Remarks by
FDIC Chairman Sheila C. Bair
to the
Florida Bankers Association,
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I'd like to start with an overview of the industry's performance, and then talk about emerging liquidity problems that we're seeing across the industry, and the need for a rainy day backup plan to raise cash quickly.

2nd quarter bank earnings

As you've probably heard by now, industry results in the second quarter were pretty dismal.

The industry earned just $5 billion in the second quarter, which is well below the $30 billion-plus record earnings that we had been seeing over the past few years.

By any yardstick, it was another very rough quarter.

But the results were not surprising as the industry coped with financial market disruptions, the housing slump, worsening economic conditions, and the overall downturn in the credit cycle.

The main reasons for the drop off are the same that we've been seeing since the second half of last year:

- declining non-interest income,
- rising non-interest expense, decrease in gains on securities sales,
- and mounting loss provisions.

The most significant negative factor overall in the second quarter was increased expenses for credit losses.

We flagged all these trends last quarter, and urged banks and thrifts to beef up reserves enough to cover any potential credit losses.

And in the second quarter, you devoted almost one-third of your operating revenue to building up reserves.

- As a result, the industry stopped the decline in the coverage ratio of reserves to non-current loans. However, the coverage ratio remains at a 15-year low because of the rapid rate at which loans are going bad.
- We expect industry to keep building up reserves for the next several quarters.

- And we strongly urge institutions, especially here in Florida to have enough reserves to cover your credit losses.

Getting the house in order

Something that you've all heard me say, but that bears repeating: it's absolutely critical that you get your balance sheets in order.

You simply must accept that the credit downturn is far from over. It's a tough slog but there's no easy way out.

- Troubled loans keep rising across all types, with residential mortgage loans accounting for the largest share of the increase in the second quarter.
- Construction loans were the fastest-growing category, which is an area we've been talking about for many months, especially given the concentrations we see in many bank portfolios.
- At the end of last year, disruptions in financial markets were mainly affecting earnings at the largest institutions that we insure.
- But the abrupt turn in the credit cycle is now hurting many more institutions. A majority are now reporting lower earnings.
- Industry earnings were 87 percent lower than a year ago. Except for the fourth quarter of last year, it was the worst quarter for bank earnings since 1991.
- And 18 percent of banks were unprofitable in the second quarter, compared with 10 percent a year ago.

Banks in danger rising

The number of "problem" institutions continues to rise as well.

- At the end of June, there were 117 institutions on the "Problem List," the largest number since the middle of 2003.
- And total assets of "problem" institutions increased from $26 billion to $78 billion. $32 billion of the increase was IndyMac Bank, which failed after the end of the quarter.
- As for the outlook, more banks will come on the list as credit problems worsen.
- While we don't see a return to the record high earnings of previous years anytime soon, most institutions remain fundamentally sound.

- 98% are well-capitalized, and account for 99% of total bank assets.

Banks have taken steps to encourage capital formation.

- For example, about half of all institutions have been reducing their dividends. And total dividends paid by the industry have fallen sharply.

Even so, retained earnings keep declining, because of a more rapid drop-off in net income.

Nevertheless, these are appropriate steps to deal with a challenging operating environment. And we welcome these efforts to shore up balance sheets.

Need for smart liquidity risk management

Asset quality problems are putting more pressure on the funding side of the balance sheet.

Ten banks have failed so far this year, and more will fail and others will go on the "problem" list.

- Liquidity problems, in varying degrees, contributed to the collapses. Given the trajectory (and a weak economy), strong liquidity management is more important than ever.

Having enough cash, securities and other marketable assets on-hand is absolutely vital.

The same can be said for the ability to maintain stable funding from core deposits and other funding sources.

But liquidity can be an elusive thing.

Liquidity squeeze: early warning signs

Liquidity can be plentiful when times are good, but scarce when it's really needed.

That's why banks need to build liquidity reserves and establish reliable contingency lines in the good times.
Liquidity problems can often hit an institution fast and hard, which is why it's so important to have ample liquidity on hand and readily available.

Some of the early signs that can alert us to liquidity problems include:

- rapid asset growth funded by potentially volatile liabilities;
- reliance on large depositors/concentrated funding sources
- offering rates significantly above the local deposit market and through internet sites.
- negative publicity;
- a decline in asset quality or earnings performance;
- counterparties who increase collateral requirements;
- and shrinking, or outright loss of credit lines.

You should know that at FDIC, we are revisiting our off-site monitoring to better detect these problems to help on-the-ground examiners identify and resolve them promptly.

FDIC liquidity letter

We highlighted our concerns about liquidity management last week in a letter to top executives at banks that the FDIC supervises.

The guidance in the letter is not new. But it clarifies our expectations framed in today's terms.

Bankers must understand the stability and volatility of the funding sources they use.

If a bank relies on volatile, and credit-sensitive liquidity strategies and other complex strategies like securitization and secondary market sales, management should step-up liquidity risk measuring, and monitoring.

To put this in perspective, consider the banks that failed so far this year.

- Over their final year, the institutions' growth in brokered deposits was over 100 percent (going from 9 percent of assets to 20 percent). At the same time their asset growth was nominal, at about 4 percent.

Contingency planning

Banks should have comprehensive contingency funding plans, which will include pro forma cash flow statements.

Backup plans and pro forma cash flow statements should address multiple stress scenarios, factoring in the various "what-ifs" that might influence funding options.

A good contingency funding plan will:

- identify areas of stress;
- clearly spell out management responsibilities and lines of decision-making;
- detail monitoring tools, such as pro forma cash flows;
- and consider all possible constraints on funding sources and back-up credit lines.

Pro forma cash flow statements are a key part of the contingency plan. They show where funding gaps and mismatches exist between assets and liabilities.

Management should work to limit these gaps and should report on progress to their boards.

Restrictions on brokered & high-rate deposits

The FDIC letter also reminds bankers that there are certain deposit restrictions on brokered and high-cost deposits.

Many banks that relied on volatile funding may now be facing new funding challenges if their capital levels drop and they fall into one of the lower capital categories we use for "prompt and corrective action."

Why does this matter?

- Because the rules for brokered deposits and high-cost funds use these categories as a key metric for determining whether an insured bank can continue to use these funds.
- When a bank falls below "well-capitalized", the amount of this funding is restricted under these rules.

Currently, there are several dozen institutions nationwide that are borderline "well-capitalized" and whose brokered deposits as a percentage of assets exceeds 25 percent.

These are the types of trends that concern us, and that will be the subject of much closer scrutiny by our examiners.

We have the power to grant a waiver for a bank that falls to "adequately-capitalized."

- Typically, waivers are short-term and are only granted in conjunction with an overall liquidity plan that demonstrates the institution's intention to reduce its reliance on brokered funds as they mature.
- And the rules don't allow a waiver for brokered deposits when a bank falls BELOW "adequately-capitalized." At that point, that funding source is cut off, which again, could have dire consequences on a bank that is heavily relying upon these funds.
- And there's no waiver process for the rules on high-cost deposits. Rate limits are automatically put on banks that are no longer "well-capitalized"—on both brokered and non-brokered funds.
- Generally, these banks can not pay more than 75 basis points over the average of all rates in their market area.

The restrictions on high-cost deposits, in the current rate environment, can significantly limit a bank's ability to renew brokered deposits even if they DO get a waiver.

In many cases, the maximum allowable rate that can be paid on brokered deposits by "adequately capitalized" banks with a waiver is well below current market rates.
These restrictions are very significant considerations for many bankers these days.

And they're another factor that examiners will evaluate as part of banks' contingency planning, and liquidity risk management.

DIF outlook

Now, I'd like to speak briefly about the deposit insurance fund.

First, and foremost, the fund has all the resources and the tools we need to meet our commitment to insured depositors.

We're confident that our industry funded reserves will be more than adequate to cover any losses caused by more bank failures.

But the public should understand that we have multiple tools at our disposal to maintain our insurance guarantee.

DIF ratio

Recent bank failures pushed the insurance fund's reserve ratio below the 1.15 percent statutory minimum.

We had anticipated that this might occur.

In early June, I warned Congress that a significant increase in insurance losses could push the fund below the minimum.

With the reserve ratio now below 1.15 percent, we're required to develop a restoration plan to increase the reserve ratio to no less than 1.15 percent within five years.

We've been working on a plan over the past couple of months that the FDIC's board will consider in early October.

It will call for an increase in premium rates.
And we'll be proposing changes to the current system that will shift a greater share of any increase onto riskier institutions.
It seems only fair that we reward behavior that reduces our costs. And higher risk institutions can reduce their premiums by changing their risk profiles.

DIF funding sources

Despite the recent draw-down to cover losses, the insurance fund is in a strong financial position to weather a significant increase in bank failures.

- The fund currently has a balance of $45 billion. But this is not a static number
- We have a steady stream of premium income.
- (And the new premiums we'll be proposing in October will help assure that our resources and the banking system remain strong.)

Another point is that the fund is a 100 percent industry-backed.

Because we have the power to raise premiums to cover our losses, in effect, the capital of the entire banking industry is available to support the fund.

- All told, well-capitalized banks had $1.3 trillion in total capital at June 30. That's $266 billion above the threshold for well-capitalized status. This is a VERY strong foundation.

We also have a line of credit at the Treasury. This would enable us to borrow, if needed, up to $30 billion to cover additional losses. But we don't expect to have to use this line.

For short term liquidity needs, we also have a separate credit line at the Treasury.

- As the level of bank failures rises, the fund is likely to have fewer liquid assets and more illiquid assets. So to make sure we have working capital for bridge funding between the time a bank fails, and when we sell its assets, Congress gave us authority to borrow from Treasury's Federal Financing Bank.
- So if need be, we can potentially raise very large sums of working capital through the Federal Financing Bank, which would be paid back as the FDIC liquidates assets.
- Our need to draw on Treasury's Federal Financing Bank will depend primarily on the pace of bank failures and how fast we sell failed bank assets.
- (Some of you may recall that this option was used in the early 1990s for temporary working capital by the Bank Insurance Fund. These short-term borrowings were repaid with interest within two years.)

We will certainly see more banks fail.

But given the stress analyses (including high-loss scenarios) that we've been doing for over a year we're confident that our industry funded resources available to the insurance fund are more than enough to cover projected losses.

But ultimately, insured deposits are guaranteed by the full faith and credit of the United States government.

- So, above all else, depositors needn't worry. No depositor has ever lost a penny of insured deposits. And they never will.

Conclusion: still a silver lining?

When I was here last December, I said I saw a silver-lining to all the problems we've been having.

I'm an optimist by nature. And I still believe we could see a renaissance in Main Street banking in the years ahead after we get through the current mess.

- As community bankers like yourselves increase mortgage lending, and do it the old-fashion way with down payments, long-term fixed rates, documented income and the like, homeownership will once again be the surest way for building wealth and re-energizing neighborhoods.

Thank you very much.

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