EMBARGOED UNTIL DELIVERY

STATEMENT OF

SHEILA C. BAIR
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

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) regarding the condition of FDIC-insured institutions and the deposit insurance fund (DIF). While challenges remain, evidence is building that financial markets are stabilizing and the American economy is starting to grow again. As promising as these developments are, the fact is that bank performance typically lags behind economic recovery and this cycle is no exception. Regardless of whatever challenges still lie ahead, the FDIC will continue protecting insured depositors as we have for over 75 years.

The FDIC released its comprehensive summary of second quarter 2009 financial results for all FDIC-insured institutions on August 27. The FDIC's *Quarterly Banking Profile* provided evidence that the difficult and necessary process of recognizing loan losses and cleaning up balance sheets continues to be reflected in the industry's bottom line. As a result, the number of problem institutions increased significantly during the quarter. We expect the numbers of problem institutions to increase and bank failures to remain high for the next several quarters.

My testimony today will review the financial performance of FDIC-insured institutions and highlight some of the most significant risks that the industry faces. In addition, I will discuss the steps that we are taking through supervisory and resolutions processes to address risks and to reduce costs from failures. Finally, I will summarize the condition of the DIF and the recent steps that we have taken to strengthen the FDIC's cash position.

Economy

In the wake of the financial crisis of last Fall and the longest and deepest recession since the 1930s, the U.S. economy appears to be growing once again. Through August, the index of leading economic indicators had risen for five consecutive months. Consensus forecasts call for the economy to grow at a rate of 2.4 percent or higher in both the third and fourth quarters. While this relative improvement in economic conditions appears to represent a turning point in the business cycle, the road to full recovery will be a long one that poses additional challenges for FDIC-insured institutions.

While we are encouraged by recent indications of the beginnings of an economic recovery, growth may still lag behind historical norms. There are several reasons why the recovery may be less robust than was the case in the past. Most important are the dislocations that have occurred in the balance sheets of the household sector and the financial sector, which will take time to repair.

Households have experienced a net loss of over $12 trillion in net worth during the past 7 quarters, which amounts to almost 19 percent of their net worth at the beginning of the period. Not only is the size of this wealth loss unprecedented in our modern history, but it also has been spread widely among households to the extent that it involves declines in home values. By some measures, the average price of a U.S. home has declined by more than 30 percent since mid-2006. Home price declines have left an estimated 16 million mortgage borrowers "underwater" and have contributed to an historic rise in the number of foreclosures, which reached almost 1.5 million in just the first half of 2009.[1]

Household financial distress has been exacerbated by high unemployment. Employers have cut some 7.2 million jobs since the start of the recession, leaving over 15 million people unemployed and pushing even more people out of the official labor force. The unemployment rate now stands at a 26-year high of 9.8 percent, and may go higher, even in an expanding economy, while discouraged workers re-enter the labor force.

In response to these disruptions to wealth and income, U.S. households have begun to save more out of current income. The personal savings rate, which had dipped to as low as 1.2 percent in the third quarter of 2005, rose to 4.9 percent as of second quarter 2009 and could go even higher over the next few years as households continue to repair their balance sheets. Other things being equal, this trend is likely to restrain growth in consumer spending, which currently makes up more than 70 percent of net GDP.

Financial sector balance sheets also have undergone historic distress in the recent financial crisis and recession. Most notably, we have seen extraordinary government interventions necessary to stabilize several large financial institutions, and now as the credit crisis takes its toll on the real economy, a marked increase in the failure rate of

[1] Sources: Moody's Economy.com (borrowers "underwater") and FDIC estimate based upon Mortgage Bankers Association, *National Delinquency Survey*, second quarter 2009 (number of foreclosures).

smaller FDIC-insured institutions. Following a five-year period during which only ten FDIC-insured institutions failed, there were 25 failures in 2008 and another 98 failures so far in 2009.

In all, FDIC-insured institutions have set aside just over $338 billion in provisions for loan losses during the past six quarters, an amount that is about four times larger than their provisions during the prior six quarter period. While banks and thrifts are now well along in the process of loss recognition and balance sheet repair, the process will continue well into next year, especially for commercial real estate (CRE).

Recent evidence points toward a gradual normalization of credit market conditions amid still-elevated levels of problem loans. We meet today just one year after the historic liquidity crisis in global financial markets that prompted an unprecedented response on the part of governments around the world. In part as a result of the Treasury's Troubled Asset Relief Program (TARP), the Federal Reserve's extensive lending programs, and the FDIC's Temporary Liquidity Guarantee Program (TLGP), financial market interest rate spreads have retreated from highs established at the height of the crisis last Fall and activity in interbank lending and corporate bond markets has increased.

However, while these programs have played an important role in mitigating the liquidity crisis that emerged at that time, it is important that they be rolled back in a timely manner once financial market activity returns to normal. The FDIC Board recently proposed a plan to phase out the debt guarantee component of the Temporary Liquidity Guarantee Program (TLGP) on October 31st. This will represent an important step towards putting our financial markets and institutions back on a self-sustaining basis. And even while we seek to end the various programs that were effective in addressing the liquidity crisis, we also recognize that we may need to redirect our efforts to help meet the credit needs of household and small business borrowers.

For now, securitization markets for government-guaranteed debt are functioning normally, but private securitization markets remain largely shut down. During the first seven months of 2009, $1.2 trillion in agency mortgage-backed securities were issued in comparison to just $9 billion in private mortgage-backed securities. Issuance of other types of private asset-backed securities (ABS) also remains weak. ABS issuance totaled only $118 billion during the first 9 months of 2009 in comparison to $136 billion during the first 9 months of 2008 and peak annual issuance of $754 billion in 2006.

Significant credit distress persists in the wake of the recession, and has now spread well beyond nonprime mortgages. U.S. mortgage delinquency and foreclosure rates also reached new historic highs in second quarter of 2009 when almost 8 percent of all mortgages were seriously delinquent. In addition, during the same period, foreclosure actions were started on over 1 percent of loans outstanding.[2] Consumer loan defaults continue to rise, both in number and as a percent of outstanding loans, although the number of new delinquencies now appears to be tapering off. Commercial loan

[2] Source: Mortgage Bankers Association, *National Delinquency Survey*, Second Quarter 2009

portfolios are also experiencing elevated levels of problem loans which industry analysts suggest will peak in late 2009 or early 2010.

Recent Financial Performance of FDIC-Insured Institutions

The high level of distressed assets is reflected in the weak financial performance of FDIC-insured institutions. FDIC-insured institutions reported an aggregate net loss of $3.7 billion in second quarter 2009. The loss was primarily due to increased expenses for bad loans, higher noninterest expenses and a one-time loss related to revaluation of assets that were previously reported off balance sheet. Commercial banks and savings institutions added $67 billion to their reserves against loan losses during the quarter. As the industry has taken loss provisions at a rapid pace, the industry's allowance for loan and lease losses has risen to 2.77 percent of total loans and leases, the highest level for this ratio since at least 1984. However, noncurrent loans have been growing at a faster rate than loan loss reserves, and the industry's coverage ratio (the allowance for loan and lease losses divided by total noncurrent loans) has fallen to its lowest level since the third quarter of 1991.[3]

Insured institutions saw some improvement in net interest margins in the quarter. Funding costs fell more rapidly than asset yields in the current low interest rate environment, and margins improved in the quarter for all size groups. Nevertheless, second quarter interest income was 2.3 percent lower than in the first quarter and 15.9 percent lower than a year ago, as the volume of earning assets fell for the second

[3] Noncurrent loans are loans 90 or more days past due or in nonaccrual status.

consecutive quarter. Industry noninterest income fell by 1.8 percent compared to the first quarter.

Credit quality worsened in the second quarter by almost all measures. The share of loans and leases that were noncurrent rose to 4.35 percent, the highest it has been since the data were first reported. Increases in noncurrent loans were led by 1-to-4 family residential mortgages, real estate construction and development loans, and loans secured by nonfarm nonresidential real estate loans. However, the rate of increase in noncurrent loans may be slowing, as the second-quarter increase in noncurrent loans was about one-third smaller than the volume of noncurrent loans added in first quarter. The amount of loans past-due 30-89 days was also smaller at the end of the second quarter than in the first quarter. Net charge-off rates rose to record highs in the second quarter, as FDIC-insured institutions continued to recognize losses in the loan portfolios. Other real estate owned (ORE) increased 79.7 percent from a year ago.

Many insured institutions have responded to stresses in the economy by raising and conserving capital, some as a result of regulatory reviews. Equity capital increased by $32.5 billion (2.4 percent) in the quarter. Treasury invested a total of $4.4 billion in 117 independent banks and bank and thrift holding companies during the second quarter, and nearly all of these were community banks. This compares to a total of more than $200 billion invested since the program began. Average regulatory capital ratios increased in the quarter as well. The leverage capital ratio increased to 8.25 percent, while the average total risk-based capital ratio rose to 13.76 percent. However, while the average ratios increased, fewer than half of all institutions reported increases in their regulatory capital ratios.

The nation's nearly 7,500 community banks -- those with less than $1 billion in total assets -- hold approximately 11 percent of total industry assets. They posted an average return on assets of negative 0.06 percent, which was slightly better than the industry as a whole. As larger banks often have more diverse sources of noninterest income, community banks typically get a much greater share of their operating income from net interest income. In general, community banks have higher capital ratios than their larger competitors and are much more reliant on deposits as a source of funding.

Average ratios of noncurrent loans and charge-offs are lower for community banks than the industry averages. In part, this illustrates the differing loan mix between the two groups. The larger banks' loan performance reflects record high loss rates on credit card loans and record delinquencies on mortgage loans. Community banks are important sources of credit for the nation's small businesses and small farmers. As of June 30, community banks held 38 percent of the industry's small business and small farm loans.[4] However, the greatest exposures faced by community banks may relate to construction loans and other CRE loans. These loans made up over 43 percent of community bank portfolios, and the average ratio of CRE loans to total capital was above 280 percent.

[4] Defined as commercial and industrial loans or commercial real estate loans under $1 million or farm loans less than $500,000.

As insured institutions work through their troubled assets, the list of “problem institutions” -- those rated CAMELS 4 or 5 -- will grow. Over a hundred institutions were added to the FDIC’s “problem list” in the second quarter. The combined assets of the 416 banks and thrifts on the problem list now total almost $300 billion. However, the number of problem institutions is still well below the more than 1,400 identified in 1991, during the last banking crisis on both a nominal and a percentage basis. Institutions on the problem list are monitored closely, and most do not fail. Still, the rising number of problem institutions and the high number of failures reflect the challenges that FDIC-insured institutions continue to face.

Risks to FDIC-Insured Institutions

Troubled loans at FDIC-insured institutions have been concentrated thus far in three main areas -- residential mortgage loans, construction loans, and credit cards. The credit quality problems in 1-to-4 family mortgage loans and the coincident declines in U.S. home prices are well known to this Committee. Net chargeoffs of 1- to 4-famly mortgages and home equity lines of credit by FDIC-insured institutions over the past two years have totaled more than $65 billion. Declining home prices have also impacted construction loan portfolios, on which many small and mid-sized banks heavily depend. There has been a ten-fold increase in the ratio of noncurrent construction loans since mid-year 2007, and this ratio now stands at a near-record 13.5 percent. Net charge-offs for construction loans over the past two years have totaled about $32 billion, and almost 40 percent of these were for one-to-four family construction.

With the longest and deepest recession since the 1930s has come a new round of credit problems in consumer and commercial loans. The net charge-off rate for credit card loans on bank portfolios rose to record-high 9.95 percent in the second quarter. While stronger underwriting standards and deleveraging by households should eventually help bring loss rates down, ongoing labor market distress threatens to keep loss rates elevated for an extended period. By contrast, loans to businesses, i.e., commercial and industrial (C&I) loans, have performed reasonably well given the severity of the recession in part because because corporate balance sheets were comparatively strong coming into the recession. The noncurrent loan ratio of 2.79 percent for C&I loans stands more than four times higher than the record low seen in 2007, but remains still well below the record high of 5.14 percent in 1987.

The most prominent area of risk for rising credit losses at FDIC-insured institutions during the next several quarters is in CRE lending. While financing vehicles such as commercial mortgage-backed securities (CMBS) have emerged as significant CRE funding sources in recent years, FDIC-insured institutions still hold the largest share of commercial mortgage debt outstanding, and their exposure to CRE loans stands at an historic high. As of June, CRE loans backed by nonfarm, nonresidential properties totaled almost $1.1 trillion, or 14.2 percent of total loans and leases.

The deep recession, in combination with ongoing credit market disruptions for market-based CRE financing, has made this a particularly challenging environment for commercial real estate. The loss of more than 7 million jobs since the onset of the recession has reduced demand for office space and other CRE property types, leading to deterioration in fundamental factors such as rental rates and vacancy rates. Amid weak fundamentals, investors have been re-evaluating their required rate of return on commercial properties, leading to a sharp rise in "cap rates" and lower market valuations for commercial properties. Finally, the virtual shutdown of CMBS issuance in the wake of last year's financial crisis has made financing harder to obtain. Large volumes of CRE loans are scheduled to roll over in coming quarters, and falling property prices will make it more difficult for some borrowers to renew their financing.

Outside of construction portfolios, losses on loans backed by CRE properties have been modest to this point. Net charge-offs on loans backed by nonfarm, nonresidential properties have been just $6.2 billion over the past two years. Over this period, however, the noncurrent loan ratio in this category has quadrupled, and we expect it to rise further as more CRE loans come due over the next few years. The ultimate scale of losses in the CRE loan portfolio will very much depend on the pace of recovery in the U.S. economy and financial markets during that time.

FDIC Response to Industry Risks and Challenges

Supervisory Response to Problems in Banking Industry

The FDIC has maintained a balanced supervisory approach that focuses on vigilant oversight but remains sensitive to the economic and real estate market conditions. Deteriorating credit quality has caused a reduction in earnings and capital at a number of institutions we supervise which has resulted in a rise in problem banks and the increased issuance of corrective programs. We have been strongly advocating increased capital and loan loss allowance levels to cushion the impact of rising non-performing assets. Appropriate allowance levels are a fundamental tenet of sound banking, and we expect that banks will add to their loss reserves as credit conditions warrant -- and in accordance with generally accepted accounting principles.

We have also been emphasizing the importance of a strong workout infrastructure in the current environment. Given the rising level of non-performing assets, and difficulties in refinancing loans coming due because of decreased collateral values and lack of a securitization market, banks need to have the right resources in place to restructure weakened credit relationships and dispose of other real estate holdings in a timely, orderly fashion.

We have been using a combination of off-site monitoring and on-site examination work to keep abreast of emerging issues at FDIC-supervised institutions and are accelerating full-scope examinations when necessary. Bankers understand that FDIC examiners will perform a thorough, yet balanced asset review during our examinations, with a particular focus on concentrations of credit risk. Over the past several years, we have emphasized the risks in real estate lending through examination and industry guidance, training, and targeted analysis and supervisory activities. Our efforts have focused on underwriting, loan administration, concentrations, portfolio management and stress testing, proper accounting, and the use of interest reserves.

CRE loans and construction and development loans are a significant examination focus right now and have been for some time. Our examiners in the field have been sampling banks' CRE loan exposures during regular exams as well as special visitations and ensuring that credit grading systems, loan policies, and risk management processes have kept pace with market conditions. We have been scrutinizing for some time construction and development lending relationships that are supported by interest reserves to ensure that they are prudently administrated and accurately portray the borrower's repayment capacity. In 2008, we issued guidance and produced a journal article on the use of interest reserves,[5] as well as internal review procedures for examiners.

We strive to learn from those instances where the bank's failure led to a material loss to the DIF, and we have made revisions to our examination procedures when warranted. This self-assessment process is intended to make our procedures more forward-looking, timely and risk-focused. In addition, due to increased demands on examination staff, we have been working diligently to hire additional examiners since 2007. During 2009, we hired 440 mid career employees with financial services skills as examiners and almost another 200 examiner trainees. We are also conducting training to reinforce important skills that are relevant in today's rapidly changing environment. The

[5] FDIC, *Supervisory Insights*, http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum08/article01_Primer.html

FDIC continues to have a well-trained and capable supervisory workforce that provides vigilant oversight of state nonmember institutions.

Measures to Ensure Examination Programs Don't Interfere with Credit Availability

Large and small businesses are contending with extremely challenging economic conditions which have been exacerbated by turmoil in the credit markets over the past 18 months. These conditions, coupled with a more risk-averse posture by lenders, have diminished the availability of credit.

We have heard concerns expressed by members of Congress and industry representatives that banking regulators are somehow instructing banks to curtail lending, making it more difficult for consumers and businesses to obtain credit or roll over otherwise performing loans. This is not the case. The FDIC provides banks with considerable flexibility in dealing with customer relationships and managing loan portfolios. I can assure you that we do not instruct banks to curtail prudently managed lending activities, restrict lines of credit to strong borrowers, or require appraisals on performing loans unless an advance of new funds is being contemplated.

It has also been suggested that regulators are expecting banks to shut off lines of credit or not roll-over maturing loans because of depreciating collateral values. To be clear, the FDIC focuses on borrowers' repayment sources, particularly their cash flow, as a means of paying off loans. Collateral is a secondary source of repayment and should not be the primary determinant in extending or refinancing loans. Accordingly, we have not encouraged banks to close down credit lines or deny a refinance request solely because of weakened collateral value.

The FDIC has been vocal in its support of bank lending to small businesses in a variety of industry forums and in the interagency statement on making loans to creditworthy borrowers that was issued last November. I would like to emphasize that the FDIC wants banks to make prudent small business loans as they are an engine of growth in our economy and can help to create jobs at this critical juncture.

In addition, the federal banking agencies will soon issue guidance on CRE loan workouts. The agencies recognize that lenders and borrowers face challenging credit conditions due to the economic downturn, and are frequently dealing with diminished cash flows and depreciating collateral values. Prudent loan workouts are often in the best interest of financial institutions and borrowers, particularly during difficult economic circumstances and constrained credit availability. This guidance reflects that reality, and supports prudent and pragmatic credit and business decision-making within the framework of financial accuracy, transparency, and timely loss recognition.

Innovative resolution structures

The FDIC has made several changes to its resolution strategies in response to this crisis, and we will continue to re-evaluate our methods going forward. The most important change is an increased emphasis on partnership arrangements. The FDIC and RTC used partnership arrangements in the past -- specifically loss sharing and structured transactions. In the early 1990s, the FDIC introduced and used loss sharing. During the same time period, the RTC introduced and used structured transactions as a significant part of their asset sales strategy. As in the past, the FDIC has begun using these types of structures in order to lower resolution costs and simplify the FDIC's resolution workload. Also, the loss share agreements reduce the FDIC's liquidity needs, further enhancing the FDIC's ability to meet the statutory least cost test requirement.

The loss share agreements enable banks to acquire an entire failed bank franchise without taking on too much risk, while the structured transactions allow the FDIC to market and sell assets to both banks and non-banks without undertaking the tasks and responsibilities of managing those assets. Both types of agreements are partnerships where the private sector partner manages the assets and the FDIC monitors the partner. An important characteristic of these agreements is the alignment of interests: both parties benefit financially when the value of the assets is maximized.

For the most part, after the end of the savings and loan and banking crisis of the late 1980s and early 1990s, the FDIC shifted away from these types of agreements to more traditional methods since the affected asset markets became stronger and more liquid. The main reason why we now are returning to these methods is that in the past several months investor interest has been low and asset values have been uncertain. If we tried to sell the assets of failed banks into today's markets, the prices would likely be well below their intrinsic value -- that is, their value if they were held and actively managed until markets recover. The partnerships allow the FDIC to sell the assets today but still benefit from future market improvements. During 2009, the FDIC has used loss share for 58 out of 98 resolutions. We estimate that the cost savings have been substantial: the estimated loss rate for loss share failures averaged 25 percent; for all other transactions, it was 38 percent. Through September 30, 2009, the FDIC has entered into seven structured transactions, with about $8 billion in assets.

To address the unique nature of today's crisis, we have made several changes to the earlier agreements. The earlier loss share agreements covered only commercial assets. We have updated the agreements to include single family assets and to require the application of a systematic loan modification program for troubled mortgage loans. We strongly encourage our loss share partners to adopt the Administration's Home Affordable Modification Program (HAMP) for managing single family assets. If they do not adopt the HAMP, we require them to use the FDIC loan modification program which was the model for the HAMP modification protocol. Both are designed to ensure that acquirers offer sustainable and affordable loan modifications to troubled homeowners whenever it is cost-effective. This serves to lower costs and minimize foreclosures. We have also encouraged our loss share partners to deploy forbearance programs when homeowners struggle with mortgage payments due to life events (unemployment, illness, divorce, etc). We also invite our loss share partners to propose other innovative strategies that will help keep homeowners in their homes and reduce the FDIC's costs.

In addition, the FDIC has explored funding changes to our structured transactions to make them more appealing in today's environment. To attract more bidders and hopefully higher pricing, the FDIC has offered various forms of leverage. In recent transactions where the leverage was provided to the investors, the highest bids with the leverage option substantially improved the overall economics of the transactions. The overall feedback on the structure from both investors and market participants was very positive.

The Condition of the Deposit Insurance Fund

Current Conditions and Projections

As of June 30, 2009, the balance (or net worth) of the DIF (the fund) was approximately $10 billion. The fund reserve ratio -- the fund balance divided by estimated insured deposits in the banking system -- was 0.22 percent. In contrast, on December 31, 2007, the fund balance was almost $52 billion and the reserve ratio was 1.22 percent. Losses from institution failures have caused much of the decline in the fund balance, but increases in the contingent loss reserve -- the amount set aside for losses expected during the next 12 months -- has contributed significantly to the decline. The contingent loss reserve on June 30 was approximately $32 billion.

The FDIC estimates that as of September 30, 2009, both the fund balance and the reserve ratio were negative after reserving for projected losses over the next 12 months, though our cash position remained positive. This is not the first time that a fund balance has been negative. The FDIC reported a negative fund balance during the last banking crisis in the late 1980s and early 1990s.[6] Because the FDIC has many potential sources of cash, a negative fund balance does not affect the FDIC's ability to protect insured depositors or promptly resolve failed institutions.

The negative fund balance reflects, in part, an increase in provisioning for anticipated failures. The FDIC projects that, over the period 2009 through 2013, the fund could incur approximately $100 billion in failure costs. The FDIC projects that most of these costs will occur in 2009 and 2010. In fact, well over half of this amount will already be reflected in the September 2009 fund balance. Assessment revenue is projected to be about $63 billion over this five-year period, which exceeds the remaining loss amount. The problem we are facing is one of timing. Losses are occurring in the near term and revenue is spread out into future years.

At present, cash and marketable securities available to resolve failed institutions remain positive, although they have also declined. At the beginning of the current banking crisis, in June 2008, total assets held by the fund were approximately $55 billion, and consisted almost entirely of cash and marketable securities (i.e., liquid assets). As the crisis has unfolded, the liquid assets of the fund have been expended to protect depositors of failed institutions and have been exchanged for less liquid claims against the assets of failed institutions. As of June 30, 2009, while total assets of the fund had

[6] The FDIC reported a negative fund balance as of December 31, 1991 of approximately -$7.0 billion due to setting aside a large ($16.3 billion) reserve for future failures. The fund remained negative for five quarters, until March 31, 1993, when the fund balance was approximately $1.2 billion.

increased to almost $65 billion, cash and marketable securities had fallen to about $22 billion. The pace of resolutions continues to put downward pressure on cash balances. While the less liquid assets in the fund have value that will eventually be converted to cash when sold, the FDIC's immediate need is for more liquid assets to fund near-term failures.

If the FDIC took no action under its existing authority to increase its liquidity, the FDIC projects that its liquidity needs would exceed its liquid assets next year.

The FDIC's Response

The FDIC has taken several steps to ensure that the fund reserve ratio returns to its statutorily mandated minimum level of 1.15 percent within the time prescribed by Congress and that it has sufficient cash to promptly resolve failing institutions.

For the first quarter of 2009, the FDIC raised rates by 7 basis points. The FDIC also imposed a special assessment as of June 30, 2009 of 5 basis points of each institution's assets minus Tier 1 capital, with a cap of 10 basis points of an institution's regular assessment base. On September 22, the FDIC again took action to increase assessment rates -- the board decided that effective January 1, 2011, rates will uniformly increase by 3 basis points. The FDIC projects that bank and thrift failures will peak in 2009 and 2010 and that industry earnings will have recovered sufficiently by 2011 to absorb a 3 basis point increase in deposit insurance assessments. We project that these steps should return the fund to a positive balance in 2012 and the reserve ratio to 1.15 percent by the first quarter of 2017.

While the final rule imposing the special assessment in June permitted the FDIC to impose additional special assessments of the same size this year without further notice and comment rulemaking, the FDIC decided not to impose any additional special assessments this year. Any additional special assessment would impose a burden on an industry that is struggling to achieve positive earnings overall. In general, an assessment system that charges institutions less when credit is restricted and more when it is not is more conducive to economic stability and sustained growth than a system that does the opposite.

To meet the FDIC's liquidity needs, on September 29 the FDIC authorized publication of a Notice of Proposed Rulemaking (NPR) to require insured depository institutions to prepay about three years of their estimated risk-based assessments. The FDIC estimates that prepayment would bring in approximately $45 billion in cash.

Unlike a special assessment, prepaid assessments would not immediately affect the DIF balance or depository institutions' earnings. An institution would record the entire amount of its prepaid assessment as a prepaid expense (asset) as of December 30, 2009. As of December 31, 2009, and each quarter thereafter, the institution would record an expense (charge to earnings) for its regular quarterly assessment for the quarter and an offsetting credit to the prepaid assessment until the asset is exhausted. Once the asset is exhausted, the institution would record an expense and an accrued expense payable each quarter for its regular assessment, which would be paid in arrears to the FDIC at the end of the following quarter. On the FDIC side, prepaid assessments would have no effect on the DIF balance, but would provide us with the cash needed for future resolutions.

The proposed rule would allow the FDIC to exercise its discretion as supervisor and insurer to exempt an institution from the prepayment requirement if the FDIC determines that the prepayment would adversely affect the safety and soundness of the institution.

The FDIC believes that using prepaid assessments as a means of collecting enough cash to meet upcoming liquidity needs to fund future resolutions has significant advantages compared to imposing additional or higher special assessments. Additional or higher special assessments could severely reduce industry earnings and capital at a time when the industry is under stress. Prepayment would not materially impair the capital or earnings of insured institutions. In addition, the FDIC believes that most of the prepaid assessment would be drawn from available cash and excess reserves, which should not significantly affect depository institutions' current lending activities. As of June 30, FDIC-insured institutions held more than $1.3 trillion in liquid balances, or 22 percent more than they did a year ago.[7]

[7] Liquid balances include balances due from Federal Reserve Banks, depository institutions and others, federal funds sold, and securities purchased under agreements to resell.

In the FDIC's view, requiring that institutions prepay assessments is also preferable to borrowing from the U.S. Treasury. Prepayment of assessments ensures that the deposit insurance system remains directly industry-funded and it preserves Treasury borrowing for emergency situations. Additionally, the FDIC believes that, unlike borrowing from the Treasury or the FFB, requiring prepaid assessments would not count toward the public debt limit. Finally, collecting prepaid assessments would be the least costly option to the fund for raising liquidity as there would be no interest cost. However, the FDIC is seeking comment on these and other options in the NPR.

The FDIC's proposal requiring prepayment of assessments is really about how and when the industry fulfills its obligation to the insurance fund. It is not about whether insured deposits are safe or whether the FDIC will be able to promptly resolve failing institutions. Deposits remain safe; the FDIC has ample resources available to promptly resolve failing institutions. We thank the Congress for raising our borrowing limit, which was important from a public confidence standpoint and essential to assure that the FDIC is prepared for all contingencies in these difficult times.

Conclusion

FDIC-insured banks and thrifts continue to face many challenges. However, there is no question that the FDIC will continue to ensure the safety and soundness of FDIC-insured financial institutions, and, when necessary, resolve failed financial institutions. Regarding the state of the DIF and the FDIC Board's recent proposal to have banks pay a prepaid assessment, the most important thing for everyone to remember is that the outcome of this proposal is a non-event for insured depositors. Their deposits are safe no matter what the Board decides to do in this matter. Everyone knows that the FDIC has immediate access to a $100 billion credit line at Treasury that can be expanded to $500 billion with the concurrence of the Federal Reserve and the Treasury. We also have authority to borrow additional working capital up to 90 percent of the value of assets we own. The FDIC's commitment to depositors is absolute, and we have more than enough resources at our disposal to make good on that commitment.

I would be pleased to answer any questions from the members of the Subcommittee.