Martin J. Gruenberg

Chairman, FDIC

Speech to the People's Bank of China

October 23, 2013

Good morning. I am deeply honored to be speaking before this distinguished audience today. I thank Governor Zhou for his very generous invitation.

I also want to thank Deputy Governor Liu and his staff for arranging the meetings for this visit, for their excellent work on our new memorandum of understanding, and for their gracious hospitality. There is a long history of close collaboration and cooperation between the People's Bank of China and the FDIC, and I am very pleased to have the opportunity to build on this strong foundation through our interaction this week.

Today I would like to speak to you about the important role that deposit insurance plays in maintaining public confidence in – and the stability of – a country's banking system. In particular, I'm going to talk about deposit insurance in the U.S., the economic crisis that led to the FDIC's creation in 1933, our experience with two banking crises since then and the very considerable expansion of authorities for the FDIC that followed from each of these crises.

These new authorities were granted in recognition of the fact that the FDIC played a critical role in maintaining the stability of the financial system in addition to protecting individual depositors during the crises. The important role of deposit insurance in maintaining financial stability also has become more widely recognized around the world in recent years, particularly as a result of the recent crisis, and I'll next talk about this international experience. I'll cite examples of the problems that arose in countries where deposit insurance systems were not credible or effective,

and discuss how this has led to new awareness of the importance of effective systems of deposit insurance, expanded cooperation among deposit insurers, and the development of international core principles to guide the design and operation of today's deposit insurance systems.

Finally, I will close my remarks with a brief discussion of the new FDIC resolution authorities over systemically important financial institutions (SIFIs) that were provided under the Dodd-Frank Act in the aftermath of this recent crisis, and the importance of cross-border cooperation on the resolution of SIFIs.

Deposit Insurance in the U.S.

Let me begin by talking about deposit insurance in the United States. This year marks the 80th anniversary of the establishment of the FDIC. Over the 80 years that the U.S. has had a national deposit insurance system, the first in the world I believe, it has proven to be a foundation of public confidence in our banking system, providing a crucial element of stability during periods of stress. As a result, from our perspective we see a great benefit in establishing an explicit deposit insurance system with clear limitations on coverage to provide certainty and security to depositors.

Creation of the FDIC

Let me turn now to the origins of the FDIC.

Between the 1880s and the early 1930s, the U.S. Congress considered a total of 150 proposals to establish a national deposit insurance system but did not enact any of them.

In the early 1930s, however, the U.S. entered the most severe financial crisis in its history up to that point. In the first few months of 1933, 4,000 U.S. banks were closed. As banks began to fail, the public began withdrawing deposits, ultimately resulting in bank runs, and a cycle of bank liquidity crises and failures. In response, President Roosevelt declared a bank holiday, essentially forcing all banks to close temporarily, and Congress created the FDIC. Upon its establishment, the FDIC was given the authority to provide deposit insurance to banks, to regulate and supervise state chartered banks, and to resolve failed banks.

The FDIC and national deposit insurance had an immediate, stabilizing effect on the financial system. Bank failures receded and banking panics became a thing of the past. People were once again willing to put their deposits in banks. The FDIC is widely viewed as one of the most successful legacies of that era, and, for over 80 years, federal deposit insurance in the U.S. has been a foundation of public confidence in the banking system. .

The Banking Crisis of the 1980s and early 1990s

There have been two financial crises in the United States since the 1930s. In the late 1980s and early 1990s, the U.S. experienced a crisis in its savings and loan industry that resulted in the failure of approximately one-third of U.S. savings and loan institutions, nearly 1000 total, which are depository institutions, commonly called thrifts, which specialize in home mortgage lending. This crisis also led to the collapse of the federal deposit insurance fund established for the savings and loan institutions, and the expenditure of approximately $140 billion in public funds to make good on the insured deposits in the failed savings and loan institutions.

Near the end of this crisis, the U.S. Congress enacted major reforms that expanded the FDIC’s authorities and strengthened our deposit insurance system. These new authorities included the

responsibility for insuring the deposits of thrifts, the authority to approve and deny deposit insurance coverage to banks and thrifts, backup examination authority over all insured financial institutions, and authority to charge risk-based premiums for deposit insurance. Significant reforms to banking regulation also resulted in the establishment of a system of prompt corrective action, which mandates regulatory intervention in failing banks as their capital declines.

The Recent Financial Crisis

During the recent financial crisis of 2008-2009 and its aftermath, the FDIC has been called upon to resolve nearly 500 failed bank and thrift institutions, with failures peaking at 157 in 2010. These failures included some of the largest and most challenging resolutions the FDIC has ever undertaken, including the failures of IndyMac Bank, with $32 billion in assets, and Washington Mutual Bank, with approximately $300 billion in assets and some 2,239 branches located in 15 states, the largest failure of a federally insured institution in U.S. history. Since 2010, both the rate of failures and the size of failed institutions has been decreasing dramatically.

To meet the challenge of resolving large numbers of failed banks, including several large banks, and to protect insured depositors, the FDIC applied some innovative resolution strategies during this crisis. These new strategies included loss sharing and structured transactions that helped preserve value and maximize returns for failed bank receiverships, while returning banking assets to the private sector. In all, 303 of the 487 bank failures since 2007, or 62 percent, were resolved via loss sharing resolution transactions. In these transactions the acquiring institution assumes most or all of the problem assets of the failed institution and shares the losses with the FDIC. Typically, the acquiring institution assumed 20 percent of losses in these deals, but this

varied according to specific characteristics such as the failed bank's portfolio and local conditions.

The sharp increase in bank failures caused the Deposit Insurance Fund (DIF) balance, or its net worth, to become negative. In the recent crisis, the DIF balance turned negative in the third quarter of 2009 and hit a low of negative $20.9 billion in the following quarter. The FDIC addressed this by increasing assessment rates at the beginning of 2009, which raised regular assessment revenue from $3 billion in 2008 to over $12 billion in 2009 and almost $14 billion in 2010. In June 2009, the FDIC also imposed a special assessment that brought in an additional $5.5 billion from the banking industry. Further, in December 2009, to increase the FDIC's liquidity, the FDIC required that the industry prepay almost $46 billion in assessments, representing over three years of estimated assessments. These measures also reaffirmed the longstanding commitment of the banking industry to fund the deposit insurance system, although the FDIC has authority to borrow from the U.S. Treasury if necessary.

The federal financial agencies in the U.S., including the FDIC, also had to take extraordinary measures to restore confidence in the financial system. At the height of the crisis, uncertainty among financial institution counterparties created a situation of generalized illiquidity in short-term funding markets. The FDIC and other U.S. financial agencies responded with a range of emergency measures to restore confidence and liquidity. One of the FDIC's emergency programs was the Temporary Liquidity Guarantee Program (TLGP), which improved access to liquidity by guaranteeing in full certain deposit accounts and by guaranteeing unsecured debt issued by financial institutions.

By having the ability to issue debt guaranteed by the FDIC, these institutions were able to extend maturities and obtain more stable unsecured funding. Along with the other extraordinary measures taken by the Treasury Department and the Federal Reserve Board in the fall of 2008, the FDIC's Debt Guarantee Program helped to calm markets and stabilize liquidity for financial institutions.

The extraordinary measures taken by the FDIC underscored the value of a credible deposit insurance system in maintaining financial stability. As the FDIC celebrated its 75th anniversary in 2008, it announced an education campaign designed to raise public awareness about federal deposit insurance. This effort included national advertising, a multi-city outreach effort and an award program for outstanding work in financial education. Later in 2008, the FDIC launched a second major initiative to raise public awareness of federal deposit insurance through public service announcements and the enhancement of our online tools that enable bank customers to determine whether their deposits qualify for FDIC insurance.

Following the crisis, the FDIC received important new authorities under legislation known as the Dodd-Frank Act. These authorities provided the FDIC greater flexibility to manage the Deposit Insurance Fund in order to have sufficient resources available in the future to close failing banks and pay depositors, reducing the chances that the FDIC will need to turn to the U.S. government for funds. The new authorities also include resolution authority over bank and nonbank SIFIs, as well as back-up examination authority for these institutions, which I will discuss shortly.

In retrospect, it is clear that the FDIC played a critical role in maintaining financial stability and protecting individual depositors in all three crises. Following the creation of the FDIC during the Great Depression of the 1930s, banking panics became a thing of the past, and since then, there

have been no depositor runs of any consequence. Large and small banks alike benefit from the stabilizing effect of deposit insurance. In the history of the FDIC, no depositor has ever experienced a loss on the insured amount of his or her deposit in an FDIC-insured bank due to a failure.

International Recognition of the Importance of Deposit Insurance

The importance of effective systems of national deposit insurance has also become more apparent internationally in recent years. Various countries faced the consequences of a weak deposit insurance system during the recent crisis. For example, the first bank run in Britain in more than a century occurred after Northern Rock, the U.K.'s fifth largest mortgage lender, requested emergency funding from the Bank of England. At the time, the deposit insurance system in the U.K. only covered in full the first £2,000 on deposit and 90 percent of the next £33,000. The U.K. government was forced to step in and guarantee 100 percent of deposits at the bank in an effort to stop the run. Ultimately, the bank was nationalized.

After the collapse of Iceland's three major banks, whose combined assets totaled more than 10 times the country's GDP, the U.K. and the Netherlands were forced to compensate depositors holding funds in U.K. and Dutch branches of the Icelandic banks because the Icelandic government did not have sufficient funds for these overseas depositors. The U.K. even took over a British bank owned by one of the failed Icelandic banks, transferring the deposits to another institution.

When Cyprus, whose banking system had grown to 7 times its GDP, was faced with a recent financial crisis, an EU-IMF proposal to address the crisis was widely criticized for its inclusion

of a tax on insured deposits. To prevent bank runs in response to the proposal, the government declared emergency bank holidays until an agreement was reached. When the banks reopened, capital controls restricted transactions and the flow of money. The Cypriot Parliament rejected the initial EU-IMF proposal, and the final deal imposed losses only on uninsured depositors.

I would suggest that these recent examples, considered in conjunction with the FDIC's experience, illustrate the need for credible, well-designed, explicit and effective systems of deposit insurance that are understood by the public in order to prevent bank runs, maintain public confidence in financial institutions, limit the severity of financial crises and maintain the stability of the financial system, especially during times of economic stress.

International Principles for Effective Deposit Insurance Systems

I would like to turn to the development of the international Core Principles for Effective Deposit Insurance Systems in response to this experience. As the value of effective systems of national deposit insurance become more apparent in the aftermath of the crises, the need for international standards to give guidance to countries in developing such systems gained recognition. In 2008, the Financial Stability Board of the G-20 countries (FSB) recommended that national authorities agree on an international set of principles for effective deposit insurance systems. At the time, although there were international standards for banking supervision and the regulation of securities and insurance, there were no comparable guidelines or best practices for deposit insurance systems.

The FSB cited a need for standards that would provide for effective deposit insurance systems while accommodating the unique circumstances of countries at different stages of economic and financial development that operate under different institutional settings.

In response to the FSB's call for international standards, a joint working group consisting of deposit insurers from the International Association of Deposit Insurers (IADI), and bank supervisors from the Basel Committee on Banking Supervision (BCBS) developed a document entitled *Core Principles for Effective Deposit Insurance Systems*. Executive bodies of IADI and the BCBS approved this document in June 2009.

The principles made for an excellent beginning, but countries needed specific guidance on how to apply them. The next step was to develop a methodology, a sort of road map or blueprint for compliance with the principles according to each country's individual circumstances and institutional settings. Representatives of IADI, the BCBS, the International Monetary Fund (IMF), and the World Bank worked together to develop and test the methodology, which IADI and the BCBS approved in late 2010.

This collaborative effort reached a major milestone in early 2011, when the FSB approved a revision of its Compendium of Standards to include the *Core Principles for Effective Deposit Insurance Systems* among its Key Standards for Sound Financial Systems. The IMF and World Bank also officially recognized the principles for use in their Financial Sector Assessment Programs (FSAPs), which they conduct to review the adequacy of national systems of financial regulation. Deposit insurance, as spelled out by the core principles, is now an integral part of the FSAP process. The inclusion of IADI's Core Principles in the FSB's compendium of Key Standards and the official recognition of the Core Principles by the IMF and World Bank for use

in FSAPs demonstrate international recognition that effective systems of deposit insurance are essential for financial stability.

The Core Principles serve as a valuable benchmark for jurisdictions to develop new systems of deposit insurance and reform existing deposit insurance systems, thereby promoting stability. The principles are comprehensive, addressing such issues as coverage, funding, powers, membership, cross-border cooperation, transitioning from blanket to limited coverage, early detection and timely intervention, reimbursement of depositors and recoveries on assets of failed institutions. The principles can be adapted to a broad range of country circumstances and currently are being revised by IADI to reflect the lessons learned from the recent crisis and the experience with assessments of compliance with the Core Principles that have been conducted by the FSB Peer Review process.

Effective Deposit Insurance Systems

To expand on that, while specific design features that work best vary from country to country, certain key challenges must always be addressed. Moral hazard is a real problem for deposit insurance systems and can undermine the purposes of deposit insurance if not properly managed. As the Core Principles point out, a well-designed deposit insurance program can enhance the discipline in the financial system by establishing standards for banks to qualify for insurance, including minimum capital requirements, and standards requiring sound internal controls and effective risk-management practices. The deposit insurance system should function within a suitable legal framework with appropriate accounting rules, prudential bank supervision, and consumer protections. In some cases, differential premiums based upon risk also can contribute a measure of discipline.

The deposit insurance system should be well understood by the public, and coverage should be adequate to provide assurance to most depositors. Other essential features of a well-designed deposit insurance program include: (1) access to information on insured banks as necessary for the deposit insurer to monitor risk exposure and to arrange resolutions for failing banks; (2) an efficient, well-understood process for closing banks and promptly paying depositors and other creditors; (3) reliable funding sources for the timely resolution of bank failures; and (4) strong corporate governance for the deposit insurance organization. To be effective, a deposit insurance system must be well designed and maintained properly to keep pace with the rapidly evolving financial marketplace.

I would also note from the FDIC's own experience that problems at a failing bank tend to lead to mounting losses over time. Consequently, it is helpful if the deposit insurer is provided with back-up supervisory authority along with the authority to close a failing bank as necessary to minimize the insurer's losses and reduce the risk that it will need to turn to the government or central bank for assistance.

The FDIC is strongly supportive of the Core Principles, and we have participated actively in the expansion of international coordination among deposit insurers. We place a great deal of emphasis on the importance of our relationships with our international counterparts. This is why we place particular value on this visit to the People's Republic of China. We have had a long, successful relationship with the People's Republic of China, and we look forward to continuing and deepening that relationship as you consider establishing a national deposit insurance system.

Resolution of Systemically Important Financial Institutions (SIFIs)

Finally, I will provide a brief overview of our work on the resolution of systemically important financial institutions. In addition to granting the FDIC new authorities with respect to deposit insurance, the Dodd-Frank Act also granted the FDIC new resolution authority over bank and nonbank SIFIs, as well as back-up examination authority for these institutions.

A key challenge the FDIC faced during the recent crisis was the collapse of large, complex, and highly integrated financial institutions. The systemic risk posed by these institutions is one of the greatest threats to financial stability. The FDIC's resolution authority during the crisis, which was limited to federally insured banks and thrift institutions, proved wholly inadequate to deal with the resolution of SIFIs. The FDIC lacked the authority to place the holding company or affiliates of an insured financial institution, or any other non-bank financial company that might pose a risk to the financial system, into an FDIC receivership. In addition, since the possibility of failure of these companies was not seriously contemplated, there was no planning by regulators for their resolution. The only option available for failure was the bankruptcy process, which was equally unprepared to handle the failure of a SIFI. This left extraordinary public support to these firms as the last resort to mitigate further damage to the financial system and the economy.

The FDIC's new authorities under the Dodd-Frank Act provide a framework for how a SIFI would be resolved. These new authorities enable the FDIC and other regulators to effectively plan for and manage the orderly failure of a SIFI.

Title I of the Act requires all bank holding companies with assets over $50 billion, as well as non-bank financial companies designated as systemic by the Financial Stability Oversight

Council, to prepare resolution plans, or "living wills," to demonstrate how they would be resolved in a rapid and orderly manner under the Bankruptcy Code in the event of material financial distress or failure. While bankruptcy is the preferred resolution framework in the event of the failure of a SIFI under the Dodd-Frank Act, Congress recognized that a SIFI may not be resolvable under bankruptcy without posing a systemic risk to the U.S. financial system and economy.

Title II of the Dodd-Frank Act therefore provides a broad new back-up authority to place any failing SIFI, including a consolidated bank holding company or a non-bank financial company deemed to pose a risk to the financial system, into an FDIC receivership process, if no viable private-sector alternative is available to prevent the default of the financial company, and if a resolution through the bankruptcy process would have serious adverse effects on U.S. financial stability

In the three years since the passage of the Dodd-Frank Act, the FDIC has focused on developing the capability to carry out a successful resolution under Title II. We have, I believe, developed a viable strategy, the Single Point of Entry (SPOE), under which the FDIC would take control of the parent holding company, allowing the firm's operating subsidiaries, domestic and foreign, to remain open and operating, diminishing contagion effects while removing culpable management and imposing losses on shareholders and unsecured creditors with no cost to the taxpayer. The FDIC plans to release later this year a detailed description of this resolution process for public comment.

International Coordination of Cross-Border Resolutions

Given the global operations of our largest, most systemically important financial institutions, a critical issue and priority for the FDIC for effective SIFI resolution is cross-border cooperation and coordination with foreign regulatory authorities. Effective SIFI resolution requires that home and host jurisdictions understand well the approach to resolution of their counterparts and work together to develop a cooperative approach to the orderly resolution of the failed company.

To facilitate cross-border understanding, cooperation, and coordination, we have been working closely with our counterparts in other countries, including the U.K., Switzerland, Germany, the European Commission and Japan. In addition, the Financial Stability Board of the G-20 has made cross-border resolution a top priority. The Resolution Steering Group of the FSB, of which the FDIC is a member, developed the first international standards for cross-border resolution, the Key Attributes of Effective Resolution Regimes, and is now in the process of developing a methodology for their implementation. The FSB has also established Crisis Management Groups for each of the G-SIFIs, which brings together regulators on a multilateral basis to discuss cross border cooperation on particular institutions. I know that the People's Republic of China is familiar with issues posed by globally systemic institutions, since the FSB has designated two of your institutions – the Bank of China and Ping An Insurance (Group) Company of China, Ltd. – as globally systemic institutions.

We look forward to working with the People's Republic of China on cross-border resolution issues, in addition to continuing our collaboration on deposit insurance issues.

Thank you very much.