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on

HOUSING FINANCE REFORM: POWERS AND STRUCTURE OF A STRONG REGULATOR

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
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Chairman Johnson, Senator Crapo and members of the Committee, I appreciate the opportunity to testify before you today on "Powers and Structure of a Strong Regulator." As the Committee considers reforms to the nation's housing finance system, including insurance and supervisory models similar to the Federal Deposit Insurance Corporation (FDIC), you have requested that we provide you with a description of the elements of the deposit insurance system that are the most important in achieving our mission.

Many lessons have been learned over the deposit insurance system’s 80 years of operation. Drawing from these lessons, both Congress and the FDIC have made a number of improvements to the deposit insurance system. During our history, which includes two serious banking crises in the last few decades, certain authorities and regulatory tools stand out as particularly important. These include clear and explicit statutory authority, monitoring to assess risk exposure and to take action in response when necessary, appropriate pricing of insurance, and adequate funding arrangements. In addition, the FDIC has experienced the challenges of managing a transition between agencies, which occurred when the Resolution Trust Corporation, created to resolve failed savings and loan institutions during the early 1990s, was folded into the FDIC at the conclusion of that crisis.

My testimony today elaborates on and describes these important authorities and tools through the lens of the FDIC's experience. In some cases, the elements of our regulatory and insurance regime may be relevant primarily to the FDIC's unique role and mission. In other cases, the Committee may determine that the lessons we have learned over the years provide insights that may be useful to the Committee in this important work. The FDIC stands ready to provide assistance to the Committee in this effort.

Explicit Authority

Since its founding in 1933, Congress has given the FDIC a clear mandate: to protect depositors and maintain financial stability. The FDIC has been successful in its mission in large part because Congress has clearly defined by statute the amount of deposits covered under the FDIC's deposit guarantee and the condition – bank failure – that triggers the exercise of that guarantee. At the same time, Congress has allowed the FDIC flexibility to craft specific regulations to cover the myriad details of its operations. The clarity of Congress' mandate provides credibility in the eyes of depositors, virtually eliminating the risk of bank runs and panics, thus providing a foundation of stability to our banking system during times of financial distress. While the banking industry pays the costs of deposit insurance, the full faith and credit of the U.S. government ultimately backs the FDIC's deposit guarantee.

The existence of clear statutory authority over the years also has served as the foundation of our supervisory approaches. Statutes clearly state congressional expectations and goals, enabling us to monitor and control for the risk posed to the Deposit Insurance Fund (DIF). For example, certain laws, such as prompt corrective action, provide statutory tripwires for supervisory action. At the same time, the statutes outlining our supervisory authorities provide flexibility to create a robust examination process within the statutory grant of authority.

Clear statutory authority also has been critical to the FDIC's resolution activities, which enable us to mitigate losses to the DIF and help maintain financial stability through timely resolution of failed banks and payment of depositor claims. Our authorizing statutes delineate the priorities of claims and provide direction to all parties in the claims process. This clarity enables the FDIC to resolve failed financial institutions efficiently and effectively, usually over the span of a single weekend.

Monitoring and Controlling Risk

An effective insurance program must include a variety of tools to identify and manage risk exposure, not only at the time when insurance is granted but also while that insurance stays in force. As deposit insurer, the FDIC assesses the risk of an institution at the time that it applies for insurance. After admittance into the system, the FDIC monitors the condition of that institution through onsite examinations and remote monitoring, and through our back-up examination authority in the case of an institution primarily regulated by another federal banking agency. Risk mitigation should include setting explicit capital standards and must be an ongoing process that allows for intervention before losses occur and insurance must be paid out. While the FDIC is not the primary federal regulator of all FDIC-insured institutions, all FDIC-insured institutions are subject to the same, or very similar, framework of regulations, policies, guidance, examination protocols, ratings, capital standards, reporting requirements, and enforcement authority.

In determining membership participation in the deposit insurance system, the FDIC carefully considers factors prescribed in section 6 of the Federal Deposit Insurance Act (FDI Act) and implements policies and guidance that supplement the factors when conducting reviews of deposit insurance applications. These factors include the financial history and condition of the institution, adequacy of the capital structure, future earnings prospects, general character and fitness of management, risk presented to the DIF, convenience and needs of the community to be served, and the consistency of the institution’s corporate powers with the purposes of the FDI

Act. Under one housing finance model the Committee is considering, the government insurance fund would have authority to approve participation by four types of companies: private mortgage insurers, servicers, issuers, and bond guarantors. The factors for approving each of these companies differs slightly, and are similar to, but not the same as, the statutory factors found in section 6 of the FDI Act which the FDIC uses to determine eligibility for federal deposit insurance.

Capital requirements

Strong capital requirements are one of the most effective means for controlling risk-taking by participants in the system and the FDIC has found explicit capital standards to be an important tool to protect the DIF. As mentioned above, the prompt corrective action framework in section 38 of the FDI Act defines minimum capital ratios and imposes progressively tighter restrictions on an institution's activities once these minimums are breached. The ratios defined in section 38 are intended to trigger regulatory sanctions when banks become less than well capitalized, but individual institutions may be required to hold capital levels that are higher than statutory minimums based on their risk profile and activities. As the Committee considers various legislative approaches, it may want to consider inclusion of explicit capital standards for all significant participants in the new system and the consequences of breaching those standards.

Ongoing monitoring and reporting requirements

Requirements for ongoing monitoring, reporting requirements, and access to records are essential to an effective regulatory regime. In the FDIC's case, these tools enable banking regulators to supervise FDIC-insured institutions on an ongoing basis and to identify and respond to increasing risk in the system. Providing the proposed mortgage insurer with similar authorities would enable that insurer to determine independently a participant's financial condition and compliance with laws and standards. For example, the FDI Act provides for the authority to conduct examinations and investigations, the minimum frequency of examinations, the authority to examine affiliates and other related entities, coordination and information sharing with other agencies, and penalties for obstruction of examination authority, among other things.

This statutory examination authority underpins our program of regular examinations and is supplemented by regulations, policies (including the standard CAMELS ratings system used for all FDIC-insured institutions), guidance, and procedural manuals. Importantly, this authority also allows the FDIC to review examination findings for banks we do not supervise directly and to conduct backup examinations and reviews of those institutions as necessary. Similarly, a statutory basis for regular examinations and investigative authority would enhance the mortgage insurer's onsite monitoring ability. Where participants are subject to oversight by other Federal or state agencies, the proposed law could clarify requirements for coordination of examination activities and information sharing agreements.

Additionally, supervisory monitoring efforts are enhanced through review of quarterly Call Reports that are required by section 7 of the FDI Act, provisions of which also impose penalties for failure to file accurate reports. Imposing reporting requirements on approved participants could enable the mortgage insurer to conduct offsite monitoring.

The FDIC has also found it essential that its monitoring authority include the ability to create standards to determine whether there has been a change in ownership, which can alter a bank's risk profile.

Authority to take enforcement action

Ongoing monitoring allows the FDIC to identify risks in the banking sector, but we also have explicit statutory authorities that allow us to take action when an institution is engaging in potentially unsafe and unsound practices. Supervisors of FDIC-insured institutions have a wide array of formal and informal enforcement actions to ensure compliance with rules and standards and to correct problematic practices or conditions before a bank becomes insolvent and causes a loss to the DIF. Informal enforcement actions can take the form of memoranda of understanding or Board resolutions. Section 8 of the FDI Act gives the FDIC the authority to pursue formal enforcement actions and civil fines against institutions, their affiliates and certain individual actors, after notice and an opportunity for a hearing. These actions include cease and desist orders, civil money penalties (CMPs), Prompt Corrective Action (PCA) Directives, written agreements, and, ultimately, termination of deposit insurance. The FDI Act also grants the authority to take actions against bank-affiliated individuals including removal and prohibition orders to prevent their participation in the financial services industry for certain misconduct and violations. Providing similar authorities to the federal mortgage insurer might enable it to correct problem situations before they result in a loss to its insurance fund.

While they are valuable supervisory tools in certain circumstances, provisions for suspension or revocation of the approved status of participants or the ability to impose CMPs are not sufficient alone as tools for effective risk management. Providing monitoring authority and authorizing a broader array of informal and formal corrective actions would enhance the mortgage insurer's ability to take corrective actions prior to losses being incurred.

Insurance Pricing

The FDIC has had experience over its history with both flat rate and risk-based pricing for insurance. Initially, Congress directed the FDIC to charge all banks the same assessment rate. This flat-rate system lasted for 60 years, but it had problems which became evident in the late 1980s when banks started to fail in large numbers. The flat-rate system resulted in less risky banks excessively subsidizing riskier banks and did nothing to reduce the incentives for banks to take excessive risk.

In response to the banking crisis of the late 1980s, Congress ended the flat-rate system in 1991 and directed the FDIC to adopt a risk-based assessment. Since 1993, the FDIC has had a risk-based pricing system where banks that take on more risk pay more in deposit insurance assessments. An important feature of the risk-based pricing system is that it is forward-looking. Since the system relies on measuring the likelihood that a bank could fail and cause a loss to the insurance fund, it is inherently more complex than a flat-rate system. To more accurately price for risk, the FDIC must collect a wide range of financial and supervisory information, which it does through quarterly financial reports prepared by banks as well as monitoring and supervising insured institutions.

The FDIC supports a risk-based pricing structure for deposit insurance. However, deposit insurance may not be perfectly analogous to federal mortgage insurance. A federal mortgage insurer is likely to have a greater ability to mitigate risk at the outset, for example, by setting robust underwriting standards for the underlying mortgages.

Funding

Funding arrangements also play a critical role in the success of an insurance system, including the FDIC's deposit insurance system. A well-designed system ensures that adequate funds are readily available to respond to problems as they arise and to avoid delays in closing failed banks or paying insured depositors. These arrangements also determine the amount and the timing of the industry's contribution toward the costs of insurance and the degree of taxpayer exposure.

The importance of pre-funding

The FDIC has always had an explicit, *ex ante* fund paid for by the banking industry to satisfy claims as they arise. Alternative arrangements, such as pay-as-you-go or ex post assessments, increase the risk that bank closings will be delayed. Delays in closing failing institutions (as the FDIC observed through the experience of the failed Federal Savings and Loan Insurance Corporation) increase the ultimate cost of failure and undermine confidence in the banking system more generally. Prefunding for future losses is also more equitable. With a pay-as-you-go or ex post system, surviving banks pay the costs generated by those that fail, which penalizes those banks that are less risky.

Prefunding also allows an insurer to smooth the cost of insurance over time. The FDIC works to charge steady premiums and avoid procyclical pricing, where rates increase in difficult times -- when banks can least afford to pay them and when those funds are most needed to lend and promote economic growth. Most bankers indicate that they prefer steady, predictable premiums rather than procyclical rates. Finally, as with any insurance arrangement, an *ex ante* fund is reassuring to depositors and taxpayers, thereby promoting confidence and enhancing financial stability.

The challenge of determining the size of the fund

The question of whether to have an *ex ante* fund is easier to answer than the question of fund size, which involves balancing significant trade-offs. The FDIC balances the need for a fund that is sufficient at all times to pay depositor claims against the possibility of holding funds that could be better used by banks for lending.

Over its history, the FDIC has experienced mixed success with various approaches to determining an optimal fund size. For more than 50 years, Congress set premium rates and there was no official target fund size, so the reserve ratio (the ratio of the amount in the DIF to estimated insured deposits) fluctuated considerably. This period coincided with great economic stability and few bank failures, so deposit insurance fund adequacy was not a pressing concern.

That situation changed during the late 1980s as the U.S. experienced a large number of bank and thrift failures and large losses to both the banking industry and taxpayer. To address concerns about the viability of the deposit insurance fund in the aftermath of these losses, Congress made a series of changes to the FDIC's authorities for managing the size of the fund. In 1989, Congress instituted for the first time a target for the size of the fund, called a Designated Reserve Ratio (or DRR), which was initially equal to at least 1.25 percent of estimated insured deposits.[1]

[1] Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (1989).

In 1991, Congress required that, when the fund was below 1.25 percent, the FDIC would be required to raise assessment rates to reach the target within one year or charge very high rates, even in periods of economic distress.[2] In 1996, shortly after the reserve ratio reached its target, Congress prohibited the FDIC from charging well-capitalized and well-managed banks anything whenever the fund was at or above that target.[3] The resulting hard target left the FDIC with almost no ability to let the size of the fund materially increase or decrease.

This framework created a number of problems including:

- a decade during which at least 90 percent of the industry paid nothing for deposit insurance,
- a free-rider problem where new entrants and fast growers diluted the fund but paid nothing, and
- potentially volatile and procyclical premiums.

In 2006, Congress removed the hard target and allowed the FDIC to manage the fund within a range of 1.15 and 1.50 percent of estimated insured deposits.[4] Unfortunately, the recent crisis came soon after these changes were enacted and bank failures again caused the fund to become negative. To prevent a repeat of these problems, the Dodd-Frank Act increased the minimum reserve ratio to 1.35 percent and removed the hard cap, which had required that the FDIC return to the industry all amounts that would cause the reserve ratio to exceed 1.50 percent. This new authority effectively allows the FDIC to determine the optimal target, so long as it is at

[2] Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (1991).

[3] Deposit Insurance Funds Act of 1996, Pub. L. No. 104-208, 60 Stat. 446 (1996).

[4] Federal Deposit Insurance Reform Act of 2005, Pub. L. No. 109–171, 120 Stat. 9 (2006).

least 1.35 percent of estimated insured deposits.[5] Some flexibility in determining a target fund size may be beneficial for the federal mortgage insurer, preventing it from facing challenges similar to the fund management problems the FDIC faced in its past.

Striving for countercyclical funding

Given its expanded authority, the FDIC has a number of options to choose from in determining an optimal size for its fund. The FDIC has explored sophisticated approaches that draw upon the portfolio management techniques and best practices used by other financial institutions that have to manage capital and financial risks.[6] The appeal of these model-based approaches is the promise of greater rigor and precision in determining potential losses and an optimal fund size. However, model-based approaches pose a host of practical challenges. It is difficult, for example, to accurately determine relationships between economic variables and the variables affecting a bank's failure or to project economic events.

Therefore, in the end, the FDIC took a different approach to determine the most appropriate fund size, one grounded in the agency's actual financial experience. Having experienced two banking crises in the past three decades, it looked at the costs associated with these crises to address two related questions. First, how high did the fund need to grow to prevent it from ever going negative? And, second, what steady premium rates would have been required to achieve the desired balance? The analysis revealed that if the DIF had been allowed to grow to at least 2 percent of insured deposits prior to each of the two preceding banking crises,

[5] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[6] The FDIC developed a Loss Distribution Model, which views the deposit insurance fund as a portfolio of credit risks, representing exposure to different banks. For each bank, a probability of failure, loss given failure, and exposure upon failure were estimated to arrive at an expected loss for that bank. An economic model determined the statistical relationships among these elements of expected loss and economic variables such as interest rates, stock price indices, and housing prices. Finally, a simulation model was incorporated to determine a wide range of economic events and produce a distribution of possible future failures and losses to the deposit insurance fund.

a steady average premium rate of a little over 8 cents per $100 of domestic deposits would have been required to meet these goals. This approach would have avoided the procyclicality that resulted in volatile premium rates, which necessarily increased during periods of bank failures.

This straightforward approach remains the underpinning of FDIC's current fund management strategy. It was used to set a long-term reserve ratio goal (DRR) of 2 percent in 2011 which continues today. This 2 percent target is viewed as a soft, rather than hard, target. While the FDIC has set rates to achieve the statutorily required 1.35 percent minimum reserve ratio, there is an explicit plan to reduce rates gradually, but not to zero, if the fund exceeds the long-term 2 percent target. In determining an optimal size for a fund for mortgage insurance, similar trade-offs and historical experiences may be considered.

Successful transition of assets from one entity to another

The FDIC has unique experience with transitioning the assets and responsibilities of one entity to another. In response to the savings and loan crisis of the late 1980s, Congress dissolved the insolvent Federal Savings and Loan Insurance Corporation (FSLIC), and divided the duties of resolving the crisis between the FDIC and a temporary agency, the Resolution Trust Corporation (RTC). As the RTC was intended to be a temporary agency to address that specific crisis, Congress set a statutory termination date of December 31, 1995, and provided for the transfer of RTC's responsibilities to the FDIC.

A number of factors contributed to the successful transition from the RTC to the FDIC. The resolution authorities and activities of the RTC and FDIC were very similar. The assets from failed savings and loan institutions resolved by the RTC were very similar to the assets of failed banks and savings and loan institutions being handled by the FDIC. In addition, both agencies shared similar policies, procedures, and organizational structures. The employees handling many of the RTC assets ultimately transitioned to the FDIC along with the assets.

Even with these similarities, the FDIC and RTC managements engaged in extensive and cooperative planning for the transition to ensure the continuity of operations. The remaining RTC assets were managed and accounted for in a separate fund as they were wound down. The FDIC/RTC experience may provide some analogies to the housing finance reform, but other aspects of the reform are more complex. Transition in this context involves two large organizations in conservatorship with various assets and liabilities transferring partly into federal hands, with other assets potentially being sold into the private sector.

Conclusion

Again, thank you for the opportunity to share with the Committee the FDIC's experience and insights regarding the elements essential for a federal insurance program. As noted at the outset, our history may provide relevant lessons as the Committee contemplates the creation of a federal mortgage insurance entity. The FDIC has benefitted from explicit statutory authority, risk monitoring and control tools, appropriate pricing of insurance, and adequate funding arrangements. We are happy to provide any assistance that the Committee would find valuable as it continues its important work to address housing finance reform.