Remarks by
FDIC Chairman Sheila C. Bair,
"Restoring the Strength and Vitality
of the
U.S. Financial System"
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I have been FDIC Chairman for almost four and a half years now. And, yes, it seems longer than that. This period has been one of historic challenges in risk management -- for the FDIC, other policymakers and regulators, and for you, the nation's leading private-sector risk managers.

Much progress has been made since the Fall of 2008 in stabilizing financial markets and real estate markets, recognizing losses and cleaning up balance sheets, and laying the foundation for economic recovery. To be sure, the pace of growth is not as high as any of us would like it to be. And there is much work that remains in dealing with problem loans and restoring the vitality of our credit markets.

Now, as financial regulatory reform moves from the legislative process to implementation, many are worried that these reforms will impose new burdens on the industry and hold back the recovery. I understand those concerns. And I'm listening. We spent an entire day last week hearing from bankers across the country during a regular public meeting of our Advisory Committee on Community Banking. And reform was among their biggest issues.

As I told them, I see a strong connection between financial reform and our progress in revitalizing U.S. financial markets and institutions. I also pointed out that Dodd-Frank seems to skew the competitive playing field in favor of smaller banks in that it protects banks with less than ten billion dollars in assets from many of its provisions. The loss of confidence we saw in the global financial system two years ago was the direct result of both a failure of risk management at an institutional level and a failure of regulators to limit the buildup of system-wide risk.

Both of these problems must be addressed if we are to fully restore confidence in our financial system. And I believe that the steps being taken now to implement the Dodd-Frank Act go a long way toward fixing both problems and paving the way to a brighter financial future.

Benefits of Regulatory Reform

Under the Reform Act, systemically-important institutions will be subject to prudential supervision by the Federal Reserve and required to submit credible resolution plans that provide a blueprint for unwinding them if that becomes necessary. These institutions have enjoyed a clear competitive advantage against community banks and nonfinancial commercial firms, and were able to take huge risks at the expense of the system as a whole. The ability to regulate and, if necessary, close these institutions will end the policy of Too Big To Fail that has undermined market discipline and promoted excessive risk taking across the system.

The regulatory costs of these provisions will fall, as they should, directly on the large institutions that create systemic risk. This leveling of the competitive playing field will help preserve the essential diversity of our financial system and prevent any institution from taking undue risks at the expense of the public. Internalizing the cost of risk-taking is also served by our efforts to strengthen bank capital requirements under the recent Basel capital agreement.

I 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. But 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.

Most large, internationally active U.S. banks already come close to meeting the new Basel standards. Community banks, those with assets less than one billion dollars, as a group already have a Tier 1 risk-based capital ratio of over 14 percent. And they managed to grow their loan portfolios in the second quarter, while larger institutions did not. This is additional evidence that higher capital is not an impediment to lending.

The new Basel standards also allow a substantial phase-in period so they can raise capital through retained earnings. There is no reason this should impede lending. These new standards will help to level the playing field between large and small banks here in the U.S., and between American banks and their overseas competitors.

Our experience in the crisis also points to the need for a more level playing field between banks and non-bank providers in the area of consumer lending. The lack of sensible, consistent mortgage lending standards in the run-up to the crisis ended up destabilizing our housing markets and our financial system, imposing large losses on banks and non-banks alike. A race to the bottom is a race no one can win. We need to establish some common-sense standards that will apply to bank and non-bank providers alike and enable legitimate consumer lenders to earn competitive returns by creating real value for their customers.

I know there are concerns that the new Consumer Financial Protection Bureau will impose an additional level of regulation on banks and thrifts and interfere with their ability to earn a fair rate of return in consumer and mortgage lending.

But I see it differently. I think the CFPB provides a golden opportunity to simplify consumer rules, making them work better for consumers while making them less costly for community banks to comply with. It provides a golden 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.

I believe that having the CFPB Director sit on the FDIC Board and leaving enforcement of its rules with bank supervisors for institutions under 10 billion dollars in size - as provided for in Dodd-Frank - will go a long way toward ensuring that legitimate financial providers are not adversely impacted for problems they did not create.

Overdraft Payment Programs

This is not to say that consumer lending practices cannot also be strengthened at FDIC-insured depository institutions. For example, in recent years we have seen a large increase in consumer complaints about bank overdraft payment programs. The FDIC's 2008 Study of Bank Overdraft Programs found that customers with five or more overdrafts per year accounted for over 90 percent of revenue from overdraft fees. Many of these customers are not simply covering inadvertent overdrafts, but are borrowing to cover cash shortfalls.

In August the FDIC issued for public comment supervisory guidance on how the banking institutions we supervise should implement and maintain robust oversight of automated overdraft payment programs. Under new rules that recently took effect under Regulation E, banks must already give customers a chance to opt-in to programs that charge a fee to cover ATM and one-time point-of-sale overdrafts.

Our proposed guidance would require banks to monitor the use of automated overdraft payment programs. For customers who overdraw their accounts more than six times in a 12-month period, the institution would be required to contact the customer and discuss less-costly alternatives such as linked savings accounts or safe and affordable small-dollar loans. Institutions should also institute appropriate limits on overdraft fees and avoid ordering transactions in a way that is simply geared toward maximizing fees.

We view our proposed guidance as a common-sense approach that can help mitigate risks to both consumers and banks. We are carefully reviewing comments and hope to finalize the guidance by the end of the year. If we have learned anything in the mortgage crisis, it is that selling consumer credit products that do not serve the long-term needs of consumers ends up hurting both consumers and financial institutions, and weakens the public confidence that is the bedrock of our financial system.

Addressing Emerging Risks

But regulatory reform is not only about improving risk management processes in the private sector. The identification and mitigation of systemic risk by regulators also was simply inadequate to prevent 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 regulatory authorities. One of the highest priorities for the Council is to establish criteria for identifying systemically important financial companies that will be subject to enhanced prudential supervision and our new resolution authority. Another 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 action to mitigate those risks.

The FSOC held its first meeting on October 1st. We had a productive discussion of a wide range of risk topics and approved measures that govern the Council's operation and begin to implement certain key Dodd-Frank provisions. Our task of identifying and responding to emerging risks is frequently referred to as macroprudential supervision. In many ways, it resembles the task before you as private-sector risk analysts. Macroprudential supervision involves monitoring a wide array of forward-looking indicators and understanding the linkages between various parts of the financial system through which a market movement or a credit event can induce a systemic crisis.

Potential for Asset Bubbles

Experience has shown that it is critically important to monitor markets for potential asset price bubbles that could lead to instability down the road. Over the past dozen years or so, the United States has experienced classic asset price bubbles in the stock market and the housing market. Where might asset bubbles be forming today?

One candidate is U.S. farmland values, which remain some 58 percent above their 2000 levels in inflation-adjusted terms. Strong agricultural conditions have spurred renewed interest in farmland on the part of investors. But today's positive fundamentals are subject to change. A sharp decline in farmland prices similar to the early 1980s could have a severe adverse impact on the nation's 1,579 farm banks. While the credit structure underlying U.S. farmland does not appear to involve excessive leverage or inappropriate loan products, this is a situation that will continue to require close monitoring.

Interest Rate Risk

A more far-reaching threat might be posed by what some analysts refer to as a "bond bubble" that has built over the past few years as the yield on 10-year U.S. Treasury bonds has declined by half. For now, investors appear content to hold safe, low-yield Treasury instruments in an uncertain economic environment. The consensus is that this low-rate environment will persist for some time into the future. But what will happen when interest rates inevitably rise, and how disruptive will that process be? Businesses, households and governments have all, at various times in recent years, taken the opportunity to borrow huge sums at these historically low interest rates. As always, however, creditors are fickle, and the terms of credit can change rapidly for the worse.

For many U.S. consumers and businesses, credit dried up in the financial crisis when securitization markets shut down, financial institutions tightened standards, and the value of real estate collateral declined.

Governments, too, now face heightened scrutiny of their creditworthiness due to the effects of the recession on their balance sheets. Sovereign issuers have the privilege of borrowing on the basis of their power to tax and print money, but they also face an additional source of market discipline related to inflation expectations. Unless both monetary and fiscal policy are well managed and well coordinated, there is the risk that market expectations for future inflation could rise sharply, pushing interest rates higher all along the yield curve.

The U.S. experienced just this type of inflationary crisis in the 1970s, as the fiscal demands of the Great Society and the Vietnam War and the attempts of the monetary authorities to offset higher energy prices resulted in rapid money growth and double-digit inflation. The adverse effects of a sharp rise in interest rates typically fall most heavily on four groups: maturity-mismatched financial institutions, variable rate private borrowers, sellers of leveraged capital assets, and federal, state and local governments.

Higher interest rates in the early 1980s had a devastating effect on savings institutions that were funding long-term mortgages with shorter-term savings deposits. Bankers and regulators should place heightened scrutiny on the interest-rate exposures on the balance sheets of financial institutions, and ensure that these institutions can withstand interest-rate increases of as much as 500 basis points over a two- to three-year period.

Despite the current historically low level of short-term interest rates, private and public borrowers should avoid over-reliance on short-term funding that could leave them vulnerable to higher debt-service costs if rates rise, or even liquidity problems if financial markets should balk at rolling over large volumes of private debt. And governments at all levels need to put credible medium- to long-term fiscal plans on the table so creditors can be assured of their commitment to policies that will preserve financial market stability.

Financial Practices and Structures

Innovation in financial practices and structures has proven to be another prime source of systemic risk. High among the lessons learned in the recent crisis is that financial innovation and complex securitization structures allowed leverage and risk to build in an opaque way that was not well understood until it was too late. While the financial industry is highly sophisticated in its ability to innovate, all too often the profit motive has proven to be more powerful than its commitment to managing risks.

The mortgage crisis has also taught us how a large and highly-rated asset class such as mortgage-backed securities can suddenly encounter unprecedented levels of credit distress. When that asset class is widely used as collateral for short-term lending, the result can be a fast-moving liquidity crisis that has dire consequences for our financial system and our economy.

Conclusion

The costly experience gained in the recent financial crisis has taught us that vigilant regulation and prudent risk management are essential to a stable, efficient and profitable financial system. We have all seen what can happen when institutions are permitted to take excessive risks at the expense of the public and make consumer loans that do not serve the long-term interests of household borrowers.

As our economy and financial industry heal from this experience, there are concerns that imposing new rules that address these problems will end up hindering financial activity and holding back our economy. I want to assure you that this is not the intent of regulatory reform, and I do not believe that this will be its effect. Reform should help community banks by imposing greater regulation on the shadow banking sector, where some of the riskiest mortgage lending practices took place.

But sometimes I wonder: Have lenders really learned their lesson? Just a few days ago, I received a flier from a non-bank mortgage lender offering a 3.75 percent fixed-rate program with loans up to 125 percent of appraised value and approval in only 24 hours.

I believe that regulators and financial industry participants share the same goal: to restore the vitality and stability of our financial system. Common-sense reforms will help level the competitive playing field for banks of all sizes and preserve the public confidence that is needed to make our system operate at its full potential. As implementation moves forward, the FDIC is committed to making our process transparent and open. We have established an open-door policy and an extensive web site to make it easier for the public to give input and track the rulemaking process.

There inevitably will be differences of opinion that arise over the details of the rules put in place. But I am confident that if we continue to communicate frankly and seek the common good, we can make our financial system stronger, more resilient, and once more a pillar of strength for the U.S. economy. Thank you.

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