Speeches & Testimony

Statement of Jason C. Cave, Deputy Director for Complex Financial Institutions Monitoring, Office of Complex Financial Institutions, Federal Deposit Insurance Corporation on the Temporary Liquidity Guarantee Program, Congressional Oversight Panel, Washington, D.C. March 4, 2011

Chairman Kaufman and members of the panel, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) concerning the Temporary Liquidity Guarantee Program (TLGP). My testimony will provide background on the inception of the program, where the program stands today and the FDIC's role in overseeing the repayment of remaining TLGP debt through 2012.

Background on the Temporary Liquidity Guarantee Program

As you recall, in 2008, conditions in the financial markets shook people's confidence in domestic and international financial systems. Credit markets did not function normally, contributing to a rising level of distress in the economy. The decline in confidence resulting from the cumulative effect of these events resulted in the U.S. and foreign governments taking action to bolster public confidence in financial institutions and the global economy.

Along with the other extraordinary measures taken by U.S. government officials in the fall of 2008, the FDIC's TLGP helped to calm market fears and encourage lending during these unprecedented disruptions in financial markets in the U.S. and abroad. The TLGP provided a guarantee, for a limited period of time, for certain newly issued senior unsecured debt issued by U.S. banks, thrifts, holding companies and certain affiliates. Additionally, the TLGP fully guaranteed certain noninterest-bearing transaction deposit accounts, which provided stability to insured banks, particularly smaller ones, enabling their commercial customers to continue to do business without disruption. By providing the ability to issue debt guaranteed by the FDIC, institutions were able to extend maturities and obtain more stable unsecured funding. This calmed what was becoming "the perfect storm" whereby creditors refused to roll their debt beyond weeks, days or even overnight and demanded more collateral at the exact time that banks needed these funds to continue to finance their operations.

The failure of the credit markets in the fall of 2008, particularly the interbank lending markets, significantly impaired the ability of even creditworthy companies to issue commercial paper, particularly at longer maturities. In the U.S., during the last two weeks of September 2008, data compiled by the Board of Governors of the Federal Reserve System (the FRB) showed that the average issuance of longer-term (i.e., maturities over 80 days) AA-rated asset-backed commercial paper fell by 82 percent, from $4.7 trillion in mid-September to $809 billion at month-end - a decline so significant it represented a virtual shut-down of the market. Even more pronounced, however, was the decline in issuance of other longer-term commercial paper, which fell by 88 percent, from $8.2 trillion in mid-September to $969 billion at month-end.

Also, at that time, market participants were showing more pronounced concern regarding counterparty credit risk. On October 10, 2008, the difference in interest rates between short-term U.S. Treasury securities and comparable Eurodollars (the TED spread) sharply increased to 464 basis points from a traditionally stable level of about 30 basis points. Unsure which financial institutions were exposed to the greatest risk and fearful about their own liquidity, market participants continued to hold on to available cash.

On October 14, 2008, the U.S. Treasury, the FRB and the FDIC jointly announced a coordinated response to the financial crisis. Following a determination of systemic risk by the Secretary of the Treasury, after consultation with the President and upon the recommendation of the Board of Directors of the FDIC and the Board of Governors of the FRB, the FDIC announced and implemented the TLGP in an effort to increase healthy financial institutions' liquidity by restoring their access to funding markets and by stabilizing bank deposits. The TLGP consists of two components: (1) the Debt Guarantee Program (DGP) - an FDIC guarantee of certain newly issued senior unsecured debt; and (2) the Transaction Account Guarantee Program (TAGP) - an FDIC guarantee in full of noninterest-bearing transaction accounts.

The Debt Guarantee Program

Under the DGP, the FDIC initially guaranteed in full, through maturity or June 30, 2012, whichever came first, the senior

unsecured debt issued by a participating entity between October 14, 2008, and June 30, 2009. Although improved, the credit markets had not yet fully stabilized by mid-year 2009. Thus, the issuance period was extended through October 31, 2009. The FDIC's guarantee on each debt instrument also was extended in 2009 to the earlier of the stated maturity date of the debt or December 31, 2012. The FDIC charged a fee based on the amount and term of the debt issued. More than half of the eligible entities opted in to the DGP at its inception. Of these, 121 institutions paid premiums for, and issued, TLGP debt.

The DGP enabled financial institutions to meet their financing needs during a period of system-wide turmoil and record high credit spreads. The AAA-rating assigned to TLGP debt, because of the explicit government guarantee, reopened the short- and medium-term debt markets for banks and other eligible institutions by allowing them to issue an array of debt instruments at a time when financial institutions were unable to roll over this debt on any terms. By year-end 2008, shortly after the inception of the TLGP, 64 financial entities - 39 insured depository institutions and 25 bank and thrift holding companies and nonbank affiliates - reported $224 billion in TLGP guaranteed debt outstanding. On January 7, 2009, less than three months after the first TLGP medium-term note was issued, the spread between a composite of three-year TLGP debt and comparable three-year U.S. Treasury securities was 88 basis points, while the spread between a composite of previously issued three-year non-guaranteed bank debt and comparable Treasury securities was 458 basis points.

By the end of the DGP issuance period (October 2009), access to funding had improved markedly. Spreads on both guaranteed and non-guaranteed debt had narrowed. Three-year TLGP guaranteed debt was trading at 31 basis points over comparable Treasury securities. Also, three-year non-guaranteed bank debt was trading at 158 basis points over comparable Treasury securities. Recently, as of February 23, 2011, three-year TLGP debt was trading at 13 basis points over comparable Treasury securities, while three-year non-government guaranteed bank debt was trading at a 112 basis points spread.

In short, the DGP and other government actions aided the successful return of the credit market to near normalcy, despite the recession and slow economic recovery. Banks and their holding companies are now successfully issuing non-guaranteed debt. For example, in January 2011, non-guaranteed debt issued by financial firms was $32.9 billion, which was comparable to pre-crisis levels. Furthermore, the TED spread dropped dramatically at the beginning of 2009, indicating a growing confidence in counterparty risk levels. Since September of 2009, the TED spread has been hovering below its long-term average and on February 23, 2011 stood at 19 basis points, in stark contrast to its peak of 464 basis points in October 2008.

This improvement in the credit markets was reflected in the increasing ability of banks and their holding companies to issue longer-term debt over the course of the DGP issuance period. At the inception of the program, firms heavily relied upon the DGP to roll over short-term liabilities given the fragility in the credit markets and investors' continued aversion to risk. As the program took hold, financial institutions began to issue debt with longer maturities and financial institutions gradually shifted to medium-term note issuance. As of October 31, 2009, 75 percent of TLGP debt outstanding had a maturity of more than two years from the date of issuance, while less than 5 percent had a maturity within one year of issuance.

At its peak, the FDIC guaranteed almost $350 billion of debt outstanding. As of December 31, 2010, the total amount of remaining FDIC-guaranteed debt outstanding was $267 billion. Of that amount, 37 percent will mature in 2011 and the remaining $167 billion will mature in 2012.

The Transaction Account Guarantee Program

Deposits provide the primary source of funding for most banks, and are particularly important for smaller institutions. The TAGP brought stability and confidence to this funding mechanism by removing the risk of loss from accounts that are commonly used to meet payroll and other business transactions purposes, allowing institutions, particularly smaller ones, to retain these accounts and maintain the ability to make loans within their communities. Through the TAGP, the FDIC initially guaranteed, in full, all domestic noninterest-bearing transaction accounts held at participating banks and thrifts through December 31, 2009. This deadline was extended twice and expired on December 31, 2010. The FDIC charged a fee for the TAGP. Last year, Congress saw the benefit of this program to small businesses and banks in weathering the economic downturn and, in the Dodd-Frank Act, replaced it with a provision mandating temporary full deposit insurance coverage for all non-interest bearing transaction accounts at all insured depository institutions. This temporary insurance will last for two additional years (until December 31, 2012).

Over 7,100 banks and thrifts, or 86 percent of FDIC-insured institutions, initially opted into the TAGP. At the peak of the program in December 2009, more than 5,800 of these FDIC-insured institutions reported having noninterest-bearing transaction accounts over $250,000 in value, representing $834 billion in TAGP-guaranteed deposits.

Fees and Costs

Through the DGP, the FDIC collected approximately $10 billion in fees and surcharges. Further, only four participating entities that had issued guaranteed debt had defaulted on their debt as of December 31, 2010. Claims filed through the

end of 2010 total $8 million. Losses through the end of the DGP guarantee period in 2012 are expected to be limited.

As of December 31, 2010, the FDIC had collected $1.1 billion in fees under the TAGP. Estimated TAGP losses as the result of insured depository institution failures as of December 31, 2010, totaled $2.35 billion.

In determining whether the TLGP has experienced a loss, the FDIC will combine fees and losses from the DGP and the TAGP. Overall, TLGP fees are expected to exceed the losses from the program. Remaining TLGP funds after payment of guarantee obligations will be added to the DIF balance.

Evaluation of the TLGP

The TLGP, in concert with other government programs, helped bring stability to U.S. financial markets in a time of crisis. Credit market conditions improved significantly at the start of 2009 and began normalizing by mid-year amid still-elevated levels of problem loans. Interest-rate spreads had retreated from the highs established during the depth of the crisis during the fall of 2008, and activity in interbank lending and corporate bond markets had increased. Banks, thrifts and their holding companies are now able to issue debt without a government guarantee; the DGP is winding down and the TAGP has expired. While not the purpose of the program, the FDIC expects a net gain in revenue for the DIF from the TLGP for assuming the risk. Overall, the TLGP was an important component of bringing stability to financial markets and the banking industry during the crisis period.

While financial firms have been issuing significant amounts of nonguaranteed unsecured debt, thus bolstering their liquidity reserves, which serve as the primary source of repayment for FDIC-guaranteed debt, the approximately $267 billion that is still subject to a TLGP guarantee is a large number that warrants continued close scrutiny. Overall, the balance sheets at our largest financial firms have improved since the crisis. Firms have deleveraged since the crisis, as measured by stronger leverage and risk-based capital ratios. Further, many of the complex structures that concealed additional leverage and exposure, such as structured investment vehicles and other off-balance-sheet conduits have been largely consigned to the history books. Cash and liquid securities represent larger percentages of the balance sheet, while reliance on short term debt has declined. These are all positive trends from the FDIC's perspective as deposit insurer and guarantor of TLGP debt.

Exit Strategy

In addition to supporting the improvements in balance sheet management, we are closely monitoring the FDIC's exposure to ensure that issuers have concrete and practical plans in place to fully repay their TLGP debt under normal and adverse scenarios. While liquidity and funding structures have improved, banking organizations are still reliant upon short-term liabilities to fund assets of varying maturities. Maintaining a stronger liquidity reserve in today's credit environment is good, but in no way serves as a substitute for proper contingency planning for tomorrow's uncertainties.

To ensure that repayment plans are reasonable and practical, the FDIC and the FRB currently are evaluating the validity of liquidity plans at the biggest users of TLGP debt, and we will challenge assumptions that seem overly optimistic. The agencies are closely reviewing liquidity reserves to ensure that ample funds will be available to meet redemptions when they come due.

Understanding that stress assumptions are just that - assumptions - we believe that firms should be actively considering balance sheet management strategies that lock in low cost long term funding today while credit conditions remain favorable, rather than waiting to issue new debt as TLGP debt matures later this year, or next. While no one knows for certain what is in store for the credit markets in late 2011 or 2012, we want firms to be more prepared for the possibility that rates could increase or credit become restricted at the very point in which significant amounts of TLGP debt comes due.

Unsecured debt

The FDIC understands that issuing unsecured debt even in a low rate environment has costs. Following passage of the Dodd-Frank Act, the FDIC adopted a rule making extensive changes to the deposit insurance assessment system. Among other things, the rule calibrated the existing reduction in assessment rates that institutions receive for issuing long-term unsecured debt to the new Dodd-Frank Act mandated assessment base calculation of assets minus equity to ensure that the assessment rate reduction will continue to lower the cost of long-term unsecured borrowing for banks and thrifts.

Dividend practices

We are also working with the FRB to review the dividend plans at the large banking organizations. We believe that the comprehensive review of dividend and capital repayment plans across large firms is entirely necessary since these payments were a large drain on cash reserves prior to the crisis, leaving institutions more vulnerable to the disruptions that followed.

This is why the dividend plan review and TLGP repayment plans are intertwined; the regulators should not approve

dividend and capital repurchases, which involve significant cash outlays by financial firms, until we are all fully confident that these firms will have the financial resources - under both normal and stressed conditions - to repay debt guaranteed by the FDIC. The FDIC and FRB are closely reviewing liquidity reserves to ensure that ample funds will be available to meet redemptions when they come due. For this reason, it is of critical importance that financial institutions continue to restructure their balance sheets and extend their debt maturities.

To "de-link" these two exercises, or to defer the review of TLGP repayments because the majority of the debt does not come due for another twelve to eighteen months, would be short-sighted and inappropriate as funding was indeed the linchpin in the recent crisis.

Simply put, plans that result in lower capital and/or liquid resources place the FDIC at greater exposure to TLGP, therefore, we will continue to be very active in these discussions to ensure that dividend and capital buybacks are reasonable in both a normal and adverse environment. We believe the FRB shares our concerns and we look forward to continuing to work with them on the dividend and TLGP repayment reviews.

This process is important to us, as any changes to the capital structure or reduction in cash has a potential impact on our TLGP position, thus, the FDIC is involved in the analysis and needs to be comfortable with the conclusions.

Conclusion

As a result of the severe disruption to the financial system that started in 2008, it was necessary that the FDIC and other government agencies take measures to stabilize the financial markets and the economy. While the TLGP clearly led to a positive outcome, it is important that financial institutions replace their reliance on government guaranteed debt with private borrowing. As such, the FDIC has embarked on a prudent exit strategy that will assure that private markets take on this role as the financial industry returns to health.

Last Updated 3/4/2011 communications@fdic.gov

Home | Contact Us | Website Policies | Search