Acting Deputy Director, John Corston Testimony to the FCIC - Systemically Important and TBTF

John Corston
STATEMENT OF

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on

SYSTEMICALLY IMPORTANT INSTITUTIONS
AND THE ISSUE OF "TOO BIG TO FAIL"

before the

FINANCIAL CRISIS INQUIRY COMMISSION

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Room 538, Dirksen Senate Office Building
Chairman Angelides, Vice Chairman Thomas, and Commissioners, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) to address the FDIC’s supervision of systemically important financial institutions during the recent financial crisis and the importance of effectively managing systemic risks going forward.

Specifically, my testimony will discuss the challenges faced by the FDIC and other federal regulators in resolving large and complex financial institutions in the supervisory and regulatory environment that existed prior to the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act). As requested by the Commission, I will discuss the chain of events and factors that led to the collapse and sale of Wachovia and contrast this event with the failure of another large institution, Washington Mutual Bank (WaMu). Next, my testimony outlines actions taken over the past few years to improve the FDIC’s ability to provide backup supervision and to resolve large complex financial institutions. These measures culminated in several important provisions included in the Dodd-Frank Act.

**FDIC Supervision of Large and Complex Institutions**

Prior to the financial crisis, the FDIC’s on-site presence and access to information at systemically important institutions were limited. The FDIC maintained a modest on-site presence at the eight largest insured depository institutions (IDI) under its Dedicated Examiner (DE) program pursuant to the terms and conditions established by a 2002
Interagency Agreement titled “Coordination of Expanded Supervisory Sharing and Special Examinations.” Specifically, the agreement permitted only a single FDIC senior examiner to be on-site full-time with the primary federal regulator’s (PFR) examination team at each of these institutions. Further, while the agreement provided that the staff of the PFR were “expected to keep the [DE] informed of all material developments,” on-site examinations were restricted since the interagency agreement provided for the PFR to “invite the [DE] to observe and participate in certain examination activities.” In cases where disagreements occurred between the PFR and DE, the issue would need to be elevated to the FDIC Chairman for resolution.

As recently reported by the FDIC and Treasury Department Inspector Generals and discussed at the Senate Permanent Subcommittee on Investigations hearing in April 2010, the terms of the 2002 Interagency Agreement were too restrictive on the FDIC’s ability to adequately exercise its backup examination authorities. Accordingly, a new Memorandum of Understanding between the regulatory agencies was developed and recently signed to address weaknesses in the 2002 agreement.

In addition to its on-site DE program, the FDIC carries out its supervisory responsibilities by performing off-site risk analyses of large banks under its Large Insured Depository Institution (LIDI) program. This program is designed to provide comprehensive and forward-looking assessments of the risk profiles of IDIs over $10 billion in assets. In addition, this program provides on-site support through technical experts, operates a continuous presence at the eight insured institutions that represent the
highest level of risk and complexity, and assists in developing and recommending strategies on specific institutions. Further, and most important, we consider the potential loss severity that the failure of these institutions could represent to the Deposit Insurance Fund. To quantify the level and direction of risk, each institution covered by the LIDI program is assigned a rating (A through E, with A being the best) and an outlook (positive, stable, or negative). Ratings and outlooks are assigned at least quarterly, with interim changes made when necessary. All relevant sources of information available are used in performing LIDI analysis, including both public information and confidential bank supervisory information. Supervisory information or internal bank reports are obtained from or through the PFR for all non-FDIC supervised institutions.

The FDIC’s ability to reduce the impact of the failure of a large IDI is governed by statutory provisions enacted by the FDIC Improvement Act of 1991, also known as FDICIA. This law requires the FDIC to choose the “least costly” resolution method and defines the method that minimizes expenditures from the Deposit Insurance Fund. The least-cost test involves the FDIC performing a cost analysis of possible resolution alternatives, based on the best available information at the time, when deciding how to resolve a failed insured depository institution. The FDIC has developed the capabilities to do this, but accurate and timely information is critical to perform such an analysis effectively. Further, the FDIC’s ability to perform an analysis in an effective manner can be significantly affected by the complexity of the institution and the short time period of notice prior to the failure – elements that are likely present in the case of a very large bank.
Under FDICIA, there is an exemption to the least-cost requirement for certain extraordinary circumstances under the “systemic risk exception.” Generally, this exception applies if both the FDIC Board and the Federal Reserve Board (FRB), by a vote of at least two-thirds of their members, and the Secretary of the Treasury, in consultation with the President, determine that compliance with the least-cost requirement “would have serious adverse effects on economic conditions or financial stability” and action or assistance other than the least-costly method would “avoid or mitigate such adverse effects.” As such, we developed a process for interagency coordination and collaboration, including protocols for communication and the criteria the responsible agencies use to make a systemic risk determination.

In addition, the FDIC has had a long-standing National Risk Committee that provides a venue where analysts from the Division of Supervision, Division of Insurance and Research, and Division of Resolutions and Receiverships identify and analyze emerging risks to the economy, the banking industry and the Deposit Insurance Fund. This Committee is composed of the most senior managers of the FDIC who are in a position to direct resources to respond to the emerging risks.

The FDIC also prepares for potential large bank failures by regularly reviewing and directing the agency’s readiness planning. Supervisory/examiner personnel are also trained in failure resolution to ensure proper coordination with our own resolution personnel and with other federal agencies and international organizations in the event of a cross border financial crisis. In addition, the FDIC identifies operational readiness needs
in certain areas that require special attention. These areas include claims determination, complications that could arise due to the blurring of business lines between separate legal entities and third parties, and capital markets activities conducted within the corporate and subsidiary structure of a failing insured depository institution.

Under situations where a large complex U.S. bank encounters difficulties, consideration of the systemic risk exception would need to take into account a number of significant operational factors. Without proper planning, the operational aspects of the resolution itself could exacerbate potential “serious adverse effects” that could then trigger the systemic risk provision. These roles and responsibilities are now assigned to the FDIC’s newly established Office of Complex Financial Institutions which will be discussed later.

To advance its preparedness, the FDIC has also run simulation exercises to test its readiness to deal with a large complex bank failure. The objective of these exercises was to simulate and stress our decision-making processes, develop strategies and plans for managing a large bank failure, and identify any gaps in FDIC processes, procedures and skill sets and possible mitigation strategies.

In 2007 and 2008, a series of strategic and tactical simulation exercises was conducted to enhance the FDIC’s readiness to address the financial crisis. Various simulations focused on specific aspects of a hypothetical failure, such as resolution determinations concerning qualified financial contracts. Our simulation exercises
identified significant information gaps due to limitations under existing law. A key finding was the lack of certain information that affected our ability to obtain a complete understanding of the impact of a holding company and affiliates on the insured depository institution and the interconnectedness of the firm with other financial institutions globally. As discussed later, the FDIC took action toward addressing these issues.

In addition to the simulations, to address the cross-border and international challenges presented by large institution resolutions, the FDIC has been moving forward to develop international protocols with foreign bank regulatory agencies to address operational issues as well as potential market consequences of a large complex bank failure.

**Wachovia**

In the case of Wachovia, the FDIC had increasing concerns with the institution during early 2008. On March 27th, the FDIC downgraded our assigned LIDI rating/outlook for Wachovia to “C Negative,” which is indicative of an institution we consider to have an elevated risk profile that is likely to migrate to a “3” CAMELS\(^1\) composite rating within the following 12 months. Our LIDI analysis at that time stated that Wachovia posed “increased risk as a result of weaknesses in risk management, asset

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\(^1\) CAMELS is a supervisory risk rating system used by all bank regulatory agencies. CAMELS includes individual component ratings for capital, asset quality, management, earnings, liquidity, and sensitivity in addition to an overall composite rating.
write-downs associated with continuing market disruption, and rapid credit quality
deterioration in certain portfolios, primarily the pay-option ARM [adjustable rate
mortgage] portfolio.” FDIC staff discussed these concerns with the on-site staff of the
primary federal regulator – the Office of Comptroller of the Currency (OCC) – assigned
to the institution. The OCC staff was in general agreement that if such trends continued,
the institution’s CAMELS rating would need to be downgraded within the following 12
months. In fact, the OCC subsequently downgraded the institution’s CAMELS rating to
a composite “3” rating in August 2008.

The main factors contributing to our concerns about Wachovia in early 2008 were
the mark-to-market valuation adjustments that were largely concentrated in the firm’s
structured finance business and increasing required provisions for loan and lease losses.
The market disruption, which began in the second half of 2007, resulted in Wachovia’s
structured finance business holding a considerable volume of inventory that could not be
readily sold. This inventory included subprime mortgages, syndicated credits within
collateralized loan obligations, and a large volume of commercial real estate credits
which were acquired or originated for inclusion in commercial mortgage-backed
securitizations.

In addition to becoming illiquid during this period, these assets also experienced
increasing credit quality problems, resulting in large mark-to-market valuation
adjustments reflecting increased credit risk and higher liquidity premiums. Higher
provision expenses were being driven by rapid deterioration in the pay-option ARM
portfolio that Wachovia acquired in its purchase of Golden West Financial Corporation, losses in large leveraged corporate loans, and rising concerns with commercial real estate credit exposures. Wachovia also took large impairments in the first half of 2008 on the goodwill asset created by the Golden West acquisition.

In early September 2008, the FDIC became increasingly concerned with the liquidity condition of Wachovia. During the week of September 15th, following the Lehman bankruptcy, Wachovia experienced significant deposit outflows totaling approximately $8.3 billion, representing a mix of deposit types, but primarily large commercial accounts. On September 23rd, senior executives and staff of the FDIC met to discuss our elevated concerns with the institution, specifically noting liquidity concerns including considerable contingent funding risk and increasingly negative market views on the firm. The institution’s marginal and weakening financial condition made it vulnerable to this negative market perception.

Liquidity pressures on Wachovia increased the evening of September 25th when two regular Wachovia counterparties declined to lend to the firm. Since the institution was a net seller of Federal Funds this signal was not viewed by the OCC as a catastrophic development. As discussed in the next section, the failure of WaMu was announced late in the evening on September 25th. As of the morning of Friday, September 26, the OCC indicated to the FDIC that Wachovia’s liquidity position remained manageable. During the day, however, market acceptance of Wachovia’s liabilities ceased as the company’s

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2 Although Wachovia was a net seller of funds, the institution was prudently testing its overnight borrowing capacity with counterparties on a regular basis. While most counterparties they contacted on the 25th did in fact advance overnight unsecured funds, two parties declined.
stock plunged, credit default swap spreads widened sharply, and many counterparties advised that they would require collateralization on any transactions with the bank.

Wachovia’s situation worsened as deposit outflows on Friday accelerated to approximately $5.7 billion, $1.1 billion in asset-back commercial paper and tri-party repurchase agreements could not be rolled over, and $3.2 billion in contingent funding was required on Variable Rate Demand Notes. By the end of the day, Wachovia management informed bank regulators that with the lack of market acceptance of Wachovia’s liabilities, the institution faced a near-term liquidity crisis. This set in motion a highly-accelerated effort to find an acquirer for the institution that would provide for protection of depositors and minimization of damage to the wider financial system.

The FDIC’s ability to develop resolution options for Wachovia was significantly limited by the short time frame for soliciting acquirer bids and by the size and complexity of the institution. In addition, Wachovia represented a large counterparty exposure to many other large financial firms and provided back-up liquidity support to many other traded instruments. Because default on these obligations would have contributed further to overall market instability, Wachovia was found by the FDIC Board, the FRB and the Treasury to pose a systemic risk to the financial industry and the economy.

On the morning of September 26th, before U.S. financial markets opened for the day, the FDIC Board approved both the systemic risk exception and the acquisition of
Wachovia by Citigroup. This proposed acquisition included government assistance in the form of an asset guaranty on a portion of Wachovia’s assets in exchange for $12 billion in Citigroup preferred stock and warrants. The terms of the asset guaranty called for Citigroup to absorb the first $42 billion in losses on a $312 billion segment of Wachovia’s assets with the FDIC covering any additional losses above that amount. While aggregate losses on these assets were projected by FDIC staff to range from $35 billion to $52 billion, these losses would not exceed the first loss position and compensation for the guaranty. As a result, there was no expected loss to the FDIC associated with the transaction. However, these loss projections were subject to some uncertainty due to the compressed time frames for the performance of this analysis.

The transaction also protected Wachovia debt holders and counterparties from loss in the interest of mitigating adverse systemic effects on financial markets and other financial institutions. Due to severe time constraints and limited available information, the FDIC felt at the time that a rapid failure of Wachovia could have resulted in losses for certain debt holders and counterparties, intensified liquidity pressures on other U.S. banks, and significant adverse effects on economic conditions and the financial markets globally.

In the end, the Citigroup transaction was superseded by an unassisted bid by Wells Fargo to acquire Wachovia that was announced on Friday, October 3rd. The deal provided Wachovia shareholders with some $15.1 billion in Wells Fargo stock, thereby improving their outcome compared to the terms of the deal with Citigroup.
WaMu Compared to Wachovia

The contrast between WaMu and Wachovia – two large, FDIC-insured depository institutions that collapsed during the same week in late September 2008 – illustrates how the complexities of resolving large institutions could, under the rules in place in 2008, result in disparate treatment for investors and counterparties in different institutions. Having the ability to analyze the financial condition of stressed institutions is critical in developing resolution strategies. In the case of WaMu, the FDIC had adequate time to develop strategies and understand the risks associated with those strategies. In the case of Wachovia, the FDIC wasn’t informed until the weekend of its collapse and as a result, had very limited information that could be used to understand the market implications – especially in a market that was extremely unstable – or to develop a resolution strategy.

Even with assets of over $300 billion, WaMu was vastly simpler in its structure compared with other similarly sized depository institutions. Its main institutional focus was on mortgage lending. While WaMu had derivatives contracts, they were used for hedging and not as part of a market-making operation. In addition, WaMu held no foreign deposits and there were no major holding company subsidiaries involved in significant financial services such as a broker-dealer that might result in large losses if forced into bankruptcy as a result of the failure of the thrift.

With the benefit of a large cushion of uninsured, unsecured liabilities exposed to loss in the failure, the Deposit Insurance Fund did not incur any loss due to the failure of WaMu. Instead, unsecured, non-depositor creditors incurred all of the losses, in
accordance with the statutorily prescribed priority for the payment of claims. The
transaction demonstrated that in the case of an institution with a relatively simple
organizational and legal structure, which is not highly connected to counterparties that
would expose them to catastrophic loss, the FDIC’s receivership authority and
operational capacity in place as of 2008 was sufficient to resolve a $300 billion institution
with 2,300 branches without resorting to a bailout and without creating further disruption
to the financial system.

As mentioned earlier, the FDIC had time to plan and implement an orderly
resolution of WaMu in advance of its closing. WaMu had been marketing itself early in
2008, and a number of institutions had conducted extensive due diligence of the
institution. Although the FDIC had only a short amount of time to market the institution,
we were able to solicit bids from a number of potential acquirers because of the
information they had already acquired directly from WaMu. When circumstances forced
the closure of WaMu on the evening of September 25th, one day earlier than originally
planned, the FDIC was still able to complete the orderly transfer of its more than 2,300
branches to JPMorgan Chase by the next day.

In the case of Wachovia, its rapid collapse was driven by market concerns
resulting in a liquidity crisis, not as a result of its capital levels triggering “prompt
corrective action” (PCA) capital levels at any point. As discussed, the lack of
information and the short timeframe for developing a resolution strategy, understanding
the economic consequences and soliciting acquirer bids were major factors that sharply
limited the FDIC’s options in this case. Given the prevailing market conditions, Wachovia’s size, structure, counterparty relationships and activities rendered it very difficult to resolve under the FDIC’s statutory least-cost mandate without the risk of creating systemic effects. Also, Wachovia’s debt provided back-up liquidity support to many other traded instruments and we believed a default on Wachovia’s counterparty obligations could have contributed further to overall market instability.

**Measures Taken to Aid in the Supervision of Large and Complex Institutions**

In response to the challenges posed by large and complex institutions during the financial crisis and aided by new regulatory tools made available by the recently-enacted Dodd-Frank Act, the FDIC has taken steps to improve its supervisory and potential resolution responses for systemically important institutions. As mentioned earlier, the regulatory agencies have reached a new agreement regarding the FDIC’s on-site activities and access to information at such institutions and we have implemented new rules to improve our resolution ability.

On July 9, 2010 the FDIC Board of Directors approved the execution of a revised Interagency Memorandum of Understanding (MOU) that defines the arrangements under which the FDIC will coordinate the exercise of its special examination authority with the primary federal regulators. The MOU addresses the implementation of Section 10(b)(3) of the Federal Deposit Insurance Act which provides that examiners appointed by the Board of Directors of the Corporation “shall have power, on behalf of the Corporation, to
make any special examination of any insured depository institution whenever the Board of Directors determines a special examination of any such depository institution is necessary to determine the condition of such depository institution for insurance purposes.” Further, the MOU addresses recommendations made by the FDIC and Treasury Inspectors General in their evaluation report of WaMu, dated April 16, 2010.

In addition, the MOU covers four groups of insured depository institutions that pose material risks to the Deposit Insurance Fund, explicitly provides that the FDIC’s authority to conduct special examinations is not limited, and acknowledges that the FDIC Board of Directors has authority to direct special examinations in uncovered institutions should circumstances warrant. Specifically, special examinations may be made by the FDIC with respect to the largest and most complex institutions, insured depository institutions with composite CAMELS ratings of “3,” “4” or “5,” institutions that are undercapitalized under PCA standards, and institutions defined by the MOU that present a heightened risk to the Deposit Insurance Fund. Finally, the MOU also confirmed an expanded FDIC presence of up to five full time on-site staff at U.S. holding companies that have total assets of $750 billion or more, and three on-site staff at other large institutions, generally those with assets of greater than $100 billion. Additional staff may be added depending upon circumstances.

On August 10, 2010, the FDIC Board of Directors approved the creation of a new Office of Complex Financial Institutions (CFI) to help carry out the new authorities under the Dodd-Frank Act, and to provide a focus to the FDIC’s engagement with the insurance
and resolution risks presented by large and complex financial institutions. This new Office will perform continuous monitoring of insured depository institutions and bank holding companies with more than $100 billion in assets, as well as non-bank financial companies designated as systemically important by the new Financial Stability Oversight Council to be established under the Dodd-Frank Act. This monitoring also will support the FDIC’s duties arising out of its membership on the Council, its responsibilities for implementing the framework for orderly liquidations of failing, systemically important bank holding companies and non-bank financial companies under the Dodd-Frank Act; and its orderly liquidation responsibilities in the event of the failure of such a company.

The FDIC has also implemented a rule to modernize the claims process that requires large banks to have the ability, in the event of failure, to do several things. Specifically, they must be able to place holds on a fraction of large deposit accounts, produce depositor data for the FDIC in a standard format, and automatically debit uninsured deposit accounts so that they will share losses with the FDIC. The rule formally establishes practices for determining deposit and other liability account balances at a failed insured depository institution. The rule also served to clarify the treatment of funds swept from a deposit account into a non-deposit investment vehicle, such as a money market mutual fund, repurchase agreement, or Eurodollar deposit. To complement the industry’s efforts, we have been extensively modernizing our computer systems and expanding our ability to categorize large numbers of claims in a very short time – one to two days.
Also, in December 2008, the FDIC issued a final rule on qualified financial contracts (QFCs), which include derivatives and some other financial contracts. When a bank fails, the FDIC has only one business day to decide how to treat the bank’s QFCs. In addition, we must decide whether to accept or repudiate all positions held with an individual counterparty – a major challenge when a bank has a large volume of QFCs and banks records are not kept in a way that provides the information we need quickly. The rule specifies the information that troubled banks have to maintain on QFCs and how it would be provided to the FDIC.

The Dodd-Frank Act places additional responsibilities on systemically important firms for managing the risks that they pose to the financial system and provides regulators with the authority to verify the effectiveness of the firms’ risk management plans. The Dodd-Frank Act also provides the FDIC with broad authority to use receivership powers, similar to those used for insured banks, to close and liquidate systemically important firms in an orderly manner.

In closing, I believe that improved supervisory tools, an expanded on-site presence, better access to information, and broader resolution powers will allow the FDIC to more effectively perform its role in managing systemic risk going forward.

I would be please to answer any questions from the Commission.