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STATEMENT OF

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on

PRIORITIES FOR THE NEXT ADMINISTRATION: USE OF TARP FUNDS UNDER THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

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Chairman Frank, Ranking Member Bachus and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the use of funds under the Emergency Economic Stabilization Act of 2008 (EESA). The incoming Administration will face a number of serious economic challenges and the effective and efficient use of the funds provided by Congress under EESA will be an essential element for maintaining stability in the financial markets and returning them to more normal operations. In addition, EESA provides statutory authority and funding that could be effective in reducing unnecessary foreclosures which have contributed substantially to our current economic problems.

On November 18, Chairman Bair testified before this Committee on efforts to stabilize the nation's financial markets and to reduce foreclosures. While some additional steps have been taken, credit remains tight and more needs to be done for homeowners in distress. Credit markets have not been functioning normally, contributing to a rising level of distress in the economy. In addition, high levels of foreclosures are contributing to downward pressure on home prices. Troubled assets continue to mount at insured commercial banks and savings institutions, placing a growing burden on industry earnings. As reported in the third quarter 2008 *FDIC Quarterly Banking Profile*, expenses for credit losses topped $50 billion for the second consecutive quarter. Third quarter income totaled only $1.7 billion, a decline of $27 billion (94 percent) from the third quarter of 2007. Almost one in four institutions (24.1 percent) reported a net loss for the quarter. However, as discussed further below, programs implemented by the

Federal Reserve Board (FRB), the FDIC, and the U.S. Treasury Department to boost liquidity appear to be making a positive impact.

Returning the economy to a condition where it can support normal economic activity and future economic growth will require a number of strategies, including providing access to additional funds under the Troubled Asset Relief Program (TARP). We understand that many Members of Congress have concerns about the past use of TARP funds. The FDIC does not serve on the TARP Oversight Board and has no statutory role in the administration of its programs. However, we will support Treasury's request for the release of the second $350 billion. We believe that these funds -- with appropriate transparency and accountability -- could provide important and necessary support to prevent additional contractions in lending, assist financial institutions in providing credit to creditworthy borrowers and provide incentives to avoid unnecessary foreclosures.

My testimony will discuss the FDIC's efforts to provide additional liquidity to insured institutions through our Temporary Liquidity Guarantee Program (TLGP), as well as our participation in the Capital Purchase Program implemented by the Treasury Department under EESA. Though the TLGP is funded through industry assessments and does not rely on TARP funding, it is an important component of combined interagency efforts to combat the financial crisis. I also will discuss the continuing need for a program to provide a means for financial institutions to sell troubled assets to free up additional balance sheet capability to engage in prudent lending. We believe a program

is needed that is capable of managing these assets until the economy and the banking industry are stabilized, and that institutions of all sizes should be allowed to participate if they otherwise qualify. In addition, I will reiterate the need for more robust mortgage loan modification efforts, such as those previously proposed and implemented under the auspices of the FDIC. Finally, I will discuss measures that financial institutions should take to ensure that TARP/EESA funds are used responsibly and effectively.

Efforts to Improve the Liquidity and Capital at Insured Depository Institutions

Temporary Liquidity Guarantee Program

The FDIC Board of Directors adopted the TLGP on October 13, 2008 in response to credit market disruptions, particularly in the interbank lending market. The FDIC's action in establishing the TLGP is unprecedented and necessitated by the crisis in our credit markets, which has been fed by a rising aversion to risk and serious concerns about the effects this will have on the real economy. The FDIC's action was authorized under the systemic risk exception of the FDIC Improvement Act of 1991 and followed similar actions by the international community. 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 have had a stabilizing effect on bank funding.

The TLGP is designed to help stabilize the funding structure of financial institutions and expand their funding base to support the extension of new credit. The TLGP has two components: 1) a program to guarantee senior unsecured debt of insured depository institutions and most depository institution holding companies, and 2) a program to guarantee noninterest bearing transaction deposit accounts in excess of deposit insurance limits. 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. With regard to the debt guarantee program, premiums are charged on a sliding scale depending on the length of the debt maturity. For the deposit insurance guarantee, a 10 basis point surcharge is applied to deposits in non-interest bearing transaction deposit accounts not otherwise covered by the existing deposit insurance limit of $250,000. This surcharge will be collected at the same time that the participating bank pays its existing risk-based deposit insurance premium paid on those deposits.

The FDIC is charging significant fees to offset its new risk exposure and minimize the likelihood that there will be any losses associated with the program. However, if losses should occur, they would be covered through a special systemic risk assessment. Unfortunately, under current law, the FDIC has authority to assess only insured depository institutions, even though the benefits of the TLGP accrue more broadly to bank holding companies. As a consequence, the FDIC is seeking authority from the new Congress to broaden its systemic risk special assessment authority to include depository institution holding companies, as appropriate to the benefits they

receive and we are pleased that Chairman Frank included such a provision in his recently proposed legislation on EESA.

The TLGP has a high level of participation; over 6,700 banks and thrifts have opted in to the deposit guarantee program, and over 6,900 bank and thrifts and their holding companies have opted in to the debt guarantee program. The program also has improved access to funding and lowered banks' borrowing costs. As of December 30, participating entities reported about $258 billion in guaranteed debt issued, with about $222 billion of this still outstanding. Data show that FDIC-guaranteed debt is trading at considerably lower spreads than non-guaranteed debt issued by the same companies. Since the inception of the TLGP program and the other interagency measures announced in mid-October, interbank lending rates have declined. For example, the LIBOR – Treasury (TED) spread declined from 464 basis points on October 10 to 120 basis points on January 9.

Capital Purchase Program

As a part of EESA, the Treasury Department developed a Capital Purchase Program (CPP) which allows certain financial companies to apply for capital augmentation of up to three percent of risk weighted assets. The ongoing financial crisis has disrupted a number of the channels through which market-based financing is normally provided to U.S. businesses and households. Private asset-backed securitization remains virtually shut down, and the commercial paper market is now heavily dependent

on credit facilities created by the Federal Reserve. In this environment, banks will need to provide a greater share of credit intermediation than in the past to support normal levels of economic activity. By contrast, a significant reduction in bank lending would be expected to have strong, negative procyclical effects on the U.S. economy that would worsen the problems of the financial sector.

Before the recent capital infusions, banks appeared to be on course to significantly reduce their supply of new credit as a response to an unusually severe combination of credit distress and financial market turmoil. Standard banking practice during previous periods of severe credit distress has been to conserve capital by curtailing lending. In the present episode, lending standards were likely to be tightened further due to higher funding costs resulting from overall financial market uncertainty. There was ample evidence in the Federal Reserve's *Senior Loan Officer Survey* in October that bank lending standards were being tightened to a degree that is unprecedented in recent history.[1]

Government intervention was needed to interrupt this self-reinforcing cycle of credit losses and reduced lending. The Treasury Department implemented the CPP as a means of countering the procyclical economic effects of financial sector de-leveraging. The federal bank regulators expect banks to actively seek ways to use this assistance by making sound loans to household and business borrowers. The FDIC recognizes that banks will need to make adjustments to their operations, even cutting back in certain

[1] Federal Reserve Board, *Senior Loan Officer Opinion Survey on Bank Lending Practices*, October 2008, http://www.federalreserve.gov/boarddocs/snloansurvey/200811/

areas, to cope with recent adverse credit trends. However, the goal of providing government support is to ensure that such cut-backs and adjustments are made mostly in areas such as dividend policy and management compensation, rather than in the volume of prudent bank lending. These considerations are consistent with the precept that the highest and best use by banks of CPP capital in the present crisis is to support prudent lending activity. As discussed in more detail below, ongoing supervisory assessments of bank earnings and capital will take into account how available capital is deployed to generate income through responsible lending.

Thus far, a number of the largest banking companies in the U.S. have taken advantage of the CPP, significantly bolstering their capital base during a period of economic and financial stress. In addition, over 1,200 community financial institutions have applied to this program. In participating in the CPP program, as well as in launching the TLGP, it was the FDIC's express understanding that $250 billion would be made available for bank capital investments and that all eligible institutions, large and small, stock and mutual, would be able to participate. We strongly encourage both the Treasury Department and the Congress to make sure adequate funding is available for community bank participation in the CPP program.

It is critically important that community banks (commonly defined as those under $1 billion in total assets) are given every opportunity to participate in this program. Although, as a group, community banks have performed somewhat better than their larger competitors, they have not fully escaped recent economic problems. Community

banks control eleven percent of industry total assets; however, their importance is especially evident in small towns and rural communities. Of the 9,800 banking offices located in communities with populations under 10,000, 67 percent are offices of community banks. In these markets, the local bank is often the essential provider of banking services and credit. Their contribution to small business and agriculture lending is especially important and disproportionate to their size. As of June 30, 2008, bank lending by community banks accounted for 29 percent of small commercial and industrial loans, 40 percent of small commercial real estate loans, 77 percent of small agricultural production loans, and 75 percent of small farm land loans.[2] Although the viability of community banks as a sector continues to be strong, the CPP offers an opportunity for individual institutions to strengthen their balance sheets and continue providing banking services and credit to their communities.

We also believe it is important for the CPP to be implemented in a manner that encourages and rewards private capital investments to be made alongside TARP capital. Private capital investments serve as a powerful vote of confidence in the viability of a financial institution over the long term and that viability is enhanced by programs that match private funds with TARP capital.

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[2] Small commercial and industrial loans and small commercial real estate loans are in amounts under $1 million. Small agricultural production loans and small farm land loans are in amounts under $500,000.

Addressing the Problems of Troubled Assets

The FDIC believes that the original intent of the TARP -- to remove problem assets from the balance sheets of banks and related entities -- continues to be vitally important. Such a program is necessary to expand banks' balance sheet capacity to undertake new lending as well as to attract private equity investment. As the receiver for failed banks, the FDIC has considerable experience with the challenges inherent in handling troubled assets. The management of troubled assets is difficult and costly. The development of a program to assist institutions in addressing their inventories of troubled assets should be a key component of TARP funds going forward.

The FDIC encourages development of a troubled asset program that meets three main principles:

> **Accountability** -- The program should follow a standardized approach that establishes a fair and transparent program upfront for dealing with troubled assets to alleviate market uncertainty. Participating entities should be required to develop compensation programs that truly reward long term performance and rely on definable metrics. It is essential that any such program carry conditions and expectations to support credit availability and the viability of the banking industry for years to come.
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> **Transparency** -- Participants in the program should be required at the outset to show how participation would expand prudent lending activity. Specifically, they should provide the government with a plan for using the funds to facilitate new lending, with definable metrics for measuring performance.
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> **Viability** -- Participants should be required to demonstrate the capacity to raise additional private capital in significant proportion to the relief provided. In order to be eligible, participating entities should have to demonstrate that the transaction would ensure their viability over the long term and an important test of viability

would be their ability to raise private common equity capital alongside their sale of assets into this structure.

Even with the various forms of government assistance that have been provided by the regulators and through EESA, troubled asset relief will still be necessary to enable financial institutions to address their inventories of troubled assets so that they can return to more normal lending activity. This program should be made available to banks of all sizes, rather than just large financial institutions, to address financial stresses that may be occurring at the regional and local levels. In the current market conditions, uncertainty about the potential losses embedded in the balance sheets of financial institutions is constricting lending between institutions and dissuading investors from providing the new capital essential to a recovery. In addition, government acquisition of troubled residential mortgages would facilitate action to restructure these loans and improve the performance of housing-related assets, providing the foundation both for a greater flow of credit and the investment of new capital into the financial system. However, because of the sheer volume of troubled mortgages, as well as the large number which are locked in securitization trusts, it also is vital to institute a specific program aimed at foreclosure prevention.

Efforts to Reduce Unnecessary Foreclosures

Minimizing foreclosures continues to be essential to the broader effort to stabilize global financial markets and the U.S. economy. There were an estimated 1.5 million U.S. foreclosures in 2007, and another 1.2 million in the first half alone of 2008. The

continuing trend of unnecessary foreclosures imposes costs not only on borrowers and lenders, but also on entire communities and the economy as a whole. 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. Foreclosures add inventory and create distressed sale prices which place downward pressure on surrounding home values. 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.[3]

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. Unnecessary foreclosures perpetuate the cycle of financial distress and risk aversion, thus raising the very real possibility that home prices could overcorrect on the downside.

Beyond their positive impact on foreclosures, there is a strong business case for loan modifications. Loan restructurings are a time-tested tool for mitigating losses when loans become delinquent. The FDIC has long used loan modifications to improve the value of troubled loans we inherit from failed banks. Not surprisingly, our experience demonstrates that performing loans are worth much more than delinquent loans we sell back into the private sector.

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[3] 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.

If, through restructuring, a borrower is able to continue making payments, this will provide more value to the lender than a foreclosed property. This is especially the case when the housing market has declined precipitously. In today's market, a foreclosure sale will usually net far less than the outstanding balance of the loan. Not only have home prices declined, but foreclosure costs currently run 20 to 40 percent of the property's value. For instance, modifying a 30-year loan with a 7 percent interest rate to 5.5 percent for the balance of the loan term would reduce the net present value of the loan by only 10 percent. By comparison, in today's market a foreclosure sale would likely impose losses of at least 25 percent, if not significantly more. Therefore, loan modifications that convert troubled loans into loans that are sustainable over the long term not only prevent unnecessary foreclosures, but make good business sense.

Foreclosure Mitigation Under EESA

EESA provides broad authority to the Secretary of the Treasury to take action to ameliorate the growing distress in our credit and financial markets, as well as the broader economy. EESA specifically provides the Secretary with the authority to use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures. We believe that it is essential to utilize this authority to accelerate the pace of loan modifications in order to halt and reverse the rising tide of foreclosures that is imperiling the economy.

Mortgage loan modifications have been an area of intense interest and discussion for more than a year now. Meanwhile, despite the many programs introduced to address the problem, it continues to get worse. During the second quarter of 2008, we saw mortgage loans becoming 60 days or more past due at a rate of more than 700,000 per quarter -- net of past due loans that returned to current status. No one can dispute that this remains the fundamental source of uncertainty for our financial markets and the key sector of weakness for our economy. We must decisively address the mortgage problem as part of our wider strategy to restore confidence and stability to our economy.

In previous testimony, Chairman Bair has outlined an FDIC proposal for the creation of a guarantee program based on the FDIC's practical experience in modifying mortgages at IndyMac Federal Bank in California. We believe this program could prevent as many as 1.5 million avoidable foreclosures. Generally, the FDIC has proposed that the government establish standards for loan modifications and provide for a defined sharing of losses on any default by modified mortgages meeting those standards. By doing so, unaffordable loans could be converted into loans that are sustainable over the long term. This proposal is authorized by the EESA and may be implemented under the existing authority provided to the Secretary under that statute.

Redefaults are a significant concern for investors with regard to loan restructurings. One recent report[4] suggested that between 35 and 42 percent of modified mortgages subsequently become more than 60 days delinquent. However, this report did not track the quality of the modifications, defining the term broadly to include any

[4] OCC and OTS Mortgage Metrics Report, Third Quarter 2008.

change in contract terms. Other reports suggest much lower redefault rates where the borrower's payment is reduced. One study found redefault rates of 15 percent where modifications reduce interest payments.[5]

Deteriorating economic conditions will certainly cause redefault rates to increase. It should be noted, however, that even with high redefault rates, loan modifications still make business sense in many cases. This is because the value preserved through a loan restructuring is generally much greater than the incremental loss from waiting a period of months before the servicer forecloses or otherwise resolves the defaulting mortgage. For instance, as conservator of IndyMac Federal Savings Bank, the FDIC has used a systematic approach to loan modifications to restructure thousands of unaffordable loans into more sustainable payments. Even assuming a redefault rate of 40 percent, the net present value of loans that we have modified exceeds foreclosure value by an average of $50,000, with aggregate savings of over $400 million. In fact, we believe redefault rates will be much lower, but even at higher rates, systematic loan modifications make good business sense.

Over the next two years, an estimated 4 to 5 million mortgage loans will enter foreclosure if nothing is done. In addition to reducing the number of foreclosures, we believe that a loss sharing program would reduce the overhang of excess vacant homes that is driving down U.S. home prices. Such an approach makes good business sense, keeps modified mortgages within existing securitization transactions, does not require

[5] Credit Suisse, Fixed Income Research Report, Subprime Loan Modifications Update, Oct. 1, 2008.

approval by second lienholders, ensures that lenders and investors retain some risk of loss, and protects servicers from the putative risks of litigation by providing a clear economic benefit from the modifications.

While the proposed FDIC program would require a cash outlay in the event of default, we must consider the returns this guarantee would deliver in terms of our housing markets and, by extension, the economic well-being of our communities. While we support the various initiatives taken to date, if we are to achieve stability in our credit and financial markets we cannot simply provide funds to market participants. We must address the root cause of the financial crisis – too many unaffordable mortgages creating too many delinquencies and foreclosures. The time is overdue for us to invest in our homes and communities by adopting a program that will prudently achieve large-scale loan modifications to minimize the impact of foreclosures on households, lenders and local housing markets.

Financial Institution Accountability for Use of EESA Funds

On November 12, 2008 the FDIC issued an *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* to all FDIC supervised institutions. To support this objective, consistent with safety and soundness principles and existing supervisory standards, each individual banking organization was urged to ensure the adequacy of its capital base, engage in appropriate loss mitigation strategies and foreclosure prevention,

and reassess the incentive implications of its compensation policies. In communicating this guidance to its supervised institutions, the FDIC encouraged them to:

- lend prudently and responsibly to creditworthy borrowers;
- work with borrowers to preserve homeownership and avoid preventable foreclosures;
- adjust dividend policies to preserve capital and lending capacity; and
- employ compensation structures that encourage prudent lending.

The FDIC emphasized that adherence to these standards would be reflected in examination ratings both for safety and soundness and compliance criteria.

To meet these objectives, it is crucial that banking organizations track the use of the funds made available through federal programs and provide appropriate information about the use of these funds. This week, the FDIC issued another Financial Institution Letter advising insured institutions that they should track their use of capital injections, liquidity support, and/or financing guarantees obtained through recent financial stability programs as part of a process for determining how these federal programs have improved the stability of the institution and contributed to lending to the community. Equally important to this process is providing this information to investors and the public. As a result, this Financial Institution Letter advises insured institutions to include information about their use of the funds in public reports, such as shareholder reports and financial statements.

Internally at the FDIC, we are preparing guidance to our bank examiners for evaluating participating banks' compliance with EESA, the CPP securities purchase agreements, and success in implementing the goals of the November 12 interagency statement. Importantly, this examiner guidance will focus on banks' use of TARP CPP funds and how their capital subscription was used to promote lending and encourage foreclosure prevention efforts. The banking agencies will measure and assess participating institutions' success in deploying TARP capital and other financial support from various federal initiatives to ensure that funds are used in a manner consistent with the intent of Congress and participants are held accountable.

FDIC examiners will be reviewing the expectations that we have established in the recent Financial Institution Letter for banks participating in the CPP, including:

- Establishment of a monitoring process for the use of TARP proceeds to determine the primary uses by the institution of received funds;
- Increased lending efforts in the institution's market since receiving a TARP CPP subscription;
- Down-streaming subscription proceeds to the insured depository institution (if a holding company structure is in place) to ensure that TARP funds can be intermediated into loans and bank capital is augmented;
- Engagement in mortgage loan modification or foreclosure prevention efforts that rely on systematic, proactive approaches that enhance the net present value of individual mortgage loans versus foreclosure;
- Utilization of executive compensation programs that exemplify good corporate governance and conform with EESA and other requirements; and
- Implementation of the goals of the November 12 interagency statement to meet the needs of creditworthy borrowers in the institution's market area.

During examinations, our supervisory staff will be reviewing banks' efforts in these areas and will make comments as appropriate in FDIC Reports of Examination. Our examiners will also be considering these issues when they assign CAMELS composite component ratings.

Conclusion

As we mentioned at the onset of this statement, the incoming Administration will face a number of serious economic challenges that will require a variety of approaches to successfully restore confidence in the financial system. TARP funds authorized by EESA will provide essential funding for capital stability for institutions and to provide incentives to avoid unnecessary foreclosures. The FDIC encourages Congress to authorize the additional $350 billion under TARP to continue these efforts. In addition, TARP funds could be used to develop strategies for the management of distressed assets that are burdening bank balance sheets. However, it is essential for institutions to account for how federal funds are being utilized. Examination staff is focusing its efforts on this issue to ensure that funds are used effectively. The FDIC looks forward to working with Congress in achieving these goals.

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