, we clearly
21 have a system that exists, it's risk-based, but we need to improve
22 it.

23 My proposal for one way of improving it -- there are
24 certainly others, but we do have a system like that.

25 On the issue of sub-debt, I think it's critical to
26 note that, for example, the risk premiums you showed, the analysts
27 that do this evaluation, the market that does it, only has a
28 certain amount of data to go on.

29 I think a component of this should be the mandatory
30 disclosure of additional data for individual banks. I have long
31 proposed making the CAMELS ratings, and I know this will not

1 please banks, public, just in the same way for CRA that we made
2 those ratings and a portion of the exam public.

3 I think we need to have more disclosure to allow these
4 market analysts when they look at sub-debt to see exactly what
5 this risk differential is. And then I get to the final question,
6 as Rick mentioned, let's say we require sub-debt. It's only at 10
7 percent of the institutions now, and we see a very big
8 differentiation in a premium from Bank A to Bank B. One of them
9 is three times as risky.

10 How do we charge differently for that additional risk?

11 So, even if we went to sub-debt, and we used those market
12 signals, what do we do with that data? How do we use that data to
13 charge differently? Do we just say okay, one's three times as
14 risky as the other or are we going to act and say this is how
15 we're going to charge for the additional risk?

16 So, we must have a way of charging for that additional
17 risk.

18 MR. MURTON: Okay. Thank you. Rick?

19 MR. CARNELL: A couple points. First, just to be
20 clear from my earlier comments, we do in a sense have a risk-based
21 system, but I urge that we keep in mind that it is a very crude
22 system.

23 It has nowhere near the degree of differentiation or
24 the finesse that a true market-based system would have and think
25 back to my point about the premium for a bank, for an under-
26 capitalized bank, CAMEL-rated 4 or 5. If you look at what the
27 statistical risk of failure of such a bank is, it's significant,
28 and no one would insure that bank in the private market for 27
29 basis points, nowhere near it, not even for probably 270 basis
30 points.

31 Second, I wanted to comment on Mr. North's proposal

1 that deposit insurance premiums only apply to insured deposits.

2 I would certainly acknowledge that there is potential
3 for inequity in the existing system in that by law, the deposit
4 insurance system only protects insured deposits, and yet
5 depository institutions pay premiums based essentially on their
6 total domestic deposits. So, you're paying premiums on a larger
7 base than is actually insured.

8 There is a little more to the picture, though, that I
9 think we should keep in mind here in thinking this through, and
10 one point we should keep in mind is that the government
11 essentially does not charge for access to the Federal Reserve
12 discount window; that is, I'm not talking about the amount charged
13 on advances from the discount window but for the right of access
14 to the discount window.

15 Institutions must maintain reserves at the Fed, and,
16 so, there is a foregone interest cost, but reserve balances at
17 this point for the banking system as a whole are negligible, and
18 the foregone interest is nowhere near the economic value of access
19 to the discount window during a financial crisis when it becomes a
20 matter of life and death.

21 So, the value of that access, which is as much for
22 large institutions as for small ones, should be taken into
23 account, I think, in the policy debate.

24 MR. MURTON: Thanks. I'd like to try to move on to
25 the next session. I'd like to take a couple questions from the
26 audience, if there are any, or ask if any of the other panelists
27 want to weigh in before we go to Q&A.

28 (No response)

29 MR. MURTON: Okay. If not, then why don't we move on
30 to the next portion of this, Maintaining the Funds, and Fred'll
31 give us more background material.

1 CHAIRMAN TANOUE: And if we could also introduce Doyle
2 Mitchell at this point? Doyle, good morning.

3 Doyle is going to be joining us and representing the
4 National Bankers Association. We're extremely pleased that he can
5 participate this morning.

6 Session on Maintaining the Insurance Funds

7 MR. CARNS: Okay. The next session deals with
8 maintaining the insurance funds.

9 Let's look at a brief history of the BIF reserve
10 ratio. The reserve ratio has been as high as 1.96 in 1941 and as
11 low as minus .36 percent in 1991. The current BIF ratio at 1.37
12 is roughly the same ratio that resulted after the refund program
13 that I talked about earlier, which began in 1950.

14 This history of the reserve ratio begs a question --
15 why have the deposit insurance funds at all -- and there are two
16 answers we can consider this morning.

17 One is to avoid delay in resolving failures. History
18 here in the United States and abroad as well shows that delay can
19 be very costly, and having insurance funds removes any uncertainty
20 or delay regarding the financing of failure resolutions. So,
21 avoiding costly delay is one reason for a fund.

22 A second answer might be to save for a rainy day, if
23 you will, to spread losses over time. Ideally, the deposit
24 insurance pricing system should not operate in a pro-cyclical
25 manner, a manner that exacerbates downturns; rather, it should
26 charge institutions when they can best afford to pay.

27 This has not always been the case, as shown in this
28 chart. At several junctures throughout FDIC history, assessment
29 income has accounted for a large share of banks' net income. This
30 is the blue line in the chart, and the percentage has been quite
31 volatile.

1 The large spike in 1987 reflects very large provisions
2 for LDC debt by money center institutions, but even abstracting
3 from that, you can see that it's not been easy to avoid charging
4 banks more when net income is already under pressure.

5 And a concern is that certain features of the current
6 system will make this even harder going forward. First is the
7 hard floor for the designated reserve ratio, if you will.
8 Whenever the insurance fund falls below the floor, 1.25 at
9 present, the FDIC's required to charge a minimum of 23 basis
10 points, unless the DRR can be achieved within a year. This means
11 at least 23 basis points in times when banks are most likely
12 already struggling.

13 Second, the DRR only can be raised for a particular
14 year by identifying a significant risk of substantial future
15 losses to the fund. For example, there's no provision for
16 adjusting the reserve target to reflect changes in industry
17 structure. For example, the fact that a surprise failure by one
18 of the largest institutions in today's environment could threaten
19 the solvency of the fund. Essentially, we must wait for rather
20 obvious trouble before adjusting the DRR.

21 These features, we think, can make it more difficult
22 going forward to avoid hitting banks with premiums at the worst-
23 possible times, and in fact, managing the reserve ratio to any
24 single target number, whether it be a floor, such as the current
25 DRR, or a cap, as envisioned under several rebate proposals, this
26 kind of fund management poses problems for spreading losses evenly
27 over time.

28 The optimal size for the funds, whatever that is, is
29 not constant. It would change with the risk environment and the
30 vulnerability of institutions, and both components of the reserve
31 ratio have been quite volatile historically, and this means that

1 the attempt to hit a fixed target will cause large variations in
2 assessments over time.

3 The deposit growth component of the reserve ratio has
4 shown considerable volatility historically, and we need only look
5 to the recent experience to see how volatile the BIF can be.

6 If we look at the past eight quarters, it would be
7 difficult for us to imagine more ideal conditions for banking than
8 have prevailed over these two years, and there have been no
9 significant disturbances to deposit growth of the type we reviewed
10 in the last chart, but the BIF ratio has fluctuated noticeably,
11 and as a result of a few medium-sized failures, the ratio is now
12 below the level of two years ago and appears to be headed in the
13 wrong direction.

14 The point here is only to provide some perspective on
15 the possible swings in the ratio going forward when conditions are
16 perhaps less favorable, and the issue is not so much whether the
17 FDIC can obtain funds going forward. We think we can, but the
18 issue is when will the FDIC call on the industry for those funds?

19 A final concern in this area is the current provision
20 in the law for systemic risk exceptions. As you're aware, when
21 the decision is made to extend protection beyond insured
22 depositors of a failed bank to other creditors in order to
23 maintain stability, FDICIA requires that the extra costs
24 associated with this protection be recovered in a timely manner
25 through special assessments on the industry.

26 These special assessments could come on top of regular
27 assessments that are already high due to adverse conditions, and
28 they would be levied on all institutions based on their total
29 liabilities less sub-debt.

30 We'd be interested in hearing the participants' views
31 on this aspect of the system. Is it too rigid? Is it likely to

1 exacerbate problems, and is it fair? And, of course, finally,
2 we'd like to hear your views on rebates in light of the
3 considerations we've just mentioned.

4 There have been several types of proposals, and the
5 basic question would be, under what conditions, if any, would
6 rebates be appropriate, and how would we address the concerns that
7 we've outlined previously?

8 MR. MURTON: Thank you, Fred.

9 Before we get to the rebate issue, I'd like to talk a
10 little bit about how people feel about the idea of the fund as a
11 rainy day mechanism as opposed to a pay-as-you-go arrangement or
12 whether that has value.

13 Rick?

14 MR. CARNELL: I think it has real value first, for the
15 reasons stated, that you build up a pot of money that can be used
16 to resolve institutions in a timely manner, and also by building
17 that up during good times, you avoid burden that would otherwise
18 be imposed during hard times when the premiums would be more
19 difficult to bear.

20 I would also note another reason or two why I believe
21 the fund system is appropriate. I think it is in the interests
22 both of the taxpayers and of the banking industry to keep deposit
23 insurance funds separate, clearly separate from general tax
24 revenues. That benefits banks by working against any political
25 desire to dip into the fund during good times, and I think it also
26 protects the taxpayers by the notion that they would be looked to
27 only as a back-up. So, I think there's additional reasons.

28 MR. MURTON: Tom?

29 MR. SHEEHAN: Well, as long as the fund continues to
30 be a budget item, though, it continues to be something that the
31 political world is going to look at, especially if it becomes a

1 fairly significant amount of money, and I think that's the concern
2 of a number of bankers, is if this fund continues to grow, and it
3 continues to be looked at as part of the budget process, is it
4 really not going to be at some point used for some other purposes
5 or diverted depending on what Administration happens to be in
6 power at that time?

7 I think if there were a reason for rebates, that's
8 probably the biggest driving force behind that. If we were sure
9 that that money was always going to be ours, be off budget, not
10 part of that process, the political process, then I think many of
11 our banks would be very, very happy to level the premium, make
12 sure that it doesn't spike up and down, because I think that is
13 really very disadvantageous, especially to some of our smaller
14 banks, in times when they really can't afford those premiums.

15 We would like to see a more level consistent premium
16 that we can at least predict in the reasonable near future, but as
17 long as it becomes a political possibility, I think then we have
18 some concern as to how big the fund gets.

19 MR. MURTON: Roy?

20 MR. GREEN: I think the survey of our members
21 indicates that clearly the view towards the FDIC and the insurance
22 funds is that it is a rainy day fund. Anything that
23 would challenge that assumption of confidence would, I think, in
24 fact lead to some political reactions that might not be otherwise
25 anticipated on the Hill in terms of what the individual depositor
26 feels about those alternative uses of funds.

27 Clearly, it is perceived extensively by our members as
28 being a rainy day fund.

29 MR. MURTON: Thank you. Jim?

30 MR. SMITH: Well, the combined funds is \$40 billion,
31 and that's a pretty good rainy day fund in my opinion, and it's

1 four billion over the designated 125.

2 The interest on that is exceeding the operating
3 expenses of the FDIC by \$1.5 billion, and, you know, I think the
4 question is, do you continue to pour money into the fund and take
5 it out of the banks and out of the communities where they're
6 trying to put it to work and do things for the community or do you
7 continue to try to just build the fund up to who knows what level?

8 MR. MURTON: Ken?

9 MR. THOMAS: Yes. I agree with Roy's point. You know,
10 we have to always remember the FDIC, the purpose is to protect the
11 depositor. This is one of my favorite collections. This is a
12 hardbacked version of the original 1934 Annual Report, and it
13 clearly says here that the purpose of the FDIC is to protect
14 depositors and instill depositor confidence.

15 As Roy is saying, confidence is assumed in this
16 concept of rainy day. I have long proposed, in fact back in '95,
17 I proposed that we go to 1.5 on the DRR.

18 In fact, we ended this year, 1934, at 1.61. We've had
19 over 10 year-end periods where we were over 1.5, including 1963
20 when we were at 1.5. It's not that big of a number as far as
21 going to that level.

22 Had we been at 1.5, we would not have the
23 embarrassment of going negative. We must never get to that
24 embarrassing point of having the fund get negative again, and I
25 believe we wouldn't have four consecutive drops the last period or
26 the loss in the last period.

27 And my other comment is, that goes with this, is that,
28 I would not allow any rebates, and I would not have a cap on the
29 fund, which I think follows from my view of rainy day.

30 MR. MURTON: Roger, did you want to -- we got taken
31 back to 1934.

1 (Laughter)

2 MR. WATSON: We now come to the reason why I'm here.
3 It's not because I can add any wisdom, but I've been around longer
4 than anybody else and know more of the history of the FDIC.

5 The deposit insurance funding mechanism has changed
6 over the years. It changed drastically from what was anticipated
7 in the 1934 Act. Originally, the FDIC was capitalized by a
8 contribution from Treasury, and if the original permanent fund had
9 been implemented, it would have been funded by a further capital
10 contribution by member banks, and then assessments basically to
11 keep the fund at the level that it was originally capitalized at.

12 To the extent that operating losses and expenses exceeded income
13 from the fund, then that was passed directly to the banks.

14 That was changed in 1935. It never really went into
15 effect, but it would be very similar to what the credit union
16 administration is today. It wouldn't have the advantage of
17 funding growth into the deposit insurance fund, but in other
18 respects, it is basically the same type of operation.

19 MR. MURTON: Yes, Ray? Could we go to Ken first, and
20 then to you? Thank you.

21 MR. McELDOWNNEY: Yes. I just want to weigh in, also,
22 on sort of the rainy day as opposed to pay-as-you-go, for a couple
23 of reasons.

24 I think to improve confidence in the fund, I think
25 people have longer memories than just the last two or three years,
26 and, also, I think that the pay-as-you-go has the danger of not
27 requiring banks to pay in when they're probably most able to do it
28 and asking for assessments in the harder times when they're least
29 able to afford it.

30 So, I think it's sort of counterproductive.

31 MR. MURTON: Nolan, and then --

1 MR. CARNELL: I would certainly agree with those who
2 have opposed lowering the reserve ratio or imposing rebates, and
3 in fact, I would add that I think the FDIC should have greater
4 freedom to adjust the designated reserve ratio.

5 Current law only allows an adjustment for an imminent
6 problem within the next year, which then reduces the ability to
7 build up the fund in the face of foreseeable problems that don't
8 happen to fit within that time window.

9 But most importantly, I wanted to respond to Tom
10 Sheehan's point about the risk of political meddling with the
11 fund. I think that's an understandable point, and Tom said that
12 he felt his members would feel comfortable paying premiums at a
13 stable rate even with building up the fund, if there was
14 confidence that this money would not be swiped by politicians.

15 I just want to be clear on some of the safeguards that
16 exist against swiping. I cannot say that this would never happen,
17 but I would note that we've had the current system, that is either
18 a high fund balance or high premium rates for 11 years. That is,
19 the current legal framework on designated reserve ratio has been
20 in effect since 1989.

21 There has only been one abortive proposal, which was
22 by a rogue OMB staffer which is even largely forgotten now but not
23 by some of us, to tap into that, and that was dead, A, as soon as
24 the Treasury heard of it, and, B, as soon as the banking industry
25 heard of it, and either of those would have sufficed to kill it.

26 It was dead, dead, dead and has not been revived, but
27 let's say you had no confidence in that. What I want to emphasize
28 is that not only would swiping involve amending the Federal
29 Deposit Insurance Act in the teeth of opposition from the banking
30 industry, but it would also involve amending the Congressional
31 Budget Act.

1 That is, right now, the rules that exist for tapping
2 the insurance fund would mean that if you were not taking the
3 money for deposit insurance purposes within the scope of the
4 deposit insurance guarantee as it previously existed, that would
5 require a pay-as-you-go treatment under the Congressional Budget
6 Act, and, so, in order to swipe money from the fund, it would
7 involve a change in the Congressional Budget Act that would be a
8 serious breach of fiscal discipline and would have political and
9 other consequences that go beyond deposit insurance and beyond
10 banking, and in a sense would mobilize a bunch of other
11 constituencies to help make sure it didn't happen.

12 MR. MURTON: Thank you. Nolan, and then Roy.

13 MR. NORTH: In regard to the large depositors in
14 banks, we fully agree that certainly the reserve fund should be
15 maintained. The 1.25 is one of those things like 16 and two-
16 thirds, not whether it's relevant or the right or wrong, but
17 that's okay.

18 Even though most of our members receive virtually no
19 coverage from the FDIC, i.e., 100,000 versus the millions we have
20 on deposit, the Association for Financial Professionals, in our
21 mission statement, one of our aims is to maintain a safe and
22 secure banking system, and the FDIC, both from an examination and
23 an insurance standpoint, is a keystone of that policy.

24 Now, whether it's a pay-as-you-go or a rainy day, we
25 would favor pay-as-you-go, and this notion that the banks would
26 have to pay when they can least afford it is at least a red
27 herring.

28 The people that pay this are the customers of the
29 bank, and the large customers have an explicit charge for it. In
30 many banks, the business customers pay at least as much as the
31 bank owes to the FDIC, and on a macro basis, the business

1 customers pay in our analysis approaching half of all the FDIC
2 assessments.

3 So, this notion that it's going to hurt the banks when
4 they can least afford it is, I think, a misdirection in how this
5 actually works.

6 MR. MURTON: Roy?

7 MR. GREEN: Well, just to build from one other
8 dimension, one of the things that the Association has taken great
9 care in distinguishing, given the power of the FDIC, the symbolic
10 power as well as the practical financial power of deposit
11 insurance, is the care that we take to try to make sure that our
12 members and consumers in general know the difference between what
13 types of products are in fact insured and which are not.

14 The value of that distinction is palpable and one that
15 we should work very hard to maintain. So, the rainy day concept
16 versus the pay-as-you-go, I think, is an issue worth protecting.

17 MR. MURTON: Thank you. Doyle, and then Bill.

18 MR. MITCHELL: Thank you, Madam Chairman.

19 For the National Bankers Association, we would favor
20 pay-as-you-go. Some of our banks and certainly most of the
21 communities in which we operate can't afford the luxury of
22 maintaining any liquidity or any excess funds off to the side. We
23 have to employ every dollar that we have available to us in doing
24 exactly what Jim said, in recycling that right back in our
25 communities, and if we pass that cost on, certainly our customers
26 can't afford the luxury of maintaining such a fund.

27 The premiums will fluctuate over time and sometimes
28 drastically as we've seen. So, if there's any dip in the fund, it
29 will certainly be required to pay the premiums necessary to bring
30 it up to satisfactory levels.

31 But to have a reserve fund, a rainy day fund, is not

1 something that our communities can afford.

2 MR. MURTON: Bill?

3 MR. FITZGERALD: The first thing we can do is merge
4 the two funds, the SAIF and the BIF. That gives you a little more
5 capital, if we get that done.

6 But I do think when we look at the requirement that as
7 soon as you drop below 1.25, you immediately go to the 23 basis
8 point, I think what the whole group in effect is saying is you'd
9 prefer to have a systematic -- if it declined from 1.25 to 1.20,
10 there ought to be a premium that kicks in, and then it ought to
11 pick up as that number gets down; and then it gets back to Ken's
12 point, I think, is 1.50 the number where there just isn't an
13 assessment any longer or if it builds up beyond that, you know,
14 should there be a consideration for rebate? I think we need to
15 look at both sides.

16 Actuarially, there has to be a way to figure out what
17 is the proper type of reserving to have, and I think that was the
18 question we discussed in the first part today as well.

19 CHAIRMAN TANOUE: This discussion does raise just a
20 very fundamental question about whose money is this anyway? Is it
21 the money that refers back to the industry or is it the money of
22 we, the people, the taxpayers?

23 MR. CARNELL: Well, I would just note there's a very
24 straightforward legal answer and also an economic answer.

25 Legally, the money is the property of the government,
26 but that's not arbitrary. This is money that was paid for
27 protection. It is money that was paid for the FDIC to bear the
28 risk, and also as part of that, for the taxpayers to stand as a
29 backstop, as they did in the early 1990s, when the fund's reserves
30 were under pressure.

31 Again, I want to come back to the point of the

1 political difficulties of pricing for a government agency, in
2 particular the difficulties of pricing for a government
3 monopolist.

4 No one would suggest that if you have car insurance
5 from State Farm and GEICO, and you don't have an accident, that
6 you get your premium back. No one would suggest if you have car
7 insurance from State Farm or GEICO, and they have adequate
8 reserves, that you'd get to have the insurance for free, and yet
9 the same argument will be made because it's a government agency
10 that because the FDIC has adequate reserves, it should charge no
11 premiums to people who are getting protection now or the
12 suggestion will be made that the fund balance is morally the
13 property of the industry because they paid it in.

14 MR. FITZGERALD: Rich, the only problem with that
15 argument is, if you're at Safeco, and somebody else offers you the
16 same product at a lower cost, you'd just switch. So, the consumer
17 just transfers.

18 So, it gets back to what is the proper dollar amount
19 of reserves that are necessary? Actuarially, you've got to be to
20 figure it out.

21 MR. NORTH: Lacking market forces. Your point is well
22 taken.

23 MR. MURTON: Yes, Ken?

24 MR. THOMAS: Just a short point, historic point, on
25 the pay-as-you-go.

26 Not to go back to '34, but going back to 1987, 1987
27 bank earnings were only 2.8 billion. They just exceeded failure
28 losses of two billion. So, in '87, actual bank earnings pay-as-
29 you-go of 2.8 billion exceeded failure losses of two billion, but
30 they were well below the 1988 losses, which were 6.7 billion.

31 So, when you look at the numbers for that period, pay-

1 as-you-go is clearly problematic.

2 MR. MURTON: Well, Skip, I wondered if you wanted to
3 comment on -- you were there when it was time to invoke to some
4 extent the pay-as-you-go.

5 VICE CHAIRMAN HOVE: Well, it was, and it was the
6 toughest time. I mean, in 1990, banks and thrifts were paying
7 eight and a third cents or the 1/12th of one percent, and the
8 decision then was made -- and I recall in my confirmation hearing,
9 a Senator from Michigan asked clearly, was I willing to raise
10 premiums, if necessary, and clearly and very soon after I was
11 confirmed, we raised them to 12 cents and then subsequently to 23
12 cents, and it was probably at the toughest time because, as Ken
13 mentioned, we went through the late 1980s and coming into the
14 1990s, earnings were a little bit better than the 2.8 billion that
15 you talked about but not a lot better.

16 In fact, I think from the period of 1983 to about 1991
17 or '92, the FDIC actually paid out every year in losses a greater
18 amount than what we took in in premiums in that entire period,
19 until we saw a real turn-around in '92 or '93, really when it
20 really turned around.

21 So, pay-as-you-go had some real difficult times. It
22 added to the severity of the bank earnings or the lack of bank
23 earnings in that period of time.

24 The rainy day, I don't know what the number is. I
25 don't know if it's 1.25 or 1.50, but there is a reserve. I would
26 argue that there is a point at which we ought to think about what
27 to do with the excess, Rick, and you have stated that you feel
28 that there should not be rebates. Clearly people think there
29 should not be, but as Bill Fitzgerald mentioned, you know, we
30 don't have the competitive pressure, so people can move back and
31 forth.

1 So that at some point, there is a reserve level that's
2 adequate. I'm not sure where that is.

3 MR. MURTON: Could I just follow up? If we were to
4 ever give rebates, does anyone have any ideas upon what basis one
5 would allocate rebates?

6 CHAIRMAN TANOUE: How to do it equitably?

7 MR. THOMAS: That's a good question. I don't have an
8 answer because I never thought that through.

9 MR. MURTON: Principles that might --

10 MR. FITZGERALD: Probably would have to figure out
11 something over an average number of years going backwards, whether
12 it was the average assets that you had in your institution over
13 the previous five years, if that's what it was, as opposed to just
14 at that point in time.

15 MR. MURTON: Right. Jim?

16 MR. SMITH: Well, obviously any bank over five years
17 old has paid into the fund, and I think if they have paid into the
18 fund, then I think there should be some eligibility there for
19 rebates.

20 As we go forward, there will be a time that that limit
21 may disappear because as new banks come on and get involved, that
22 -- we may have to rethink that idea.

23 MR. NORTH: Isn't there a precedent? It may not be a
24 good precedent based on this set of facts, but there was a point
25 in time in the last few years when the FDIC did over-charge, I'm
26 going to use that term, and there was a need to rebate, and they
27 rebated back some of that over-charge over a period of time, but
28 at that time, you could clearly go way back to the bank that made
29 the payment --

30 MR. MURTON: Right.

31 MR. NORTH: -- and make the rebate, but I think a

1 similar concept is what he's discussing, is the people that paid
2 into the fund should get the rebate from the fund.

3 MR. SMITH: And I would like to add to that, because I
4 was present in the ag crisis that we had in the Midwest and also
5 the real estate crisis, we didn't have any oil problem in
6 Missouri, but we paid very heavy, and the fund did not get to \$40
7 billion because we just paid a set premium to try to keep going.
8 We paid extra dollars to get this fund to a level so that it is
9 safe and secure for our customers, and that is one of the things
10 that I think we keep forgetting, because we really bit the bullet
11 back in the '80s, and we got this fund whole, so that it's there,
12 and it is \$40 billion for our customers, and, so, I think that's
13 what the bankers are looking at now.

14 Look, we stepped up to the plate, and we put this fund
15 to \$40 billion, you know. Don't keep pounding on us for
16 additional premiums if they're not needed, and that's what's on
17 the table.

18 MR. MURTON: Rick, and then we'll try to go to Q&A,
19 unless --

20 MR. CARNELL: Three points. First, I'd certainly
21 agree with Jim that that banking industry stepped up to the plate,
22 and I think the industry has been rewarded with the low premium
23 rates that we have now, and even if the FDIC were charging
24 something, as I believe it should be, it would still be a much,
25 much smaller premium than in the past, reflecting the much, much
26 smaller risk of the banking system as it exists now.

27 My three points. First I want to acknowledge the
28 point that's been made, I think by Mr. North and Mr. Smith and
29 maybe by some others and by the Vice Chairman, that the FDIC does
30 not operate in a fully-competitive market; that is, there are not
31 competing providers of deposit insurance that can offer a

1 comparable product, and, so, that means that depository
2 institutions are to some degree a captive market. So, that's a
3 little bit different than State Farm and GEICO.

4 But I think we would make a mistake if we thought that
5 the money involved was fully captive. It's also worth remembering
6 that depository institutions operate in highly-competitive
7 financial markets, and that non-depository financial institutions
8 offer products that are to a significant degree substitutes for
9 the products, such as deposit accounts, offered by depository
10 institutions.

11 What that means is that if you don't have a fund, and
12 you were to have to have large FDIC premiums, you could see a
13 migration of financial assets out of the banking industry -- I
14 think we saw this to some degree during the time when we had 23
15 basis point premiums, and things worked out okay in that case --
16 but keep in mind that banks, as in a sense the customers of the
17 FDIC, do operate in competitive markets, and if banks face huge
18 premium spikes, it has effects on their competitiveness and their
19 ability to retain market share.

20 Second, I think the American people would be surprised
21 to hear that the law considers one and a quarter cents in reserves
22 per dollar of insured deposits to be an adequate reserve and would
23 be surprised to hear that people believe that one and a half cents
24 in reserves per dollar of insured deposit is excessive.

25 I think people would be surprised that the reserves
26 are as low as they are, even though they're high right now by
27 historical standards.

28 The third is that I wanted to point out that we have
29 had an unsuccessful experience with pay-as-you-go. The insurance
30 rates for both the FDIC and the old Federal Savings and Loan
31 Insurance Corporation were set arbitrarily by statute. In the

1 FDIC's case, it seemed to work out well for awhile, although, as
2 Ken points out, there was a time when the fund went into deficit
3 because the premiums it had been collecting didn't in fact equal
4 its risk.

5 But the experiment in pay-as-you-go pricing that
6 didn't work out was the Federal Savings and Loan Insurance
7 Corporation. The premiums that it was collecting did not reflect
8 the risk to the fund, and the result is that the U.S. taxpayers
9 eventually paid \$125 billion to protect depositors at FSLIC-
10 insured institutions, and to this day, the taxpayers continue to
11 pay the interest on that portion of the national debt.

12 So, we should keep in mind that this has in a sense
13 been tried, and that there was a political gamble made in the
14 thrift industry around 1986 and 1987 to resist having adequate
15 funding for a thrift clean-up at the time with the idea being that
16 if things didn't work out, then it would be so big that it
17 couldn't be put on the thrift industry and would have to go to the
18 taxpayers.

19 MR. MURTON: Okay. Thank you.

20 I'd like to take questions from the audience, if there
21 are any, before we go to a break.

22 Jim?

23 MR. CHESSEN: I've got one. One thing that doesn't
24 seem to be on the table yet, I think we've talked about the
25 opportunity costs of having too much money, that's better in the
26 communities that's there.

27 The other issue seems to me is what are the
28 protections that the FDIC has to meet the obligations that they
29 might have, and no one has mentioned the reserves that the FDIC
30 holds for future losses and the ability to manage that, and I
31 would point out that, as you all know, the reason that the BIF

1 fund appeared to be insolvent is because the FDIC held 16 billion
2 in reserves at that time, 13 billion of which was subsequently
3 recaptured and helped boost the fund.

4 So, I would be interested in the panel's observations,
5 if you limit the fund, is there any authority that the FDIC needs
6 to maintain the obligations?

7 Of course, I would argue that they have all the
8 obligations that they need or all the authority that they need.

9 MR. MURTON: Just for the record, that was Jim Chessen
10 from American Bankers Association, for the purposes of our
11 meeting.

12 MR. BRIAN SMITH: One additional point that I think is
13 different, also, Rick, is that unlike the prior situation where,
14 after the reserves and the funds were consumed, then the taxpayer
15 was the next stop on the financing circuit, whereas, now, ever
16 since the change in the law, there is the fund, the sort of petty
17 cash, as it were, the rainy day fund or, as it's getting to be,
18 the torrential downpour fund, that is the first source of payment
19 for insured depositors, but there is also now a virtually
20 unlimited call on the capital of the banking system -- of all
21 insured depositories -- which was not present in the prior
22 statute.

23 So that the role of the federal taxpayer is pushed one
24 remove back, so that that is a very, very substantial additional
25 cushion, and clearly the banking institutions obviously in the
26 event of trouble will pay one way or another, and to some extent,
27 in a way ought to have some choice as to whether they pony it up
28 in the petty cash or hold it within the institutions because one
29 way or another, they will in fact, under the new laws, pay in a
30 way that was not previously the case.

31 MR. FITZGERALD: Brian, I think the one other added

1 item also is that the SAIF-insured institutions today carry
2 reserves that are significant, whereas in 1988 and '89, there
3 weren't any reserves in that industry. So, there's another added
4 layer of reserving that's there that wasn't in the fund.

5 MR. MURTON: Right. We're trying to keep on schedule.

6 MR. CARNELL: Okay. Very quick point. Some have
7 suggested that any money paid into the deposit insurance fund is a
8 burden on the banking industry and a drain on communities.

9 I just want to point out that rational economic
10 pricing in general is not a burden, and one of the things that we
11 saw in the presentation and that the Chairman has made in her
12 speeches is pointing out that the lack of a premium right now
13 creates some perverse incentives for people to saddle the
14 insurance fund with risk, and, so, a rational pricing, including a
15 premium, and if that means building up the fund even so, is
16 protecting insured institutions from some of the costs that they
17 could be saddled with from gamesmanship of others.

18 MR. MURTON: Thank you. Why don't we take a break
19 now, 15-minute break, and then we'll come back and do the last
20 session on Coverage.

21 Thank you.

22 (Whereupon, a recess was taken.)

23 MR. MURTON: If we could get started again, this third
24 and final session is on the deposit insurance coverage levels, and
25 again I'll turn it over to Fred to give us a little background.

26 Session on Deposit Insurance Coverage Levels

27 MR. CARNES: Okay. Thanks, Art.

28 The primary basis for our discussion of coverage
29 limits is the falling real value of the \$100,000 limit.

30 The blue line in this chart shows the value of the
31 coverage limit in 1980 dollars, using the CPI deflator. We can

1 see that the real value of the \$100,000 limit, the blue line, has
2 fallen by about half since it was adopted in 1980.

3 The real value of coverage today is even below that of
4 1974, when the coverage limit was raised to \$40,000.

5 The diagram indicates that the real value of coverage
6 was much lower during the first 30 years or so of the FDIC's
7 operation, but the CPI's only one gauge, and other measures show a
8 different result. For example, although I don't have a picture
9 for this, the \$5,000 coverage limit in 1935 was almost 10 times
10 per capita income at that time, while the \$100,000 limit today is
11 just over three times per capita income.

12 A question arises, why was coverage increased from
13 40,000 to 100,000 in 1980? Again, using the CPI, an increase to
14 \$60,000 would have been sufficient for inflation. I think your
15 handout may say 50,000. That was actually the original Senate
16 proposal in 1980, but it turns out that \$60,000 would have been
17 about the right inflation adjustment. So, why 100,000?

18 There's not a lot on the record regarding the
19 discussions that took place in the Congress, but it's clear that
20 there was concern about the banking and thrift industries'
21 abilities to attract funds in a high-interest rate environment,
22 and thrifts in particular were experiencing problems at that time.

23 There's little doubt that raising coverage to \$100,000
24 played a role in the ensuing S&L crisis. The question is how much
25 of a role. It allowed for an influx of deposits which elevated
26 FSLIC's liability, and this effect is more pronounced due to the
27 lifting of Reg. Q ceilings at the same time.

28 The easy availability of insured funding clearly fed
29 into this so-called moral hazard problem that was already
30 operating in the thrift industry. It facilitated excessive risk-
31 taking.

1 In considering higher coverage limits today, we need
2 to take stock of what occurred in the 1980s and be sure not to
3 repeat any mistakes in that experience.

4 We don't have sufficiently-detailed information on the
5 call reports to confidently project the initial impact of an
6 increase in coverage, say to \$200,000, but we do have enough
7 information to take a stab at the upper limit of the increase in
8 insured deposits that we might expect as the immediate result of
9 doubling coverage.

10 Rough estimates suggest that there are about a million
11 deposit accounts between a \$100,000 and \$200,000 at present, and
12 the average size of these accounts approaches about a \$160,000.
13 There are about three and a half million accounts over \$200,000,
14 and we assume that these would each increase the amount of insured
15 deposits by 100,000, if the limit were raised.

16 Now, this gives us an over-estimate, which is why we
17 call it a high-end estimate, because some of these accounts
18 already are fully insured through the pass-through rules on
19 institutional deposits and similar arrangements.

20 In any case, ignoring this factor gives us an increase
21 in insured deposits of approximately 400 billion by raising
22 coverage to \$200,000. If it all occurred at once, this would
23 reduce the reserve ratio of the combined BIF/SAIF fund from 1.38
24 to about 1.22.

25 Again, I would caution that this is a rough
26 calculation, and we know that it would over-estimate the initial
27 impact of the increase in the limit.

28 Finally, just for purposes of comparison, we can look
29 at coverage levels in other countries. The U.S. is in line with
30 the average level of coverage worldwide. Some 68 countries have
31 explicit coverage, and on average, they provide about three times

1 per capita GDP. The U.S. is just above this.

2 Africa has the highest coverage levels, averaging over
3 six times per capita income in countries with explicit deposit
4 insurance systems there. The European average is 1.6 times
5 income, and this lines up with the rule of thumb that's been
6 suggested by the IMF that coverage levels somewhere between one
7 and two times per capita income represent appropriate limits on
8 deposit insurance.

9 We have a number of related issues to discuss in this
10 area, including indexing and appropriate coverage levels for
11 municipal deposits. So, with that, I'll just turn it over to Art.

12 MR. MURTON: Thanks, Fred.

13 I'd like to start with the coverage issue, and what
14 I'd like to suggest is maybe we hear from the consumer side of
15 things first, and maybe we can start with Roy Green.

16 MR. GREEN: Well, I think we have over the years, of
17 course, wanted to make sure there weren't severe deposit insurance
18 limitations, and taking that to the issue on the table, I think
19 the Association would certainly support a raise in the cap that is
20 insured to the \$200,000 range in part based on the calculations of
21 what the inflation rate's done to the \$100,000 current insurance
22 policy over the years since it was raised to that point.

23 So, that is a fundamental issue that we would support
24 in part because, as our membership and as the population as a
25 whole ages or when they move into older age categories, they tend
26 to want to -- a larger percentage of them put their assets, of
27 course, into insured accounts and instruments.

28 So, by and large, we would favor that change in
29 policy.

30 MR. MURTON: Ken?

31 MR. McELDOWNEY: I guess we think it needs more study

1 just to see in terms of what the impact would be. The most recent
2 Federal Reserve study indicated that the median transaction
3 account was about \$3,100, ranging from \$500 up to \$19,000 for
4 people making more than a \$100,000 a year.

5 For CDs, it was an average of 15,000 with a range of
6 7,000 to 22,000, and even for retirement accounts, it was 2,400
7 with a range of 7,500 to 93,000.

8 It seems like the one area where it is approaching an
9 area where it should be increased is with retirement accounts.

10 The question, I think, we would have is just in terms
11 of who would actually benefit from this. Would it be consumers or
12 would it be businesses?

13 MR. MURTON: Ken?

14 MR. THOMAS: I would like to conclude my comments with
15 going back and referencing another historic item, not this time
16 back to 1934 but back to 1997. This excellent book was the
17 "History of the '80s: Lessons for the Future". It was
18 commissioned by Former Chairman Al Firth, and the Vice Chairman
19 actually wrote the Foreword here, and I think this is very
20 important, the concepts here, look for lessons for the future.

21 In here, they look back at the 1980 -- what happened
22 there in the increase. The question becomes: how did we get to
23 100,000? Everybody agrees a 100,000 then is equal to 200,000 now.

24 So, the math is correct. You go to a 100 to 200. There's no
25 doubt about that.

26 But the question is, was a 100 in 1980 the right
27 number? The answer is absolutely not. It was a mistake.

28 First of all, back then, Chairman Sprague wanted to go
29 to \$60,000, based on inflation, and as Fred mentioned, there were
30 some other people -- the actual Senate proposal was to go to
31 50,000, and the 50,000 proposal was in the law till the very last

1 minute, and as noted here and also in Chairman Seidling's book,
2 "Full Faith and Credit", at the very last minute, in the midnight
3 meeting in a conference committee, thrift lobbyists, two
4 lobbyists, changed it over, had them change it over, and it went
5 to a 100,000 almost as an afterthought.

6 That one factor caused the S&L crisis to significantly
7 increase in the cost to the taxpayers, and, so, we have to look
8 back and say yes, what happened there, it was a mistake, and if we
9 went back to the correct number, which should have been 50 or 60,
10 it would now be a 100.

11 So, we're at a 100 now, and I think that's where we
12 should be and where we should keep it. So, that's my historic
13 view of the situation.

14 MR. MURTON: Jim?

15 MR. SMITH: I think we need to raise it, and I also
16 think we need to look at some future indexing for future inflation
17 so that we keep pace, and we don't have to revisit this.

18 I can tell you from my personal experience, my
19 customers are very cognizant of the \$100,000 limit. They're coming
20 in and splitting deposits. If it's over a 100, they're taking it
21 down the street to a competitor, and then I'll have another
22 customer from the competitor walking in splitting their deposits
23 down there.

24 So, I think these deposits are being insured. It's
25 just being split up, and I think it's a real inconvenience to the
26 customer in order to handle it, but my customers are very well
27 aware of the \$100,000 limit and handle their deposits accordingly.

28 MR. MURTON: Thank you. Tom?

29 MR. SHEEHAN: We at ICBA have sort of been leading the
30 fight on the increase of the deposit insurance, and we thank
31 Chairman Donna Tanoue for holding these hearings this morning,

1 having this discussion.

2 She was gracious at our convention back in March and
3 made some very appropriate comments that I think our members were
4 encouraged by.

5 Many of our small banks are really having difficulty
6 attracting core deposits, and as it was said, a lot of this is
7 insured anyway. It's inconveniencing the consumer because the
8 consumer has to look for two or three banks to try to find a place
9 to deposit their retirement funds.

10 As you get older, and I am starting to get closer and
11 closer to that point, you can't afford to take a lot of risk, and
12 the FDIC and its full faith and credit and the entire confidence
13 that the depository public has in that system is very important to
14 people of that age.

15 They do not want to take risks. They would much
16 rather put it in an insured depository account to earn five or six
17 or whatever percent, be sure that they're going to get their
18 principal back, rather than taking the risks that they really
19 can't afford to take.

20 So, as that money continues to accumulate, and 100,000
21 certainly isn't what it used to be, at least not as much as it was
22 20 years ago, they want that protection.

23 We have a number of depositors that have far in excess
24 of a 100,000, don't get me wrong, but it seems like there is
25 either a total disregard for it, in other words they don't really
26 care all that much about the insurance, they have the capability -
27 - generally, larger depositors have the capability of ascertaining
28 a value in their investments. They are a little bit more
29 sophisticated. They tend to be a little bit more capable of
30 analyzing that.

31 It's the smaller depositors, the 100 to 200,000, that

1 aren't sophisticated, that do need the protection, the confidence
2 that they're going to get their money back when they do retire and
3 when they need that money.

4 So, it is extremely important. A lot of our small
5 banks are losing core deposits because of the \$100,000 limit. I
6 think it would bring money back into our smaller communities, into
7 our smaller banks, allow that money to be reinvested in those
8 communities, and I think it could be a very, very important
9 factor, both on the consumer side, not just from the depository
10 side, but from the reinvestment side in the communities in which
11 that money will go.

12 MR. MURTON: Nolan?

13 MR. NORTH: From a business standpoint or the business
14 customer of the bank standpoint, for the average business, the
15 difference between 100 and 200,000 of coverage is almost
16 irrelevant.

17 Your point for perhaps the small businessmen out at
18 the margin, the difference between 100 and 200 may be a factor,
19 but for those of us who have to work in the millions to tens of
20 millions of bank deposits every day, this is just not much of a
21 factor.

22 The thing I would point out in regard to coverage, and
23 it relates back to pricing, is the 100,000 is 100,000 of collected
24 balances. The FDIC has always pointed out that checks in the
25 course of collection, i.e. float, are not part of what is insured.
26 When those checks are collected, they're turned back over to the
27 depositor.

28 Yet from a pricing standpoint, the assessment has
29 always been on total ledger balance minus 16 and two-thirds. In a
30 meeting I had with Mr. Murton a few years ago, I showed him an
31 account analysis I have at one of my banks, and it's fairly

1 typical of large companies, and that account still runs the same
2 way today.

3 We deposit checks in an account, and the next day, we
4 wire the money out to our mutual funds. They are mutual fund
5 purchase checks. The average ledger balance runs about \$25
6 million. The average float is about \$25 million. The average
7 collected balance runs from \$5 to \$50,000 average per month.

8 So, the coverage that I have in that business is
9 50,000. The assessment base is the 25 million, but since that is
10 all checks in the course of collection, it never would have been
11 covered by insurance had that bank been taken over.

12 So, when we talk about coverage, I always want to
13 relate it back to pricing, and let's keep in mind that the
14 coverage here is 100,000 or 200,000 of collected balances, and
15 that's an important distinction for business customers.

16 MR. MURTON: Doyle?

17 MR. MITCHELL: We also support the increase to
18 200,000. It would be nice if we could go back to 1935 and do ten
19 times per capita income, but I guess there's no point in arguing
20 that.

21 For the reasons stated, our customers are also very
22 conscious of the limit, and because many of them are older
23 customers, they diversify their deposits among different
24 institutions, including the non-profits, who may by a fact of
25 their bylaws have a policy not to keep more than a \$100,000 in any
26 one institution.

27 We've seen as many as nine banks in some of our non-
28 profits, and I guess that's a good problem for them to have, but
29 it certainly represents an inconvenience, and we believe that if
30 we were to be able to consolidate some of those deposits, again,
31 we can do a lot in our communities with that additional liquidity

1 as well.

2 MR. MURTON: Bill, did you want to --

3 MR. FITZGERALD: The ACB Group, obviously we support
4 the increase to 200,000.

5 The impact it has on the customer, we kind of have a
6 mixed feeling on that, as to what will happen in the transfer of
7 the funds. I think our bigger concern is what's the cost of
8 having to put that 200,000 insurance on, and if there's an added
9 cost, then we need to weigh that against the value of it. But
10 obviously if it's up for grabs, and you want 200,000, we'd go with
11 that.

12 MR. MURTON: Jim?

13 MR. SMITH: Well, obviously my small bank, I'd like to
14 have one of Mr. North's customers because I think it would be
15 really nice to have one of those large customers. But keep in
16 mind when they do wire that money to the mutual funds, I don't
17 think there's any insurance coverage for that.

18 MR. FITZGERALD: Thank you.

19 MR. MURTON: Ken?

20 MR. McELDOWNEY: Yes. I guess I'd like to reiterate
21 just in terms of who is it going to benefit? Again, the Federal
22 Reserve's most recent figures, 70 percent of the households have
23 an annual income of less than \$50,000 a year.

24 If you look at that category of 50,000 to a 100,000,
25 retirement accounts are still only 31,000 median. CDs are 13,000,
26 and transaction accounts are 6,000.

27 So, I think particularly in terms of looking at
28 consumers as opposed to businesses, I think you'd need to look at
29 exactly what portion of folks are going to be helped by this.
30 That's the first point.

31 The second point, I think, is that I think there would

1 be a premium impact, and certainly while a lot of it has flown
2 back directly to businesses, I think consumers have also seen over
3 the years much lower interest rates on savings accounts, much
4 higher fees on checking accounts and credit card accounts, and I
5 would hate to see increased premium reflected into this as well,
6 plus, as I sort of heard around the table, it appears that
7 stronger support, I think, is coming from the banking industry,
8 and I think that one of the things that should be considered in
9 terms of that, since the benefits, I think, are not going to go to
10 moderate-income consumers so much or low-income consumers,
11 certainly it's consideration of this possible increase in
12 conjunction with support for some basic banking legislation.

13 MR. MURTON: Tom?

14 MR. SHEEHAN: Well, just to dwell on that point a bit,
15 the money that comes into a community bank, for example, if it has
16 to be funded by borrowings, higher cost acquisition of funds, that
17 gets passed on to the consumer, to the individual that wants to
18 buy a car, to the individual that wants to buy a home.

19 If we are able to fund our operations and our lending
20 with lower-cost deposits, protected by the FDIC, we are able to
21 pass that money on to our borrowing public, many of whom are your
22 lower-income consumers, at a price that's obviously going to be
23 less than if we had to go out into the money market and acquire
24 those same funds in order to provide those loans to the lower-
25 income families.

26 So, everybody benefits from that. I mean, if we get
27 more money into our banks -- banks are nothing more than
28 intermediaries. The money that comes in has to be reinvested in
29 order for us to continue to be in business.

30 If our cost of funding our banks continues to go up
31 because we have to pay more and more and more to replace what we

1 used to call core deposits, our costs to the borrowing public is
2 going to continue to go up, and it's going to impact those low-
3 income consumers. No question about it.

4 MR. MURTON: Roy?

5 MR. GREEN: Yes. I'd like to make one additional
6 point in agreement actually with Ken, and that is, of course, the
7 Association has for a long time supported the notion of low-cost
8 banking accounts and savings accounts, and we would certainly like
9 to see these initiatives doubled in that regard, and we thought we
10 missed a chance with the Financial Modernization Act to accomplish
11 that, and we certainly would like to work in the future to make
12 sure that happens.

13 MR. NORTH: If this were moved to 200,000, and if we
14 achieved the notion of assessing insurance premiums on that which
15 is insured, in this case it would be 200,000, I would submit to
16 you that what would happen is each one of my members, if we were
17 back in a payment mode, would simply be paying twice as much as we
18 did when we provided 40 percent of the total into BIF, and this
19 would just double the costs on the average business, and the
20 average consumer, I think our statistics will point out, would
21 have zero costs.

22 And to the extent that doubling the coverage would in
23 any way lead to financial institution management thinking they had
24 more flexibility in how to run their institution like it did in
25 the last decade, the last century, that we would be opposed to
26 that influence.

27 I'd like to flip this around from a little different
28 perspective, if I may, in regard to coverage and what it is that's
29 covered, because one of the things we expect to be looking at in
30 the near future coming out of the elimination of Reg. Q, whereby
31 banks would be able to pay interest on business accounts, but for

1 the next several years, it will be tied to a 24 times sweep into
2 an MMDA per month is going to make the money market deposit
3 account to be coupled with the checking or DDA account, and since
4 this money is fungible, we would like from an administrative
5 standpoint from the FDIC to view those as one account as it does
6 its administration and examination.

7 MR. MURTON: Yes, Ken?

8 MR. THOMAS: A quick point. I don't want to get into
9 class warfare issues here, but I do want to reiterate Ken's
10 excellent point here.

11 The 1998 most recent Fed Survey of Consumer Finance
12 showed that the median transaction balance of all accounts was
13 only \$3,100, a median CD was only 15,000. Even for the richest
14 category income-wise, it's in the low twenties.

15 I'm afraid that some people might perceive this
16 proposal just as a "tax break for the rich", as a deposit
17 insurance assessment increase for the rich. So, I just wanted to
18 throw that point out. I think that was an excellent point Ken
19 made.

20 MR. MITCHELL: I'd also like to point out that
21 although there may be many people or some people impacted by the
22 increase to 200,000, all of these individuals are not wealthy
23 individuals.

24 Particularly in our institutions, those that may be
25 impacted by the increase to 200,000 are moderate-income
26 individuals. They've saved for a long time to accumulate what
27 they have put in this safe vehicle, as they see it. They may have
28 a home that's paid, and they may have a couple hundred thousand
29 dollars in the bank, but that's all they have, and they're now
30 working off of in many cases fixed incomes which are not
31 substantial.

1 MR. MURTON: Tom?

2 MR. SHEEHAN: Just one more comment on Nolan's comment
3 about businesses paying more if this should happen.

4 I don't know about the rest of the bankers in the
5 room, but I long ago decided that this wasn't a cost-plus
6 business. I mean, it would be nice if we could take our costs and
7 add an increment for profit and charge that to the consumer, and
8 he would pay it.

9 Unfortunately, in a free market, in a very competitive
10 market, especially in Southeastern Wisconsin, that just isn't
11 possible. So, market forces do have a great impact on the amount
12 that we can charge, and also in credits that we give on commercial
13 accounts for certain types of balances.

14 Those are all very competitive, and I suspect that as
15 we go into money market transfers and sweep accounts, those will
16 also be very competitive.

17 So, I think that with our diverse financial structure
18 and the 5,000 or so members of ICBA and all of the community banks
19 around the country, I think you just need to continue to
20 experiment with alternatives, and I think you'll find a pretty
21 competitive environment out there for those funds.

22 CHAIRMAN TANOUE: I wanted to ask a question to
23 clarify the trade groups' positions, and I'll direct my question
24 to Jim.

25 MR. SMITH: Okay.

26 CHAIRMAN TANOUE: Jim, some time ago, I thought ABA's
27 position was not in support of increased coverage levels, but more
28 recently, and based on today's statement by the ABA, it indicates
29 that ABA does support adjusting the insurance limit of \$100,000,
30 and in some portion of the text, it talks about potentially
31 looking at doubling.

1 But is ABA supporting a doubling to \$200,000, and
2 basically I'm asking for a clarification of ABA's position --

3 MR. SMITH: Okay.

4 CHAIRMAN TANOUE: -- and how does that position differ
5 from ICBA's?

6 MR. SMITH: The answer is yes, we are supporting an
7 increase in the coverage limit.

8 I think what we want to do is see what the cost is,
9 whether we take it to 200, maybe we take it to 250. I think if
10 you index it for future inflation, maybe 200's not the right
11 number.

12 But, yes, we are in favor of raising the insurance
13 limit, and we would like to see future indexing to take it for
14 inflation in the future, so that we don't have to revisit this
15 situation again.

16 I think what we want to do is see a total
17 comprehensive plan on the table, so we understand what we're
18 dealing with and everything, a cap, rebates, insurance coverage,
19 future indexing for inflation, et cetera, because I think just to
20 take one piece of this and say this is what we'd like to do and
21 then find out later what it's going to cost us, I think, is the
22 wrong approach.

23 So, we would like to see a total comprehensive
24 program, and we are presently have sent out a survey to all of our
25 Government Relations Committee members, and we meet in May, and
26 they will make a recommendation to our board, and we will have a
27 firm recommendation at that time.

28 But hopefully at that time, we'll have some things on
29 the table that we can see what this cost is going to be.

30 VICE CHAIRMAN HOVE: Jim, do you have a position on
31 merging the funds?

1 MR. SMITH: We would like to see the funds merged but
2 not as the only alternative. There has to be --

3 VICE CHAIRMAN HOVE: That's the other part of the
4 package?

5 MR. SMITH: Right. We have to see the total
6 comprehensive package to make sure it works, but, yes, we would
7 like to see the funds merged, but not only the funds.

8 MR. MURTON: Roger? Roger, Ken had mentioned earlier,
9 when it was increased to 100,000 in 1980, that that was a
10 contributing cause of the subsequent thrift problems.

11 Would you care to comment on that?

12 MR. WATSON: I would, indeed. Once again, my age
13 plays in my favor. So, I do have some knowledge about that
14 midnight romp in the committee room that ended up going from 50 to
15 100,000.

16 At that point in time, Reg. Q was in effect up to
17 deposits of a 100,000 or more. Interest rates were starting to
18 rise rather rapidly. It became clear that thrifts in particular
19 were not going to be able to compete effectively with banks on a
20 rate basis, and thus the 100,000 limit which permitted them to
21 compete on the basis of interest rates rather than have a ceiling.

22 That was the secret discussion that probably wasn't all that
23 secret, except it never got in the Congressional Record, and
24 clearly we don't have the same consideration today since we no
25 longer have a deposit interest rate law.

26 MR. MURTON: Jim?

27 MR. SMITH: It seems to me the theme is that the
28 \$100,000 coverage caused the real crisis back in the '80s, but
29 don't forget we also had a change in the tax law. We had a crisis
30 in the oil industry. We had a crisis in real estate which evolved
31 somewhat from the change in the tax law. We had a crisis in

1 agriculture that evolved from the real estate problem but also low
2 commodity prices.

3 So, I don't think we can say that the \$100,000
4 increase in coverage was the reason we had the problem. There was
5 a whole bunch of problems that created the thrift crisis, and
6 let's just don't lay the increase in coverage on just to be the
7 blame for that.

8 MR. THOMAS: I agree, totally. My comment was just to
9 increase the costs, it increased the costs of the bail-out. The
10 125 billion perhaps would not have been a 125 billion, it'd be
11 significantly less.

12 Certainly you're absolutely right. There were many
13 causes, many more causes.

14 CHAIRMAN TANOUE: I have another question. This one I
15 direct to Tom or Jim or Bill.

16 There seems to be a presumption in some circles that
17 if we increase the deposit insurance coverage levels, that it'll
18 correlate to significantly more core deposits for small community
19 banks.

20 But there's a significant unknown with that -- how
21 savers or how consumers will react, and will they really shift
22 their funds from one small community bank to another or will they
23 go to the larger institutions and have their money there?

24 Now, is there any hard evidence or statistical surveys
25 that have been compiled to support any of this type of presumption
26 or do you have any suggestions about how we, and I use the royal
27 "we", whether individually as entities or collectively might go
28 about trying to gather this type of data to get a better handle on
29 what the likely reaction of consumers would actually be to higher
30 coverage levels?

31 MR. SHEEHAN: Well, I think we're finding in some of

1 the smaller communities, and again, I don't think there's been any
2 hard statistical evidence as to how these deposits flow, but as it
3 becomes more evident that there are institutions in this country
4 that are too big to fail, many of our smaller depositors that are
5 aware of that will look for alternatives for their deposits, and
6 oftentimes, they will place their deposits in branches of larger
7 institutions, that they feel there is a less risk involved because
8 of that.

9 It hasn't exactly been a hidden media event, you know,
10 that this does exist, and I think the recent bail-outs of various
11 -- even the long-term capital group -- I mean, those kinds of
12 incidences tend to reinforce that perception among the depositors
13 that are interested in that.

14 In smaller communities, yes, I think money is going
15 other places, and it would be nice if it could stay in those
16 communities, in those banks. There are a number of people that
17 have far in excess of \$100,000. The old 80/20 rule still is valid.

18 In fact, it may be even 90/10 in some cases, but a small number
19 of our depositors numerically fund our banks more and more and
20 more. They have larger and larger deposits, and if those deposits
21 continue to leave our small banks, we continue to have funding
22 problems.

23 So, I think those are the kinds of things that can be
24 statistically analyzed. I mean, Lord knows, there's enough
25 information available with the databases we have today, we should
26 be able to do that analysis, although I don't think it's been done
27 up to this point.

28 VICE CHAIRMAN HOVE: Tom, are these primarily consumer
29 accounts or business --

30 MR. SHEEHAN: Yes.

31 VICE CHAIRMAN HOVE: -- accounts?

1 MR. SHEEHAN: No. Almost all of what I'm talking
2 about, Skip, are consumer accounts.

3 Surprisingly, the business accounts don't tend to be nearly
4 as sensitive to that as the consumers are. The businesses tend to
5 be a little bit more sophisticated, tend to have a little
6 different relationship with their banks.

7 As Nolan has said earlier, this is not going to change
8 the dynamic as far as business accounts are concerned. They do
9 business with larger banks or smaller banks depending on their
10 other relationships, not necessarily the deposit side, but the
11 consumers, especially the older consumers, are very cognizant of
12 this insurance level.

13 VICE CHAIRMAN HOVE: You know, we've made some
14 simplifications of deposit insurance regulations.

15 Are they aware of some of these changes? In other
16 words, a joint account can be \$200,000 today.

17 MR. SHEEHAN: Right.

18 VICE CHAIRMAN HOVE: Are consumers generally aware of
19 that, your customers, so that a husband and wife can have a
20 \$200,000 account, and it's all insured?

21 MR. SHEEHAN: Oh, yes, yes. In fact, they can
22 actually have more than that, but --

23 VICE CHAIRMAN HOVE: Oh, yes, yes.

24 MR. SHEEHAN: -- with various combinations, but many
25 of them just don't want to bother with that. They're aware of it.
26 It's funny how people like to have their own accounts in their
27 own names.

28 We have much more of an independence that has been
29 created in our country over the last couple of years. The genders
30 tend to be more independent now. They don't want to be
31 necessarily -- they'd like to have their own accounts.

1 So, that does tend to happen, and we have a lot of
2 widows, we have a lot of widowers, those types of situations,
3 single moms, you know. So, it isn't the same dynamic that it was
4 10 years ago when you had the atomic family of a husband and a
5 wife and two kids. I mean, it's a different society today.

6 MR. SMITH: I don't know of any specific study that we
7 have that can say with a degree of certainty this is what will
8 happen if we go to 200,000.

9 We are looking at some things, at the ABA, and we're
10 doing some surveys in light of that to try to get a handle on
11 that.

12 I will say that I think the 200,000 will help us. It
13 will help us to hold some core deposits in our banks and in our
14 communities that may be seeking that coverage some place else, and
15 I agree with Tom.

16 We're in an era of a lot of single older people, and,
17 you know, if the spouse passes away, and there's 200,000 in the
18 account, all of a sudden they just have coverage on 100. So, they
19 start trying to figure out what they're going to do with that
20 money, and amazingly, some of it may go to the securities firms
21 that's uninsured or something of this nature.

22 So, I think if we can help keep those funds in our
23 institutions to fund our communities and our banks and our loans,
24 it would be a real help to us.

25 MR. MURTON: With the time we have remaining, I'd like
26 to move on to municipal deposits and the idea of covering
27 municipal deposits, and if we could cover that relatively quickly.

28 So, I'd like to open that up for anyone who'd like to
29 comment on that.

30 MR. NORTH: We think it would be a mistake to start
31 targeting types of depositors in banks to be more senior in

1 standing to other types of depositors in banks, and even though
2 many of these municipalities are members of ours, we would still
3 take that position, that all depositors should be treated the
4 same.

5 MR. SHEEHAN: Well, I'll just make a comment. We have
6 a number of our members that do feel that municipal deposits
7 should be insured. In many cases, it's for a lot of the same
8 reasons. Most states and municipalities require some
9 collateralization of those deposits anyway.

10 So, what happens is the bank must use securities or
11 other types of instruments to collateralize the deposits that they
12 obtain from their communities, from their municipalities, and if
13 something should happen, those securities would not be available
14 to the FDIC anyway. Those would go with the deposits.

15 So, I guess the obvious result of increasing the
16 insurance of deposits would be the fact that those securities
17 would then be available for other uses. They would be able to be
18 used, and the funding would be able to be returned to the
19 community.

20 I don't think there's any question that there could be
21 a problem if it became a bidding war, if some bank decided they
22 wanted to increase their deposits dramatically, they could distort
23 the market. I think if we're going to do this, we have to have
24 safeguards, speed bumps and other kinds of things.

25 I guess most of us that talk about municipal deposits
26 are talking about deposits in our own communities. I mean, these
27 are the deposits we get -- we don't generally get deposits outside
28 of our community anyway, and I think the FDIC would have to build
29 in safeguards for those kinds of activities.

30 But the type of deposits I get from my school system,
31 from the village government and other types of deposits, they want

1 to keep it in the community. We would like to see them keep it in
2 the community, and, so, I think that could be a very positive
3 aspect of this entire process.

4 MR. SMITH: I would just like to say in Missouri, we
5 have to provide collateral for those municipal deposits and
6 pledging of our securities. So, our municipal deposits are
7 covered one way or the other anyway.

8 I think from the ABA, what we would like to see is
9 again what's on the table with this, because if we do allow full
10 coverage, what's to keep somebody from another state from coming
11 in and bidding on our local municipal deposits? What's to keep me
12 from going into another state and bidding on municipal deposits if
13 I feel like I want to do that?

14 So, I think there has to be all the items on the table
15 that addresses this, so we can understand how this will affect us
16 and how it will affect our local communities and what will take
17 place on it.

18 MR. SHEEHAN: We agree with that.

19 MR. MURTON: I'd now like to open it up again for
20 questions from the gallery, and I'd like to ask you for the
21 purposes of our recording to state your name and affiliation, if
22 you would, before you ask the question.

23 MR. GUENTHER: Ken Guenther. I'm with the Independent
24 Community Bankers of America.

25 I think there's an institutional question on the table
26 that really hasn't been addressed. I think we are in the
27 strongest financial system in the world, the most stable financial
28 system in the world, and I think since the creation, the
29 establishment of the FDIC, this has been a bulwark of the very
30 remarkable financial system of the United States, which I think
31 has been very good for AARP members, like me.

1 I think it's been very, very good for the consumers of
2 America, and, you know, read the press in terms of countries
3 elsewhere, this is really not the case, and really since 1980, the
4 FDIC has been withering away in importance.

5 The FDIC is not as important now as it was 20 years
6 ago. If nothing is done in terms of deposit insurance levels, the
7 FDIC will continue to wither away, and I think the FDIC will
8 continue to become less important, and I think this has safety and
9 solvency implications. I think it has implications in terms of
10 the American consumer.

11 I do think the most interesting table that I have seen
12 in terms of the FDIC presentation is this table entitled "Deposit
13 Concentrations Have Shifted", and there has been this remarkable
14 shift of deposits, core deposits, from your smaller institutions
15 to your largest institutions from 1980 to 1999, and I think it's
16 probably worth noting that that shift moves deposits into those
17 institutions carrying systemic risk or, to use a terminology of
18 Dr. Thomas, it shifts more and more core deposits into the too-
19 big-to-fail which also are those who carry more systemic risk.

20 I don't think that's the way we want to go, and I
21 think the only way you can stem that is by increasing deposit
22 insurance levels, and again I don't think it's pro-consumer to
23 have more and more financial resources and core deposits
24 concentrated in fewer and fewer and fewer institutions.

25 Thanks.

26 MR. MURTON: Nolan?

27 MR. NORTH: May I comment, Ken? I'm not sure what you
28 mean by withering away, and if it relates to reserve levels
29 relative to deposits, then once again from my members' standpoint,
30 I would say that's not terribly relevant.

31 But what we haven't talked at all about this morning

1 from a safety and soundness standpoint, which we all will agree
2 on, is the exam. That's what our members rely on from the FDIC,
3 is that they are monitoring the management and the practices of
4 the institutions.

5 My members have to do their independent credit
6 analysis of each financial institution. Most of us -- many of us
7 buy a service. I happen to have it done in-house. Every one of
8 my banks is analyzed every six months.

9 So, the safety and soundness aspect of what I expect,
10 what my members expect, from the FDIC has to do with counseling
11 and watching the management of the institutions. The reserve
12 level is not terribly relevant in that regard.

13 MR. MURTON: Any other questions or comments?

14 (No response)

15 MR. MURTON: If not, I'd like to turn it back over to
16 Chairman Tanoue.

17 CHAIRMAN TANOUE: Okay. I think earlier this morning,
18 the point was made that the deposit insurance system is not
19 broken, and I think we fully agree with that, and I know that as I
20 meet with my colleagues from other countries to discuss deposit
21 insurance systems, it is very clear that our system here in the
22 U.S. is a model for many.

23 But it is clear, and I think we have a consensus here,
24 that we can refine the system. We can reform the system, and I
25 want to thank everyone here today for participating and to say
26 again that this is the first step in the process, and we look
27 forward to continuing our discussions with you, to going out
28 across the country again through our outreach sessions that will
29 be occurring this month and May and June, to gain even further
30 feedback and perspective from bankers and consumers alike.

31 Now, we are shooting to again put forward a set of

1 policy options for public comment in July, and perhaps the most
2 important point that was mentioned over and over again today is
3 that we need to look at these issues comprehensively and not in a
4 piecemeal fashion.

5 But as you leave today, I hope you will leave
6 convinced, as I am, more than ever that now is the appropriate
7 time to look at these issues and to look at them very hard.

8 With that, I thank you. Thank you, everyone.

9 (Applause)

10 (Whereupon, at 12:08 p.m., the roundtable was
11 concluded.)

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