Remarks by
Sheila C. Bair, Chairman, FDIC
at the
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Good morning and thank you for inviting me today.

Among the miracles of our modern world are global financial markets. They generally provide an efficient way to allocate capital for growth and prosperity.

However today, we may be experiencing, what Governor Mervyn King of the Bank of England recently described as: the swing from "irrational optimism to irrational pessimism."

The reasons are numerous. But the main ones are lax lending and limited market transparency. Mix these up, and you'll always get a bubble. And now that the housing bubble has burst, we're all dealing with the consequences.

The fact is, you can't have efficient and sustainable markets without transparency. And you can't have innovation without efficient markets. Transparency and innovation need each other. They are the lifeblood of modern, efficient capital markets.

So the task at hand is to ensure that our financial and credit markets rebound, and that they return to a sound footing. I believe that covered bonds can be part of that sound foundation.

Coming to America: covered bonds

Amidst current market turmoil, as more issues arise about the "originate-to-sell" model, bankers are looking for new tools to fund mortgages.

Covered bonds might become one of them.

While new to America, covered bonds aren't a new financial product in the global market. Europe's covered bond market is well-established, and is a central part of the European financial system.

In the U.S., as you know, Bank of America and Washington Mutual have successfully gone to the market with substantial mortgage-backed covered bond deals. Even in these difficult market conditions, potential issuers are considering new transactions, and that's an encouraging sign.

At the same time, financial policymakers are interested in sources of liquidity that preserve incentives for strong underwriting and maintain capital. I think that covered bonds can bring positive innovation to the U.S. market, and could be a good on-balance-sheet financing tool.

Covered bond rules

As regulators, we can perform a valuable role by setting the rules. So, in April the FDIC proposed a policy statement that would facilitate the development of an American covered-bond market. Our job as supervisor and deposit insurer is to assess any risks that these innovations may pose ... and to evaluate the pros and cons. And as with any market innovation, we'll be closely watching as things develop.

We have a long history of supporting market innovation. The FDIC and the old RTC both played a direct role in developing the securitization market during the early 1990s – securitization helped sell large numbers of loans from failed banks and thrifts.

Since then, the FDIC has continued to work with market players while balancing our roles of bank supervisor, deposit insurer, and receiver for failing insured banks.

To answer questions, we adopted rules for securitizations and participations. This regulation clarified the impact of a bank failure on the securitization process by confirming the FDIC's long-standing practices on asset sales.

FDIC policy statement

Let me now give you a quick rundown on our pending policy statement, and the public reaction we've gotten so far.

The statement addresses the simple question presented to the FDIC: How would we respond as receiver for a bank issuing covered bonds?

While answering this question, we also think the criteria used in our policy statement will help foster a balanced and sustainable U.S. covered bond market. These criteria also strike a balance between innovation and protecting the deposit insurance fund.

The gradual approach we've chosen also will give us time to evaluate the covered-bond model as it grows within the broader U.S. mortgage market ... which already has other substantial sources for liquidity, such as the Federal Home Loan Banks, Freddie Mac, and Fannie Mae.

As background, it's important for you to understand what would happen if a bank with covered bonds were to fail.

Our first duty as receiver, is to protect insured depositors and the insurance fund.

However, U.S. law clearly protects bondholders' rights to the mortgages securing the covered bonds – even if the bank fails. And we must respect those secured rights as receiver. As receiver, we can take one of three steps: continue paying the covered bonds; pay-off the covered bonds in cash; or liquidate the mortgages to pay-off the covered bonds.

Our policy statement simply says that if we decide to stop paying on the bank's covered bonds ... we'll pay in cash, or allow liquidation of the mortgages no more than 10 business days after notice is given.

This commitment is conditioned on the covered bonds meeting certain specific criteria. The key criteria are straight-forward:

- The covered bond must be a recourse obligation of the bank;
- It must be secured either by performing residential mortgages based on sound underwriting standards, or by up to 10% of AAA-rated securities backed by these eligible mortgages; and
- Total covered bonds cannot exceed 4% of total liabilities.

These underwriting standards will support strong, sustainable lending. And they will give stability to the value of the covered bonds as well.

We firmly believe that stability is vital to achieving a strong U.S. covered bond market.

Public comments

Now to the public comments. The comment period just closed on Monday (June 23), so this will be a preliminary thumbnail sketch.

So far, we've received more than FIFTY comments. Most have been broadly supportive of our policy statement. Not surprisingly, a number of comments seek to expand the types of loans that could be eligible for the covered pool. On the other hand, several suggest that we impose "loan-to-value" requirements to create stronger covered pools.

A number also say that we should define the pay-off amount. This naturally poses some questions because we must ensure that we always fulfill our legal duty to minimize losses to the deposit insurance fund.

Still others want us to lengthen the maximum term for eligible covered-bond transactions.

At this point, we've made no decisions on how we might modify the policy statement. I've asked FDIC staff to look carefully at the comments. I want them to make recommendations on the best ways to balance the value of innovation and a strong covered bond market with our responsibilities as supervisor, insurer, and receiver.

Once they have thoroughly reviewed the comments and provided recommendations, we plan to move forward with a final policy expeditiously.

But remember: In the meantime, the new policy is now in effect. And bankers can rely on its terms for new covered bonds.

Conclusion: a call to be responsible & transparent

Finally, I would ask that whatever your involvement with this new product, be responsible, and be transparent.

Sure, you want to make money. That's what free market capitalists are supposed to do.

But international credit markets are in turmoil today. The U.S. housing slump has hurt millions of homeowners and created uncertainty that has damaged financial institutions around the globe and slowed global economic growth. And it's largely because of poor underwriting practices, a lack of transparency, and a breakdown in market discipline.

In making your investment decisions, whether it's in covered bonds or other securities, I ask that you seek out prudent investments that are backed by responsibly underwritten mortgage loans or other assets.

If your decisions focus on sustainable mortgages then your investments are more likely to perform and the extreme mortgage market volatility we've seen will be less likely to happen again. I believe this is in everybody's best interest --lenders, investors, and borrowers.

Innovation, risk dispersion, wealth creation ... are laudable pursuits. And they can do much for the public good. But if they create bubbles so large that when they burst they have widespread economic consequences, then its time to step back and reassess.

And my advice would be: get back-to-basics in banking and investing.

Thank you very much.

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