Remarks by
FDIC Chairman Sheila Bair,
The Johns Hopkins University
Carey Business School Leaders & Legends Lecture Series
Baltimore, MD
November 20, 2008

The FDIC has been as prepared as anybody for what's come our way. We saw a storm brewing over two years ago as the "Golden Age of banking" was coming to an end. We started preparing by taking a number of actions.

We warned about sub-prime mortgage lending and the problems caused by a lack of proper underwriting standards.

We told our banks to build reserves to cover potential losses. We told them to watch for concentrations of residential housing and construction loans. We said: "be ready if things took a turn for the worse."

We encouraged wide-scale loan modifications to keep people in their homes and reduce the negative fallout from escalating foreclosures on the economy.

We successfully launched a protocol for systematically modifying loans at IndyMac Federal Bank, a bank we took over in July. Using this as a model for a "Loan Mods in a Box" national program, we could help 1.5 million families avoid foreclosure using $24 billion in government financing.

This would get at the root cause of the credit crunch and the economic downturn, and would be a stimulus for the economy. If we could stop the decline in home prices by just 3 percentage points, we could preserve over a half a trillion dollars in home equity, translating into more than $40 billion in consumer spending

So where do we stand now?

The FDIC will announce third quarter industry results next Tuesday. Earnings will again be substantially below the prior year. But despite the problems facing our economy, the vast majority of banks remain well-capitalized, profitable, and in sound condition.

The number and assets of problem banks, though rising, remain well below the levels seen in the early 1990's. Today's industry – especially larger institutions – is much better capitalized than the industry was back then.

More institutions are geographically diversified. Banks have more sources of income, thanks to product innovation and expanded powers. And the industry has become significantly more efficient.

Asset quality has deteriorated since the exceptionally strong performance we saw in 2006. Erosion has been concentrated in two major loan types: residential mortgages, and construction and development loans. But delinquency rates for most other loan types, while rising, have remained well below their historic peaks.

We expect bank failures to continue at a higher rate than we've seen in the previous few years. But the industry's problems are manageable, and the FDIC has sufficient resources to deal with them.

Liquidity problems

While the banking industry overall remains in good condition and has ample capital, liquidity has been a problem. The credit markets have been experiencing problems. Interest rate spreads have been very wide.

However, recent coordinated actions taken by the government, including Treasury's Trouble Assets Relief Program (TARP) that commits to injecting $250 billion of capital into the banking system, the Federal Reserve's Commercial Paper Funding Facility, and the FDIC's Temporary Liquidity Guarantee Program (TLGP), all have had a positive effect. They've succeeded in stabilizing the systemically important financial institutions. There are several measures that show this.

- Yields on short-term Treasury instruments, which had approached zero in mid-September, have been more in line with longer-maturity instruments.
- Quotes for Libor, the London Interbank Offer Rate, have declined in relation to Treasury yields -- indicating a slow thaw in the interbank lending market.
- The TED Spread – the difference between the three month T-bill and three month Libor – was 2.11 percent earlier this week – down from a peak of 4.63 percent on October 10.
- Interest rates on short-term commercial paper have fallen to their lowest levels since mid-September, indicating that liquidity is also starting to return to that market.

The TLGP

As part of the new Stabilization Act, Congress temporarily raised the deposit insurance limit to $250,000. And on October 14, we announced the TLGP.

The TLGP gives a 100 percent guarantee for unsecured debt and a 100 percent guarantee for non-interest bearing transaction accounts, such as business payroll accounts. The purpose of the increase in the deposit insurance limit and the additional guarantees through the TLGP was to reinforce public confidence in banks and to preserve liquidity.

We issued an Interim Rule on the TLGP on October 23 that was well received by the industry. We asked for and received many comments, which we have taken to heart.

As a result of the comments, we'll be making several changes to the final rule, which will be voted on tomorrow by the FDIC's board, to provide greater certainty for investors. In particular, we will be acting to assure a prompt payment mechanism on the guaranty, as well as tiered pricing depending on the maturity of the guaranteed debt.

Taken together, we are confident that these changes will create significant investor demand, and dramatically reduced funding costs for eligible banks and bank holding companies.

I expect that the industry will take full advantage of this guarantee and that it will not only reduce funding costs, but provide longer maturities to secure a more stable liquidity base to support healthy and sustained lending.

The guarantee on qualifying senior unsecured debt and on non-interest bearing transaction accounts is just as secure as our guarantee on other FDIC insured accounts. In the FDIC's 75 year history, no depositor has ever lost a penny of insured deposits. Ultimately, this is a guarantee that is backed by the full faith and credit of the United States Government.

I also expect that the program will ultimately lead to lower credit spreads for the entire banking industry and more credit availability, which is what we need to get the credit markets back to normal.

And we'll accomplish this at no cost to the taxpayer or the deposit insurance fund. The TLPG is being offered under the systemic risk exception in our statute. Fees for the guarantee have been structured to cover our expected costs. However, in the unlikely event of a shortfall, the difference will be made up through a special assessment on all insured institutions, consistent with the procedure contained in our statute.

Bank lending

As we said in an interagency statement last week, these efforts are designed to improve the functioning of credit markets and to strengthen capital in our financial system so that banks can continue to make prudent loans during these times of economic distress.

These programs should get banks lending again to consumers and businesses. It is critical that lending increase where credit has contracted, such as mortgage lending, consumer credit, and small business lending.

While it is clearly too early to declare the end of the financial crisis, as a result of the coordinated response of the Congress, 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.

We need to give these programs time to work.

The full impact of the TLPG will not be felt until after our rule is finalized tomorrow. However, this new program has the potential for infusing up to 1.4 trillion dollars of longer term, low-cost funding into the banking sector. This is stable funding that can expand credit availability as well as lower credit costs.

Looking ahead

Expanding the safety net is temporary. Our end game should be to get the government out of these emergency programs as things get back to normal. The TLPG will expire at the end of June of next year.

Still, we've crossed the Rubicon; there's no turning back. We need continued government intervention in the form of stronger and smarter regulation and supervision.

For starters, we need to modernize the regulatory structure to match the complexity of our markets and to fill any gaps. Mortgage lending standards is the obvious example. What got us into this mess was "regulatory arbitrage," with different rules for banks and for non-bank lenders.

We also need greater transparency and prudential oversight of structured finance and over-the-counter derivatives trading. I also think we need a resolution process for systemically important institutions like we use for insured banks.

In short, we need smart rules that protect consumers, increase transparency, level the playing field, and use common sense.

A silver lining?

I'm an optimist by nature, I guess because I was born and raised in Kansas by parents who lived through the Great Depression. So I'm optimistic that the country will emerge from this economic mess. It will take time. It will cause some pain. But I'm hopeful we'll emerge wiser and stronger.

I was concerned by market volatility yesterday, which I viewed as an over-reaction to market events.

We must take care not to transition from "irrational exuberance" to "irrational despair." Our economy is resilient; we're a hard-working, innovative people. We will get through this and emerge even stronger.

Consumers need to get back to the basics of saving money, of thinking things through before you buy, of not getting too deeply into debt.

And financial institutions need to get back to the basics of customer service, solid underwriting, making loans people can understand and repay, and managing risk for long term profitability.

We need to get back in touch with these cultural values of thrift and common sense regulation.

These are the values that made our economy the greatest in modern history. And they are the values that will keep America strong in the years ahead.

Thank you very much.

Last Updated 11/20/2008