Remarks by
John F. Bovenzi, Chief Operating Officer,
FDIC on
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Good afternoon.

It's a pleasure to be here with you to talk about the important role of deposit insurers in financial crises.

Since July 14th I have gained a perspective not always available firsthand for regulators. I have been serving as the Chief Executive Officer at IndyMac Federal Bank, a bank owned and operated by the FDIC.

I'd like to cover four areas related to IndyMac Bank. They relate to the closing process, managing the conservatorship, loan modifications, and cost to the insurer.

Before doing that I'd like to start by reading a few quotes that I believe are relevant to our discussion today.

"Rumors of problems... began circulating which caused a deposit runoff."

"The failure... was one of the most publicized and most difficult" in the FDIC's history.

It "became the largest failure in FDIC's history in which uninsured depositors suffered losses."

When the bank was reopened "customers with insured deposits were treated like customers of a normal bank. They could continue writing checks and leave their savings accounts and CDs in the bank. In addition they did not have to stand in line to get their insured deposits (although many... did)."

And now I'm quoting FDIC's outstanding Legal counsel Don McKinley, who said: "I'll never forget... [they were] lined up as far as you could see in the hot July sun ... waiting to get their deposits."

"Another problem, although short-lived was that some of the local financial institutions would not accept the insurance checks or wanted to put holds on them. That situation caused near panic, as customers who thought they were being paid returned to the bank complaining that they could neither cash nor deposit their checks. By Wednesday that situation was resolved when the local institutions agreed to accept the insurance checks."

End of quotes.

Every line I just read to you is from Managing the Crisis: the FDIC and RTC Experience, a book that was published in 1994.

The bank referred to was closed on July 5th.... 1982.

At that time Penn Square Bank had $470 million in deposits of which over half were uninsured.

The FDIC established a new bank in order to pay off the $200 million in insured deposits.

Does this sound familiar?

IndyMac Federal Bank opened for business on July 14th of this year after the former IndyMac Bank was closed on July 11th.

IndyMac had $32 billion in assets and serviced $184 billion in mortgage loans.

The bank also had $584 million in uninsured deposits, now the largest amount of deposits that have ever been subject to a loss from a bank failure in the FDIC's 75 year history.

Every quote I read to you could have been written about the IndyMac closing.

Even the one by Don McKinley, who 26 years later, was also at the IndyMac closing.

The point is: that while there are many differences between today's financial crisis and previous crises, some things never change.

One is that no one likes to lose money.

And an important reminder to us, as regulators, is that we should never underestimate people's reaction to losing money.

After the Penn Square closing there were a number of other small bank closings in which uninsured depositors lost money. Two years later Continental Illinois National Bank received open bank assistance. All depositors were protected against any loss. That disparate treatment in small versus large bank failures was heavily criticized. The perception began that some banks were too-big-to-fail. Subsequently, as a matter of practice, all depositors were protected against any loss when their bank failed.

Between 1984 and 1991, about 2,300 banks and S&L's were closed, about one a day for nearly seven years. Yet the public did not panic.

There were no lines of people waiting to take their money out of banks. Public confidence and stability were maintained even if market discipline was eroded.

Ultimately the Resolution Trust Corporation (RTC) spent about $150 billion in taxpayer money and the FDIC spent about $35 billion.

These numbers sounded larger at the time than they do today. Many believed those costs would have been less had there been more market discipline. As a result, the Federal Deposit Insurance Improvement Act was passed by Congress in 1991. That marked the beginning of the least cost test, which meant that when a bank failed uninsured depositors generally would lose money. However, in recent years, there have only been a few small bank failures, with little in the way of uninsured deposits.

Now to jump forward to the events of the past year. I'll start with a few observations about IndyMac Bank.

(1) Closing Weekend

I'll start with the closing process.

The most difficult part of a bank closing for the FDIC is separating insured from uninsured deposits in a timely manner. "Timely" generally means over a weekend. That was the case at IndyMac. Seventy people worked around the clock so the new bank could open early Monday. It was a monumental effort.

The bank's deposit information was run through a computer program that segregated the insured from the uninsured amounts.

However, there were many accounts where the insurance status couldn't be determined. So our staff had to ask the customer for more information. This created delays and uncertainty, which added to customer anxiety.

When Indymac reopened for business, lines of anxious depositors formed at each of the banks' branches. Some of these depositors were fully insured. Others clearly had uninsured money. However, there was a third group of depositors where we needed more information. This added to the public's overall anxiety.

We learned a lot of lessons from the first few days after IndyMac Bank was closed.

First, we know we need better public awareness of the deposit insurance rules.

In this regard we have launched a broad effort to better educate people on those rules.

Second, we need to keep the deposit insurance rules as simple as possible.

In the U.S our rules are quite complicated. Some people believe they are insured when they are not. Many bank employees are not sure of the rules.

Since the IndyMac closing the FDIC has simplified the coverage rules for trust accounts, one area where there was much uncertainty.

Third, we need to modernize our systems that calculate insured and uninsured deposits.

This is underway and will be completed soon. We are also requiring the largest banks to standardize their deposit information in a way that it is readily usable for our purposes.

Fourth, where possible, we are advancing a portion of funds to uninsured or potentially uninsured depositors.

We did this at IndyMac. Fifty percent of the uninsured portion of people's accounts was made available to them based on a conservative estimate of what they would get back from the sale of the bank's assets. This reduced the disruption to their lives and the potential adverse impact on the local economy.

We are also requiring the largest banks to develop systems that would allow them to place holds on a portion of a depositor's account. This will facilitate the process of making more of their money immediately available to the bank's customers even if it takes more time to sort out the insurance status of some accounts.

(2) Conservatorship Operations

Let me now turn to conservatorship operations.

I think it is safe to say that a private sector solution to a failing bank situation is preferable.

However, that is not always possible without government assistance, in the time allowed, on acceptable terms.

For a larger bank, that may mean temporary government ownership while a sale is being arranged. In other words, setting up a bridge bank or a conservatorship.

In these situations the insolvent bank is closed, then a new bank reopens.

The key distinction between leaving the bank open and providing government funds and closing the bank is that in a closing, the bank's uninsured creditors are not protected against loss.

This preserves market discipline, but it creates disruption.

Business counterparts want to be sure you have the appropriate authority to continue the previous business relationships. And, they may not be inclined to do so if they were amongst those that lost money.

The bank's employees start looking for new jobs.

Everyone questions on what terms they should be interacting with this new and unusual entity.

Some will look to take advantage of the situation.

Disruption is inevitable, even though the goal of the conservatorship is to provide stability.

Running a bank under government control immediately raises a whole new set of issues.

Immediately, corporate governance structures need to be set up.

Employee retention plans need to be put in place.

Open communication with all parties is critical.

However, you will need lawyers.

Beyond that, there are reputational issues.

Are the loans that are being made meeting the highest of underwriting standards?

Are those loans being made in compliance with all appropriate laws, regulations and policies?

In short, the new bank quickly must begin to meet the highest of standards, even if the old bank did not.

Obtaining the best possible value for the bank's creditors, including the FDIC, is our statutory obligation, but to do this we must first suffer through disruption during the closing process then work quickly to obtain stability at the bridge bank.

At the IndyMac Federal Bank conservatorship, I have been fortunate to be able to work with a very capable and very experienced FDIC staff that understands what has to be done and how quickly it must happen. And they get the job done. That experience is critical.

(3) Loan Modifications

Let me now turn to loan modifications.

FDIC Chairman Sheila Bair deserves tremendous credit for her nationwide leadership on preventing unnecessary foreclosures. She saw the developing problem and came up with a solution.

At IndyMac, we have focused on carrying out that plan and developing a systematic loan modification program that benefits both the bank and the homeowner.

Systematic does not mean everyone gets an identical mortgage. But there is a detailed model that calculates the net present value to the lender of proceeding with foreclosure.

That is compared with the net present value of the returns associated with a modified loan with monthly payments reduced by enough to make the payments affordable and sustainable.

Hopefully, that program can serve as a model for others.

The key to that program is that a decision to modify loans rather than to proceed with a foreclosure must make good business sense.

If proceeding with foreclosure results in a 30% loss in value, then modifying a loan to reduce a homeowner's monthly payments by 20% to make those payments affordable and sustainable benefits everyone.

This doesn't work for everyone.

Half of the homeowners heading toward foreclosure won't be able to meet the net present value test of having an affordable modified loan provide a higher return to the lender than would a foreclosure.

But the other half can be helped.

This helps the conservatorship maximize the return to creditors, helps families keep their homes, and helps stabilize our financial system.

(4) Cost

Let me now turn to cost issues.

IndyMac will turn out to be the most expensive bank closing in the FDIC's history.

It could cost the FDIC $9 billion.

Virtually all of IndyMac's assets are connected to the housing market, mostly residential mortgage loans and mortgage-backed securities.

The loans are predominately in the markets that have suffered the greatest loss in housing values, California, Nevada and Florida.

Most of the loans have little or no documentation, including no verification of income.

Many were interest-only or payment option adjustable rate mortgages.

Most were designed to be refinanced after housing prices continued to appreciate.

All of these characteristics make it easy to see why the bank's losses would be high.

But while the bank's asset quality may determine the amount of loss, it is the liability side of the balance sheet tells us who absorbs those losses.

Virtually all of the bank's nondeposit liabilities were secured borrowings.

Secured lenders don't lose any money if they have adequate collateral. Since all of IndyMac's other borrowings were deposits, the FDIC and the uninsured depositors will absorb all of the losses.

Contrast that situation with the closing of Washington Mutual Bank.

There were no losses to the FDIC in that closing, despite the fact that the bank had assets that were similar to those at IndyMac.

However, on the liability side of Washington Mutual's balance sheet were $15 billion in senior and subordinated notes. That represents as much as $15 billion in cost that would have been absorbed by the FDIC had Washington Mutual's liability structure looked like IndyMac's.

This dramatic difference in cost to the FDIC between the two banks resulted in the FDIC modifying its risk-based premium structure to impose higher costs on those insured institutions that have a large portion of their liabilities secured and reducing the costs imposed on those banks that have a large portion of their liabilities unsecured and subordinate to depositors.

Conclusion

In conclusion, conservatorships and bridge banks are important tools available to the FDIC to handle bank failures.

Our experience with IndyMac only strengthens that belief in this process for resolving failed banks.

But subsequent events, which no one really anticipated, have shown the value in the government having broad and flexible powers.

Every subsequent development since the failure of IndyMac Bank has been unique.

At Washington Mutual, a closed bank sale was arranged transferring $300 billion assets, at no cost to the FDIC, without protecting creditors, other than depositors.

At Wachovia, an over $800 billion bank, an open bank transaction was arranged with Citigroup that would have resulted in no expected cost to FDIC. The FDIC used its systemic risk exception to facilitate this transaction. Subsequently, Wells Fargo arranged a purchase of Wachovia without government help.

The FDIC now temporarily guarantees non-interest bearing accounts and some of the debt of banks, thrifts and their holding companies.

This is a broader use of the systemic risk authority.

We are also in discussions with the Treasury Department about a loss sharing program for banks that engage in loan modifications along the same lines as what we are doing at IndyMac Federal Bank.

The final point I'd like to make is that no two financial crises are alike. Therefore, I believe regulators, like those of us in this room, need broad powers, creativity, and flexibility, in order to address financial crises in a timely and successful manner.

We can look at this financial crises and past crises, and make policy adjustments from these experiences, but we can't predict what the next crisis will be only that we will need to be creative and flexible to deal with it when it comes.

Thank you.

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