Podcast Script

Episode 3: The Temporary Liquidity Guarantee Program

Moderator Introduction	**Diane:** Hello again. My name is Diane Ellis. Welcome to Episode 3 of the FDIC's ongoing podcast of *Crisis and Response: An FDIC History, 2008-2013*.
What This Episode Will Cover	**Diane:** Episode 2 covered the origins of the financial crisis, and we ended by discussing the events in September 2008. People will recall just how bad things were. That month saw Fannie Mae and Freddie Mac taken into government conservatorship, the largest bank failure in FDIC history—Washington Mutual Bank, the first government assistance to American International Group, and the bankruptcy of Lehman Brothers, the largest in U.S. history. In this episode we're going to pick up where we left off and start looking at how the FDIC responded to the system-wide problems of the financial crisis. Our focus this time will be on the FDIC's Temporary Liquidity Guarantee Program, or TLGP, which was put in place in October 2008 and is covered in Chapter 2 of the study. This program did two things: First, the FDIC guaranteed certain types of debt issued by the banking industry using the Debt Guarantee Program. It should be emphasized that this program was not only innovative, it meant the FDIC would be exploring entirely new territory—guaranteeing something other than deposits. Second, the FDIC expanded deposit insurance coverage, providing unlimited coverage to certain kinds of bank accounts, using the Transaction Account Guarantee Program or TAG. Both of these programs were voluntary. It is also important to note that because of the legal authority used to create them, no taxpayer funds were at risk—had the programs generated losses, the banking industry would

	have been responsible for covering them. In this podcast we'll explain why the TLGP was needed, how it worked, and how effective it was.
Introduce Art and Fred	**Diane:** Two of the FDIC's most senior economists join me today. Both played substantial roles here at the FDIC during the crisis. Art Murton is the Deputy to the Chairman for Policy. During the financial crisis Art was one of the senior advisors to then-FDIC Chairman Sheila Bair, as well as the Director of the Division of Insurance and Research. Thanks for joining us Art. **Art:** It's nice to be here, Diane. **Diane:** Fred Carns is Principal Advisor in the FDIC's Division of Insurance and Research, who's joined me on the previous podcasts. Welcome back Fred. **Fred:** Thanks Diane.
Context: The Systemic Risk Exception	**Diane:** Before we get into our discussion of the TLGP, we should give listeners some background on the special authority used to create the program, the Systemic Risk Exception. A good place to start would be a few basics about the how the FDIC dealt with failed and failing banks in the past, particularly during the banking crisis of the 1980s and early 1990s.

Fred:

Before 1991, the FDIC had a significant amount of discretion when it came to resolving failed institutions and assisting institutions in danger of failing.

One famous example of that kind of discretion happened in 1984, when Continental Illinois National Bank, the 7th largest bank in the nation, was about to fail. Regulators' decision to assist the bank and protect uninsured depositors and other creditors was the starting point for the decades-long debate over whether some banks were "too-big-to fail".

Although Continental Illinois was a particularly notable case, the FDIC often used resolution strategies where uninsured depositors and, sometimes, other creditors were protected. These strategies had the potential to increase failure costs and generated some criticism.

So by the beginning of the 1990s, a consensus developed that the FDIC should try to limit its protection only to insured depositors , and should resolve failed banks at the least cost to the deposit insurance fund.

Diane:

And the requirement for resolutions at the least cost to the fund was mandated by law in 1991. But policymakers understood that the least-cost requirement might prevent regulators from stepping in if a failure would lead to serious problems for the entire banking system.

So, the Systemic Risk Exception was born.

Art:

That's right Diane. The least-cost test generally had to be followed.

BUT, if the FDIC and the Federal Reserve recommended a systemic risk exception, and if the Secretary of the Treasury, in consultation with the President, agreed with that recommendation …

THEN, the FDIC could step outside of the least-cost test and act as necessary to avoid systemic disruption that a major-bank failure might cause, even if the method chosen wasn't at the least cost to the FDIC.

While this was put in place in 1991, this exception wouldn't be used for 17 years, until 2008, when the financial crisis arrived.

The Policy Debate	**Diane:** That's right. In fact, when the TLGP was created in October 2008, it was only the second time a systemic risk exception was invoked (we'll talk about the first time in our next podcast). But creation of the TLGP was the first time a systemic risk exception was actually implemented. Now, let's go back to the situation policymakers faced in the fall of 2008, but look at it specifically in the context of the TLGP. You'll recall the financial market turmoil was severe; as I said earlier, the situation was dire, with many large financial firms failing or in danger of failure. Credit markets had stopped working normally and were essentially frozen. Corporations as well as banks were unable to roll over debt to fund their operations. There were concerns that a lack of liquidity would lead to the failure of large financial institutions. And there was evidence of deposit outflows, and banks of all sizes need deposits to carry on their business. Art, you were there when policymakers were trying to figure out how to respond to the severe problems in financial markets in October. Why don't you talk about what happened then? **Art:** Sure. We need to remember that the financial market problems were not limited to the United States—it was an international problem and other countries were also trying to figure out how to respond. In early October finance ministers from around the world gathered in Washington, DC, and they developed a plan that included making sure financial institutions had access to liquidity and funding. Most advanced economies accomplished this by guaranteeing debt issued by banks and by expanding deposit insurance guarantees. So the FDIC was asked to find a way to design a debt guarantee program, and the Secretary of the Treasury, Hank Paulson, invited the regulators over Columbus Day weekend to work out the steps that we were going to take to address the financial crisis, not just the debt guarantee program, but other programs. And so he had the heads of the Federal Reserve, the FDIC, and

	other agencies convene at the Treasury over the weekend and we spent three days hold up there, working out the design of these programs. And after much debate about different aspects of the program, we came up with a proposal for a debt guarantee program and expanded deposit insurance that policymakers could agree to and we announced it on Tuesday following Columbus Day weekend. In terms of deposit insurance and the debt guarantee —the elements of the TLGP—after some deliberation, the policymakers decided the best available course was a broad interpretation of the systemic risk exception—essentially using it to provide assistance to the entire industry. **Diane:** TLGP wasn't the only program being developed that weekend, was it? **Art:** No. It wasn't. There were two other key elements to the program: • The first was the Treasury's capital injections into banks from the Troubled Asset Relief Program or TARP, • And the other was a Federal Reserve program, the Commercial Paper Funding Facility, which provided liquidity by purchasing short-term commercial paper. In other words, there were three aspects to the support for the financial system developed over that Columbus Day weekend: capital, liquidity, and guarantees. **Diane:** Art, I remember you coming back from the Treasury that weekend, and you indeed just brought back the broad outlines of a program, both a debt guarantee program and a deposit insurance guarantee program.
Policy Issues	**Diane:** It was really up to the FDIC to figure out all of the details— and we faced a lot of challenges in figuring out how to implement this program. Also, it needed to be done incredibly quickly since the program was effective immediately. I thought the challenges were particularly true for the Debt Guarantee Program. Would you agree with that Art?

	Art: Yes, we had a conference call with thousands of bankers and other interested parties to explain the TLGP on October 16th, just two days after it was announced, and to be able to have that dialog with the industry, we needed to have the main elements of the program sorted out right away. But that short timeframe also meant there were many specifics that had to be finalized from the broad structure that we had put in place at the inception. And the adjustments continued after the TLGP got off the ground; the FDIC had decades of experience insuring bank deposits deposits but it turned out guaranteeing debt is very different, and it took some time to understand what that meant. There were three important issues that needed to be decided before the program could be announced: first, how broad would the debt guarantee be; second, what banks and other firms would be able to participate; and third, how much would banks be charged for the guarantee? After some debate, policymakers decided that we should only cover newly issued debt. The idea was to allow banks to roll over existing debt and give them a little room to issue more if they needed to. As for who could participate, the question was should it only be insured banks, or should some other financial firms be able to participate as well? And it was decided that we would allow participation beyond just insured banks. In terms of how much to charge, the FDIC chose to charge a rate that was above “normal” credit protection costs (in other words what it would cost an institution to purchase insurance against default), but much lower than banks would have paid at the height of the crisis. The idea was that issuers should pay something meaningful for the guarantee, but not so much that it undercut the goals of the program. After first proposing a single flat rate of 75 basis points, the FDIC decided that issuers should pay between 50 and 100 basis points, depending on the maturity of the debt. **Diane:** Art, I want to go back to that phone call we had with the industry two days after the program was effective. I remember that call very well. I think it was very helpful in helping to advance our thinking about how to design

	this program, and it also helped us understand how different this program was compared to our traditional role as deposit insurers. I remember, in particular, one aspect of the program that needed to be amended was the way in which the FDIC would satisfy claims if an issuer defaulted. The FDIC, confronted with a novel responsibility, thought about claims as a deposit insurer. But that suggests there might be delays in making payments. But the industry was very clear that that wasn't what they or market participants or the rating agencies expected—they expected payment right away after a default. So we had to make changes to the payment triggers to address those concerns, ensuring that the firms that needed to would participate. And, as I recall, I think that was a pretty important change we made in ensuring success of the program. Would you agree? **Art:** Yeah I would. I would. Remember the phrase "timely payment". Two simple words but it took us a while to figure out exactly what that meant in terms of our debt guarantee program, and we had to have a lot of discussions with market participants to really get the program on sound footing. **Diane:** That's right. So Fred let's turn over to the TAG. How did the expansion of deposit insurance work? Since the FDIC had been guaranteeing deposits for 75 years (at that time), I don't think it posed the same kind of challenge as the Debt Guarantee Program. **Fred:** Yeah that's right. We should keep in mind that Congress had already increased the basic coverage level of FDIC insurance from \$100,000 to \$250,000. That was on October 3rd, ten days before the TLGP was announced. But TLGP went beyond this. There was a concern that banks might face runs not by individual depositors, but by those holding deposits above the insurance limit—like small businesses and municipalities.

	As a way to forestall rapid deposit outflows, particularly from smaller banks, policymakers decided to extend an unlimited guarantee on transaction accounts that paid little to no interest (hence the name Transaction Account Guarantee Program, or TAG). This was the first time the FDIC ever offered deposit insurance above the statutory amount. The FDIC also charged for the TAG. Initially the fee was set at 10 basis points through 2009. But during 2010, what banks paid depended on how regulators evaluated the banks' riskiness, and there was a range for the fees of 15 to 25 basis points.
Who entered the program, and how big was it?	**Diane:** Since this program was effective immediately but many of the deatals were yet to be worked out, for the first 30 days, all eligible firms were covered by the program for free, but it was meant to be a voluntary program, and after that first month fees would be charged. That gave eligible firms the opportunity to look at the programs and opt out before they incurred any fees. Art, just how wide was participation in the Debt Guarantee Program? **Art:** Over half of the 14,000 eligible firms chose to remain in that program during the initial period. Let me digress for just a minute. I think it is important to note that not all eligible banks were allowed to participate. From the start, no troubled banks (those with poor supervisory ratings) could participate, and even some other less-troubled firms were restricted from participating. I think overall, we excluded more than 1,500 banks from the program. So, although thousands of firms stayed in the program, the vast majority of them didn't issue any debt. In fact, just over 100 firms actually issued any debt under this program. But that low number doesn't mean the program was small. The Debt Guarantee Program actually guaranteed more than $600 billion of debt, and the amount of guaranteed debt outstanding peaked at about $350 billion in April 2009.

	Although approximately 100 institutions issued debt, as you can imagine most of it was issued by the largest banks. In fact, the three banks that issued the most debt accounted for about 70 percent of all of the debt that was issued under the program—and anyone interested in seeing which firms issued how much debt can find it in the study we released. **Diane:** So Fred, what about the TAG? Did many insured banks opt out of that? **Fred:** Actually, the TAG was even more widely adopted than the debt program—about 86 percent of FDIC-insured institutions stayed in the program at the beginning, although that level declined somewhat during the two program extensions to the end of 2010. The amount of deposits covered under the TAG peaked at more than $800 billion at the end of 2009. But with the immediate crisis having passed, during 2010, this amount decreased significantly. It was down to about $100 billion at the end of the program.
Effectiveness and Costs	**Diane:** Okay. So we've talked about why this program was needed, we've talked about some of the design features, and who participated and how big they were. Let's talk a little bit about effectiveness and costs. Art, how would you assess TLGP's effectiveness? Did it do what it was intended to do? **Art:** There is a chart in the book that shows that debt issuance by banks pretty much ground to a halt after the Lehman Brothers bankruptcy on September 15th. It only resumed again when the FDIC's debt guarantee program started. Banks were able to roll over their debt more or less normally, and so the program freed up frozen credit and greatly improved firms' liquidity at a time when it was desperately needed to help support real economic activity. As for the TAG, it stabilized deposit funding for insured banks by removing the risk of loss to businesses and municipalities that used transaction accounts with large balances, like payroll accounts for example. You know I think it's fair to say that most observers believe that the TLGP

	was one of the most important and successful government programs created to address the financial crisis. **Diane:** So Fred why don't you talk about costs, I mean given its success, did the TLGP end up forcing the FDIC to assess the industry to cover losses? After all, between the two programs at their peaks, the FDIC had extended guarantees of more than a trillion dollars. **Fred:** Because the programs were well-designed, charged appropriate fees, and took steps to prudently manage risk, there was no need to impose a systemic risk assessment on the industry. In fact losses were significantly less than the fees charged. It turned out that we didn't need to assess the industry, and we recovered more than we lost.
	Diane: Okay. Well thank you Art and Fred for your insights on the TLGP today. In our next podcast, we'll continue our look back at the extraordinary actions the FDIC took, along with other banking regulators, to address system-wide problems in the industry in late 2008 and early 2009.