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STATEMENT OF

JOHN F. BOVENZI
DEPUTY TO THE CHAIRMAN AND CHIEF OPERATING OFFICER
FEDERAL DEPOSIT INSURANCE CORPORATION

on

PROMOTING BANK LIQUIDITY AND LENDING THROUGH DEPOSIT INSURANCE, HOPE FOR HOMEOWNERS, AND OTHER ENHANCEMENTS

before the

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Chairman Frank, Ranking Member Bachus and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding efforts to promote bank liquidity and lending. As discussed in previous statements before this committee, asset quality deterioration, especially among residential mortgages, played a large role in triggering the current crisis. However, it has become increasingly apparent that a lack of liquidity in the financial services sector has emerged as a major obstacle to efforts to return the economy to a condition where it can support normal economic activity and future economic growth.

My testimony will discuss the reasons why measures are needed to enhance liquidity sources for financial institutions and the FDIC's efforts to provide additional liquidity to institutions through our Temporary Liquidity Guarantee Program (TLGP), as well as through maintaining a strong and flexible deposit insurance system. In addition, I will discuss the role of programs funded though the Emergency Economic Stabilization Act's (EESA) Troubled Asset Relief Program (TARP) in promoting stability and liquidity.

The Importance of Liquidity

Sufficient sources of liquidity are necessary to ensure appropriate funding of financial institutions' ongoing financial obligations to depositors, debtors and creditors. The most extreme examples of financial institution's inability to meet their obligations were seen in several of the financial institution failures that occurred during the latter part of 2008. While several institutions had significant asset quality problems, their reported book capital had not yet reached the Critically Undercapitalized threshold typically seen in failing banks. While the assets of these institutions were quickly deteriorating, their liquidity positions were deteriorating at a faster rate. This deterioration was brought on in part by significant deposit outflow over a relatively short period of time that resulted in a funding shortfall, which ultimately caused their failure.

Clearly, even absent the immediate liquidity issues that led to the closure of these institutions, the continued viability of these institutions was unlikely. However, liquidity failures result in more complicated resolutions. Also, the timeframes necessary to gather deposit and loan information as well as to solicit bids from interested acquirers, become compressed, which can place greater demands on the resources of the FDIC. Stabilizing liquidity could potentially avoid unnecessary costs to the Deposit Insurance Fund (DIF) by eliminating the need to close, or prematurely close, otherwise viable institutions.

In addition, a combination of adequate liquidity and capital buttresses financial institutions' ability to lend. Higher capital, resulting from TARP capital injections or private equity, enables financial institutions to lend more from their funding sources -- with deposits now being the most important. However, institutions need both liquidity and capital. Liquidity alone does not help if capital is insufficient and capital alone is not enough if the institution cannot obtain funds to lend.

Efforts to Improve Liquidity at Insured Depository Institutions

Temporary Liquidity Guarantee Program

In October, the FDIC Board of Directors approved the TLGP to unlock inter-bank credit markets and restore rationality to credit spreads. This voluntary program is designed to free up funding for banks to make loans to creditworthy businesses and consumers. The TLGP has two components: 1) a program to guarantee senior unsecured debt of insured depository institutions and most depository institution holding companies, and 2) a program to guarantee noninterest bearing transaction deposit accounts in excess of deposit insurance limits. The TLGP has a high level of participation. Of about 8,300 FDIC-insured institutions, nearly 7,000 have opted in to the transaction account guarantee program, and nearly 7,100 banks and thrifts and their holding companies have opted in to the debt guarantee program.

The TLGP's first component -- the guarantee of senior unsecured debt of insured depository institutions -- is designed to help stabilize the funding structure of financial institutions and expand their funding base to support the extension of new credit. Indications to date suggest the program has improved access to funding and lowered banks' borrowing costs. As of January 28, outstanding debt covered by a TLGP guarantee totaled about $221 billion. Data show that FDIC-guaranteed debt is trading at considerably lower spreads than non-guaranteed debt issued by the same companies. Since the inception of the TLGP program and the other interagency measures announced in mid-October, interbank lending rates have declined. For example, the LIBOR -- Treasury (TED) spread declined from 464 basis points on October 10 to 94 basis points on January 29.

The TLGP's second component provides insured depository institutions with insurance coverage for all deposits in non-interest bearing transaction accounts unless the institution chooses to opt out. These accounts are mainly payment processing accounts such as payroll accounts used by businesses. Frequently, such accounts exceed the current temporary maximum insurance limit of $250,000. Many smaller banks have expressed concerns about deposit outflows based on market conditions. This component of the TLGP gives assurance to bank customers that their cash accounts are protected. The guarantee should help stabilize accounts at these institutions and help the FDIC avoid having to close otherwise viable banks because of large deposit withdrawals. The temporary guarantee will expire December 31, 2009, consistent with the temporary statutory increase in deposit coverage.

Systemic Risk

The FDIC's action to establish the TLGP was authorized under the systemic risk exception of the FDIC Improvement Act of 1991 and followed similar actions by the international community. It is important to note that the TLGP does not rely on taxpayer funding or the Deposit Insurance Fund. Instead, both aspects of the program will be paid for by direct user fees.

The FDIC is charging TLGP participating institutions fees to offset the FDIC's risk exposure and minimize the likelihood that there will be any losses associated with the program. If losses should occur, they would be covered through a special systemic risk assessment.

However, under current law, even though the benefits of the TLGP accrue more broadly to bank holding companies, the FDIC's authority to assess extends only to insured depository institutions, not to bank holding companies. For example, the recent actions taken under the systemic risk authority have directly and indirectly benefited holding companies and non-bank affiliates of depository institutions, including shareholders and subordinated creditors of these organizations. Among the beneficiaries are large holding companies owning depository institutions that make up only a very small part of the consolidated organization.

The FDIC would recommend amending current law to allow us to impose, through rulemaking, systemic risk special assessments on insured depository institutions or depository institution holding companies, or both, as the FDIC determines to be appropriate. This approach would be more consistent with the FDIC's other assessment authority, which is set out more generally in the statute and implemented through notice-and-comment rulemaking. In addition, such a statutory change should permit the FDIC to establish the appropriate timing for recovering any loss in its assessment rulemaking in a manner that is not procyclical or exacerbates problems in the financial industry.

The Importance of Maintaining a Strong and Flexible Deposit Insurance System

Since the creation of the FDIC during the Great Depression, deposit insurance has played a crucial role in maintaining the stability of the banking system. By protecting deposits, the FDIC ensures the security of the most important source of funding available to insured depository institutions -- funds that can be lent to businesses and consumers to support and promote economic activity. At the end of the third quarter of 2008, the DIF had a balance of $35 billion available to absorb losses from the failures of insured institutions. This fund balance is net of loss reserves set aside for failures anticipated over the next 12 months, which are subject to adjustments based on changing economic and financial conditions. In addition, the FDIC has announced premium increases that are designed to return the DIF reserve ratio to within its statutory range in the coming years.

As part of our contingency planning, the FDIC would recommend that Congress provide additional support for our deposit insurance guarantee by increasing our existing $30 billion line of credit to $100 billion. Assets in the banking industry have tripled since 1991 -- the last time the line of credit was adjusted in the FDIC Improvement Act (from $5 billion to $30 billion). The FDIC believes it would be appropriate to adjust the statutory line of credit proportionately to ensure that the public has no confusion or doubt about the government's commitment to insured depositors. Because of the FDIC's ability to adjust premiums, the FDIC has never needed to draw on the line of credit to cover losses.[1]

Last fall, as part of its restoration plan and associated proposed rulemaking on assessments, the FDIC estimated a range of possible failure cost estimates over the 2008-2013 period, with $40 billion considered the most likely outcome. Since that time, another quarter of financial data on banking industry performance has become available. These data, combined with ample evidence of deteriorating economic and industry conditions, now suggest that the range of losses to the insurance fund (and the most likely outcomes) over the next few years will probably be higher. Thus, the uncertain and changing outlook for bank failures and the events of the past year have demonstrated the importance of contingency planning to cover unexpected developments in the financial services industry. If it ever became necessary to exercise this borrowing authority, the FDIC is statutorily required to ensure repayment of any borrowing over time through assessments on the banking industry.

In addition to increasing the borrowing authority of the FDIC to $100 billion, we believe it would be prudent to provide that the line of credit could be adjusted further in exigent circumstances by a request from the FDIC Board requiring the concurrence of the Secretary of the Treasury and subject to the consultation requirements with this Committee, as outlined in the current statute. These adjustments to FDIC borrowing authority would ensure that the FDIC is fully prepared to address any contingency.

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[1] The FDIC's Bank Insurance Fund did borrow funds from the Treasury's Federal Financing Bank in 1991 for working capital, which the FDIC fully repaid with interest by 1993.

With regard to proposals to make permanent the current temporary increase in deposit insurance coverage to $250,000, the FDIC believes that the level of deposit insurance coverage is a policy determination that appropriately should be made by Congress. However, because any increase in the level of deposit insurance coverage increases exposure to the DIF, such a change must also permit the FDIC to assess premiums against the newly insured deposits to maintain the DIF.

Permanently increasing the level of insurance coverage also will have the effect of immediately reducing the reserve ratio of the DIF. Because the DIF reserve ratio is currently below the statutorily mandated range for the reserve ratio, the FDIC is required to implement a restoration plan to return the reserve ratio of the DIF to at least 1.15 percent of estimated insured deposits within five years. The FDIC Board has instituted premium increases necessary to implement the restoration plan. Because of the immediate dilutive effect on the DIF of permanently increasing coverage to $250,000, extending the time period for restoring the DIF reserve ratio to within the statutorily mandated range would be appropriate.

EESA Programs

Foreclosure Mitigation Under EESA

EESA provides broad authority to the Secretary of the Treasury to take action to ameliorate the growing distress in our credit and financial markets, as well as the broader economy. EESA specifically provides the Secretary with the authority to use loan guarantees and credit enhancements to facilitate loan modifications and prevent avoidable foreclosures. We believe that it is essential to utilize this authority and accelerate the pace of loan modifications in order to halt and reverse the rising tide of foreclosures that is causing uncertainty in the financial markets.

Mortgage loan modifications have been an area of intense interest and discussion for almost two years now. Meanwhile, despite the many programs introduced to address the problem, it continues to get worse. During the third quarter of 2008, we saw mortgage loans becoming 60 days or more past due at a rate of more than 800,000 per quarter -- net of past due loans that returned to current status. No one can dispute that this remains the fundamental source of uncertainty for our financial markets and the key sector of weakness for our economy. We must decisively address the mortgage problem as part of our wider strategy to restore confidence and stability to our economy.

In previous testimony, Chairman Bair outlined an FDIC proposal for the creation of a guarantee program based on the FDIC's practical experience in modifying mortgages at IndyMac Federal Bank in California. We believe this program could prevent as many as 1.5 million avoidable foreclosures. Generally, the FDIC has proposed that the government establish standards for loan modifications and provide for a defined sharing of losses on any default by modified mortgages meeting those standards. By doing so, unaffordable loans could be converted into loans that are sustainable over the long term. This proposal is authorized by the EESA and may be implemented under the existing authority provided to the Secretary under that statute.

Redefaults are a significant concern for investors with regard to loan restructurings. One recent report[2] showed that 35 percent of mortgages modified in the second quarter of 2008 had become 60 days or more past due within 5 months of modification. However, this report did not track the quality of the modifications, defining the term broadly to include any change in contract terms, including modifications that were merely temporary or actually increased borrower payments. In contrast, the modifications achieved at IndyMac Federal lowered borrower payments to an affordable level for the life of the loan using several tools, including interest rate reductions. Other reports suggest much lower redefault rates where the borrower's payment is reduced. One study found redefault rates of 15 percent where modifications reduce interest payments.[3]

Deteriorating economic conditions will certainly cause redefault rates to increase. It should be noted, however, that even with higher redefault rates, loan modifications still

[2] OCC and OTS Mortgage Metrics Report, Third Quarter 2008.
[3] Credit Suisse, Fixed Income Research Report, Subprime Loan Modifications Update, Oct. 1, 2008.

make business sense in many cases. This is because the value preserved through a loan restructuring is generally much greater than the incremental loss from waiting a period of months before the servicer forecloses or otherwise resolves the defaulting mortgage. At IndyMac Federal, the FDIC has used a systematic approach to loan modifications to restructure thousands of unaffordable loans into more sustainable payments. Even assuming a redefault rate of 40 percent, the net present value of loans that we have modified exceeds foreclosure value by an average of $50,000, with aggregate savings of over $400 million. In fact, we believe redefault rates will be much lower, but even at higher rates, systematic loan modifications make good business sense.

Over the next two years, an estimated 4 to 5 million mortgage loans will enter foreclosure if nothing is done. One of the benefits of reducing the number of foreclosures would be the reduction of the overhang of homes that would become vacant, a phenomenon that is driving down U.S. home prices. Such an approach keeps modified mortgages within existing securitization transactions, does not require approval by second lienholders, ensures that lenders and investors retain some risk of loss, and protects servicers from the putative risks of litigation by providing a clear economic benefit from the modifications.

The FDIC generally supports the concept of a safe harbor for servicers in connection with loan modifications. However, we note that, in crafting safe harbor provisions, it is important to avoid language that would implicate a constitutionally impermissible taking through the impairment of contract rights. In addition, Congress may want to condition a servicer's eligibility for the safe harbor on the affordability of the loan modification for the borrower.

Capital Purchase Program

As a part of EESA, the Treasury Department developed a Capital Purchase Program (CPP) which allows certain financial companies to apply for capital augmentation of up to three percent of risk weighted assets. As noted earlier, the ongoing financial crisis has disrupted a number of the channels through which market-based financing is normally provided to U.S. businesses and households. Private asset-backed securitization remains virtually shut down, and the commercial paper market is now heavily dependent on credit facilities created by the Federal Reserve. In this environment, banks will need to provide a greater share of credit intermediation than in the past to support normal levels of economic activity. By contrast, a significant reduction in bank lending would be expected to have strong, negative procyclical effects on the U.S. economy that would worsen the problems of the financial sector.

Before the recent capital infusions, banks appeared to be on course to significantly reduce their supply of new credit as a response to an unusually severe combination of credit distress and financial market turmoil. Standard banking practice during previous periods of severe credit distress has been to conserve capital by curtailing lending. In the present episode, lending standards were likely to be tightened further due to higher funding costs resulting from overall financial market uncertainty. There was ample evidence in the Federal Reserve's *Senior Loan Officer Survey* in October that bank lending standards were being tightened to a degree that is unprecedented in recent history.[4]

Government intervention was needed to interrupt this self-reinforcing cycle of credit losses and reduced lending. The Treasury Department implemented the CPP as a means of countering the procyclical economic effects of financial sector de-leveraging. The federal bank regulators expect banks to actively seek ways to use this assistance by making sound loans to household and business borrowers. The FDIC recognizes that banks will need to make adjustments to their operations, even cutting back in certain areas, to cope with recent adverse credit trends. However, the goal of providing government support is to ensure that such cut-backs and adjustments are made mostly in areas such as dividend policy and management compensation, rather than in the volume of prudent bank lending. These considerations are consistent with the precept that the highest and best use by banks of CPP capital in the present crisis is to support prudent lending activity. As part of our ongoing supervisory assessments of bank earnings and capital, the FDIC is taking into account how available capital is deployed to generate income through responsible lending.

Thus far, a number of the largest banking companies in the U.S. have taken advantage of the CPP, significantly bolstering their capital base during a period of economic and financial stress. In addition, over 1,600 community financial institutions

[4] Federal Reserve Board, *Senior Loan Officer Opinion Survey on Bank Lending Practices*, October 2008, http://www.federalreserve.gov/boarddocs/snloansurvey/200811/

have applied to this program. In participating in the CPP program, as well as in launching the TLGP, it was the FDIC's express understanding that $250 billion would be made available for bank capital investments and that all eligible institutions, large and small, stock and mutual, would be able to participate.

It is critically important that community banks (commonly defined as those under $1 billion in total assets) are given every opportunity to participate in this program. Although, as a group, community banks have performed somewhat better than their larger competitors, they have not entirely escaped recent economic problems. Community banks control eleven percent of industry total assets; however, their importance is especially evident in small towns and rural communities. Although the viability of community banks as a sector continues to be strong, the CPP offers an opportunity for individual institutions to strengthen their balance sheets and continue providing banking services and credit to their communities.

The Importance of Using Additional Liquidity to Lend to Creditworthy Borrowers

In light of recent and proposed measures to improve liquidity at banks and promote additional lending, the FDIC and the other banking agencies have issued guidance to financial institutions and bank examiners to underscore the importance of using these resources to support lending to creditworthy borrowers. In November 2008 the FDIC issued an *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* to all FDIC supervised institutions, encouraging institutions to:

- lend prudently and responsibly to creditworthy borrowers;
- work with borrowers to preserve homeownership and avoid preventable foreclosures;
- adjust dividend policies to preserve capital and lending capacity; and
- employ compensation structures that encourage prudent lending.

The FDIC emphasized that adherence to these standards would be reflected in examination ratings both for safety and soundness and compliance criteria.

Further, to meet these objectives, it is crucial that banking organizations track the use of the funds made available through federal programs and provide appropriate information about the use of these funds. The FDIC recently issued another Financial Institution Letter advising insured institutions that they should track their use of capital injections, liquidity support, and/or financing guarantees obtained through recent financial stability programs as part of a process for determining how these federal programs have improved the stability of the institution and contributed to lending to the community. Equally important to this process is providing this information to investors and the public. As a result, this Financial Institution Letter advises insured institutions to include information about their use of the funds in public reports, such as shareholder reports and financial statements.

Internally at the FDIC, we are preparing guidance to our bank examiners for evaluating participating banks' compliance with EESA, the CPP securities purchase agreements, and success in implementing the goals of the November 12 interagency statement. Importantly, this examiner guidance will focus on banks' use of TARP CPP funds and how their capital subscription was used to promote lending and encourage foreclosure prevention efforts. During examinations, our supervisory staff will be reviewing banks' efforts in these areas and will make comments as appropriate in FDIC Reports of Examination. Our examiners will also be considering these issues when they assign CAMELS composite component ratings. The banking agencies will measure and assess participating institutions' success in deploying TARP capital and other financial support from various federal initiatives to ensure that funds are used in a manner consistent with the intent of Congress.

Conclusion

I appreciate the opportunity to testify on behalf of the FDIC regarding the measures that need to be taken to restore liquidity to the banking system so that lenders can provide needed credit to creditworthy borrowers. A number of approaches will be necessary to shore up the stability of the banking system and promote liquidity. The FDIC will continue to work with Congress to ensure the banking system is able to support economic activity in these difficult times.

I would be pleased to answer any questions from the Committee.