Remarks by
FDIC Chairman Sheila C. Bair
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I am pleased to join you at the outset of this conference. I have served as FDIC Chair for almost four and a half years now. The financial crisis and regulatory reforms that followed have really come to define my term in office.

When I joined the FDIC in the summer of 2006, U.S. housing markets were just beginning to weaken, and the problems in subprime and nontraditional mortgage lending were only just starting to come into focus. The FDIC was early in sounding the alarm. But not even we foresaw the huge disruptions that were to take place in securities markets and overnight money markets, as well as the impact the resulting crisis would have on financial institutions.

As the crisis accelerated in late 2007 and peaked in the fall of 2008, the FDIC and other regulators focused first and foremost on taking measures that would restore stability to our financial system. We knew in the fall of 2008 that the crisis on Wall Street would take a terrible toll on the U.S. economy. In the six months following the bankruptcy of Lehman Brothers, the U.S. economy shed more than 4.2 million jobs, while domestic steel production fell by half. As we meet today, nearly 15 million Americans remain officially out of work, while discouraged workers and the under-employed number millions more.

Financial instability has imposed an unacceptable cost on the U.S. economy that will be felt for years to come. Now, as a tentative economic recovery continues to build, and as the earnings of banks and other financial companies begin to recover, we must resist the natural impulse to return to business as usual.

Instead, now is the time to carry through with our work to strengthen financial market practices and products and sharpen our approach to financial regulation.

Dodd-Frank Implementation

The financial crisis has exposed critical flaws in how our financial system operated and was regulated. Fortunately, the reforms authorized under the Dodd-Frank Act include far-reaching changes to restore market discipline, internalize the costs of risk-taking, protect consumers, and make our regulatory process more attuned to systemic risks.

The most fundamental reform is the new resolution authority for large bank holding companies and systemically important non-bank financial companies. This new authority directly addresses the dilemma we faced in the fall of 2008, when a number of these companies ran into serious trouble. We all saw the result of the Lehman bankruptcy, which threw global financial markets into chaos.

In contrast, the FDIC regularly carries out a prompt and orderly resolution process using its receivership authority for insured banks and thrifts. The Dodd-Frank Act for the first time gives the FDIC a similar set of receivership powers to close and liquidate systemically-important financial firms that are failing.

The FDIC recently issued a proposed rule clarifying how we would handle the claims process under this new authority. The law gives us discretion to pay certain creditors more than others when necessary to maintain essential operations or to maximize recoveries. But our proposed rule makes clear that shareholders and holders of subordinated and senior unsecured debt will never qualify to receive additional payments above the liquidation value of assets under the statutory priority of claims.

It also affirms that secured creditors will only be protected to the extent of the fair value of their collateral, with any unsecured portion remaining subject to loss. By ensuring that all creditors know they are at risk of loss in a failure, this proposed rule is a solid first step in implementing the resolution authority under Dodd-Frank and ending Too Big To Fail.

Another key step is to develop requirements for the resolution plans that all systemically-important financial companies now have to establish. These resolution plans are essentially blueprints for the orderly unwinding of these companies if they should run into serious problems.

Under Dodd-Frank, the FDIC and the Federal Reserve wield considerable authority to shape the content of these plans. If the plans are not found to be credible, the FDIC and the Fed can even compel the divestiture of activities that would unduly interfere with the orderly liquidation of these companies. The success or failure of the new regulatory regime will hinge in large part on how credible these resolution plans are as guides to resolving these companies.

And let us be clear: we will require these institutions to make substantial changes to their structure and activities if necessary to ensure orderly resolution. If we fail to follow through, and don't ensure that these institutions can be unwound in an orderly fashion during a crisis, we will have fallen short of our goal of ending Too Big To Fail.

A Top Priority: Resolution Authority

I cannot overstate the significance of making sure this resolution authority is properly implemented.

In a world of Too Big To Fail, risk taking is subsidized by the taxpayer. Systemically-important companies take on too much risk because the gains are private while the losses are socialized. Market discipline fails to rein in the excesses at these institutions because equity and debt holders – who should be at risk if things go wrong – enjoy an implicit government backstop. This skewing of financial incentives inevitably leads to a misallocation of capital and credit flows that keeps our economy from performing up to its potential.

And proscriptive regulation will only take you so far in fixing the problem. After all, banking was already among the most heavily regulated of all economic sectors before the crisis. It was the incentives in place under Too Big To Fail that helped push risk out into the so-called shadow banking system, where regulation was the lightest. That's where you saw most of the subprime and nontraditional mortgage lending, as well as holdings of mortgage-related derivative instruments.

So implementing the new resolution authority and ending Too Big To Fail is a game changer. Market discipline will be restored. Financial incentives will be better aligned. Capital and credit will be allocated more efficiently. And taxpayers will no longer be on the hook when financial companies get it wrong.

Basel Capital Requirements

We also need to strengthen bank capital requirements. As many of you know, the G-20 earlier this month endorsed a Basel Committee compromise on stronger standards for the quality and quantity of bank capital around the world. The standards are not as high as many of us would have liked. But there should be no doubt that they are a major improvement over current requirements. I also know that there are concerns that higher capital requirements will reduce the balance-sheet capacity of the banking industry, and choke off the availability of credit.

While it will not be cost-free to move to a stronger capital regime, I do not agree that the new requirements will reduce the availability of credit or significantly raise borrowing costs. Studies by economists at Harvard, the University of Chicago, and the Bank for International Settlements argue persuasively that the impact on the cost of credit will be modest, and that these costs will be far outweighed by the benefits of a more stable financial system.

Fair Value Accounting

Another ongoing regulatory process is FASB's proposal to substantially revise the accounting standards for financial instruments. Under the proposed rule, banks would be required to measure substantially all of their financial instruments at fair value on the balance sheet.

While we understand that the objective of the rule is to make financial statements more transparent, we believe that its effect could be to undermine financial stability by making bank performance more procyclical. In short, we do not believe that a bank – whose business strategy is to hold loans and deposit liabilities for the long term – should be required to measure them at fair value on the balance sheet. Why? Because fair value does not necessarily reflect the manner in which the cash flows associated with these instruments will be realized or expended.

In September, the five federal bank regulatory agencies submitted a joint comment letter to FASB outlining our opposition to fair-value measurement. Instead, we support the continued use of amortized cost – subject to a robust asset impairment model – for financial instruments when the bank's business strategy is to hold them for the collection or payment of regular cash flows. We do agree that some instruments with highly variable cash flows, such as derivatives and marketable equity investments, should be subject to fair value accounting.

We also support enhanced supplemental disclosure of fair-value information that will give investors and others a more informed view of the institution. But, as outlined in our joint comment letter, we believe that there are a number of other approaches that could enhance the reporting of forward-looking information by banks without imposing an accounting model on them that is inappropriate for their business.

Loan-Loss Reserves

Another area of accounting policy where we need to achieve a healthy balance is in standards for setting aside loan-loss reserves.

One of the fundamental tasks of bank regulation is to ensure that financial institutions maintain appropriate resources on hand to absorb losses. Conceptually, loan-loss reserves should represent the credit losses inherent in an institution's loan portfolio at any given time, while protection against unanticipated credit losses should be provided through the institution's equity capital. In that regard, we support moving from a probable-loss measurement of impairment to an expected-loss threshold.

At the same time, we do not support simply projecting a continuation of existing economic conditions when measuring expected future loss. Instead, we believe that the allowance should reflect forecast changes in economic conditions that will influence the size of those losses.

There is no question that FDIC-insured institutions carried inadequate levels of loan-loss reserves coming into the crisis. Provisions for loan losses have totaled more than $550 billion since the end of 2007. Yet as of mid-year, the industry's "coverage ratio" of loan-loss reserves to noncurrent loans was just over 65 percent, compared with levels of more than 100 percent before the crisis. Now, we are seeing some of the largest institutions reduce their loan-loss reserves as their levels of problem loans diminish.

We wholeheartedly agree with the premise that loan-loss reserves should not be used to manipulate earnings or mislead users of financial statements. But depository institutions play a critical role in our economy, and loan-loss reserves play an equally important role in ensuring the viability of these institutions. That's why we believe banks should err on the side of caution by maintaining adequate levels of loan-loss reserves, and not rushing to draw them down while their volumes of problem loans are still at elevated levels.

Reforming Securitization

Finally, I would like to address a topic that I know will be an overriding theme of this conference – and that is the reform and the revitalization of asset-backed securitization. The private issuance of asset-backed securities is an essential capital market activity that must be restarted in order to efficiently channel savings to meet the credit needs of U.S. households and businesses.

It is true that misaligned incentives in private securitization in the middle of the last decade led to the risky mortgages that fed the housing bubble and caused the financial crisis. But the answer to this problem is certainly not to turn away from securitization, but to reform it by establishing greater transparency and common-sense rules that will restore market discipline to the process. These reforms should empower investors to perform their own due-diligence on the assets they are buying, and should ensure that the economic interests of issuers are aligned with the long-term performance of those assets.

We fully supported FASB's 2009 guidance on securitization accounting that made significant changes regarding transfers of financial assets and the consolidation of special purpose entities. Prior to those changes, companies were in some cases able to conduct significant banking activities off their balance sheets and off their financial statements. While these transactions were compliant with GAAP, we now know that the accounting practices in place at that time understated the resulting risk and use of leverage.

In this regard, the FASB's new guidance makes accounting practices more consistent with recent changes to the legal environment surrounding securitization activities.

Safe Harbor Protection

At the FDIC, we have also set standards for risk retention and other securitization practices by updating our rules for safe harbor protection for securitized assets in failed bank receiverships. This new rule simply confirms that securitized assets will receive sale treatment in receivership when the transaction complies with conditions for the safe harbor. But it has also been designed to address the weaknesses in securitization that contributed to the financial crisis.

Our safe harbor helps ensure greater transparency, better documentation, and risk retention that creates better incentives for sound lending and better long-term performance. Knowing that the issuer is on the hook, and that servicer incentives are aligned with investors, provides assurance that the deal will likely perform over the long term.

Dodd-Frank and Risk Retention

The Dodd-Frank reform law mandates that regulators develop rules requiring any securitizer to retain at least 5 percent of the credit risk for any asset that is securitized and sold, transferred, or conveyed to a third party. We are currently working on an interagency basis to develop standards for risk retention across several asset classes – including requirements for low-risk "Qualifying Residential Mortgages," or QRMs, that can be exempt from risk retention.

These rules give us a chance to set a "gold standard" for underwriting criteria so that securitization will encourage high-quality mortgages that are sustainable for the long term.

The recent controversy over "robo-signing" by mortgage servicers highlights the unfortunate fact that servicers do not always have the proper economic incentives to make their process as robust and efficient as it needs to be.

Throughout this crisis, servicers have been too reluctant to modify mortgages, opting instead in too many cases to go through a costly foreclosure process. Meaningful reform of securitization is needed to ensure that servicers have: the authority to act to mitigate losses; the responsibility and the incentives to act for the benefit of all investors; and the oversight to make sure they do the job right.

The new rules under Dodd-Frank for risk retention and QRMs give us a unique opportunity to better align the incentives of servicers with those of mortgage pool investors. We believe that risk retention should require issuers – particularly those who also are servicers – to retain a "vertical slice" interest in the mortgage pool that is directly proportional to the value of the pool as a whole.

We also believe that the QRM rules should require servicers to disclose any ownership interest in other whole loans secured by the same real property, and to have in place processes to deal with any potential conflicts.

What I'm referring to is when a single company services a first mortgage for an investor pool and the second mortgage for a different party, or for itself. The many serious conflicts that have arisen in mortgage servicing during this crisis must be addressed if we are to achieve meaningful reform of the securitization process.

Conclusion

I know these are issues that will be discussed and debated during this conference. We all know there are no easy shortcuts to rebuilding our financial infrastructure. And it is always appealing to try to go back to old and familiar ways.

But in American finance, those are the practices that led our economy to the brink of ruin. Instead, we must move forward, make the tough choices, and accept that preserving stability is a prerequisite to making the financial system more efficient and more profitable.

Washington, too, must mend its ways if we are to preserve financial stability in the years ahead. Total U.S. public debt has doubled in just the past seven years to almost $14 trillion, or more than $100,000 for every U.S. household. This explosive growth in federal borrowing is not only the result of the financial crisis, but also the unwillingness of our government over many years to make the hard choices necessary to rein in our long-term structural deficit.

The preliminary report of the National Commission on Fiscal Responsibility and Reform, released earlier this month, is a credible first step toward recognizing and addressing the problem. But actually fixing the problem will require a national commitment to a comprehensive package of spending cuts and tax increases over many years. It is critical for the new Congress to act. While I do not see short term risk, I do believe that there is a systemic risk to the financial system if structural deficits are not credibly addressed over the next few years.

Financial stability and public confidence are the ultimate public goods and the foundation of our prosperity. Let us work together as Americans to rebuild that foundation and secure our economic future. Thank you.

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