Remarks by
FDIC Chairman Sheila C. Bair
"Ending Too Big To Fail
The FDIC and Financial Reform
2010 Glauber Lecture
at the
John F. Kennedy Jr. Forum
Harvard University
Cambridge, MA
October 20, 2010

Good evening. I am pleased to have the opportunity to return to Massachusetts and speak to you in this prestigious forum. I think it is safe to say that the past couple of years have been the most eventful period for U.S. economic policy since the 1930s. And that, of course, is because during this time our nation has suffered its most serious economic setback since the Great Depression.

When short-term money markets seized up in September and October 2008, following the bankruptcy of Lehman Brothers, policymakers were forced to undertake unprecedented emergency measures to stabilize the financial system. We knew at the time that the crisis posed a grave threat to the U.S. economy. During the next six months, the weekly volume of domestic steel production fell by one half, and employers shed more than 4 million jobs. In all, about 6.3 million mortgages have entered foreclosure since the recession started, and almost 15 million people remain out of work – not counting the millions who are underemployed or who have left the labor force.

These statistics, which can only hint at the true human dimension of the crisis, nonetheless explain the urgency with which Congress, the Administration, and regulators have pursued financial regulatory reform. The changes authorized in July by the Dodd-Frank Act are historic in their scope. The FDIC and other regulatory bodies are now engaged in an extensive implementation process. As you may have been hearing, change itself can be unsettling to financial industry participants and other economic actors. Some are even citing the reforms as a source of uncertainty that may be holding back the economic recovery.

What I would like to do this evening is outline for you what I see as the rationale for these reforms and describe how the U.S. financial system will work once they are fully implemented. The crisis has revealed some critical flaws in how our financial system operated and was regulated. In the aftermath of the crisis, a policy of "business as usual" was simply not an option. It would have been an invitation for another similar crisis in the not-to-distant future. But if we follow through and implement these reforms in a sensible, transparent manner, we should soon see a financial system where: market discipline is restored, the costs of risk-taking are borne by shareholders and creditors, and not by the public, consumers are better protected, and regulators are much more attuned to the types of systemic risks that led to the recent crisis.

Resolution Authority

One of the most fundamental problems that led to the crisis was that a number of large banks and other financial companies were Too Big To Fail. This term is really just shorthand for the dilemma that policymakers faced in the Fall of 2008, when a number of these institutions ran into serious trouble.

We faced this choice: To let them fail, and risk destabilizing the entire financial system. Or to bail them out – imposing costs on the taxpayer and encouraging the type of risky behavior that caused the crisis in the first place. Needless to say, both of these options were highly problematic.

How did we get into this situation? One big reason is that neither bank holding companies nor non-bank financial companies, both of which figured prominently in the crisis, were subject to an FDIC-like receivership authority. That means they could not be resolved in an orderly fashion without bailing out debt and equity holders or disrupting the financial system. Instead, these entities were subject to the commercial bankruptcy process, where it takes a long time and a lot of money to determine what creditors ultimately stand to collect. For example, the Lehman Brothers bankruptcy has cost almost a billion dollars to administer so far, and many creditors still do not know where they stand. By contrast, because of our ability to plan in advance, the FDIC receivership process for insured banks and thrifts sorts most of this out over a much shorter time frame, and generally returns the failed institution to private hands right away.

Claims Process

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. In resolving failed banks, federal law has long given the FDIC discretion to pay certain creditors more than others when necessary to maintain essential operations or to maximize recoveries. Certain bills need to be paid to keep the institution running. For instance, the FDIC would typically continue paying firms for services such as IT, utilities, payments processing, and building maintenance, even though these providers are technically unsecured creditors.

Dodd-Frank gives the FDIC similar discretion in resolving non-bank financial institutions. While we have always used this power very narrowly, this new authority has created uncertainty among those who are unfamiliar with our process. Our proposed rule makes clear that some creditors will never be deemed essential to operations or maximizing value. It states clearly that shareholders, subordinated debt and long-term bondholders will never qualify to receive additional payments above their liquidation value 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.

Resolution Plans

Another key element of the implementation process will be to develop requirements for the resolution plans that all systemically-important financial companies will now have to establish. These resolution plans are essentially blueprints for the orderly unwinding of the company if it 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. So it is critically important that they not be viewed simply as a "paper exercise"; they must be actionable.

Practical Significance of Ending Too Big To Fail

Let me briefly describe to you the practical significance of this new resolution authority. In a world of Too Big To Fail, risk taking is subsidized. 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 rightly 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.

In this crisis, far too much credit was directed to single-family housing, when it might have been put to far better use in rental housing, public infrastructure, or industry sectors such as energy or manufacturing. The figures I cited a few minutes ago on foreclosures and unemployed workers speak to the scale of the resources wasted in this episode.

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. 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 in terms of economic incentives. 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.

Other Elements of Regulatory Reform

I have focused this discussion on the resolution authority under Dodd-Frank because I think it is fundamental to changing incentives and behavior on Wall Street and among the big banks. But there are three other elements of reform that I would like to briefly touch on.

The first is the need to strengthen bank capital requirements. As many of you know, the Basel Committee recently reached a 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 here 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.

Dodd-Frank also strengthens consumer protection in the financial marketplace, which is essential to financial stability. There is ample evidence that consumers did not understand the subprime and nontraditional mortgages that were sold to them in the run-up to the crisis.

When it comes to financial regulation, our experience shows that safety and soundness and consumer protection are really two sides of the same coin. Where standards are not uniform, and consumers are not well informed, there will be a race to the bottom in credit practices. The losers in this race will include both legitimate financial providers and the consumers that the system is supposed to be serving.

I know there are concerns that the new Consumer Financial Protection Bureau created under Dodd-Frank will impose an additional level of regulation on banks and thrifts. But I think the CFPB provides a golden opportunity to simplify consumer rules, making them work better for consumers while making them less costly for banks to comply with. It also provides the opportunity to apply more rigorous rules and examinations on non-bank providers, while rewarding good actors who are trying to do the right thing by their customers.

Under the new law, the CFPB Director will sit on the FDIC Board and enforcement of its rules will remain with bank supervisors for institutions under 10 billion dollars in size. I think this will go a long way toward ensuring that legitimate financial providers are not adversely impacted for problems they did not create.

Finally, the identification and mitigation of systemic risk by regulators also was simply inadequate in the run-up to the recent crisis. That is why the Dodd-Frank Act established a Financial Stability Oversight Council made up of the Treasury, the Federal Reserve, the FDIC, and other financial regulators. A key task for the Council is to identify risks to financial stability and potential gaps in regulation, and then to make recommendations for primary regulators and other policymakers to take actions that would mitigate those risks.

The FSOC held its first meeting on October 1st. Even as we continue to deal with the aftermath of the last crisis, we all know there are new risks on the horizon. For example, with interest rates currently at historic lows, we know eventually they will go up. The question is how abrupt this shift will be, and how well prepared governments, variable rate borrowers, and financial institutions will be when it inevitably occurs.

The Council is charged with looking across the financial system, evaluating these risks, and making recommendations for primary regulators and other policymakers to take action to mitigate them. At the same time, it was not meant to interfere with the ability of the independent agencies to fulfill their statutory mandates and move ahead with clearly needed reforms. We look forward to working with our colleagues on the Council to keep our financial system strong and to narrow the regulatory gaps that contributed so greatly to the financial crisis.

Conclusion

I hope this discussion gives you a high-level overview of the strategy behind financial regulatory reform, the urgent need to make changes, and what is being done now to implement the reforms. Although change can be unsettling, in this case the status quo was an invitation to more financial disasters down the road. These reforms promise to usher in an era of greater stability and efficiency in our financial system, and to once again make finance a pillar of support for the economy – and not the other way around. I would be glad to take your questions.

Last Updated 10/21/2010