Statement of
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Federal Deposit Insurance Corporation
On
The State of
The Banking Industry
PART II before the Committee
On
Banking, Housing and Urban Affairs
U.S. Senate
June 5, 2008
Room 538, Dirksen Senate Office Building

Chairman Dodd, Senator Shelby and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the state of the banking industry and to describe specific actions we have been taking to address issues discussed at the March hearing on this topic.

Uncertainties in today's economic environment continue to pose significant challenges for the banking industry, households and bank regulators. Banks continue to experience increased pressure on earnings resulting from a deterioration in credit quality noted first in higher-risk nontraditional mortgage loans and now evident in other sectors. Deterioration has been particularly pronounced in construction and development (C&D) lending, which is receiving enhanced scrutiny from FDIC examiners.

My testimony will provide an update of bank financial performance during the first quarter and detail specific steps the FDIC is taking to address issues in institutions under our supervision. In addition, I will discuss initiatives that are underway to bolster our ability to address the resolution of failed financial institutions. Finally, my testimony will describe FDIC initiatives aimed at addressing the increasing number of foreclosures and problems in the mortgage credit markets. In particular, I will discuss a new proposal, the Home Ownership Preservation (HOP) loan program, which is designed to convert unaffordable mortgage loans into long-term, sustainable loans that permit borrowers to remain in their homes. HOP loans would complement the recent work of this Committee to expand the ability of the Federal Housing Administration (FHA) to refinance unaffordable mortgages. Further, the HOP proposal would address some of the complex issues related to second liens and adverse selection.

The Banking Industry's First Quarter Performance

Last week, the FDIC released its Quarterly Banking Profile, a comprehensive summary of financial results for all FDIC-insured institutions for the first quarter of 2008. The banking industry's performance during the first quarter of this year highlighted the challenges facing financial institutions in the current economic environment. FDIC-insured institutions reported total industry earnings of $19.3 billion in first quarter 2008, up from $646 million during the previous quarter, but down 46 percent from first quarter 2007. Weakness in first quarter earnings was driven primarily by a quadrupling of loan loss provisions to $37.1 billion from $9.2 billion during the same quarter last year. The economic slowdown brought on by the disruptions in credit availability is expected to exert continuing downward pressure on industry earnings over the coming quarters.

The credit quality of insured institutions' lending portfolios continued to deteriorate during the first quarter. Noncurrent loans grew by $27 billion in fourth quarter 2007 and $26 billion in first quarter 2008, and now represent 1.71 percent of all loans.[1] Loans secured by real estate accounted for almost 90 percent of the total increase in noncurrent loans during the first quarter, but almost all major loan categories registered increases. Net charge-offs climbed 20 percent to $19.6 billion during the first quarter. Net charge-offs were higher than a year ago in all major loan categories, but the largest increases occurred in residential real estate loans and in real estate C&D loans.

Insured institutions continued to build their loan-loss reserves in the first quarter. The $37.1 billion in loss provisions that they added to their reserves was $17.5 billion more than they charged-off. However, the growth in loss reserves was outstripped by the increase in noncurrent loans, and the industry's coverage ratio fell for the eighth quarter in a row to 89 cents in reserves for every dollar of noncurrent loans. This is the lowest level for the coverage ratio since the first quarter of 1993. During times of stress, such as now, the risk of loss increases in both loan and investment portfolios.

The FDIC expects banks to be proactive in analyzing current credit conditions, make appropriate loan loss provisions, and maintain an appropriate allowance for loan losses. Management also needs to make sure their capital supports their institution's overall risk profile. In this regard, as credit quality decreases and noncurrent loans increase, there should be a commensurate increase in the allowance for loan losses. Based on first quarter 2008 information, allowance levels do not appear to be keeping pace with problem credits or loss rates. FDIC examiners will be vigilantly monitoring developments in credit quality and loan loss reserve levels throughout 2008.

Low net interest margins (NIM) continued to be a drag on the earnings and profitability of FDIC-insured institutions. The industry's average NIM in the first quarter held steady at 3.3 percent. However, 70 percent of institutions reported declines in their margins as compared to their fourth-quarter 2007 levels. In fact, the average NIM of community banks was 3.7 percent during the first quarter, the lowest level since fourth quarter 1988.[2] Net interest income is particularly important to community banks. It represented 76 percent of net operating revenue at community banks during the quarter, but only 59 percent at larger institutions.

Even with the challenges in loan performance and earnings, capital ratios remained relatively strong at most FDIC-insured institutions. At the end of March, about 99 percent of all insured institutions, representing over 99 percent of industry assets, met or exceeded the minimum regulatory capital standard for well capitalized status according to the definition for Prompt Corrective Action. Management is expected to review capital not just with respect to regulatory minimums but with respect to overall loss exposure, and to build cushions beyond regulatory minimums given uncertainties in the economic environment. Many institutions have offset their losses by raising capital or by cutting dividend payments to conserve capital. Almost half (48 percent) of the 3,776 insured institutions that paid common stock dividends in the first quarter of 2007 paid lower dividends in the first quarter of 2008, including 666 institutions that paid no dividends.

Risks to the Banking Industry

Commercial real estate (CRE) loan concentrations at banks have increased significantly in recent years. Community and mid-sized banks, in particular, increased their exposure to CRE credit since it is a lending category where smaller institutions have remained competitive.3 That said, large institutions also maintain significant CRE exposure with institutions with assets greater than $10 billion holding about half of all CRE credits. Strong real estate market conditions also led to a substantial increase in C&D lending for both large and small institutions. However, since mid-2007, the significant slowdown in home sales, turmoil in the credit markets, and the increasing probability of a sluggish economic environment have increased risks in C&D lending, and CRE lending in general. The C&D segment of the CRE lending category stands out as the most important short-term credit quality issue for the institutions supervised by the FDIC.

Given the prospect of a protracted housing market slowdown, there may be negative consequences for institutions with significant concentrations of residential C&D loans as they navigate through this corrective phase of the credit cycle. Loss rates have risen dramatically on C&D loans through first quarter 2008 and likely will increase because of the current oversupply of new housing units. In addition, weakness in the residential construction lending sector may spill over to other segments of CRE loans such as the retail and office sectors. Local real estate and economic dynamics greatly influence the credit performance of each individual institution. For example, in some markets the decline in the housing sector has begun to affect loans to develop shopping centers and other retail establishments.

Economic weakness and rising food and energy costs also have increased the potential risks associated with consumer lending. The consumers who are most vulnerable to default are those who are already struggling to make their mortgage payments. Credit card delinquencies and charge-offs have increased, particularly in those areas experiencing the greatest downturn in home prices. This increase in delinquencies continues a three-year trend, but is still below the highs of the previous recession. For example, the net charge-off rate on credit card loans at all FDIC-insured institutions was 4.8 percent in first quarter 2008 -- well below the 7.7 percent peak rate of first quarter 2002 following the last recession -- but up from 4.1 percent in first quarter 2007.

The FDIC anticipates a rise in the number of problem institutions over the next few quarters, but so far the number of problem institutions remains well below levels seen during previous economic downturns.4 As of the end of March, there were 90 institutions with total assets of $26.3 billion on the FDIC's Problem Bank List, up from 76 institutions with total assets of $22.2 billion at the end of 2007. During the first quarter, twenty institutions were added and six were removed from the problem list. Three-quarters of the new problem institutions had CRE and/or C&D concentrations and, given the number of institutions with concentrations in these loan types, this trend is expected to continue. Problem institutions are currently scattered across the country; however, new additions to the list are more likely to come from the areas experiencing the highest levels of economic stress. The number of problem institutions -- and to a greater degree, the total assets of problem institutions -- are expected to rise over the coming quarters. However, the current list is small in comparison to the 1,430 institutions with combined assets of $837 billion that were listed at year-end 1991. Also, institutions on the problem list receive heightened supervisory attention, and most ultimately do not fail.

Last year, the FDIC closed three insured institutions with total assets of $2.6 billion and losses currently estimated at $178 million. So far this year, four institutions have failed, with total assets of $2.2 billion and estimated losses of $225 million. The number of failures in recent years has been unusually low by historic standards, and we expect that bank failure activity in the near term will be higher. There is also the possibility that future failures could include institutions of greater size than we have seen in the recent past.

The Condition of the Deposit Insurance Fund

As of March 31st, the balance in the Deposit Insurance Fund (DIF) stood at $52.8 billion. Fund growth during the first quarter, however, slowed to 0.8 percent from 1.3 percent during the previous quarter, and 1.2 percent during the first quarter of last year. Rising assessment income continued to bolster the DIF, but higher loss provisions restrained overall growth. The fund earned assessment income of $448 million in the first quarter, up from $239 million last quarter, as more institutions exhausted the credits that they received under the Federal Deposit Insurance Reform Act of 2005 (Reform Act). First quarter loss provisions totaled $525 million, including a $459 million increase in the DIF contingent liability for anticipated failures over the next 12 months. By contrast, loss provisions in all four quarters of 2007 totaled $95 million.

After three consecutive quarters of flat or moderate growth, estimated insured deposits rose sharply in the first quarter of 2008, by 3.3 percent (13.8 percent annualized). Quarterly growth outpaced even the strong 2.2 percent rate (9.1 percent annualized) reported in the first quarter of last year. Both large and small banks experienced strong insured deposit growth on average. Retail deposits, such as savings and interest-bearing checking accounts, appeared to drive much of the growth. Significant variation in quarterly insured deposit growth rates is not uncommon, and a large increase is reasonable to expect after a prolonged period of low growth. Furthermore, the safety of federally insured deposits is an attractive feature in periods of economic uncertainty and financial sector difficulties.

The strong growth in insured deposits, together with the increase in loss provisions, pushed down the DIF reserve ratio to 1.19 percent at March 31st from 1.22 percent at year-end 2007. On March 14, 2008, the FDIC Board considered industry requests to lower assessment rates but voted to leave rates unchanged this year. Given the current difficulties stemming from problems in the housing sector, financial markets, and overall economy, the possibility remains that the fund could suffer insurance losses that are significantly higher than indicated by staff projections in March. A significant increase in insurance losses due to failures (or the fund's loss reserve for anticipated failures) combined with strong deposit growth could push the fund below the 1.15 percent minimum of the statutory range. The Board will act as necessary under the statutory requirements of the Reform Act to maintain the integrity of the DIF.

Risk-Based Deposit Insurance Pricing

The new risk-based assessment system implemented after the enactment of the Reform Act has now been in place for over one year. The FDIC has begun to review how the system is working in order to determine whether changes to the assessment regulations would improve its effectiveness.

For well-managed, well-capitalized smaller institutions (and a small number of larger institutions), the FDIC determines a risk-based assessment rate using five financial ratios and a weighted average of supervisory component ratings. The FDIC selected and combined these measures based on a model that relates them to the probability that an institution's supervisory ratings will decline significantly within one year. To test how well this pricing method is working, the FDIC analyzed recent data available after the model was developed and found that the higher the assessment rate assigned under this method, the higher the percentage of banks whose supervisory ratings declined significantly within one year. This finding provides support that the pricing method is determining risk-based assessment rates as intended. The FDIC still plans to update the model this year in order to incorporate more recent data.

For most well-managed, well-capitalized large institutions (generally, those with over $10 billion in assets), the FDIC determines risk-based assessment rates using supervisory component ratings and long-term debt issuer ratings assigned by the rating agencies. For every large institution, the FDIC, after consulting with the applicable primary federal regulator, also determines quarterly whether to adjust the assessment rate within prescribed limits. These adjustments are intended to ensure consistency, fairness, and consideration of all available information. The FDIC has begun a review of the pricing method for larger institutions to determine whether it is sufficiently responsive to changing conditions. The agency plans to examine, among other issues, whether changes in how long-term debt issuer ratings are used to determine premium rates can improve the assessment system's effectiveness in capturing risks posed by large institutions.

In light of the current difficulties facing insured institutions, including institutions that are on the FDIC problem list, and recent failures, the FDIC also will consider other modifications to improve the risk-based assessment system's ability to account for risks in a timely manner and provide appropriate incentives. For example, the FDIC plans to review whether heavy reliance on brokered deposits (particularly when combined with rapid growth), excessive concentrations of difficult-to-value assets and disproportionate reliance on secured liabilities create risks to the fund that risk-based premium rates should reflect.

Recent Initiatives to Enhance Supervision

Commercial Real Estate

For several years, the FDIC has recognized the risks associated with CRE and C&D lending concentrations, and has made efforts to advise the industry on prudent risk management and oversight for these exposures. As of the end of first quarter 2008, 2,535 insured institutions had C&D concentrations of 100 percent or greater to Tier One capital.

In December 2006, the FDIC joined the Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System (FRB) in issuing guidance titled, "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices." This guidance advised institutions to implement strong underwriting and risk management practices, and to maintain appropriate levels of capital to support a sound CRE lending program. Although this guidance has been an effective tool to help institutions manage concentrated CRE exposures, the levels of exposures in some banks continue to require that regulators remain vigilant.

On March 17, 2008, the FDIC issued a Financial Institution Letter to bank management on managing CRE concentrations that reinforced the 2006 CRE guidance. The March guidance articulates the FDIC's significant concerns about concentrations of CRE loans, particularly in the construction and development segment. It re-emphasizes that banks must be attentive to capital adequacy, loan loss reserve appropriateness, portfolio management, and workout functions. Notably, the letter also encourages institutions to continue making CRE loans available -- on prudent terms.

In addition to providing guidance, the FDIC is monitoring institutions' CRE concentrations through both on-site examinations and off-site surveillance. Over the past five years, the FDIC has expanded the review procedures used by our examination force. These internal steps have provided examiners with procedural guidance and the necessary tools to expand examination coverage as necessary to effectively monitor and evaluate exposures. In addition, we have used our enforcement authority to address unsafe and unsound conditions regarding CRE exposures, and will use that authority as necessary to effectively discharge our supervisory responsibilities going forward.

Earlier this year the Division of Supervision and Consumer Protection conducted a targeted visitation program at 27 FDIC supervised institutions reflecting elevated concentrations in CRE loans and C&D lending. The purpose of the program was to determine the effect that deteriorating markets are having on institutions with significant concentrations in commercial real estate lending and whether changes to the current supervisory approaches for these institutions are warranted. The visitations found that some institutions with C&D lending concentrations in former high growth markets are experiencing a rapid increase in problem loans that may translate into losses this year. As a result of the visitations, the FDIC will accelerate some on-site reviews, refine our off-site surveillance and stress testing of institutions involved in C&D lending, and revise procedural guidance and examination tools for our staff.

Enhanced Bank Supervision

In March 2007, the FDIC launched a coordinated strategy for supervising and monitoring state nonmember institutions with significant exposure in nontraditional mortgage (NTM) and/or subprime mortgage products. This strategy included targeted visitations of institutions with the highest exposures to these products and follow-up visitations at institutions that present the highest level of supervisory concern.

The visitations identified weaknesses in credit administration practices, underwriting, and credit analyses but found that these areas are being strengthened at most institutions. The visitations also found that institutions were generally adhering to the 2006 Interagency Guidance on Nontraditional Mortgage Products, the 2007 Statement on Subprime Mortgage Lending, and consumer compliance policies.

The FDIC continues to focus attention on institutions under our supervision with significant NTM and subprime exposures, and we have modified our internal tracking reports to help us accomplish this. In cases where we see increased risk, we accelerate our examination and visitation schedule, change the CAMELS rating, or use appropriate enforcement action, if necessary.

In addition to monitoring bank NTM and subprime exposures in banks, the FDIC is closely monitoring trends in liquidity risk management and bank investments in structured credit products. The recent credit market turmoil has resulted in significant disruptions in wholesale, credit sensitive funding programs, causing institutions to rapidly seek alternative funding sources, often at a greater cost. Further, some highly rated assets that were considered to be liquid and marketable proved to be problematic when the market seized up, resulting in a strain on liquidity and sizeable realized and unrealized portfolio losses. Much of these problems can be attributed to the lack of transparency in the structured finance market and a failure by investors to ask the basic question: "what is the collateral that serves as my primary source of repayment?" To address these concerns, the FDIC expects to issue guidance to the institutions we supervise on liquidity risk and issues related to investments in structure credit products. Market stress over the past year made shortcomings evident in some institutions' risk management of these areas, and our guidance will address specific areas where risk management efforts should be improved.

The FDIC also recently created an Emerging Issues Section within the Division of Supervision and Consumer Protection, to enhance the Corporation's ability to develop proactive, forward-looking bank supervision policy. The section will augment existing processes for ensuring that the FDIC Board and executives are apprised of developments affecting the safety and soundness of insured institutions and the treatment of bank customers -- and to identify, at the earliest possible time, issues that may merit a consistent policy response.

To address the issues faced by banks that rely on third parties for critical services and activities, the FDIC is issuing Guidance for Managing Third-Party Risk. Banking institutions often rely on third parties for a wide variety of services and activities that are critical to their safe and sound operation. Basic elements of the guidance will include: effective risk assessment and due diligence when selecting a third party, careful contract structuring, and compensation arrangements that avoid encouraging third parties (which could include loan originators and mortgage brokers) to steer consumers into higher cost or other inappropriate products.

Finally, the FDIC is addressing the growing complexity within the banking industry by ensuring that on-site supervisory activity is commensurate with an institution's complexity and risk profile, and by enhancing procedures related to offsite monitoring of large insured institutions. The FDIC's focus on large, complex financial institutions has evolved to meet emerging challenges posed by consolidation and market innovation. For example, the FDIC recently approved and implemented comprehensive changes to its Large Insured Depository Institution Program, which includes 128 institutions with $10.2 trillion in assets. Key among these changes is the centralizing of risk analysis for supervisory, insurance, and resolutions business lines. The FDIC has developed a system to capture critical data elements identified by each business line in a standardized format to allow for effective comparative analysis and risk ranking of insured financial institutions. This enhances the coordination between these functional areas and ensures effective offsite monitoring, resource allocation, insurance pricing, and resolution planning related to complex insured depository institutions.

Basel II

Last December, the U.S. agencies finalized the rules that will allow the largest banks to use their internal models for calculating their risk-based capital requirements. Although I support the concept of a more risk sensitive capital framework, I have been a skeptic of model-based capital regulation. The last quantitative impact study showed capital requirements declining significantly in many categories with declines particularly dramatic in capital held against residential mortgages. Further, many of the recent problems in the credit market can be attributed to a failure of bank and rating agency models to accurately predict the risk and the resultant losses in the mortgage markets.

For those reasons, the FDIC insisted that the final rule require a comprehensive study by the bank regulators on the effectiveness of the Basel II rules. This study must be completed before any institution is permitted to exit the transitional floors that were established to limit unwarranted reductions in risk-based capital requirements. These procedures will permit a careful review of the Basel II framework that addresses the capital and modeling issues before the bank regulators move to full implementation. Given the recent market turmoil, I believe a cautious approach to adopting a model-reliant capital regime will produce a more rigorous and robust set of capital standards.

Most importantly, the bank regulators retain the leverage ratio for all banks. The leverage ratio complements the risk-based capital requirements by ensuring a base level of bank capital exists to absorb losses and protect the deposit insurance fund, even in situations where the risk-based metrics erroneously indicate risk is minimal and little capital is needed. These safeguards, along with the Prompt Corrective Action framework that provides regulators with the power to step in early to rectify problems and limit losses, will preserve capital and promote a safe and sound banking system for now and for the years to come.

For several years now, community banks have been asking for a more risk-sensitive capital rule that does not hurt their ability to compete with big banks. To address this concern, the FDIC and other federal banking agencies have developed a proposed rule that would allow all banks that are not required to use the Advanced Approaches the option of implementing a risk-based capital framework based on the Standardized Approach contained in the Basel II Accord. A question in the preamble to the proposed rule also will ask for comment on whether all banks, including those that are required to use the Advanced Approaches, should be allowed to use the Standardized Approach. The comments received in support of such an approach in prior rulemakings strongly supported such an option.

The proposed Standardized Approach provides banks with an alternative that is more risk sensitive than the existing framework, while being less reliant on models than the Advanced Approaches. The Standardized Approach introduces a more risk sensitive approach for residential mortgages that bases the capital charges on first and second liens on loan to value measures, and also better captures the risks on negative amortization loans. This rulemaking will include key questions about the use of external ratings to set capital for complex structured finance instruments as the bank regulators are very interested in alternatives that enhance the ratings based approach and improve the transparency in this market. The Notice of Proposed Rulemaking (NPR) solicits comments on whether enhancements to the capital treatment of off-balance sheet exposures such as Structured Investment Vehicles are needed, given their role in exacerbating the recent credit market turbulence. The OCC and OTS submitted the proposed rule to the Office of Management and Budget (OMB) for review on April 3, 2008. The OMB review is expected to be completed in a few weeks, and the proposed regulation will be published for public comment.

The FDIC is also participating in larger policy initiatives stemming from the recent market stress, most notably those being conducted by the Basel Committee. The Basel Committee is working on several initiatives that would enhance the minimum capital requirements, supervisory review processes, and transparency of complex structured credit products and is very close to updating and improving upon their existing Sound Practices for Liquidity Risk Management which will be issued for public comment.

Staffing

The FDIC is increasing its staffing to address increased supervisory needs and to handle the increase in its current and projected failure-resolution workload. Because of the similarity of skill sets, the FDIC has been engaging in cross training to create a flexible workforce where examiners can provide support for resolution activities and resolution specialists can provide support for examination activities.

In recognition of the current economic environment, the Board of Directors authorized an increase in bank examination staff levels. As of April 30, 2008, the FDIC has added 178 Financial Institution Specialists and 94 mid-career employees to the supervisory function. In addition, we have added 65 retired annuitants hired under a special authority provided by the U.S. Office of Personnel Management. Notwithstanding these additional steps, the current credit environment is putting stress on all regulators' supervisory activity and we will continue to take steps to ensure appropriate resources are available for this important activity.

To address staffing needs for a potential increase in financial institution failures, the FDIC has placed great emphasis on cross training existing employees to cover certain resolutions functions. The FDIC has approximately 1200 people with the skill sets to work on resolutions who could be called upon if necessary.

In addition, the Division of Resolutions and Receiverships (DRR) recently received approval to increase its authorized 2008 staffing level from 223 to 331. This increase includes a permanent increase of 39 positions as well as a temporary increase of an additional 69 positions for a period of up to two years. Other FDIC divisions also were given approval to fill additional permanent positions to offset a potential high level of retirement attrition in coming years and allow for a transfer of valuable knowledge to a new group of employees. The FDIC intends to temporarily hire specialists with expertise in asset management, investigations, owned real estate, accounting and marketing, among other qualifications. The complexity of financial products and assets has changed tremendously over the years and the professional skill sets required to handle this work is highly specialized. In addition to these staffing initiatives, the FDIC plans to supplement its staff with contractors, participants in our corporate employee program and mid-career hires to assist with receivership workload.

The FDIC also is using cutting edge technology to assist staff with key functions from marketing failed bank assets to identifying insured depositors. In addition, we have established contingency plans to increase call center and Internet capacity to ensure quality customer service to the public.

Recent Initiatives to Enhance Resolutions Capabilities

Because the rate of bank failures is expected to return to a level above that of recent years, the FDIC is actively engaged in ensuring that we have the capacity and appropriate skills to address the resolution of failed institutions. With the significant consolidation in the banking industry, we are focusing particularly on the unique issues associated with large financial institutions. Even if the probability of such a failure is unlikely, the development of mega-institutions means that the FDIC must ensure that its processes and systems are capable of handling the complex issues such a failure would pose.

Large Bank Claims Rulemaking

The FDIC needs data to make deposit insurance determinations at large banks in the event of failure. Some of these institutions may have millions of deposit accounts and the ability to determine their insured status quickly is essential to a successful resolution of a large failed bank. In January 2008, the FDIC issued an NPR proposing that the largest and most complex banks modify their deposit systems to facilitate the claims process. The NPR represents the culmination of two years of analysis, including public and industry input. The proposed rule includes a process to hold some fraction of large deposit accounts in the event of failure, the ability to produce depositor data for the FDIC in a standard format, and the ability to automatically debit uninsured deposit accounts to share losses with the FDIC.

The FDIC Board will be considering a final rule on this issue at our meeting later this month. Through this rulemaking, the FDIC also proposed using a failed depository institution's ledger balance after the completion of the day's business (by the receiver) to determine the amount of deposits in the failed institution for deposit insurance purposes. Scheduled internal transfers (for example, from one account to another account within the institution) would be completed before the FDIC would determine the extent of deposit insurance coverage. This particular change is meant to provide clarity and legal certainty regarding when the FDIC will make an insured deposit determination and will not require systems changes on the part of banks.

QFC Rule

Another key resolution area where the FDIC has sought to improve its preparedness is in our ability to respond effectively to larger and more complex portfolios of qualified financial contracts (QFC). QFCs are statutorily-defined financial contracts such as swaps and repos. In a bank failure, other parties to QFCs are granted special statutory rights to close-out their contracts in order to avoid cascading defaults in potentially volatile markets and to protect the stability of the financial markets. These special rights are stayed only briefly to allow the FDIC to make decisions about the disposition of these contracts.

In 2005, Congress recognized the importance of the FDIC having quick access to information critical to its decision-making by approving a statutory change that expressly authorizes the FDIC to adopt rules addressing QFC recordkeeping by troubled institutions after consultation with the other banking regulators. To implement this statute and to improve its access to essential information, the FDIC is developing a rule to require troubled institutions to maintain critical information and make it available to the Corporation upon request.

The FDIC has successfully made QFC determinations in small and mid-sized institution failures. However, in the unlikely event of a larger failure, the FDIC will need to have QFC-related information compiled, organized and available for our immediate use. Most troubled and healthy banks already maintain and use this information as part of their regular and ongoing efforts to manage counterparty credit risk exposure. For example, fundamental elements in counterparty risk management are management of counterparty exposures and the ability to quickly determine net counterparty exposures. However, it may not be organized in the way needed to make QFC determinations within the prescribed one day timeframe. In addition, the information sought in the rule will streamline supervisory assessments of QFC activities and improve our ability to evaluate the riskiness of those activities. To that end, the proposed rule specifies the essential information and defines how the information should be made available in order to facilitate the most effective response by the FDIC.

Contingency Planning

To increase the FDIC's preparedness to address a potential large-bank failure, we have been running bank failure readiness exercises since 2002. These exercises usually target a single hypothetical large, troubled insured institution, although sometimes the exercises involve scenarios with multiple troubled institutions. In each case, we work through the FDIC's preparedness plans and identify areas for improvement. The most recent exercise was held earlier this year, involving the hypothetical failure of a very large commercial bank.

Depositor Education

The current uncertainty in the financial markets has generated concern on the part of the public about the safety of their money and a renewed interest in deposit insurance coverage. Calls to the FDIC's toll free number regarding deposit insurance coverage have increased dramatically in recent years. For example, the FDIC received 7,827 calls in April 2006 regarding coverage issues compared to 20,874 calls in April 2008. Also, in light of the recent changes in the coverage levels for retirement accounts and the continuing existence of disinformation about the safety of insured deposits, the FDIC is increasing our efforts to educate the public about deposit insurance coverage.

As part of our 75th Anniversary this year, the FDIC will launch a series of new initiatives to broaden public awareness of deposit insurance and the FDIC's mission. The foundation of the FDIC's anniversary activities will be a national advertising campaign promoting basic deposit insurance information. The FDIC's campaign will be designed to address the increased public interest in deposit insurance issues and provide the essential information in a straightforward and reassuring manner. The FDIC also will hold a series of events in four cities across the country aimed at sharing ideas about the effectiveness of financial education and leadership while gathering key elements to produce effective financial education tools.

Other elements of the campaign will further promote the important work of the Corporation. Given the current economic environment, it is a unique opportunity to leverage our anniversary to educate the public about the confidence and stability that the FDIC has been providing for 75 years.

The Housing Market

Promoting Responsible Lending Going Forward

Because the problems surrounding unaffordable mortgages are acute in today's environment, and because I believe things may get worse before they get better, the FDIC is engaged in a wide range of activities to address home ownership and credit concerns. The FDIC has addressed public policy concerns regarding unfair and unsound lending practices by providing comments on the FRB Home Ownership and Equity Protection Act (HOEPA) proposed rule. Further, the FDIC has proposed a rule to make it easier for institutions to use covered bonds as a means to add additional liquidity for funding responsibly underwritten mortgages. In addition, the FDIC has embarked on fact-finding and outreach initiatives, such as an upcoming Forum on Mortgage Lending for Low- and Moderate-Income Households (LMI Mortgage Forum).

HOEPA Comment Letter

Earlier this year, the FRB, utilizing its authority under the Truth in Lending Act (TILA) and the Home Ownership and Equity Protection Act (HOEPA), proposed amendments to Regulation Z. The FDIC strongly commended the FRB for taking this important step and filed comments to address our views on the numerous consumer protection concerns that have arisen in the context of residential mortgage lending.

In its comment letter, the FDIC recommended significant revisions to the FRB's proposal with regard to several issues, including: providing a straightforward standard requiring mortgage creditors to determine a borrower's ability to repay a loan, and prohibiting underwriting based only on the initial "teaser rate" for all higher priced and nontraditional mortgage loans; requiring disclosure to borrowers and investors of loans with debt-to-income (DTI) ratios greater than 50 percent; prohibiting "stated income" underwriting outright for higher-priced first- and second-lien mortgage loans, as well as for nontraditional mortgage loans; banning or limiting prepayment penalties for higher cost loans; prohibiting the use of yield spread premiums to compensate mortgage brokers; restricting use of the term "fixed," or similar terms, in marketing information for adjustable rate or hybrid mortgage products; and keeping the proposed requirement that higher-priced mortgage loans have escrows for real estate taxes and insurance, but not allowing borrowers to opt out of escrows until longer than the minimum 12-month period proposed.

The FDIC strongly supports efforts to use rulemaking authority to establish consumer protections against abuses that are strong and consistent across industry and regulatory lines. In light of the existing patchwork of state laws, consistency in consumer protection standards through the application of uniform national standards for banks and nonbanks has the potential to raise the bar for all institutions and reduce the incentives for regulatory arbitrage. However, state laws should not be preempted unless they are inconsistent, since many states have proven to be innovative laboratories for the development of consumer protections in recent years.

Covered Bonds

In order to promote greater liquidity in the mortgage credit markets, some have suggested the broader use of covered bonds as an additional funding source for mortgage lenders. Covered bonds are general obligation bonds issued by a bank that are secured by a pledge of loans that remain on the bank's balance sheet. Proponents argue that covered bonds provide an additional source of funding for mortgages while providing stronger incentives for sound underwriting practices than securitizations. Loans that secure the bank's performance of the covered bonds it has issued remain on the bank's balance sheet, so the bank is required to hold capital to cover the risk in these loans.

Last year, market participants communicated to the FDIC that uncertainty surrounding how we would handle covered bonds in the event of an issuing bank's insolvency was hampering efforts to market covered bonds. In April, the FDIC issued guidance addressing the treatment of covered bonds in receiverships and conservatorships.

The FDIC's guidance clarifies how the FDIC will treat covered bonds in the event of a bank failure and establishes safeguards to permit the prudent and incremental development of a covered bond market in the United States. For example, the guidance states that in order to obtain favorable treatment by an FDIC receiver, covered bond issuances must be made with the consent of an insured depository institution's primary federal regulator and the total covered bond obligations at issuance cannot comprise more than four percent of the institution's total liabilities. Importantly, the collateral for the covered bonds must be secured by perfected security interests under applicable state and federal law on performing mortgage loans on one- to four-family residential properties, be underwritten at the fully indexed rate and rely on documented income in accordance with existing supervisory guidance governing the underwriting of residential mortgages. The FDIC's guidance should permit the development of a covered bond market in a way that permits bank supervisors to evaluate the growth and risks of this funding mechanism. While not a panacea, a developing covered bond market could provide an additional, importance source of secondary market funding for responsibly underwritten mortgages.

Mortgage Lending for Low- and Moderate-Income (LMI) Households

On July 8, 2008, the FDIC will be hosting an LMI Mortgage Forum. The purpose of the forum is to discuss the elements of a framework for LMI mortgage lending in the future, including identifying market and regulatory incentives for encouraging responsible LMI mortgage lending. Participants will include Secretary Paulson and Chairman Bernanke, as well as prominent private sector participants. The Forum is designed to focus on ways to ensure that LMI lending is properly underwritten and provides a profitable opportunity for lenders. Unfortunately, much of the LMI lending in recent years has been poorly underwritten or done in ways that are not sustainable for borrowers. The Forum will provide guidance for a return to fundamentals in lending to this important segment of the population. Following the LMI Mortgage Forum, the FDIC will convene a meeting of our Advisory Committee on Economic Inclusion to discuss issues raised at the LMI Forum and to make recommendations to the FDIC regarding how our agency can enhance our efforts to encourage safe and sound lending that is fair to LMI consumers.

Addressing the Needs of the Current Housing Market

In addition to promoting responsible lending going forward, the FDIC has been engaged in efforts to address the current problems in the housing market. The FDIC has issued guidance to foster better reporting of restructured loans by servicers, underscoring the FDIC's ongoing commitment to the HOPE NOW program. The FDIC also has proposed a new initiative, the Home Ownership Preservation (HOP) loan proposal, which would augment the existing or proposed FHA refinancing strategies and has the potential of helping many homeowners weather these difficult times and stay in their homes.

Voluntary Loan Modifications

The FDIC was an early proponent of voluntary industry efforts to systematically modify troubled mortgages into sustainable mortgage obligations. We have strongly supported the HOPE NOW initiative and encouraged banks to work with borrowers under streamlined loan modification procedures to help prevent unnecessary foreclosures. On March 3, 2008, the FDIC joined the other banking agencies in issuing a Financial Institution Letter on bank reporting of securitized subprime adjustable rate residential mortgages under HOPE NOW's reporting standards. As banks and servicers report this data, the industry and regulators will have a better understanding of how loan modification and foreclosure prevention efforts are progressing and what areas of these efforts can be enhanced.

In addition, the FDIC joined the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators in encouraging servicers to consider the borrower's ability to repay modified obligations taking into account their monthly housing-related payments in relation to gross income. The thrust of this September 2007 Financial Institution Letter was to encourage institutions to apply loss mitigation techniques to achieve long-term, sustainable mortgage loans for homeowners.

Enhancing FHA

As you know, foreclosures keep rising as mortgages reset to higher rates, home prices continue to drop, and millions of families continue to struggle with unaffordable mortgages. I commend the Committee on its recently passed legislation to expand eligibility for loans guaranteed by the FHA, combined with GSE modernization and regulatory reform. This legislation is laudable and will help many borrowers. I have seen hundreds of ordinary homeowners at foreclosure workshops desperately looking for ways to keep their homes. There is no single solution that can address all types of unaffordable loans.

Home Ownership Preservation Loans

Given the scope of the problem and differing circumstances of troubled borrowers, we encourage Congress to provide multiple tools for addressing rising foreclosures and the self-reinforcing spiral of declining home prices. Specifically, as a complement to FHA refinancings and voluntary loan modifications, we suggest a borrower loan program to meet the needs of homeowners who might not benefit from these other proposals.

Under our Home Ownership Preservation (HOP) loan proposal, the Treasury Department would make loans to borrowers with unaffordable mortgages to pay down as much as 20 percent of their principal. Mortgage investors choosing to participate would be required to restructure the mortgage to ensure an affordable, long-term payment and subordinate their lien interest to the government's claim. Both securitization trusts as well as portfolio lenders would be eligible to participate. To give borrowers time to stabilize their finances and rebuild some equity, repayment of the Treasury loan would be delayed for five years and then amortized over the remaining life of the mortgage. Mortgage investors would pay a subscription fee to cover the government's interest costs during the first five years. To prevent gaming of the system, eligibility could be confined to loans originated in recent years that were unaffordable at origination, based on a simple debt-to-income ratio.

Importantly, this proposal keeps the risk of re-default on mortgage investors. It allows the government to leverage its lower borrowing costs to reduce foreclosures significantly with no expansion of contingent liabilities and little net cost. Ownership of the loans, with the corresponding risk of declining collateral values and credit risks, remains with the current mortgage investors. As a result, it has built-in incentives for mortgage investors to qualify those borrowers who have a good chance of paying off a restructured loan over the long term.

This strategy would work within existing securitization contracts and would be less administratively complex than loan-by-loan refinancings. In most cases, borrower eligibility could be assessed with information readily available from existing records. Principal write-offs, which can require investor consent, are not required, limiting the prospect of potential conflicts of interest. Most importantly, the proposal does not require the consent of second lien holders, new appraisals or refinancing the loans.

Investors benefit by receiving immediate principal payments and from the reduced default risks.

The FDIC developed the HOP loan proposal to serve as an additional tool along with the existing proposals, and is designed to meet some important goals, including the following:

- No bailout. The proposal is not a bailout because borrowers are required to fully repay the principal of their loan.
- No government cost. The proposal is designed to result in no cost to the federal government.
- Investors bear risk. The proposal is designed so that mortgage investors continue to bear the risk of future default.
- Stabilization. The proposal would help stabilize high-cost mortgages (which would be good for credit markets) while keeping people in their homes making their payments (thereby, reducing foreclosure-driven reductions in home prices).

The HOP loan proposal would help homeowners who remain committed to their homes the means to stay in their homes with a mortgage that is sustainable over the long term. I believe the HOP loan program could be a valuable additional tool to address the problems created by unaffordable mortgages. It would complement the current FHA proposals recently adopted by this Committee. The FDIC would welcome an opportunity to work with Congress to achieve this result.

Conclusion
In the time since I testified before this Committee in early March, the FDIC has taken a number of specific actions to address current and potential future risks to insured institutions from the deterioration in the housing and mortgage markets as well as the economy. Some of the FDIC's efforts have focused on mitigating losses on existing mortgages, while others have been geared toward strengthening underwriting standards and consumer protection to prevent today's unprecedented wave of mortgage defaults from recurring in the future. Although nearly all FDIC-insured institutions remain well-capitalized, they face significant risks from economic conditions, the fallout from recent unsustainable mortgage lending practices, and disruptions in the credit and capital markets. The FDIC is focused on these risks to ensure that the institutions it supervises maintain their safety and soundness. In addition, the FDIC is prepared to move promptly to resolve any bank failures that may occur.

This concludes my testimony. I welcome any questions that the Committee might have.

1 Noncurrent loans are loans that are 90 days or more past due or in nonaccrual status.

2 "Community banks" in this context refers to all insured institutions with less than $1 billion in total assets.

3 "Mid-sized banks," in this context, are defined as institutions with $1 billion to $10 billion in total assets.

4 Federal regulators assign a composite rating to each financial institution, based upon an evaluation of financial and operational criteria. The rating is based on a scale of 1 to 5 in ascending order of supervisory concern. "Problem" institutions are those institutions with financial, operational, or managerial weaknesses that threaten their continued financial viability. Depending upon the degree of risk and supervisory concern, they are rated either a "4" or "5."

Last Updated 06/05/2008