Remarks by
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It's a great joy to be back home in Kansas. There are few places on earth that compare with Kansas and the hardworking, standup people who live here. Wherever I've worked or traveled I've never forgotten the basic American values of liberty, opportunity, and common sense that I learned while growing up in Independence. And like a lot of Kansans, I was taught to be honest and direct.

Alf Landon as we all know never pulled a punch in politics, which he once remarked would be a sin. He was thoughtful and a problem solver, always promoting the common good, not the expedient. Despite opposition from some in his party, as governor in the middle of the Great Depression of the 1930s, he embraced many parts of President Roosevelt's New Deal.

And he used his common sense in getting at the heart of the problems in his own state by lowering taxes, pushing for utility regulation, passing a moratorium on mortgage foreclosures and sponsoring laws to bolster troubled banks. We need more men and women in Washington with that kind of courage and boldness.

We're tackling the aftermath of a financial and economic crisis that has done as much, if not more, damage to our country than a Kansas tornado.

How will we weather the crisis?

How will we protect consumers from the abusive practices of the past few years?

How do we stop the excessive risk-taking?

How do we keep people in their homes?

How do we prevent more of those massive bailouts of giant financial institutions?

As a life-long Republican and market advocate, it's not been easy for me. The government has been going into places where we don't want to be. We've been doing things we'd rather not be doing, but have had little choice. So I want to talk today about how the stability of our financial system was jeopardized to the point that the federal government was forced to intervene in ways that were unthinkable just a few years ago. I also want to talk about what we've learned from this very painful episode, and what must be changed to avoid these problems from recurring in the future.

Origins of the Crisis

It's hard to believe that just a few years ago, economists were touting 'The Great Moderation,' a pattern of long expansions punctuated by brief and mild recessions. Interest rates and inflation were low. Easy credit in the wake of the "dot-com bust" and 9-11 terrorist attacks buoyed the demand for real estate. Easy lending standards led to an increase in home ownership rates and home prices rose throughout most of the country. Few homeowners defaulted on their mortgages as home price appreciation, historically low interest rates, and relaxed underwriting standards made refinancing an easy and attractive option. Financial institutions also thrived in this low interest rate and easy credit environment – this was true of banks as well as a growing "shadow sector" of non-bank credit providers.

From June 2004 through February 2007, not a single bank failed—this is the longest period without a bank failure in FDIC history. The banking industry posted quarter after quarter of record profits. Non-performing assets were at historical lows, and U.S. bank capital levels were strong both historically and by comparison to their global competitors.

Underneath this golden veneer, a huge asset bubble was building.

In order to maintain earnings growth, financial institutions found ways to increase leverage using securitization and off-balance-sheet financing. Existing home owners were eager to tap their new-found home equity; others were anxious to become homeowners, but were unable to qualify for a traditional mortgage. Financial institutions created new mortgage products—many of which could only be repaid if home prices continued to climb—and thereby made credit available to ever-more-risky borrowers through unsustainable mortgages.

I started becoming concerned about predatory lending and sub-prime mortgages in 2001 when I was Assistant Treasury Secretary for Financial Institutions. Some lenders, generally not banks, were offering mortgage loans that borrowers couldn't afford. These sub-prime loans were financed through Wall Street securitization vehicles and were replete with exotic features and complex fees.

While my concerns were clearly justified, my warnings did not resonate at that time, in part because rising home prices enabled weak borrowers to refinance and push their problems into the future. So even where federal powers existed to regulate nonbank mortgage lending, they were not used appropriately. The wave of defaults and problem loans would not come until the housing price bubble faltered.

In early 2007, as Chairman of the FDIC, I began to speak loudly, clearly, and frequently about the wave of mortgage payment problems that would hit the industry. I have long advocated for pro-active and sustainable loan modifications as a cost-effective way to deal with an unaffordable mortgages. (As an advocate of modifying mortgages, no doubt Alf Landon would have agreed!) Modifications can help lenders and families avoid the financial and personal losses associated with foreclosure.

As we have seen, the subprime mortgage problem has turned into a prime mortgage problem as the economy has declined. Far too many families are now facing foreclosure because of lost income from the economic distress brought about from the subprime debacle. These developments set the stage for what followed: The worst financial crisis since the Great Depression.

Let me go over the dramatic events that shaped the crisis.

The Peak of the Crisis and Regulators' Response

Inevitably, the housing bubble burst. The decline in home prices led to a large-scale downgrade in the credit ratings of a variety of complex financial instruments—CDS, CDOs and CDOs-squared – terms most Americans – as well as a few financial executives – had never heard of before. Ultimately, the losses from the bursting bubble exposed how much risk had been created in the financial system.

As the crisis unfolded, it became clear that potential losses would be large and would threaten the viability of many larger financial institutions. As we all know, any talk of "The Great Moderation" ended in 2007.

In June 2007, Bear Stearns announced devastating losses for two of its subprime hedge funds which had been marketed as low-risk investments. These losses prompted a cascade of rating agency downgrades of similar investments and the financing that had been available through securitization and structured credit markets quickly dried up. Mounting credit losses shook investor confidence and firms became unwilling to do business with each other in ways that prior to these events had been routine and perceived to be low risk.

As 2008 unfolded, conditions in the mortgage and other markets continued to deteriorate. Many non-bank mortgage finance companies went out of business. In March, Bear Stearns was acquired in a Federal-Reserve assisted transaction by JPMorgan Chase. And in July, IndyMac Bank, a large thrift in California, failed — resulting in the most costly bank failure in FDIC history.

Soon after, Fannie Mae and Freddie Mac were forced into conservatorship, and in September Lehman Brothers filed for bankruptcy. The insurance giant AIG received $85 billion from the federal government to avoid collapse and would eventually require another $100 billion.

WAMU became the largest insured depository institution to fail, though thanks to the FDIC's resolution powers, it was sold in a seamless transaction that required no support from the government and fully protected all depositors.

Liquidity in the inter-bank market evaporated. And, the United States was not alone in facing this crisis.

In September 2007, Northern Rock, a large mortgage lender in the U.K., experienced a liquidity crisis and a subsequent run by depositors -- the first bank run in the U.K. in over 100 years. And by the end of 2007, Northern Rock had received a huge loan of almost £27 billion pounds (or $54 billion) from the Bank of England. By February 2008, the U.K. government was forced to take ownership of Northern Rock. And in the fall of 2008, subsequent banking crises swept through many western European countries and again in the UK.

In the fall of 2008, the U.S. authorities took a series of internationally coordinated actions to contain the damage from the collapsing financial system. The Congress passed the Emergency Economic Stabilization Act (EESA) in October, which funded the U.S. Treasury's Temporary Asset Relief Program, known as TARP. The FDIC's deposit insurance limit was temporarily increased to $250,000, and temporary guarantees were instituted for money market mutual funds. The Federal Reserve opened new lending facilities to provide funding to a much wider range of companies than have historically been able to borrow from the Fed, targeting firms burdened by large holdings of now illiquid mortgage related securities.

The FDIC created the Temporary Liquidity Guarantee Program to guarantee bank debt in order to improve liquidity. The Treasury invested hundreds of billions in large institutions to stabilize them and provide them with "fortress" balance sheets.

These actions were an unprecedented broadening of the federal safety net. But, given the tools available, they were mostly necessary to prevent more failures of other large, complex financial institutions that would have caused severe damage for the global financial system and the real economy.

Credit markets are now slowly thawing, and liquidity has vastly improved with short-term credit spreads returning to normal levels. Equity markets have recovered somewhat, but are still well below their pre-crisis levels. With the worst of the crisis apparently behind us, it's time to consider the fallout from this calamity.

While government intervention has been successful in preventing wider failures, it has also introduced "moral hazard" into our financial system by providing previously unimaginable amounts of taxpayer support for open institutions. Government intervention has in too many cases protected stockholders, bondholders and managers from the consequences of their mistakes. We must make fundamental changes to our financial regulatory system to reduce this "moral hazard" and to make sure a financial crisis does not happen again.

Regulatory Reform

Reforms are needed to create a more resilient, transparent, and better regulated financial system – one that combines stronger and more effective regulation with market discipline. This crisis gives us an opportunity to achieve significant regulatory reform. And it is imperative that we meet the challenge and not sidestep our responsibilities to ensure financial stability and to protect the taxpayers.

We simply cannot afford to maintain the status quo.

So, what's to be done?

First, we must end too-big-to-fail.

Second, we must close destabilizing regulatory gaps and have more checks and balances to make sure regulators do their jobs.

And third, we must do a much better job of protecting the American consumer when it comes to financial products.

Addressing Too Big to Fail

To end "too big to fail," we must find ways to impose greater market discipline on systemically important institutions and ensure that no firm is too big or too inter-connected to fail. After all, in a properly functioning market economy there will be winners and losers. And when firms – through their own mismanagement and excessive risk taking – are no longer viable, they ought to fail.

One thing we learned from our handling of this crisis is that "too big to fail" has become explicit, when it was once implicit. By contrast, small institutions and their investors know that they can and will be allowed to fail. This competitive disparity makes it more expensive for small banks to raise capital and secure funding. The FDIC has resolved more than 100 institutions this year alone. Everyone knows that small institutions are not "too big to fail."

Firms that the market believes are too big or too inter-connected to fail distort our system. These firms can raise large amounts of debt and equity at favorable terms that do not reflect their true risk profile. When investors and creditors believe a firm is too-big-to-fail, they grow more complacent.

Indeed they are even more likely to encourage these firms to take on greater risk, additional leverage and become even larger. Investors and creditors believe, and so far have been proven correct, that the government will not allow these firms to fail for fear of major repercussions for the broader market and economy. This crisis clearly revealed that today for non-banks we have no practical way to address this problem.

We do not have an effective resolution process for handling large, complex financial firms that become troubled or are failing. The FDIC's process only extends to insured depository institutions. And without the ability to close and impose losses on systemic firms which get into trouble, we run the risk that we will have to repeat the costly and unpopular taxpayer bail-outs of the past year.

Resolution Authority

Foremost on the reform agenda is the need for a special legal and regulatory framework to ensure the orderly wind down of systemically important financial firms while avoiding financial disruptions that could devastate our financial markets and economy. A resolution mechanism that makes it possible to break-up and sell the failed institution offers the best option. It should be designed to protect the public interest, prevent the use of taxpayer funds, and provide continuity for the failed institution's critical financial functions. The FDIC's authority to resolve failing banks and thrifts is a good model.

This is the same model that has allowed the FDIC to seamlessly resolve thousands of institutions over the years. We protect insured depositors while preserving vital banking functions. The FDIC has the authority to move key functions of the failed bank to a newly chartered bridge bank. Losses are imposed on market players who reap the profits in good times, but who also should bear the losses in the case of failure. Shareholders of the failed bank typically lose all of their investment. Creditors generally lose some or all of the amounts owed them. Top management is replaced, as are other employees who contributed to the institutions' failure. And the assets of the failed institution are sold to a stronger, better managed buyer.

If this process is applied to systemically important financial institutions — whether banks or non-banks —it would prevent instability and contagion, while promoting fairness. Financial markets would continue to function smoothly, while the firm's operations are transferred or unwound in an orderly fashion. The government would step in temporarily to provide working capital for an orderly wind down, including providing necessary funds to complete transactions that are in process at the time of failure.

We propose that working capital for such resolutions come from a reserve which the industry would fund in advance. This would provide better protection for taxpayers. Building the fund in advance would also help prevent the need for assessments during an economic crisis, and assure that the firm which failed paid something into the fund. To avoid double counting for banks which already pay deposit insurance premiums, the assessments should be based on assets held outside of insured depositories.

Any costs associated with the resolution not covered by the fund would be recouped through additional industry assessments. This resolution mechanism would address systemic risk without a taxpayer bailout and without the near panic we saw a year ago. It would provide clear rules and signals to the market. Most importantly, over the long run, it would provide the market discipline that is so clearly lacking today

Incentives to Reduce Size and Complexity

A reserve funded in advance through industry assessments would also provide economic disincentives to size and complexity. Another way to address the risks of systemic institutions is to make it expensive to be one. Industry assessments could be risk based, with firms engaging in higher risk activities paying significantly more. Proprietary trading, complex structured finance, and other high risk activities would warrant higher fees.

In addition, systemic firms would be required to have in place their own liquidation plan – a living will so to speak –which would demonstrate that they could be broken apart and sold in an orderly way. This would mean greater legal and functional separation of affiliates within these large financial holding companies and in particular, greater autonomy and firewalls surrounding insured banks.

In addition, the largest firms that impose the most potential for systemic risk should be subject to greater oversight, higher capital and liquidity requirements, and other prudential safeguards. 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.

Taken together, these measures would help ensure that our largest and most complex firms can stand on their own two feet without resort to an implicit or explicit government backstop. Only by instituting a credible resolution process and penalizing high risk activity will we be able to limit systemic risk, and the long-term competitive advantages and public subsidy it gives to the largest institutions under the current system.

Making the Financial System Stronger and More Resilient

We also need better regulation of systemic risk and systemic institutions. Unfortunately, our current system has too many regulatory gaps and needs more checks and balances to make sure that regulators get the job done.

Systemic Risk Council

In the run-up to the current crisis, our financial and regulatory systems and supervisory surveillance did not identify and address the build-up of risk within the system. In short, it failed to provide effective macro-prudential oversight.

We need to develop a more effective way to monitor and pro-actively deal with emerging risks from a system-wide perspective. We need to be able to integrate insights from a number of different regulatory perspectives, including banks, securities firms, holding companies, and perhaps others. From these differing perspectives we must arrive at a holistic view of the developing risks to our system.

What we need is a Systemic Risk Council of national regulatory agencies with the authority and responsibility to identify, monitor, and take action to prevent future systemic risks. A Systemic Risk Council would provide an appropriate system of checks and balances to ensure that decisions reflect the interests of public and private stakeholders.

It should have broad authority and responsibility for identifying institutions, products, practices, services and markets that create potential systemic risks. It should have the authority to step in and fill regulatory gaps when they are exploited in a way that threatens the safety and soundness of the financial system. And it should have authority to establish and implement minimum, mandatory, macro-prudential standards for such things as capital, liquidity and leverage when individual regulators fail to act.

Derivatives Markets

Concentration and complexity of the derivatives markets were yet further sources of risk in the current crisis. While these markets perform important risk-mitigation functions, they have also proven to be a major source of contagion during the crisis.

Losses on mortgages were exponentially magnified by trillions of dollars in derivatives whose values were derived from the performance of those mortgages. And concentrations of derivatives exposures among certain dealers helped catalyze systemic breakdown. When the market decides a derivatives dealer is weakening, other market participants can demand more and more collateral to protect their claims.

At some point, the firm cannot meet additional collateral demands and it collapses. The resulting fire sale of collateral can depress prices, freeze market liquidity, and lead to the collapse for other firms. Derivative counterparties have every interest to demand more collateral and sell it as quickly as possible before market prices decline. The collateral calls generated by derivatives counterparty credit risk management mimic the depositor runs of the past.

One way to reduce these risks while retaining market discipline is to make derivative counterparties keep some "skin in the game" throughout the cycle. Under this approach, the receiver for a failed institution could impose losses of up to 20 percent of the secured claim. This would ensure that market participants always have an interest in monitoring the financial health of their counterparties. It also would limit the sudden demand for more collateral because the protection could be capped. Standardized derivatives contracts should also be required to trade on a nationally regulated exchange or through a regulated, centralized counterparty system.

Consumer Protection

While we need to take these steps to strengthen the safety and soundness of the financial system, we also need to address the human side. We must make sure that consumers have access to financial products and services that are transparent, easy to understand, and competitively priced.

Improved consumer protections are in everyone's best interest. It is important to understand that many of the current problems affecting the safety and soundness of the financial system were caused by a lack of strong, comprehensive rules against abusive practices in mortgage lending.

Looking over the financial landscape for consumers over the past several years, I see many positive changes in terms of technological innovations and wider availability of credit. But I also see too much emphasis on credit availability at the expense of products and services that help build wealth. I see poorly regulated and trained mortgage originators making loans to families whose biggest lifetime financial commitment will be that mortgage loan. I see complex, poorly understood mortgage contracts, accompanied by indecipherable disclosures and mind numbing legalese. I see an explosion of payday lenders and check cashers charging unbelievably high fees for the kinds of financial services you and I get for no or minimal cost at our local bank. But I also see some banks imbedding complex, opaque fee structures on checking accounts and credit cards, trapping unwary or less sophisticated bank customers.

Given the importance of the consumer to our overall economy, it is amazing to me that we haven't done a better job in protecting them. I think we can do better so I support the establishment of a new agency whose sole job would be to set effective, common sense standards and protections for consumers.

And I think such an agency would help banks and the more responsible providers of consumer credit, by helping to get the bad elements out of the system and creating a more even playing field for those who are trying to do the right thing.

Conclusion

Many in the industry are working constructively in Washington for meaningful reform. Some however, are working furiously against it. Fear is their tactic.

They say reform would stifle innovation. They say reform would impede the ability of our country to grow and compete in the global economy. But these are the very same arguments used to justify deregulation in the first place. Some want to keep the status quo. And, by implication, they want to keep the taxpayer on the hook.

That makes me angry.

My mentor and former boss, Bob Dole, has always lived his life by his father's view of the world as "stewers versus doers." He is a doer. These "stewers" would have us do nothing, even after millions in lost jobs and trillions in lost wealth.

I'm a Republican. But I'll always be a Republican from Kansas. So I believe as Bob Dole believes that "when it's all over, it's not who you were - it's whether you made a difference." I believe that government has a role to play in setting rules for protecting the common good. I believe that government is a "doer," and can make a difference, especially in the face of adversity and unfairness.

So my hope is that Alf Landon was right ... that there are some intelligent people in Washington ...even though he knew there are "more of 'em in Kansas!"

My hope is that the intelligent people in Washington will be "doers" -- willing to take on the special interests -- and willing to do, what's right for America.

Thank you very much.

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