Remarks by
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Today I want to talk about how we can strengthen our banking system by restoring market discipline.

Looking back over just the past 12 to 18 months, it's abundantly clear that the market failed to prevent the excessive risk-taking that drove our financial system to the brink of collapse. Of course, the government also failed to prevent the crisis.

So the critical question is do we now have the willpower -- both in government and in the industry -- to address a root cause of the crisis by eliminating the belief that the government will always support large, interconnected financial firms? Or will we maintain the status quo and risk a repeat of this episode sometime down the road?

Key resolution features

To end too big to fail, we need an effective mechanism to close large, financial intermediaries when they get into trouble. A good model is the FDIC process for banks. To prevent bank runs from spreading and affecting the broader financial system, insured deposits must be made immediately available to the customers of failed institutions. To achieve this, the insurer itself must have ready access to funding. In the case of the FDIC, this is accomplished by maintaining a Deposit Insurance Fund and by the existence of government lines of credit as an emergency backstop for potential liquidity needs.

A second feature of our resolution scheme is the ability to recycle valuable banking relationships and assets from the failed bank back into the private sector via acquisition. This allows the FDIC to reduce losses to the Deposit Insurance Fund while ensuring that these valuable relationships and assets can continue to finance economic activity that creates new jobs. Banking relationships with businesses and consumers are costly to establish and valuable to maintain. Whenever possible, they should be preserved in the resolution process.

A third feature of our resolution scheme is that we can provide continuity for the capital markets, trust and transactions services that were being provided by failing institution to its customers. Similar to traditional bank lending relationships, these services also cannot be immediately replaced without substantial cost or a significant disruption to real economic activity. An efficient resolution process ensures continuity for such transactions. In the case of larger institutions, this continuity is sometimes preserved by the temporary creation of a bridge bank.

The FDIC is the only Federal government agency with the responsibility for resolving failing banks and thrifts. The FDIC seamlessly resolves failing institutions using a receivership system separate from the court-administered bankruptcy process. Since 1934, the FDIC has been involved in more than 3,000 insured depository institution failures and assistance transactions. This year alone, the FDIC has resolved 120 institutions that held total deposits of $112 billion, almost all of which will turn out to be fully insured.

Resolution vs. bankruptcy

While the FDIC has, for the most part, the legal authorities and resources to efficiently resolve insured depository institutions that have failed, a large share of financial intermediation now takes place outside of traditional insured depositories. When these institutions become critically undercapitalized, there is no recourse other than the commercial bankruptcy process. While bankruptcy works well to resolve the vast majority of business failures, it is not well-suited for resolving large interconnected financial firms.

As we saw with the financial crisis, large financial firms are subject to the same types of liquidity runs as banks. And when they run into trouble, it's essential to have the ability to act quickly and decisively to maintain critical operations, retain franchise value, and protect the public interest.

By contrast, the commercial bankruptcy process begins by freezing creditor claims and giving management a right to reorganize. This process does not provide the type of continuity and certainty embodied in the rules that govern the FDIC's receivership authority. Forcing large, non-bank financial institutions through the bankruptcy process can create significant risks for the real economy by disrupting key financial relationships and transactions.

In bankruptcy, there is no readily available funding to ensure the continuity of operations. Absent bankruptcy financing, the courts will typically force liquidation even if that raises the costs to claimants and disrupts essential services. In bankruptcy, there is no option for a bridge bank that can provide continuity of operations until the failed institution is sold. The lack of an acceptable alternative to bankruptcy tied the hands of policy makers in the recent crisis.

It was clear that these non-depository financial institutions were too important to the global financial system to subject them to the costs and economic uncertainties of the bankruptcy process. But absent an alternative process for intervention and resolution, policy makers were forced to extend the public safety net at taxpayer expense to support a number of financial institutions. In doing so, governments made explicit the fact that some institutions are simply too big to fail.

Addressing too big to fail

This crisis has given us an opportunity to achieve significant regulatory reform. It is imperative that we meet this challenge head-on and not sidestep our responsibilities to ensure financial stability and to protect the taxpayers. We must create a more resilient, transparent, and better regulated financial system – one that combines stronger and more effective regulation with market discipline.

Our first task is to end too big to fail. Only by doing so can we ensure a competitive balance between large and small institutions and limit the built-in incentives for large, complex financial firms to take on greater risk, greater leverage and greater size. There are four elements to this task.

Resolution authority

First, we must have an effective and credible resolution mechanism that provides for the orderly wind-down of systemically important financial firms, while avoiding financial disruptions that could devastate our financial markets and the global economy. I believe that the best option is to create a resolution mechanism that makes it possible to break-up and sell the failed firm. It should be designed to protect the public interest, prevent the use of taxpayer funds, and provide continuity for the failed institution's critical functions.

The FDIC's present receivership authority is a good model. We have the authority if necessary to temporarily move key functions of the failed institution to a newly chartered bridge bank. We also have the obligation to impose losses on those who should bear them in the event of a failure. Shareholders of the failed bank typically lose all of their investment, and unsecured creditors generally lose some or all of the amounts owed to them. Top management is replaced, as are other employees who contributed to the institution's failure. And the assets of the failed institution are eventually sold to a stronger, better managed institution.

This type of resolution mechanism should be applied to all systemically important financial institutions – whether banks or non-banks. We should require that these firms prepare detailed plans for their dissolution (so-called "living wills"). This would assist the receiver, and allow financial markets to continue to function smoothly while the firm's operations are transferred or unwound in an orderly manner. This process could address the potential for systemic risk without a bailout and without the near panic we saw a year ago.

Importantly, over the long run, it would provide the market discipline that is so clearly lacking from the present arrangement. A new resolution scheme for systemically important non-banks would need access to liquidity in order to effect a resolution, provide continuity of services and complete transactions that are in process at the time of failure. This would facilitate an orderly wind down. And costs associated with the resolution would be borne by shareholders and creditors.

In my view, it is vital that the funding for working capital should come from the industry. A reserve fund should be established, maintained and funded in advance of any failure by imposing risk-based assessments on the industry. This would not be a bail-out fund. This would not be an insurance fund. It would provide short term liquidity to maintain essential operations of the institution as it is broken up and sold off. It would not be used to `recapitalize or prop-up failing firms. Only this pre-funded approach can assure that taxpayers will not once again be presented the bill for these failures.

Building a resolutions fund balance in advance would also help prevent the need for imposing assessments during an economic crisis, and assure that any failed firms will have paid something into the fund. Loss absorption by the shareholders and creditors would provide clear rules and signals to the market that will be crucial to restoring market discipline in our financial sector.

International Cooperation

Second, a more resilient resolution process also requires greater international cooperation, as our largest financial firms now span the globe. Under current resolution protocols, systemically important institutions operate under national laws that focus on domestic concerns. In a crisis, the domestic resolution laws of most countries are simply inadequate to deal with the complexities posed by cross-border financial firms. As a consequence, there is no functioning international resolution process.

The FDIC has co-chaired a working group under the auspices of the Basel Committee to evaluate current law and policy and make recommendations for the future. The report recommends reform and greater harmonization of national laws to achieve more effective tools to resolve cross-border institutions. It also recommends specific steps to reduce the likelihood that a failure in one country will create a crisis in another.

Moving toward a more 'universal' resolution approach will require us to address some difficult issues – such as how to share the costs of a resolution and how to provide an international forum to resolve disputes. Today, the lack of any internationally agreed upon protocols means that ring-fencing or a territorial approach is the likely outcome. Recognizing this reality, we must consider how improvements in governance and operational autonomy within an international holding company structure could enhance the ability to conduct resolutions and avoid future bailouts.

Living wills are one key initiative supported by the Basel Committee working group and the G-20 leaders. These plans would be developed in cooperation with the resolution authority and reviewed and updated annually. Clearly, this would be helpful to any future receiver. But I believe they also would be of immense assistance to financial institutions themselves by highlighting dependencies, risks, and ways to improve their own resiliency in a crisis.

Tougher bank capital standards needed

Third, stronger bank capital standards also are urgently needed. There's an emerging consensus among policymakers around the world on this point. I'm encouraged by some of the capital reform discussions under way in the Basel Committee. Yet while international regulators certainly are "talking the talk", it is far too early to declare victory.

Despite almost universal agreement the Basel I-based capital requirements were too low, bank supervisors around the world are diligently implementing a rule designed to lower those requirements still more. I refer to the advanced approaches of Basel II. The advanced approaches were designed at a time when confidence in the reliability of banks' internal models and risk estimates went almost unchallenged. Banks outside the U.S. have been reporting lower capital requirements from Basel II even during the depths of the current downturn, when the risk estimates driving those requirements are surely as pessimistic as they will ever be.

There is little doubt that there will be eye-popping reductions in required capital when the good times return to banking. The obvious lesson of the crisis is that we need to strengthen capital standards at our large banks, not weaken them.

From the FDIC's perspective, banks may not use the advanced approaches to lower their capital. I expect our supervisors to require the general risk-based capital requirements to serve as a floor under the advanced approaches, as a condition of any bank's approval. For now, that means Basel I will serve as a floor. Once we finalize the new rules for the standardized approach under Basel II, I anticipate that will serve as a new higher floor.

To repeat: large banks today need more capital, not less.

Incentives to reduce size and complexity

The fourth and final major task in creating a new resolution process is considering alternative measures that will curb the unbridled growth and complexity of large, systemically important firms.

One way to achieve this is to significantly raise the cost of being too big or interconnected. Institutions deemed to pose a systemic risk by virtue of their size or activities should be subject to higher capital and liquidity requirements – as well as higher deposit insurance premiums – commensurate with the risks they pose to the system and the competitive benefits they derive from their unique regulatory situation.

In addition, large financial holding companies should be subject to tougher prompt corrective action standards under U.S. law. And they should be subject to holding company capital requirements that are no less stringent than those for insured banks. Off-balance-sheet assets and conduits, which turned out to be not-so-remote from their parent organizations in the recent crisis, should be counted and capitalized as on-balance-sheet risks.

Conclusion

As you know, Congress is tackling these very serious issues. The FDIC is working closely with Chairman Barney Frank in developing a responsible approach that will end bail-outs, promote competition and restore market discipline for our largest institutions. I'm very pleased with the progress to date in the House Financial Services Committee toward ending too big to fail.

It is my understanding Chairman Frank's proposed legislation will be strengthened. Including certain areas: the elimination of assistance to specific open firms so that firms that fail are closed; a ban on capital investments so that in the future government will not take an ownership interest in financial institutions; a resolution process that makes shareholders and creditors, not taxpayers, bear the losses; a pre-funded systemic resolution fund paid by the largest financial firms, to provide working capital for orderly resolutions; and a higher standard for both the FDIC and the Federal Reserve to provide support to healthy institutions in the event of a systemic meltdown of the type that we saw last October.

Chairman Frank will conclude his committee work next week. And I believe the House will consider this tough legislative proposal in December.

We've had too many years of unfettered risk-taking, and too many years of government subsidized risk. It's time we changed the rules of the game. It's time we closed the book on the doctrine of too big to fail. Only by instituting a credible resolution process and removing the existing incentives for size and complexity can we limit systemic risk, and the long-term competitive advantages and public subsidy it confers on the largest institutions.

Thank you.

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