

Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation on Turmoil in the U.S. Credit Markets: Examining Recent Regulatory Responses to the Committee on Banking, Housing and Urban Affairs, U.S. Senate;

October 23, 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 recent efforts to stabilize the nation's financial markets and reduce foreclosures. The events of the past several weeks are unprecedented.

Conditions in the financial markets in recent weeks have shaken the confidence of people around the world in their financial systems. Losses in the stock markets have reduced the valuations of publicly-traded companies and have imposed losses on individual investors. Credit markets have not been functioning properly, threatening grave harm to the economy.

The loss of confidence created by the cumulative impact of these events has required the government to take extraordinary steps to bolster public confidence in our financial institutions and the American economy.

Achieving this goal requires a sustained and coordinated effort by government authorities. Congress is to be commended for passing the Emergency Economic Stabilization Act of 2008 (EESA), which provides authority for the purchase of troubled assets and direct investments in financial institutions, a mechanism for reducing home foreclosures, and a temporary increase in deposit insurance coverage. Working with our colleagues at the Treasury Department and our fellow bank regulators, the FDIC is prepared to do whatever it takes to preserve confidence in the financial system.

Despite what we hear about the credit crisis and the problems facing banks, the bulk of the U.S. banking industry is healthy and remains well-capitalized. What we do have, however, is a liquidity problem. This problem is largely caused by uncertainty about the value of mortgage assets, which is making banks reluctant to lend to each other or lend to consumers and businesses.

In my testimony, I will detail recent actions by the FDIC to restore confidence in financial institutions. I also will discuss the FDIC's continuing efforts to address the root cause of the current economic crisis – the problems caused by the failure to effectively deal with unaffordable loans and unnecessary foreclosures.

Recent Actions to Restore Confidence

The FDIC has been a participant in several actions by Congress, the Treasury Department and the federal regulators in recent weeks designed to restore confidence in insured financial institutions. These have included temporarily increasing deposit insurance coverage and providing guarantees to new, senior unsecured debt issued by banks, thrifts or holding companies. These measures will help banks fund their operations.

Increased Deposit Insurance

With the enactment of the EESA, deposit insurance coverage for all deposit accounts was temporarily increased to \$250,000, the same amount of coverage previously provided for self-directed retirement accounts. Temporarily raising the deposit insurance limits should bolster public confidence and provide additional liquidity to FDIC-insured institutions.

The FDIC implemented the coverage increase immediately upon enactment of EESA. The FDIC website and deposit insurance calculators were updated promptly to reflect the increase in coverage and ensure that depositors understand the change. The two bank failures since the change in the coverage level were resolved by healthier banks acquiring all of the failed institutions' deposits. These two failures did not require individual deposit insurance determinations, although the FDIC was fully prepared to implement the \$250,000 coverage limit.

It is important to note that the increase in coverage to \$250,000 is temporary and only extends through December 31, 2009. The FDIC will work closely with Congress in the coming year to ensure that consumers are fully informed of changes to the deposit insurance coverage level and understand the impact on their accounts.

Temporary Liquidity Guarantee Program

Last week, the FDIC Board of Directors approved a new Temporary Liquidity Guarantee Program (TLGP) to unlock inter-bank credit markets and restore rationality to credit spreads. This voluntary program is designed to free up funding for banks to make loans to creditworthy businesses and consumers.

The program has two key features. The first feature is a guarantee for new, senior unsecured debt issued by banks or thrifts and bank holding companies and most thrift holding companies, which will help institutions fund their operations. Eligible entities include: 1) FDIC-insured depository institutions, 2) U.S. bank holding companies, 3) U.S. financial holding companies, and 4) U.S. savings and loan holding companies that engage only in activities that are permissible for financial holding companies under section 4(k) of the Bank Holding Company Act.

The guarantee applies to all newly-issued senior unsecured debt issued by participating entities on or after October 14, 2008 through and including June 30, 2009, including fed funds purchased, other interbank funding, promissory notes, and commercial paper. In general, issuers will be limited in the amount of guaranteed debt they raise, which may not exceed 125 percent of senior unsecured debt that was outstanding as of September 30, 2008 and scheduled to mature before June 30, 2009. For eligible debt issued on or before June 30, 2009, coverage is only provided until June 30, 2012, even if the liability will not have matured.

Eligible entities will automatically participate in the FDIC's TLGP unless they opt out by November 12. Participating institutions will be subject to supervisory oversight, including to prevent rapid growth or excessive risk-taking. The FDIC, in consultation with the entity's primary Federal regulator, will determine continued eligibility and parameters for use.

Both term and overnight funding of banks have come under extreme pressure in recent weeks, with the interest rate for short-term funding ballooning to several hundred basis points over the rate for comparable U.S. Treasury bills. The new temporary FDIC guarantee will allow banks and their holding companies to roll maturing senior debt into new issues fully backed by the FDIC.

The second feature of the new program provides insurance coverage for all deposits in non-interest bearing transaction accounts at institutions unless they choose to opt out. These accounts are mainly payment processing accounts such as payroll accounts used by businesses. Frequently, such accounts exceed the current maximum insurance limit of \$250,000. Many smaller, healthy banks have expressed concerns about deposit outflows based on market conditions.

This temporary guarantee will expire December 31, 2009, consistent with the temporary statutory increase in deposit coverage. This aspect of the program allows bank customers to conduct normal business knowing that their cash accounts are safe and sound. This guarantee should help stabilize these accounts, and help the FDIC avoid having to close otherwise viable banks because of large deposit withdrawals.

It is important to note that the TLGP does not rely on taxpayer funding or the Deposit Insurance Fund. Instead, both aspects of the program will be paid for by direct user fees. Coverage for both parts of the program is automatic for the first 30 days, without charge. After that, the FDIC will begin assessing premiums or user fees for the coverage unless an institution opts out of one or both elements of the program. Prior to the end of this period, eligible entities must inform the FDIC whether they will opt out of the guarantee program. If an entity does not opt out of the program within the 30 days, it must participate in the program. If an institution opts out, the guarantees are good only for the first 30 days.

Premiums will be structured as follows. All newly issued senior unsecured debt will be assessed an annualized fee equal to 75 basis points multiplied by the amount of debt issued under the program. This assessment will generally be at the time of issuance or shortly thereafter. For non-interest-bearing transaction deposit accounts, a 10 basis point surcharge would be applied to non-interest-bearing transaction deposit accounts not otherwise covered by the existing deposit insurance limit of \$250,000 and implementing rules or other guarantee. This surcharge will be added to the participating bank's existing risk-based deposit insurance premium paid on those deposits.

The TLGP parallels actions by European and Asian nations. If the FDIC had not acted, guarantees for bank debt and increases in deposit insurance by foreign governments would have created a competitive disadvantage for U.S. banks. Along with Treasury's actions to inject more capital into the banking system, the combined coordinated measures to free up credit markets, should give banks the self-assurance to resume normal lending.

Since these measures were implemented at the beginning of last week, we have seen steady progress in reducing risk premiums in money and credit markets. Yields on short-term Treasury instruments, which had approached zero in mid-September, have now risen back in line with longer-maturity instruments. Quotes for Libor, the London Interbank Offer Rate, also have declined in relation to Treasury yields -- indicating a slow thaw in the interbank lending market. Interest rates on short-term commercial paper

have fallen back to their lowest levels since mid-September, indicating that liquidity is also starting to return to that market. While it is clearly too early to declare the end of the crisis in our financial markets, as a result of the coordinated response of the Fed, the Treasury, the FDIC and our counterparts overseas, we are making steady progress in returning money and credit markets to a more normal state.

The FDIC's action in establishing the TLGP is unprecedented and necessitated by the crisis in our credit markets, which has been fed by rising risk aversion in financial markets and serious concerns about the effects this will have on the real economy. The FDIC's action is authorized under the systemic risk exception of the FDIC Improvement Act of 1991. In accordance with the statute, the Secretary of the Treasury invoked the systemic risk exception after consultation with the President and upon the recommendation of the Boards of the FDIC and the Federal Reserve. The systemic risk exception gives the FDIC flexibility to provide such guarantees which are designed to avoid serious adverse effects on economic conditions or financial stability.

Efforts to Reduce Unnecessary Foreclosures

Minimizing foreclosures is important to the broader effort to stabilize global financial markets and the U.S. economy. Foreclosure is often a very lengthy, costly and destructive process that puts downward pressure on the price of nearby homes. While some level of home price decline is necessary to restore U.S. housing markets to equilibrium, unnecessary foreclosures perpetuate the cycle of financial distress and risk aversion, thus raising the possibility that home prices could overcorrect on the downside.

The continuing trend of unnecessary foreclosures imposes costs not only on borrowers and lenders, but also on entire communities. Foreclosures may result in vacant homes that may invite crime and create an appearance of market distress, diminishing the market value of other nearby properties. In addition, the direct costs of foreclosure include legal fees, brokers' fees, property management fees, and other holding costs that are avoided in workout scenarios. These costs can total between 20 and 40 percent of the market value of the property.¹ The FDIC has strongly encouraged loan holders and servicers to adopt systematic approaches to loan modifications that result in affordable loans that are sustainable over the long term.

Over the past year and a half, the FDIC has worked with mortgage lenders, the securitization industry, servicers, consumer groups, other regulators and Congress to identify and correct barriers to solving current market problems while establishing controls to guard against their reappearance in the future.

As we all know from events over recent months, no single solution or "silver bullet" can address the adverse effects of the deficiencies that have contributed to the current market turmoil. Rather, a number of approaches emphasizing different solutions for the different segments of the market are required.

HOPE for Homeowners Act

The FDIC has been playing a role in the implementation of the HOPE for Homeowners Act. As a member of the Board of Directors of the HOPE for Homeowners Program (Oversight Board), which oversees

implementation of the Act, the FDIC has joined the Departments of Housing and Urban Development (HUD) and Treasury and the Federal Reserve in establishing requirements and standards for the Program that are not otherwise specified in the legislation, and prescribing necessary regulations and guidance to implement those requirements and standards.

By working cooperatively together to address the many issues necessary to achieve implementation, the Oversight Board was able to meet the October 1, 2008 statutory deadline for implementation. The final rules, as well as other guidance documents and disclosures, were posted on the Program's website on October 1. The final rules were published in the Federal Register on October 6. They will soon be updated to reflect amendments to the HOPE for Homeowners Act made by EESA. Outreach efforts to servicers, investors, housing counselors and borrowers are underway.

The statutory approach for the Program made effective use of existing governmental and market structures. By modeling the proposal on existing FHA programs, the time and expense of implementing the Act have been significantly reduced. The Program incorporates many of the principles the FDIC considers necessary to be effective. It converts current problematic mortgages into loans that should be sustainable over the long-term and subsequently convertible into securities. It also requires that lenders and investors accept significant discounts and prevents borrowers from being unjustly enriched if home prices appreciate.

Emergency Economic Stabilization Act

The EESA, recently passed by Congress, includes a number of provisions to encourage loan modifications. In particular, EESA addresses the issue of foreclosure mitigation and provides authority that could hold significant promise for future loan modifications. The statute grants authority to the Secretary of the Treasury to use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures.

Loan guarantees could be used as an incentive for servicers to modify loans. Specifically, the government could establish standards for loan modifications and provide guarantees for loans meeting those standards. By doing so, unaffordable loans could be converted into loans that are sustainable over the long term. The FDIC is working closely and creatively with Treasury to realize the potential benefits of this authority.

IndyMac Federal Bank Loan Modifications

As the Committee knows, the former IndyMac Bank, F.S.B., Pasadena, California, was closed July 11. The FDIC is conservator for a new institution, IndyMac Federal Bank, F.S.B. (IndyMac Federal), to which the accounts and assets of the former IndyMac Bank, F.S.B. were transferred. As a result of this arrangement, the FDIC has inherited responsibility for servicing a pool of approximately 712,000 mortgage loans, including more than 60,000 mortgage loans that are more than 60 days past due, in bankruptcy, in foreclosure, and otherwise not currently paying. As conservator, the FDIC has the responsibility to maximize the value of the loans owned or serviced by IndyMac Federal. Like any other servicer, IndyMac Federal must comply with its contractual duties in servicing loans owned by investors.

Consistent with these duties, we hope to convert as many of these distressed loans as possible into performing loans that are affordable and sustainable over the long term. We are now actively evaluating distressed mortgages for refinancing through FHA programs, including FHA Secure and HOPE for Homeowners, and are sending letters proposing refinancing through FHA to more than 2,000 borrowers this week.

As we have done in some past failures, the FDIC as conservator for IndyMac Federal initially suspended most foreclosure actions for loans owned by IndyMac Federal in order to evaluate the portfolio and identify the best ways to maximize the value of the institution. While not all mortgages can be successfully modified, and foreclosures will be necessary in some cases, I have long advocated streamlined loan modifications. In the case of IndyMac Federal, the FDIC has begun a program of loan modifications for delinquent and at-risk borrowers. The FDIC as conservator for IndyMac Federal is systematically identifying loans in the portfolio that are currently delinquent or in default, or where borrowers are unable to make their payments due to interest rate resets or other reasons. Where it will improve the value of the loan, IndyMac Federal is offering loan modifications to eligible borrowers.

Specifically, on August 20, the FDIC announced a loan modification program to systematically modify troubled residential loans for borrowers with mortgages owned or serviced by IndyMac Federal. Of the more than 60,000 mortgages serviced by IndyMac Federal that are more than 60 days past due, in bankruptcy, in foreclosure, and otherwise not currently paying, approximately 40,000 are potentially eligible for our loan modification program. Initially, the program was applied only to mortgages either owned by IndyMac Federal or serviced under IndyMac Federal's pre-existing securitization agreements, which provided sufficient flexibility. However, with their agreement, we are now applying the program to many delinquent loans owned by Freddie Mac, Fannie Mae, and other investors. We are working with the owners of the remaining mortgages to gain approval to apply the new modification program to those loans as well. Let me emphasize that securitization agreements typically provide servicers with sufficient flexibility to apply the IndyMac Federal loan modification approach. In fact, the agreements at IndyMac Federal were more restrictive than those that apply to many other securitizations.

By achieving mortgage payments for borrowers that will be both affordable and sustainable, these distressed mortgages will be rehabilitated into performing loans and avoid unnecessary and costly foreclosures. We expect that by taking this approach, future defaults will be reduced, the value of the mortgages will improve, and servicing costs will be cut. The streamlined modification program will achieve the greatest recovery possible on loans in default or danger of default, in keeping with our statutory mandate to minimize impact on the insurance fund and improve the return to uninsured depositors and creditors of the failed institution. At the same time, we can help many troubled borrowers remain in their homes. Under the program, modifications are only being offered where doing so will result in an improved value for IndyMac Federal or for investors in securitized or whole loans, and where consistent with relevant servicing agreements.

Applying workout procedures for troubled loans in a failed bank scenario is something the FDIC has been doing since the 1980s. Our experience has been that performing loans yield greater returns than non-

performing loans. In recent years, we have seen troubled loan portfolios yield about 32 percent of book value compared to our sales of performing loans, which have yielded over 87 percent.

Through this week, IndyMac Federal has mailed more than 15,000 loan modification proposals to borrowers, and has called many thousands more in continuing efforts to help avoid unnecessary foreclosures. While it is still early in our implementation of the program, over 3,500 borrowers have accepted the offers and many more are being processed. We are still working to verify incomes, but thousands of borrowers are already making their modified payments. I am pleased to report that these efforts have prevented many foreclosures that would have been costly to the FDIC and to investors. This has been done while providing long-term sustainable mortgage payments to borrowers who were seriously delinquent. On average, the modifications have cut each borrower's monthly payment by more than \$380.

Our hope is that the program we announced at IndyMac Federal will serve as a catalyst to promote more loan modifications for troubled borrowers across the country.

Conclusion

In recent weeks, the FDIC has engaged in unprecedented actions to maintain confidence and stability in the banking system. Although some of these steps have been quite broad, we believe that they were necessary to avoid consequences that could have resulted in sustained and significant harm to the economy. The FDIC remains committed to achieving what has been our core mission for the past 75 years – protecting depositors and maintaining public confidence in the financial system.

I will be pleased to answer any questions the Committee might have.

¹ Capone, Jr., C. A., *Providing Alternatives to Mortgage Foreclosure: A Report to Congress*, Washington, D.C.: United States Department of Housing and Urban Development, 1996.