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Bair FDIC on Bank of America acquisition of Merrill (House)

Sheila Bair

Speeches & Testimony

Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation on Bank of America Acquisition of Merrill Lynch before the Committee on Oversight and Government Reform and the Subcommittee on Domestic Policy; House of Representatives; Room 2154, Rayburn House Office Building
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Thank you Chairman Towns, Chairman Kucinich, Ranking Members Issa and Jordan, and members of the Committee. I appreciate the Committee's interest in the role of the Federal Deposit Insurance Corporation in the measures being taken to address the challenges facing the economy and the financial industry.

As you know, just over one year ago, we faced an historic liquidity crisis in global financial markets that shook the confidence of the financial systems in the United States and around the globe. Markets were under extraordinary stress and exceptional measures were taken in an effort to stabilize the economy. Included in those measures were steps taken to provide capital and liquidity to our nation's financial institutions. I believe that these measures have largely accomplished their objectives and have remedied many of the immediate problems associated with the financial crisis.

As requested by the Committee, my testimony today will focus on the FDIC's role in the decision to provide assistance to Bank of America. Let me note at the outset that Bank of America is an open institution and the FDIC is very sensitive, as I am sure the Committee is, about any discussion of the condition of open and operating insured depository institutions.

Background

The FDIC has the statutory responsibility to oversee the national deposit insurance system. As part of this responsibility, the FDIC is responsible for resolving all failures of insured financial institutions. The FDIC also serves as primary federal supervisor for approximately 5,000 state-chartered banks that are not members of the Federal Reserve System. Since the creation of the FDIC during the Great Depression, deposit insurance has played a crucial role in maintaining the stability of the banking system. By protecting deposits, the FDIC ensures the security of the most important source of funding available to insured depository institutions -- funds that can be lent to businesses and consumers to support and promote economic activity.

In the event of a bank failure, the FDIC must determine which resolution strategy will be used. The decision for each failed institution must be in keeping with the least-cost provisions in our operating statute, the Federal Deposit Insurance Act. The Act further includes provisions to authorize action by the Federal government in circumstances involving systemic risk. Specifically, it permits the FDIC to take action or provide assistance as risk by the FDIC's Board of Directors, concurrence of the Board of Governors of the Federal Reserve System and a subsequent determination of systemic risk by the Secretary of the Treasury, following consultation with the President.

Bank of America

As deposit insurer for Bank of America NA ("Bank of America") and the other insured depository institutions owned by Bank of America Corporation ("BOA") and Merrill Lynch & Co., Inc. ("Merrill Lynch"), the FDIC has a continuing stake in the financial well-being of those insured depository institutions. The FDIC is not the primary federal regulator for bank holding companies or for most of the largest banks, including Bank of America. We rely heavily on the judgment and observations of the primary federal regulator at the largest financial institutions. However, because of our role as deposit insurer, we maintain an examiner presence -- albeit limited -- at the largest banks, such as Bank of America.

In mid-September 2008, in the wake of Lehman's failure, BOA had announced that it would acquire Merrill Lynch. That acquisition was scheduled to close at the beginning of 2009. BOA's acquisition of Merrill Lynch was approved by the Federal Reserve on November 26, 2008.[1]

On or very shortly before December 21, 2008, the FDIC was told by the Federal Reserve and Treasury that BOA had expressed reservations about completing the acquisition of Merrill Lynch. The FDIC was told that some form of assistance might be necessary. Over the next three and a half weeks, examiners from the Federal Reserve, OCC, and FDIC worked to learn more about the type of assistance that might be required and the pool of assets that BOA suggested might be included in a transaction where the FDIC, Treasury and Federal Reserve would share in a guarantee against certain losses ("ring fence" transaction). Based upon the information that was made available, the FDIC continued to raise questions about whether any assistance was necessary. The FDIC made no commitment to provide assistance to BOA at that time.

On January 9, I participated in a conversation with Secretary Paulson, Chairman Bernanke, and several other regulatory staff in which BOA's financial condition was discussed. Secretary Paulson indicated that providing assistance to BOA in a form similar to what had been provided to Citigroup -- capital assistance and asset guarantees -- had been discussed, and that he hoped the FDIC would participate in providing such assistance. We continued to gather information about whether any assistance was necessary. We also asked for additional information about BOA's liquidity and about other risks if no assistance was provided, and about the risks that would be incurred if the FDIC participated in this assistance package. The FDIC also requested more detailed information on where the exposures resided -- were the exposures in the insured depository institutions and funded with insured deposits, or were these derivative exposures that were created and housed within the non-depository investment bank? This distinction -- that there would be relatively small exposures in the insured depository institutions and large in the investment bank -- was important if the FDIC was to consider any role in a possible transaction. The FDIC continued to refrain from a commitment of assistance to BOA.

Discussion, review and information gathering, as well as consideration of other options, continued for several days. It was clear that officials from the Federal Reserve and Treasury believed that systemic risk would exist absent an agreement by the government to provide assistance to BOA.

On January 14, 2009, the FDIC received from the Federal Reserve a draft

Term Sheet describing the assistance package, the principal elements of which were a capital infusion and a ring fence transaction. We were told that the Term Sheet had previously been sent to Treasury and BOA. There were further intense discussions about the terms and the risks of providing this assistance and of not providing this assistance. The final Term Sheet included provisions addressing executive compensation and common stock dividends. The FDIC's exposure was limited to $2.5 billion, to coincide with the proportion of exposures covered under the ring fence that resided within the insured depository institutions. In compensation for the guarantee, the FDIC was to receive $1 billion in BOA preferred stock with an 8 percent dividend rate and certain warrants.

The FDIC's Board ultimately was persuaded that BOA's condition presented a systemic risk, and that the ring fence transaction would mitigate that risk -- and the risk to the Deposit Insurance Fund -- in a cost effective manner. The transaction also limited the FDIC's risk to a small portion of the covered exposures, in recognition of the fact that most of the exposures resided within the investment bank and not the insured depository institution. Thus, on January 15, 2009 the FDIC's Board of Directors unanimously voted to authorize advising the Secretary of the Treasury that we recommend that he make a systemic risk determination regarding BOA. The FDIC's Board also authorized FDIC participation in the ring fence transaction, subject to the Secretary making a systemic risk determination.

Prior to the FDIC Board's vote on January 15, we were advised that the Board of Governors of the Federal Reserve System had voted to make a systemic risk recommendation to the Secretary, and we were advised that the Secretary expected to make a systemic risk determination after receipt of the recommendations from the FDIC and Federal Reserve, and after consultation with the President.

On January 16, 2009, the planned capital infusion and ring fence transaction were announced. On the same day Treasury purchased $20 billion of BOA preferred stock.

Work to precisely define the exposures to be included in the ring fence transaction -- and to assure ourselves that the value of the BOA preferred stock the FDIC and Treasury were to receive as compensation for our participation in the ring fence transaction at least equaled the economic value of the risk we were to assume -- had been started before January 16, and it continued well into the spring. However, in early May 2009 BOA asked that the ring fence transaction not be completed. In late summer, an agreement was reached to terminate efforts to complete the ring fence transaction. BOA agreed to pay $425 million as a termination fee of which $92 million was paid to the FDIC.

Moving Forward

In the aftermath, the FDIC has worked continuously with Congress, the Treasury and the financial regulators to make sure we have a more resilient, transparent, and better regulated financial system -- one that combines stronger and more effective regulation with market discipline. We commend the House of Representatives -- and the Financial Services Committee -- in moving towards providing the regulators with the tools to effectively deal with any future crises.

I would be pleased to answer any questions from the Committee.

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[1] Merrill Lynch was an investment bank, regulated by the Securities and Exchange Commission, which had two insured depository institutions: a

thrift which was regulated by the Office of Thrift Supervision and an Industrial Loan Company for which the FDIC was the primary federal regulator.

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