Remarks by
FDIC Chairman Sheila Bair
American Banker's Banker
of the
Year Awards Keynote Speech
New York, NY
December 4, 2008

Good evening everybody. And thank you for that very kind introduction. I hardly recognized myself. And I'm very flattered to share the stage with Ken Lewis and the other luminaries of the banking world being honored tonight.

Several years ago when they lured me out of the serene world of academia to take this job, I was given several promises. They promised me it would be regular hours, nine to five, Monday through Friday, no weekends. They promised me trips to the Swiss Alps to talk about global capital standards. And they said my only headache would be whether Wal-Mart should own a bank. So much for promises backed by the full-faith and credibility of the United States government!

They were right about one thing: I'd be getting a lot of phone calls from reporters at the American Banker. All those calls and interviews resulted in good, solid, well-balanced stories. At least that goes for most of them!

Honestly, the financial press has been great to work with. But now the mainstream media have discovered the FDIC. They want to talk about what we do, and they want it in five-second sound bites. So I can get lost translating the jargon into common English. I was on a TV news show in October talking about the need for our new temporary liquidity guarantee program. I said the program was intended to bring down LIBOR. The interviewer, of course, asks me: "What's LIBOR?" You should have seen the look on the poor guy's face when I said: "about 400 basis points."

Managing the Crisis and Planning for the Future

All kidding aside, I want to take this opportunity tonight to talk about some of the lessons of the ongoing crisis in the financial services industry, how we got here and what the future may look like.

As you all know, it's now official: the U.S. has been in recession for the past twelve months. While most of us suspected this was the case, the announcement formalized for the nation the daunting challenge of how to emerge from what could become the longest recession in post-World War history.

So, how did we get here?

Clearly the two biggest factors are the boom and bust in housing and a dramatic loss of confidence in the financial system. It turns out that securitization – the process that transformed the credit markets – is related to both of these. While securitization has created market efficiencies and broadened and deepened the credit channels, the current crisis exposes a few of its weaknesses.

Chief among these is misaligned incentives. Mortgage brokers, originators, underwriters, ratings agencies and investors all got paid in ways that created incentives for maximizing their own short-term profits, while allowing the accumulation of huge, undetected long-term risks.

Originators and underwriters usually did not retain a financial stake in the long-term performance of their loans. They got paid on day one, when the loan closed or the security was issued.

Securitization drove the boom in housing. Issuance of private residential mortgage-backed securities totaled over one trillion dollars in 2005 and 2006. But as of the third quarter of this year it had declined to virtually zero. Investors have lost faith in many of the market practices that securitization was built on.

Securitization will eventually come back. But fundamental reforms will be necessary to ensure that the incentives are aligned to produce transparency, stability and confidence by all market participants.

This loss of confidence required the government to step in to the financial markets in unprecedented ways and to enable the banking system to be the engine that helps drive the country toward economic recovery. During the last six weeks, the FDIC Board has invoked the systemic risk exception three times in order to provide assistance outside of our normal least-cost requirement.

These actions were undertaken with the goal of preserving the stability of our system as a whole. We stand ready to take additional action if necessary to maintain the stability of our system.

We're also raising deposit insurance premiums and rethinking our approach to assessing premiums according to risk. These measures are not intended to impose hardship on the industry during a difficult time. They are intended to restore the deposit insurance fund – and the public confidence that it generates – to its proper size and to make our system fairer toward those banks that work hard to contribute to financial stability.

More broadly, the FDIC, the Treasury and the Federal Reserve have worked together to put in place a number of extraordinary programs to bolster confidence and restore stability to our financial markets.

The Treasury instituted the Capital Purchase Program through the TARP, and the FDIC created the Temporary Liquidity Guarantee Program. Treasury's program is designed to bolster the capital base of FDIC-insured banks and their holding companies, and to give them the capacity to recognize losses and support new lending. The FDIC's guarantee program is designed to stabilize the funding structure of these institutions. This will help ensure that banks can roll over their existing liabilities when they come due, and expand their funding base to support the extension of new credit.

So far, this program seems to be working well. About $37 billion of debt was issued by participating institutions as of Tuesday. The premiums we're charging for the debt guarantee program are significantly higher than those charged for deposit insurance. We expect to make a profit on this program, and we'll put the proceeds into the deposit insurance fund.

The Federal Reserve has initiated a number of new lending programs over the past year, to provide additional liquidity to the markets.

We're working hard to ensure that the benefits of these programs will work just as well for small and mid-sized institutions as they do for the largest institutions.

Expanded Safety Net Must be Temporary

I'm a capitalist. I believe in markets. The expansion of the federal safety net which has been so necessary in this crisis cannot be considered a permanent fixture of our financial system. Even as we manage the crisis, we need to plan ahead in terms of how we scale back these protections against systemic risk. That means that banks will need to improve their own processes for managing credit risk, market risk, operational risk, and liquidity risk.

Going forward, you will need to convince your customers, your counterparties and your regulators that you have covered all the bases ... and that you truly are prepared for the worst. And the sooner you prove you have things under control ...and can keep them under control ... the sooner we can move back to a system where your shareholders earn the rewards, but bear the full consequences of the decisions that you are paid to make on their behalf.

Lessons for Bankers and Bank Regulators

The current crisis highlights both the important role that depository institutions play in smooth functioning of credit markets and in the overall economic well-being of the country. The FDIC hosted a conference a few weeks ago at which Paul Volcker and Bill Seidman, your honoree last year, each delivered some remarks. Both of them stressed what they saw as the central importance of a stable bank deposit franchise in the functioning of our financial system.

A strong deposit base is a source of stability, and is the reason bankers can take the long view when it comes to managing risks. And most of all, core deposit funding is the anchor that holds fast in a crisis ... especially with the ultimate backstop of federal deposit insurance.

As this financial storm has destroyed certain other segments of the financial services industry, most banks have remained relatively strong. Your reliance on stable deposit funding backed by deposit insurance -- as well as the regulatory regime that entails -- has insulated most banks from the harshest consequences of this crisis.

The Future of Banking

So, what will the banking industry look like in the coming years? If this crisis has taught us anything, it's that both bankers and their regulators are responsible for maintaining the public's trust. This means we must work together to ensure that the public's trust is well placed.

First, from a regulatory perspective, I think we need to return to the fundamentals. This crisis period has shown the need for a more systematic approach to regulation overall, as well as a greater focus on financial incentives. By a systematic approach, I mean that we need to plug any gaps that allow regulatory arbitrage, which was a major factor in the blowup in the mortgage securitization market.

The regulatory system also needs to make certain that the right people have skin in the game and get paid not for short-term gains, but for taking the long view. The most problematic mortgage loans were made to people who couldn't afford them, were unable to make the payments over the long term, and who may not have fully understood the terms of the deal. Protecting the consumer is essential to risk management and safe-and-sound banking.

Regulation also needs to promote transparency and control complexity. As financial instruments have become ever more complex, the analysis that supports them has become less well-grounded in experience.

Complex instruments in many cases have become a tool for inflating leverage, which as you know is a time-honored recipe for financial instability. That is why we need to have meaningful constraints on leverage -- not just on bank balance sheets, but across the financial system.

The extraordinary measures that have been undertaken by the federal government in recent months do not come with the unconditional support of the American public. The public will only support these programs to the extent that you use them in good faith to serve the interests of your customers and your communities.

Look at it from the industry's perspective. The future of banking will depend a great deal on how bankers embrace their role in maintaining the public's trust, and by how you respond to the current crisis. This is an opportunity for bankers to demonstrate that the public's trust in them, is well-placed. In many ways it means the industry must return to the fundamentals of banking.

It means accepting the obligation to make credit available to qualified borrowers on reasonable terms. It means re-asserting the banking industry's central role as the engine of economic growth and prosperity. It means forging ahead to find the path to success where others have failed in the current crisis.

If this industry will embrace that role, that challenge, and that public trust, then I believe that the future of banking will be bright indeed.

Thank you very much.

Last Updated 12/4/2008