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STATEMENT OF

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on

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Chairman Johnson, Ranking Member Crapo and members of the Subcommittee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on current issues in deposit insurance.

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.

Under the current severe economic conditions, the FDIC's deposit insurance guarantee has proven to be more valuable than ever. While many sources of bank funding have disappeared during the past six months, deposits have not. They remain a stable source of funding because depositors know that insured deposits are absolutely safe. No one has ever lost a penny on an insured deposit.

My testimony will discuss the current condition of the Deposit Insurance Fund (DIF) and the reasons for the recent decision by the FDIC Board of Directors (Board) to increase deposit insurance premiums and impose a special assessment on insured institutions. In addition, I will discuss the need for an increase in the FDIC’s borrowing authority with the Treasury Department, which has not been permanently increased in almost 20 years. I will also comment on legislative proposals to make permanent the temporary increase in the deposit insurance coverage, to extend the time period for restoring the DIF to the statutorily mandated range for the reserve ratio and to improve the systemic risk provisions of the Federal Deposit Insurance Act. Finally, I will discuss whether we should reexamine the mandatory rebate provisions that were enacted as part of the Deposit Insurance Reform Act in 2006.

Condition of the Deposit Insurance Fund

During 2008, 25 FDIC-insured institutions with assets of $372 billion failed, the largest number of failures since 1993 when 41 institutions with combined assets of $3.8 billion failed (excluding thrifts resolved by the RTC). So far this year, 17 FDIC-insured institutions with combined assets of $7.7 billion have failed. In addition, two banking organizations have received assistance under a systemic risk determination over the past six months. As part of its restoration plan and recent final rulemaking on assessments, the FDIC is estimating a range of possible failure cost estimates over the 2009-2013 period, with $65 billion considered the most likely outcome.

In 2008, the DIF balance fell by more than $33.5 billion (64 percent), primarily because of over $40 billion in loss provisions.[1] The industry funded Deposit Insurance Fund (DIF) decreased by almost $16 billion during the fourth quarter to $19 billion. This fund balance is net of loss reserves totaling $22 billion set aside for failures anticipated in 2009, which are subject to adjustments based on changing economic and financial conditions.

[1] The figure includes $18 billion in losses not previously reserved for failures in 2008 and $22 billion in estimated losses for anticipated failures in 2009.

The DIF's reserve ratio equaled 0.40 percent on December 31, 2008, which was 36 basis points lower than the previous quarter. During 2008, the reserve ratio decreased by 82 basis points, from 1.22 percent at year-end 2007. The December figure is the lowest reserve ratio for a combined bank and thrift insurance fund since June 30, 1993, when the reserve ratio was 0.28 percent.

Recently, the FDIC's Board of Directors made a series of very difficult decisions to ensure that our nation's deposit insurance system maintains the integrity of its industry funded assessment base. First, they extended the period in which the DIF reserve ratio must return to 1.15 percent from five to seven years, due to the extraordinary circumstances facing the banking industry. Second, they set an assessment rate schedule under which most insured institutions would pay between 12 and 16 basis points before certain adjustments, effective the second quarter of 2009. These rates are in line with the rates we had signaled would be necessary last October to bring the reserve ratio back up to the statutorily mandated minimum of 1.15 percent over the restoration plan horizon. Finally, and most importantly, the Board adopted an interim rule setting a special assessment of 20 basis points for June 30, to be collected September 30. We welcome comments on the interim rule that will be considered in any final rulemaking.

The FDIC realizes that these assessments are a significant expense, particularly during a financial crisis and recession when bank earnings are under pressure. Banks face tremendous challenges right now even without having to pay higher assessments. We also recognize that assessments reduce the funds that banks can lend in their communities to help revitalize the economy. However, the reality is that these increases in assessments are necessary to ensure the adequacy of the FDIC's industry funded resources to resolve projected bank failures. The FDIC's guarantee has always been funded by the industry. All banks benefit from the FDIC's industry funded status and deposit insurance has been one key component of addressing our current financial crisis that has not relied on taxpayer funding.

Some have suggested that the assessment burden should fall more squarely on weaker, higher risk banks. In point of fact, the new risk-based rules the FDIC finalized on February 27, 2009 assure that the regular assessment system will charge higher risk banks significantly more. But there is only so much burden that we can place on weaker banks without forcing them into insolvency, a self-defeating exercise which would end up costing the insurance fund even more. This is why a flat-rate special assessment was deemed the wiser course. Moreover, any system of insurance requires to some degree that premiums paid by well-managed and healthier institutions cover the losses caused by their weaker counterparts.

It also has been suggested that the assessment should target larger banks. The Board is seeking public comment on whether the base for the special assessment should be total assets or some other measure that would impose a greater share of the aggregate special assessment on larger institutions than the regular assessment base (domestic deposits). We are also seeking comment on whether the special assessments should take into account the assistance provided to systemically important institutions.

Borrowing Authority

The FDIC strongly supports S. 541, the Depositor Protection Act of 2009, legislation to increase the FDIC's borrowing authority with the Treasury Department if losses from failed financial institutions exceed the industry funded resources of the DIF.

The FDIC's borrowing authority was statutorily set in 1991 at $30 billion and has not been raised since that date. Assets in the banking industry have tripled since 1991, from $4.5 trillion to almost $14 trillion, and the FDIC believes it is prudent to adjust the statutory line of credit proportionately to leave no doubt that the FDIC can immediately access the necessary resources to resolve failing banks and provide timely protection to insured depositors. Deposits insured by the FDIC are backed by the full faith and credit of the United States and the FDIC's borrowing authority ensures that this obligation to protect depositors is met seamlessly and without interruption.

S. 541 would permanently increase the FDIC's authority to borrow from Treasury from $30 billion to $100 billion. In addition, the bill also would authorize a temporary increase in that borrowing authority above $100 billion (but not to exceed $500 billion) to address exigent circumstances, based on a process that would require the concurrence of the FDIC, the Federal Reserve Board and the Treasury Department, in consultation with the President. Any use of the borrowing authority is required by statute to be repaid by assessments on insured institutions. This temporary emergency authority is being requested as part of contingency planning. From a public confidence standpoint, we believe it is important to demonstrate the FDIC's ability to immediately access significant liquidity in even high stress scenarios. We want to make sure the funding mechanics are in place to meet all contingencies.

The FDIC Board's decision regarding the size of the recently announced special assessment reflected the FDIC's responsibility to maintain adequate resources to cover unforeseen losses. Chairman Bair has stated that increased borrowing authority would give the FDIC flexibility to reduce the size of the recent special assessment, while still maintaining assessments at a level that supports the DIF with industry funding based on current loss projections. While the industry would still pay assessments to the DIF to cover projected losses and rebuild the Fund over time, a lower special assessment would mitigate the impact on banks at a time when their communities need them more than ever and they are called upon to revitalize the economy.

The events of the past year have demonstrated the importance of contingency planning to cover unexpected developments in the financial services industry. Indeed, in temporarily increasing deposit insurance coverage from $100,000 to $250,000, Congress also temporarily lifted all limits on the FDIC's borrowing as necessary to carry out the increase in the maximum deposit insurance amount. The Depositor Protection Act would leave no doubt that the FDIC will continue to have the resources necessary to address future contingencies and seamlessly fulfill the government's commitment to protect insured depositors against loss. The FDIC strongly supports this legislation and looks forward to working with the sponsors to enact it into law.

Improving the Systemic Risk Special Assessment

Section 13(c)(4)(G) to the Federal Deposit Insurance Act (FDI Act) authorizes action by the Federal government in circumstances involving systemic risk to the banking industry. It permits the FDIC to take action or provide assistance as necessary to avoid or mitigate the effects of the perceived risks, following a recommendation of the existence of systemic risk by the FDIC's Board, with the written concurrence of the Board of Governors of the Federal Reserve System (FRB) and an eventual determination of systemic risk by the Secretary of the Treasury (after consultation with the President).

The FDI Act also requires the FDIC to recover any loss to the DIF arising from any action taken or assistance provided pursuant to a systemic risk determination. Under current law, the FDIC must recover any loss expeditiously from one or more emergency special assessments on the insured depository institutions based on the amount of each insured depository institution's average total assets minus the sum of the institution's average total tangible equity and its average total subordinated debt.

The Federal government exercised the systemic risk authority for the first time in September 2008, and on three more occasions since then. In each of these cases, the FDIC took sound actions, such as charging fees, to offset its new risk exposure and minimize the likelihood that there will be a loss requiring a systemic risk special assessment. However, the FDIC's recent experience suggests that the current statutory provisions regarding a systemic risk special assessment may not provide sufficient flexibility to appropriately allocate any special assessment among the parties who benefit from government action to address challenges that pose a risk to the financial system.

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. Such actions were necessary to stabilize financial markets and provide increased liquidity in the financial system. Yet, while holding companies and their non-bank affiliates, shareholders, and subordinated creditors stand to benefit from the government's actions, they would bear a cost under the current systemic risk assessment that is disproportionately small compared to the benefits. Instead, the assessment would disproportionately burden many traditional banking companies, particularly those with few or no non-bank affiliations.

The statutory language in H.R. 1106 would allow the FDIC to impose systemic risk special assessments, by rulemaking subject to the notice-and-comment procedures of the Administrative Procedure Act, on insured depository institutions or depository institution holding companies, or both. When exercising the authority to assess holding companies, the FDIC would consult with the Secretary of the Treasury and the Board of Governors of the Federal Reserve System. This authority would not be used to pre-fund assessments to pay for losses that the FDIC contemplates may be incurred as a result of invoking the systemic risk authority; rather, it would be used to recover losses actually incurred.

This approach would be more consistent with the statutory provisions governing the FDIC's other assessment authority, which set broad direction for the FDIC to implement through notice-and-comment rulemaking, and with the provisions governing systemic risk determinations. In prescribing systemic risk special assessment regulations, the FDIC would be required to consider certain factors, including economic conditions; the effects on the industry; and such other factors as the Corporation deems appropriate. In addition, the proposed amendment would enable the FDIC to establish the appropriate timing for recovering any loss in its assessment rulemaking in a manner that is not pro-cyclical and does not exacerbate problems in the financial industry. Depository institution holding companies also would be subject to the statutory requirements to pay assessments and penalties for late payment or nonpayment.

In addition to the provisions in H.R. 1106 to broaden the base for a systemic risk special assessment, the FDIC would recommend a statutory change to provide a priority for the government over general creditors in cases where the bank defaults on debt that has been guaranteed by the FDIC and is placed in receivership. In October 2008, the FDIC Board of Directors approved the Temporary Liquidity Guaranty Program (TLGP) to free up funding for banks. Indications to date suggest the program has improved access to funding and lowered banks' borrowing costs.

The purpose of this statutory change would be to put the FDIC and senior unsecured debt holders that are guaranteed by the TLGP immediately after depositors to recover from the assets of the estate of a failed insured depository institution. Debt guaranteed by the FDIC serves an important public policy purpose and should receive a priority in a bank receivership over general creditors. Without this amendment, the debt holders of insured depository institutions and the FDIC as subrogee of their rights will share pro rata with general creditors of the estate. This provision will increase the likely recovery to the FDIC for the costs of any guarantee of insured institution debt that it might be required to honor and could reduce the need for or amount of a systemic risk special assessment.

Permanently increasing coverage to $250,000

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 account for the newly insured deposits when setting premiums necessary 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. Since the DIF reserve ratio is currently below the statutorily mandated range for the reserve ratio, the FDIC is operating under a restoration plan to return the reserve ratio of the DIF to at least 1.15 percent of estimated insured deposits. The FDIC Board recently extended the length of that plan from five to seven years due to the extraordinary circumstances facing the banking industry and instituted a combination of premium increases and special assessments necessary to implement the restoration plan. Because of the immediate dilutive effect on the DIF of permanently increasing coverage to $250,000, extending the statutory 5-year time period for restoring the DIF reserve ratio to at least the bottom end of the statutorily mandated range would be appropriate.

Mandatory Rebates

One of the most important goals of the reforms included in the Federal Deposit Insurance Reform Act was to make the deposit insurance assessment system less pro-cyclical. To achieve this result, in 2006, the FDIC was provided with greater flexibility to assess institutions based on risk and to build up the DIF in good times. However, the legislation included restrictions on the growth of the DIF that may still contribute to higher assessments against financial institutions during times of economic stress.

Under current law, the FDIC is required to rebate half the assessment revenue it collects when the DIF reserve ratio is above 1.35 percent. In addition, the FDIC is required to rebate all amounts in the DIF that keep the reserve ratio above 1.5 percent. The result of these mandatory rebates is to limit the ability of the DIF to grow in good times and to effectively cap the size of the DIF.

These restrictions on the size of the DIF will limit the ability of the FDIC to rebuild the Fund in the future to levels that can offset the pro-cyclical impact of assessment increases during times of economic stress. Limits on the size of the DIF of this nature will inevitably mean that the FDIC will have to charge higher premiums against the industry when conditions in the economy are causing significant numbers of bank failures. As part of the consideration of broader regulatory restructuring, Congress may want to consider the impact of the mandatory rebate requirement or the possibility of providing for greater flexibility to permit the DIF to grow to levels in good times that will establish a sufficient cushion against losses in the event of an economic downturn.

Conclusion

The events of recent months have clearly demonstrated the benefits of deposit insurance to depositors and banks. During this difficult period, insured deposits have been fully protected in every bank failure. Assured by this guarantee, consumers have continued to maintain deposits in insured financial institutions that have provided vital liquidity for communities across the country. With additional modifications to the deposit insurance system, such as the increase in the FDIC's borrowing authority, we can maintain a system that continues the FDIC's mission of providing stability to the financial system.