US Daily Financial Market Comment

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FOR THOSE PERMISSIONED:

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Q&A on the FDIC, Deposit Insurance, and the Federal Budget

- So far this year, federal regulators have closed seven institutions with combined assets of $37.9 billion, reducing the balance of the deposit insurance fund by at least $5 billion, or about 10% of the fund). This has raised interest in what existing capacity of the FDIC has to deal with these issues, and what additional actions might be necessary if a large institution were to fail.
- In short, the FDIC has significant authority to deal with large failures, by virtue of (1) a deposit insurance fund, (2) its ability to borrow from the Treasury, and (3) the ability to raise assessments on banks in the future to repay losses it incurs in the near term. That said, the impact of federal financial intervention on the federal budget is beginning to add up. As of yesterday, official estimates imply at least $17 billion in additional FDIC losses, in addition to costs associated with assistance for Fannie and Freddie.

The Federal Deposit Insurance Corporation (FDIC) insures deposits totaling $4.4 trillion. So far this year, federal bank regulators have closed seven banks with combined assets of $37.9 billion, which is likely to reduce the balance of the deposit insurance fund by at least $5 billion. This has raised interest in what the existing capacity of the FDIC is to deal with additional failures, what additional actions might be necessary if a large institution were to fail, and what assistance the federal government could provide in such an event.

Q: What capacity does the FDIC have now?
A: As of the end of the first quarter, the FDIC held $53 billion in its deposit insurance fund (DIF). Since that estimate, regulators have closed banks with combined assets of nearly $38 billion. IndyMac, by far the largest of these failures, held $32 billion in assets and $19 billion in deposits and will result in claims of $4 billion to $8 billion against the fund, with much smaller losses likely related to several other failed institutions.

With at least $44 billion in capacity remaining after these failures, the DIF balance will stand at roughly 1% of the current level of insured deposits. Assuming additional losses, this ratio is likely to drop further, and in any case will be well below the 1.15% minimum threshold the DIF is required by law to hold.

Q: How many additional claims on the fund are expected?
A: At least $17 billion over the next two years seems likely, but the risk seems tilted to the upside. The FDIC has not estimated the amount of claims it expects on the deposit insurance fund. At the end of the first quarter, the agency showed 90 problem banks with total assets of $26 billion. By comparison, in 1990 the list included 1500 problem banks with $647 billion in assets.

However, the White House Office of Management and Budget (OMB) revised its estimate of FDIC's impact on the budget in the Mid-Session Review (MSR) it released on July 28. For the fiscal year beginning on October 1, 2008, OMB expects deposit insurance losses to cost $12 billion more than it expected in its February estimate and $5 billion more for the following year. However, the FDIC is projected most of this cost over several years starting in 2011. Nevertheless, if the OMB estimate is accurate, the FDIC will incur a larger loss in 2009 than at any year since 1992.

Q: How will the FDIC offset these losses?

A: The most likely route is an increase in assessments on deposits paid by banks. The DIF will collect an estimated $2.7 billion in assessment revenue from insured deposits in 2008, and $4 billion in 2009. In addition, the fund earns $2 billion per year in interest from the Treasury. This is essentially an intragovernmental transfer, rather than cash income, but does count toward the FDIC's overall capacity to pay claims.

In 2006, Congress enacted the Federal Deposit Insurance Reform Act, which granted the FDIC flexibility in establishing the reserve ratio for the fund (the previous law required a target of 1.25%). While the target is now a range of 1.15% to 1.5%, the FDIC must nevertheless adopt a capital restoration plan to replenish the fund once the ratio drops below 1.15% (or is expected to within six months) with the goal of restoring the ratio to at least the minimum 1.15% ratio within five years. The reform act also granted banks $4.7 billion in credits against assessments, to recognize past contributions to the fund. Most banks are likely to exhaust these credits by 2009, so revenue to the fund is likely to increase somewhat even under the status quo. In addition, the FDIC will review an increase in assessments for 2009 in September. Assessments currently stand at 5bps to 7bps of deposits for banks representing 98% of deposits. A small number of higher risk banks pay between 10bps and 43bps.

Q: Does the FDIC have existing ability to deal with a large bank failure?

A: IndyMac was the second largest bank failure in U.S. history, at $32 billion in assets. The resolution costs, as noted above, are expected to be between $4 billion and $8 billion, or roughly 20% of assets and 30% of deposits. Although there are few recent failures to examine—there were only three limited bank failures in 2007, and none before that since 2004—the experience of the 1980s and 1990s shows that insurance fund has typically incurred costs around 20% of assets, but this has varied widely depending on the individual circumstances of the failed institutions.

This implies that the $45 billion or more that the insurance fund will hold after the resolution of IndyMac and other recent failures will be sufficient to deal with additional failures totaling several times the size of those so far this year. However, to go beyond that the FDIC would need to exercise additional authority it gained in the early 1990s to deal with a particularly large failure, if it becomes necessary.

Q. Could additional legislative authority be needed, as it was for the GSEs?

A: In the event that the FDIC must cope with a larger bank failure beyond the capacity of the DIF, it has additional sources of funds it can tap before special legislation would be needed:

- The FDIC is authorized under current law to borrow up to $30 billion from the Treasury. Until 1991, the FDIC has only $5 billion, but Congress raised the limit when insurance funds were expected to be depleted by 1992. So while the Treasury needed a legislative change to be included in the recently passed housing bill to increase the credit line to the GSEs, the FDIC faced similar problems in the early 1990s and thus already has expanded borrowing authority.

- The FDIC may also borrow from the Federal Financing Bank (FFB). There is no dollar cap on the amount that can be borrowed from the FFB, but the borrowing is limited to 90% of the assets of the failed bank. In the early 1990s, FFB funding was used as working capital to fund the resolution of failed banks after the insurance fund had been drawn down. The FDIC repaid this debt over several years with revenues from bank insurance assessments.

- The housing legislation that just cleared Congress and is expected to be signed into law shortly also includes relevant new authority for chartering bridge banks, which the FDIC uses to temporarily address large bank failure until a permanent resolution can be worked out (often an acquisition). First, the bill removes the current requirement that if any deposits are assumed by a bridge bank, all deposits must be assumed. Second, the bill authorizes an undercapitalized bridge bank to borrow from the Federal Reserve, despite current restrictions on Fed lending to undercapitalized institutions. While these are fairly technical changes, both seem intended to provide FDIC with additional flexibility in handing a large failure.

In the event that these existing powers are not enough to deal with a large failure, it is very likely that Congress would authorize additional borrowing or another funding mechanism to ensure continued payment of insured deposit claims.

Q. This is starting to sound expensive…

As noted above, the OMB has estimated that the insurance fund could face $17 billion in additional losses over the next two years, in addition to at least $4 billion estimated for 2008. The Congressional Budget Office (CBO), which will revise its budget projections in August, is likely to increase its estimate as well. While the OMB does not assume any cost from the recently passed legislation providing the Treasury with authority to assist Fannie Mae and Freddie Mac, the CBO estimates it will cost the federal government $25 billion, with $20 billion of this cost coming in 2009. Given that the estimate assumes a greater than 50% chance that the authority is never used, this implies that if the Treasury does indeed provide assistance to the GSEs, the cost will be $50 billion or more. Thus, the combination of GSE and FDIC related losses could lead to a hit to the budget of $71 billion, most of which could come in fiscal 2009.

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Goldman Sachs Financial Conditions Index[SM]*(October 20, 2003=100)

*Revised as described in our April 8, 2005, *US Economics Analyst*.

Tuesday 07/29 (prel.)	Monday 07/28	Friday 07/25	Wk ending Wed 07/23	3 mos. earlier	6 mos. earlier
99.00	99.09	99.04	99.00	98.21	98.80

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