

Thought for the Week: Monday, July 26, 2010

How Safe is FDIC Insurance?

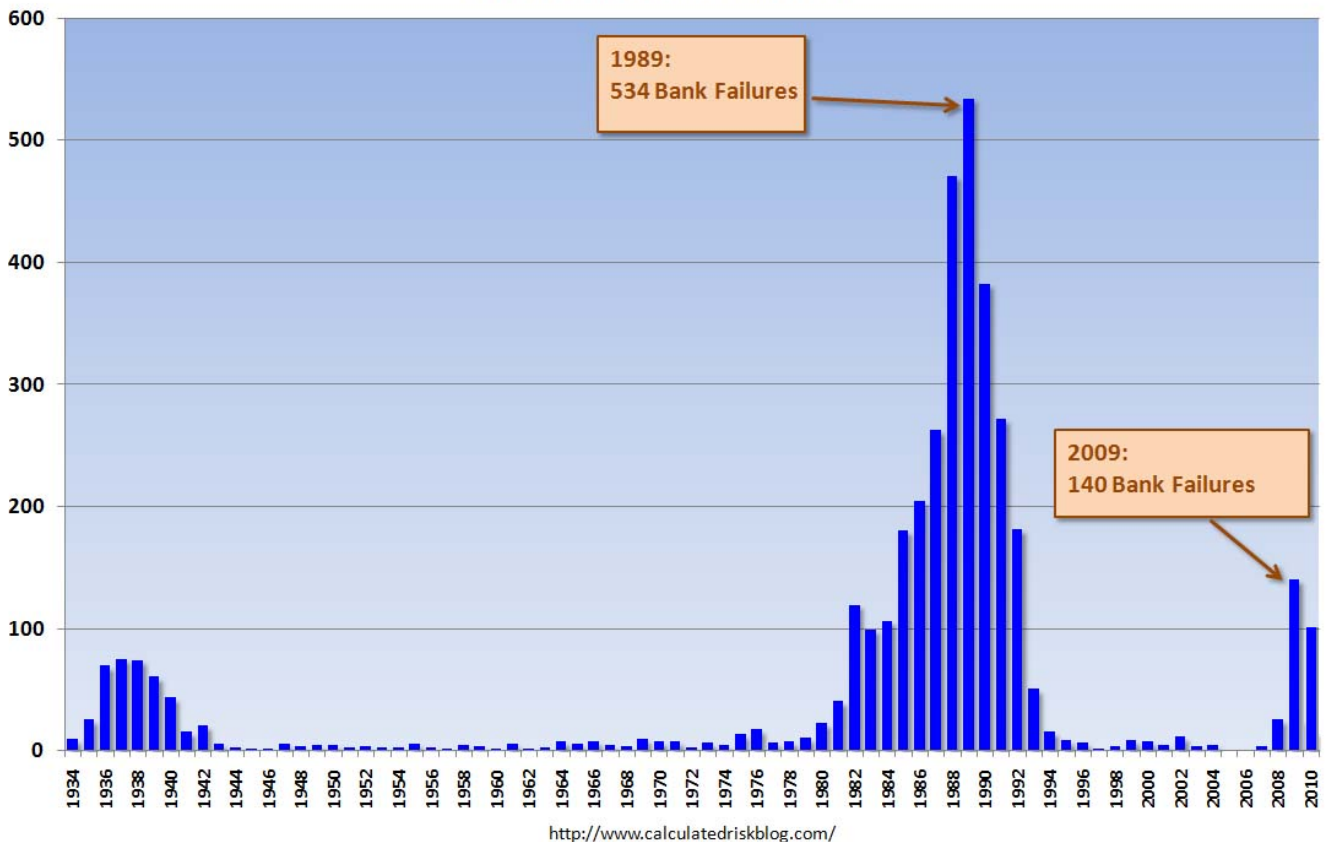
A few years ago, investing in a regional bank was a fantastically fashionable financial move:

- **Individual investors bought shares in regional banks** hoping that the bank would be acquired at a premium within 5 to 10 years.
- **Large financial institutions acquired smaller banks** to widen their distribution of financial products.
- **Companies with significant cash flows and balances bought or created banks** to squeeze a few extra percent from their cash positions.
- The Financials sector constituted **30% of the entire S&P 500 market capitalization**.

What a difference a few years makes! The chart below shows the recent rise in banks that failed and needed rescuing by the FDIC. Last week it was announced that in excess of 100 banks have failed this year already.

Although the chart below shows the increase in failures is not at the level of the late 1980s, **the total assets of failed banks already exceeds the 1989 peak** (even when inflation is taken into account).

Bank and Thrift Failures per Year



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...but the Federal Deposit Insurance Corp. (FDIC) pays Depositors when a Bank Fails, RIGHT?

The definitive answer to this question is **both Yes and No**:

- **Yes**, the FDIC insures all deposits held within member banks and thrifts, currently up to \$250,000. As this insurance is backed by the “full faith and credit of the United States Government”, the FDIC should be able to cover all future failures.
- **No**, the FDIC is required by law to maintain a Deposit Insurance Fund (DIF) of at least 1.15% of total insured deposits. Currently, **DIF is approximately \$20 billion in the red**, a negative ratio of 0.39% of insured deposits.

Since the start of FDIC insurance on January 1, 1934, **no depositor has lost a single cent of FDIC insured funds** as a result of a bank failure and we do not expect this to change – the FDIC is still ‘safe’.

The FDIC also examines certain banks for financial soundness; in its current view, there are **approximately 800 ‘troubled’ U.S. banks**.

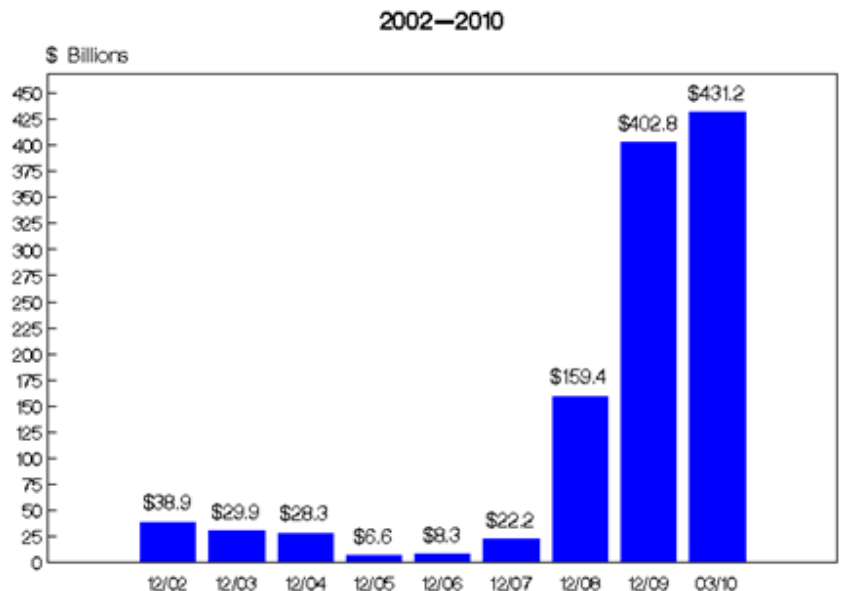
Is the FDIC Risk and Worry Free?

Given the fact that **cash deposits are currently paying ‘close to zero’ interest**, shouldn’t we know more about the risks involved in FDIC insurance?

We’ve already stated that the FDIC has covered every failed cent since 1934, and this includes accrued interest.

However, **FDIC payouts are not instantaneous**; therefore insured deposits are illiquid for a period. Moreover, hearing that your bank has failed can’t be the most reassuring piece of news – causing a few interrupted, if not sleepless, nights? **Is this risk worth ‘near zero’ returns?**

Assets of FDIC–Insured "Problem" Institutions



The FDIC Board currently anticipates that **the DIF will return to a positive balance in 2012** but will not reach the level of 1.15% required by law until early 2017. However, this is on the basis of FDIC Chairman Bair expecting “...that we’ll see far fewer failures in 2011 than what we’re experiencing this year.” **We feel this view is already out-of-date, or wildly optimistic**; especially when the number of Problem Banks has nearly tripled in less than 18 months, as shown above.

Here’s the bottom line:

- Assets at FDIC classified **‘Problem Banks’ are nearing \$500 billion**.
- **The FDIC has a cash deficit of \$20 billion** secured by a \$100 billion Treasury line of credit.
- It has the **authority to borrow up to \$500 billion** from the Government without requiring political consent.
- **It collected about \$50 billion** in pre-paid fees last year.



- **It is now securitizing and selling bad bank assets** to raise cash, called The FDIC Securitization Pilot Program, and starting with a \$500 million issue. However, Uncle Sam is guaranteeing these sales.

What Next?

If a bank failure Tsunami hits, and remember the FDIC are the ones who decide when banks need to be closed, **short term DIF cash requirements should be met by a government bailout**; hopefully, with minimal approval delays in getting their hands on the cash. Moreover, there's an argument that **the FDIC doesn't have enough staff to close enough banks** to use up all the \$500 billion.

The biggest concern is the ability to pay this money back – liquidating all the troubled assets (and there may be more to come) would require a very different fee schedule if the government is to be repaid. This probably won't happen and the government, i.e. taxpayers, will not get repaid.

Therefore, in light of the financial measures above, **the FDIC will probably fudge their safe capital requirements and allow a percentage of insolvent banks to continue to trade**, so banks can keep kicking the can down the road until the economy heals.

We would recommend anyone with uninsured deposits should immediately **move this cash to insured accounts**.

Check your local press and internet to see how well your bank is doing. Here's a site that has an unofficial Problem Bank list (the FDIC keeps their list confidential):

<http://calculatedriskimages.blogspot.com/2010/04/unofficial-problem-bank-list-april-30.html>

Conclusion

Although **bank failures are not a big 'leading indicator'** in our assessment of where the economy is going, the information above does suggest **more bad news is on the horizon**. The FDIC may have to ask the Government for more money; all of which adds to their financial burden and economic bad news.

The main point of this week's thought is: **It's hard to see credit easing down at your local bank!** This does not suggest a grass roots revival of consumer or small business spending; two areas of the economy that rely greatly on bank credit.

Unfortunately, even though **interest rates are at historically low levels**, the only way you can get a loan is if you don't need it!

Has anyone heard the joke about Banks and Umbrellas??