

Podcast Script
Episode #5: Supervision

Moderator Introduction	Diane: Hello again. My name is Diane Ellis. Welcome to Episode 5 of the FDIC’s podcast of <i>Crisis and Response: An FDIC History, 2008-2013</i>. [pause]
What This Episode Will Cover	Diane: To this point in our series, we have described the pre-crisis buildup of risk associated with subprime and alternative mortgage products. We described the fear and illiquidity that took hold of the financial system when the housing bubble burst—the failure or government rescue of some of the largest financial institutions in the United States—and the extraordinary steps the FDIC took to address a potentially catastrophic situation. It is important to remember that the collapse in housing prices and the severe recession that followed had effects beyond Wall Street. Nearly 500 banks failed across the U.S., and many hundreds more experienced severe financial distress. In the remainder of this series, we will discuss this broader banking crisis from the perspective of the three primary FDIC business lines that were called on to address it: these are supervision, deposit insurance and resolution of failed banks. First up will be supervision. We will focus on how FDIC supervisors responded to the crisis and the lessons they learned.

Introducing Fred and Doreen	Diane: Joining me today are two of the FDIC’s most senior officials, who played significant roles in identifying and addressing the crisis a decade ago. Fred Carns is Principal Advisor in the FDIC’s Division of Insurance and Research. Welcome Fred. Fred: - Thank you Diane. Diane: And Doreen Eberley is Director of the FDIC’s Division of Risk Management Supervision—or RMS. During the crisis, Doreen was Regional Director of the FDIC’s New York and, subsequently, Atlanta Regions. She became the RMS Division Director in 2013. Welcome Doreen. Doreen: - Thank you Diane.
What is bank supervision?	Diane: So before we jump into our topic, for the benefit of our listeners Doreen, can you explain what bank supervision is? Doreen: Sure. Bank supervision is a broad term that refers to the ways we interact with banks to ensure a safe-and-sound financial

	system. The core of the program is our risk management examination function. Through examinations, we assess institutions' operating conditions, management practices and policies, and compliance with applicable laws and regulations. In addition to examinations, we provide banks various documents that describe the rules of the road. We review applications, for example if someone wants to insure a new bank or merge two existing banks. And, if necessary, we take enforcement actions directing banks to correct problems. We also work closely with the part of the FDIC that handles bank failures.
Central Question: Why did so many small banks fail?	Fred: I think it's fair to say those activities gave supervisors a front row seat for the crisis. So why did almost 500 banks fail from 2008 through 2013? How important were the alternative mortgage products that brought down the Wall Street firms? Doreen: They definitely played a role in some failures, especially at thrift institutions. For example, alternative mortgage products played a central role in the most expensive failure, which was IndyMac July of 2008, and again in the largest failure, which was Washington Mutual in September of 2008. But most community banks, including most that failed, weren't involved with these products. Most banks that failed did so because they didn't do a good job of managing the risk in commercial real estate lending, and especially acquisition, development and construction lending—which we call ADC lending for short. Fred: Of course a lot of banks did real estate lending and still do. What differentiated the banks that failed from those that survived? Doreen:

	First, I would say that many banks have strong expertise in real estate lending and most of them don't fail. The banks that failed were less effective at managing the risks in their portfolios and they were not able to navigate the severe downturn in real estate. The banks that did <u>not</u> fail, including many banks with significant concentrations in commercial real estate and construction lending, tended to be more prudent with growth plans and loan underwriting. They were more likely to have boards of directors that were actively engaged in managing and mitigating risks. They also tended to be more receptive to examiner recommendations made through the examination function. Fred: So for the 500 failures, it was more or less the opposite? Doreen: Exactly, there were certain patterns we saw repeatedly with the failed banks. • First, failed banks had high levels of commercial real estate or construction lending relative to their capital; • Second, they grew rapidly without good controls – they had weak loan underwriting, made loans outside of the bank's normal market area, and were usually led by a dominant bank official with limited board oversight; and • Third, they funded their growth with large amounts of brokered deposits or other wholesale funding sources. Diane:
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	So wholesale funding, could you explain that term? Doreen: Sure – the term “Wholesale funds” generally refer to funding sources other than small relationship deposits. So the term includes items such as brokered deposits, internet deposits and Federal Home Loan Bank advances. Banks can raise large amounts of these wholesale funds quickly, so the funds may be attractive to banks that are planning rapid growth. One of the downsides is that if the bank’s financial condition deteriorates - wholesale funds may become unavailable, or only available at a much higher cost. Deposits provided by a broker for a fee are a type of wholesale funds we often saw in failed banks. Diane: Thanks. You’ve given us some metrics that may signal a heightened risk profile at a bank. Were there other common factors in the failures? Doreen: Yes, two come to mind. First, banks that operated with lower capital during the pre-crisis period were more likely to fail during the crisis. And second, banks chartered in 2000 or after failed at much higher rates than those chartered before 2000. It makes intuitive sense that newer banks would tend to be more vulnerable while they build their book of business. And we also saw this during
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	the 1980s banking crisis. While we're on the topic of metrics, I want to emphasize that various financial ratios we can observe from banks' financial reports do not paint a complete picture. How well the bank manages its risk and the quality of its governance are the most important drivers of its success – and these can only be evaluated adequately in an onsite examination.
Resource challenges for the FDIC bank examination function	Diane: OK, so we've heard about the risks associated with high concentration levels, rapid growth, excessive reliance on wholesale funds, and operating with thin capital cushions. You've heard about vulnerabilities during a bank's early years, and the importance of onsite examinations. Now let's turn to some of the operational challenges the FDIC's examination program had to address. Doreen, I guess it's fair to say that it wasn't business as usual in the FDIC's supervision area during the crisis years? Doreen: No, definitely not. At the end of 2006, out of almost 8,700 insured banks, only 50 were problem banks, meaning they were rated 4 or 5 on a 5 point scale with 1 being the best. There were no bank failures at all from mid-2004 through early 2007. So we were seemingly in the best of times. Then the condition of the banking industry then deteriorated very rapidly after the bankruptcy filing of Lehman Brothers in September 2008. By year-end 2010, there were almost 900 problem banks, and 325 banks had failed. The FDIC entered into more than 500 formal safety and soundness enforcement actions in 2010 alone. A significant challenge was simply getting examiners into the

	banks in a timely manner. This was important in order to get corrective programs in place where they were needed and to make sure we had an accurate picture of the health of the industry. But we weren't staffed for a crisis of that speed and magnitude – so we took a number of extraordinary actions to bolster staff resources including hiring temporary loan review specialists and bringing back retired FDIC employees.
Typical supervisory issues encountered at individual banks Formal and informal enforcement actions	Fred: When FDIC examiners would go into a bank and find real problems, what would happen? Doreen: A typical problem situation involved a bank with a large amount of distressed commercial real estate or construction loans relative to its capital. In these situations there often would be liquidity issues such as possible withdrawals by large depositors, the need for collateral to secure borrowings, or potential loss of access to brokered deposits because of the bank's condition. Problem banks would normally be subject to a formal enforcement action, which is a public and legally enforceable directive to the bank to do things like improve its capital ratios, resolve problem loans, and curtail dividends or limit growth. And then, in some severe situations, boards of directors were instructed to either raise sufficient capital, or sell or merge their bank. Fred: What if a bank had problems that didn't rise to the level of a formal enforcement action?

Doreen:

That's a good question. The FDIC uses informal actions in those cases. These typically involved either a bank board resolution or a Memorandum of Understanding, or MOU, between the FDIC and a bank's board of directors, in which the bank committed to address its weaknesses. The key differences compared to formal actions, are that the informal actions are not made public and are not enforceable in court.

Fred:

So you had formal actions—more than 500 in a single year, you said. You must have had a lot of informal actions as well. Did you get criticism for being too harsh?

Doreen:

There were some concerns, the biggest of which was that our use of public enforcement actions would make it impossible for a bank to raise new capital when it needed it most.

Our FDIC Inspector General studied this at the request of Congress and found that enforcement actions did not hinder an institution's ability to raise capital.

They also found, by the way, that enforcement actions were applied consistently with policies, and were supported by the findings in examination reports.

Diane:

I guess a different question though is, did they work? Did they prevent bank failures?

Doreen:

I think they did.

We work intensively with problem banks to get them to address

	their issues and return to health, and most of them are able to do so. For context, about 1,800 banks have entered problem bank status at some point since 2008. And while around 500 of these failed, the others successfully addressed their problems and were upgraded or merged into another bank without FDIC assistance. Also, we found that when a bank was rated 3 and received some kind of a corrective action—formal or informal—nearly two-thirds of the time it never became rated worse than 3. And that illustrates a bigger point I think. When we can identify risks early and address them proactively, before the problems facing the bank become insurmountable, the end result is usually a success story.
Supervisory issues that were unique to the crisis	Fred: OK let's change gears a bit. Examinations and some number of enforcement actions are happening virtually all the time. But there were also some supervisory issues that were unique to the crisis. Could you touch on those?
New banks	Doreen: There were some unique issues. One issue I mentioned earlier was the high failure rate of new banks. Although new banks also failed at a higher rate in the previous crisis, the reason for failure was different this time. Early in the crisis we found that new institutions that failed had materially departed from the business plan that was the basis for their application for deposit insurance. So we put in place a policy of heightened supervisory attention during the first 7 years of a new bank's existence. This included a requirement for FDIC approval for any significant business plan changes. In 2016, we restored

the former three-year de novo period.

Diane:

You know, I recall another development came about because of all the failed bank deposits and assets the FDIC was marketing. Private equity firms saw an opportunity there, right—that is to become investors in banks at bargain prices? How did you deal with that?

Doreen:

They did see an opportunity. And frankly we had some concerns. Many private equity firms were known for a strategy of buying and reselling quickly at a profit and we were concerned that this short-term profit focus might not be consistent with the long-term health of the bank. As a result, the FDIC established parameters for failed bank acquisitions by private equity firms – basically to ensure that the acquired institutions would not return to the ranks of troubled or failed banks. The FDIC did this by publishing a policy statement on qualifications for failed bank acquisitions in September 2009. I can attest that the review of proposed failed bank transactions with private equity firms was an important activity for supervision staff during the crisis.

Fred:

There is a lot of discussion in Crisis and Response about issues related to bank holding companies. Probably more than we have time for, but can you give us the highlights?

Doreen:

Sure - there were a number of issues the FDIC had to consider when working with troubled banks in holding company structures.

In some cases, the underlying bank would request a waiver of the restrictions on inter-affiliate transactions. We had to determine

	whether these requests were consistent with the safety and soundness of the bank. Sometimes supervisory input was needed on whether the FDIC should assess financial liability for a bank failure against other affiliated banks. This is called a cross-guarantee liability assessment – and it can reduce the cost to the Deposit Insurance Fund in a failure. The decision whether to use this authority is made case-by-case – and the goal is to reduce the cost from the original failure without creating a second one. The study also describes the challenges to recapitalizing troubled banks when the holding company had outstanding Trust Preferred Securities—or TruPS. These securities were subordinated debt of the holding company, that were often sold into collateralized debt obligations held by many investors. Recapitalizing a bank whose holding company had issued TruPS would often require the TruPS investors to accept less than their full amount of their claims and it was often difficult or impossible to obtain that consent. Fred: It’s a complicated issue that we can’t do full justice to in the time we have. But what was the bottom line in terms of failures? Doreen: Sometimes the result was the bankruptcy of the holding company. But the study documents a number of situations where insured banks survived, or the FDIC incurred no cost, even while their holding companies entered bankruptcy.
Lessons learned	Diane: Okay, so far we have focused on what happened. Let’s spend the remaining time on the lessons learned. Doreen, you’ve been a bank examiner and supervisor at the FDIC for many years. What were the main lessons of the crisis for bank supervision from

	your perspective? Doreen: To me the number one lesson is the importance of addressing weaknesses in risk management at an early stage, before the weaknesses turn into real financial trouble. So what do I mean by “addressing” the weaknesses? Both identifying the problem and taking steps to correct it. We did a good job of identifying the issues early – but we should have been more forceful in requiring correction of weaknesses in risk management practices at an earlier stage. We have incorporated these lessons into our training programs and guidance to examiners. It’s always a challenge to criticize banks when they are engaged in legal activities and making lots of money. But the crisis was a reminder that we need to be willing to address risk management weaknesses when we see them. Fred: One of the other lessons discussed in the study is the importance of understanding the risk in large banks. There is an extended discussion of the FDIC’s role with respect to banks supervised by other agencies. Would you comment on that? Doreen: Sure, the largest banks that make up most of our deposit insurance exposure are supervised by the OCC and the Federal Reserve. But the FDIC has statutory authority to examine these institutions to have a window into the insurance risks they pose. But sometimes that was a challenge. For example, the study describes some of the issues regarding the FDIC’s access to Washington Mutual. Fred:
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	There also was an interesting comment in the study about Wachovia ... Doreen: That's right, up until a few days before Wachovia experienced a liquidity crisis, it was not viewed as a problem bank. In fact liquidity wasn't viewed as a threat to the institution. This illustrates both the difficulty and importance of identifying risks at the largest banks. The crisis showed us we needed better access to do a better job.
Need to wrap up	Diane: Alright Fred, Doreen – We are running out of time. Is there anything that you would like to add?
Prosperous times can mask the buildup of risks	Fred: I think another lesson to keep in mind is that past performance is not a guide to future performance, and that prosperous times can mask a buildup of risks. Based on past performance, it was easy to assume that we would never have a serious problem with residential mortgages or with investment grade securitizations. And yes, there were discussions of bank concentrations of ADC lending and the possibility that we were in a housing price bubble. But there was never a consensus about how real the risks were. Doreen: You are right, and realistically, we will never see all the risks or be able to predict the exact risk that will trigger the next crisis or economic downturn. But what we can do, is examine for a strong risk management culture at banks, which will help them be more resilient in the face of economic cycles. That is why we call the examination function the core of our supervisory program.

	And if I could, I would like to close with a tribute to the examiners and bank supervisors who addressed the crisis. Addressing risks at healthy banks and mitigating issues at troubled banks is labor intensive, and it requires experience and expertise. We have been fortunate at the FDIC to have a well-trained and seasoned examination staff. We could not have adequately responded to the crisis without them.
Closing Remarks	Diane: That seems like a good place to wrap up today’s discussion of bank supervision. Our next episode will describe how the FDIC managed the deposit insurance program during the crisis, and following that we will wrap up the series with a description of how the FDIC handled the 489 banks that failed from 2008 through 2013. On behalf of my colleagues Fred Carns and Doreen Eberley, this is Diane Ellis – thanking you for joining us for Episode 5 of the FDIC’s <i>Crisis and Response</i> podcast.