Remarks by
FDIC Chairman Sheila Bair
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Good afternoon everybody. I'm honored to be here this afternoon. I'm told it's the first time in your distinguished, 102-year history that you've invited an FDIC chairman to speak. You've had presidents, prime ministers, five-star generals, lots of Fed chairmen and Treasury secretaries, and many corporate CEOs ... not to mention the U.S. Senate Majority Leader, my former boss, Bob Dole. That's a lot of gravitas and intellectual capital to follow. So I'm feeling (dare I say) that this is my own personal 'stress test'.

I hope that the ideas I discuss with you today will have value in the ongoing debate over how we restore our financial sector to vitality and return it as the engine of growth for the real economy.

During a recent visit to the University of Massachusetts where I used to teach, I was asked by a former student (who knows my market-based proclivities) to explain the extraordinary government intervention of the past several months.

How do you explain what the government is doing? As a life-long Republican and market advocate, it's not easy. The government is going into places where we don't want to be. We're doing things we'd rather not be doing, but had little choice not to undertake them – and they have worked so far.

We've moved beyond the liquidity crisis of last year. Most major institutions managed to turn a profit in the first quarter. And one of the few that didn't was hurt by an improvement in its credit spreads, which damaged its balance sheet by increasing the theoretical cost of repurchasing its own debt.

As I see it, we are now in the clean up phase. We need to get in, do the repair work, and get out. And we also must look to how to improve our system for the future.

At the FDIC we have two credos which have pretty much driven our corporate culture over the past 75 years): One: No depositor should ever lose a penny of insured deposits (and none ever has). And two, failed banks should be closed expeditiously. There should be a minimum of disruption, their financial assets quickly sold back into private hands, and the losses first absorbed by their shareholders and creditors to maintain market discipline.

This FDIC resolution mechanism has worked in prior eras, when the vast majority of financial activity occurred inside insured depository institutions.

The reality is the bulk of the financial activity which has driven the current crisis falls outside of FDIC insured banks. The past 25 years have seen vast changes in how credit is provided and in the types of firms which provide financial intermediation.

Unfortunately, our laws for dealing with financial crises have not kept pace with these changes. As a consequence, we have very different laws to resolve the different parts of a financial firm. This makes a coordinated resolution of entire financial organizations -- which may or may not include an FDIC insured bank – almost impossible.

And as I will discuss later, the bankruptcy process simply does not work for large, systemically important financial institutions in a way that can preserve stability and avoid disruptions in the financial system.

The lack of an effective resolution mechanism for large financial organizations is driving many of our policy choices. It has contributed to unprecedented government intervention into private companies. It has fed the "too big to fail" presumption, which has eroded market discipline for those who invest and lend to very large institutions. And this intervention, in turn, has given rise to public cynicism about the system and anger directed at the government and financial market participants.

We need a new resolution regime for these large institutions, which does a better job of imposing loss on investors and creditors, instead of leaving it in the hands of government and the laps of the taxpayer. To be sure, creating such a resolution mechanism would be very bold. But recent history –I believe-- has shown that it is a very necessary step.

Why we need resolution authority

For 75 years the FDIC has quickly and effectively resolved failed banks. We are good at this. We have had a lot of practice over the years.

When an FDIC-insured bank or thrift is in danger of failing, the FDIC has standard procedures that kick into gear. Typically, where a bank is approaching insolvency, we invoke Prompt Corrective Action. This involves formal notification to the bank of its undercapitalized status and the need for a corrective plan.

We begin assembling an information package for bidders with the structure and terms of the transaction. Then we send FDIC staff to review the bank's books, contact prospective bidders, and begin the process of auctioning the bank to achieve the best return to the Deposit Insurance Fund. Our staff work with the acquiring bank, and make the hand-over as unintrusive (and seamless) as possible, arriving at the failed bank after it closes the doors for the day, usually on a Friday night.

The FDIC takes control of the bank and begins the closing process. At the same time, the acquirer begins to prepare the bank to reopen. Over night, all insured deposits are transferred to the acquiring bank and are made available on-line or through ATMs.

By Monday morning, the bank reopens with a new name and under control of the acquiring institution. And the FDIC is hard at work dealing with the failed bank's assets in accordance with our priority structure. This is the typical process, though sometimes banks have to be closed because of an inability to meet their funding obligations.

These "liquidity failures" can be sudden, and require that we set up a bridge bank to give us time to market and sell the institution. The biggest positive from our process is the very quick reallocation of resources from the weak, to the strong.

Make no doubt about it, this can be a painful process for shareholders, creditors and bank employees. The differences between this process and the government's actions since last fall in dealing with this nation's largest financial institutions are stark.

Was it pretty? No. Given the benefit of hindsight, could things have been done differently? Perhaps. But most of us in this room I hope would agree that the government's actions were necessary and successful for now in stabilizing a very volatile situation. But going forward, it is very clear in my mind that we need new tools and new methods to promptly and effectively deal with the clean up.

We must not forget the lessons learned from the Savings and Loan debacle in the 1980s. Delay was very real, and had very significant costs. The S&L crisis started in 1980 when interest rate controls on deposits were lifted at a time of historically high interest rates. With most S&Ls holding long-term fixed-rate mortgages portfolios, the higher interest rates for deposits generated huge losses, almost completely wiping out the industry's tangible capital two years later. While some S&Ls were closed, the main response was manipulating accounting rules, reducing capital requirements, lightening up supervision ... and basically, just hoping it all worked out.

Seven years later the thrift industry collapsed, generating billions of dollars in losses in residential and commercial real estate. The Resolution Trust Corporation was then created, with taxpayers forced to pay $124 billion to shut down 750 S&Ls. Not a pretty sight, nor an easy case to explain to taxpayers. But it had one redeeming virtue; it removed a huge backlog of toxic assets from our "nation's portfolio," which allowed our economy to move back into the black.

Why we need to change how we resolve systemically important institutions

The FDIC's resolution powers are extremely effective when a smaller bank fails. But they fall short when it comes to very large financial organizations. Why? The main problem is that we don't have the ability to resolve bank holding companies. We can only resolve the insured depository institution within the holding company.

When a failing bank is part of a large, complex holding company, many of the essential services for the bank's operations lie in other parts of the company, outside our reach. The loss of essential services can make it difficult to run the bank.

Because of the complex network of corporate relationships, holding companies often wield critical control over bank and non-bank subsidiaries, as well as mutually dependent business activities. It's not unusual for many corporate services to operate in both the insured and non-insured affiliates, without regard to legal separation.

In some cases, the insured depository may be so dependent on its holding company that it is difficult, if not impossible, to operate without holding company cooperation. This can hamstring the FDIC and our ability to preserve the bank's franchise value, and minimize losses to the Deposit Insurance Fund (which is our number one mandate).

Taking control of just the bank is not a practical solution. A basic change to give us the ability to resolve both banks and their holding companies would remove a key limitation in the tools we currently have to deal with non-viable large institutions.

The second reason we need a change in the game rules is the FDIC's resolution powers don't apply to financial firms that are not depository institutions. These firms – like bank holding companies -- must be resolved through bankruptcy.

This can be a messy business in the case of systemically important non-bank financial firms. Bankruptcy is designed to protect the interests of creditors, not to prevent a meltdown of the financial system when a systemically important financial firm gets into trouble. When a firm is placed into bankruptcy, an automatic stay is put on most creditor claims to allow management time to develop a reorganization plan. This can create liquidity problems for creditors who must wait to get their money. For financial firms, bankruptcy can trigger a rush to the door, as counterparties to derivatives contracts exercise their rights to immediately terminate the contracts, net out their exposures, and sell any supporting collateral.

When these statutory rights were initially provided in the 1980s and expanded in 2005, they were designed to reduce the risks of market disruption. However, during periods of economic instability, this rush-to-the-door can overwhelm the market's ability to complete settlements, depress prices for the underlying assets, and further destabilize the markets. This can have a domino effect across financial markets, as other firms are forced to adjust their balance sheets.

Financial firms are highly interconnected. They are central to credit and liquidity and tying up those intermediation functions during a court-based process is untenable. We need a process that provides for continuity in functions, as the government undertakes an orderly transfer or unwinding of the firms' positions. At the same time, special expertise is required to provide that continuity, while also protecting market functionality and taxpayer exposure.

This stands in contrast to the mandate of a bankruptcy court to protect creditors.

Our goal should be to create a new resolution process that imposes losses on the appropriate parties without interrupting essential operations. Bankruptcy doesn't meet these objectives. For instance, the FDIC has special resolution authority to prevent immediate close-out netting and settlement of an insured depository's financial contracts. We have 24 hours after appointment as receiver to decide whether to transfer the contracts to another bank or to an FDIC-operated bridge bank ... or to cancel the contracts. This remedial authority prevents instability and contagion, which is what you can get from a bankruptcy. The lack of a resolution mechanism has required the government to improvise for each individual situation, making it very difficult to address systemic problems in a coordinated manner.

On top of that, there is the matter of fairness. There needs to be a clearly laid out process in place. Government should not be in the business of arbitrarily picking winners and losers. And smaller banks shouldn't be subject to one regime, while larger institutions and non-banks are subject to another. Investors and creditors have lacked strong incentives to perform due diligence because of the perception that these institutions are so large and complex that the government would have to bail them out. And they were absolutely right.

New resolution regime

What's needed is a new way to unwind these big institutions. We need an effective resolution mechanism, not a get-out-of-jail free card. Taxpayers should not be called on to foot the bill to support non-viable institutions because there is no orderly process for resolving them. This is unacceptable, and simply reinforces the notion of "too big to fail" ... a 25-year old idea that ought to be tossed into the dustbin.

When the public interest is at stake, the resolution process should support an orderly unwinding of the institution in a way that protects the broader economy and the taxpayer, not just private financial interests.

To be sure, a new resolution regime is not panacea. We also need better and smarter regulation. Many of the institutions that got into trouble were already heavily regulated. We didn't do enough to constrain leverage, regulate derivatives, and most important, protect the consumer. We forgot that there is a difference between "free markets", and "free for all markets".

But while considerable attention has been focused on regulatory shortcomings, not enough has been focused on the lack of market discipline fostered by "too big to fail". To address this problem, we must have a realistic way to close and resolve non-viable systemic institutions.

Here's how a resolution authority could help.

Many have cited a "good bank" -- "bad bank" model for resolving these institutions. Under this scenario, you'd take over the troubled firm, imposing losses on stockholders and unsecured creditors. Viable portions of the firm would be placed into the "good bank" using a structure similar to the FDIC's bridge bank. The nonviable or troubled portions of the firms would remain behind in a "bad bank," and would be unwound or sold over time.

The cost of the bad bank would be partially paid for by the losses imposed on the stockholders and unsecured creditors. Any additional costs would be borne by assessments on other systemically risky firms. This has the benefit of quickly recognizing the losses in the firm and beginning the process of cleaning up the mess.

The stockholders and managers of some big banks might not like this process. They might prefer a too-big-to-fail subsidy or investment from the government. (And some regulators might fear it because it would give an independent body the ability to close institutions for which they are responsible.)

Short term pain, long term gain

It would be a brave new world which, in the short term, could increase the cost of capital for large institutions. Investors and creditors will come to understand their own responsibility (and the wisdom) of conducting due diligence of the strengths and weaknesses of bank managers and balance sheets. In turn, investors and creditors will charge a premium for the newly recognized risk, that indeed, these institutions could fail.

This is as it should be. Everybody should have the freedom to fail in a market economy. Without that freedom, capitalism doesn't work. In the longer term, a legal mechanism to resolve systemically important firms would result in a more efficient alignment of capital with better managed institutions. Ultimately, this would benefit those better managed institutions and make the financial system and the economy stronger and more resilient.

Funding

So who should pay for an "anybody can fail" doctrine? Certainly not the taxpayer. As a tax-paying citizen, I don't favor encouraging foolish behavior. Nor should those costs be borne by the Deposit Insurance Fund, which should continue to be used only for the costs of protecting depositors when banks fail.

A new resolution authority could include assessments on larger firms to fund a reserve that would be tapped to absorb losses for a failure. I believe it's only fair that the industry that benefits should pay ... just as banks pay for deposit insurance.

The assessments could be based on the differential in the cost of capital between smaller institutions -- which clearly can fail and thus have higher costs -- and their larger competitors. Moreover, we should not base this strictly on size, which might not be perfectly aligned with risk. For example, a large mutual fund that invests in the S&P 500 is not systemic. Risk-based surcharges should be imposed on higher risk behavior. This might include certain derivatives, market making or proprietary trading, and rapid growth. We now have such a risk-based system for the insurance premiums we charge for deposit insurance, and it's working very well.

Where to put the new regime

Who is best-able to get the job done? I don't think we need another government bureaucracy or program. This is cyclical work. We have a lot of agencies already. I'm not sure it makes much sense to create another one that would need to be staffed up and ready to go. But the FDIC is up to the task, and whether alone or in conjunction with other agencies, the FDIC is central to the solution. Given our many years of experience resolving banks and closing them, we're well-suited to run a new resolution program.

Some have said we don't have experience in resolving large institutions. But no other agency has the skills and tools needed for resolving these institutions. The knowledge and skills used to resolve smaller institutions can be applied to larger ones. In addition, we can and would reach out to the private sector for experienced bank management to help us unwind and resolve larger entities.

Creating a stand-alone resolution authority or housing it in another agency could actually lead to instability down the road. Systemic events are infrequent. The last big failure, the Continental Illinois crisis, happened 25 years ago. With such long periods between crises it is difficult to imagine the duties of the stand alone resolution authority in the interim. When crisis does strike, the authority would likely be understaffed and unprepared because we all know too well how hard it is to see the brewing storm. This would make it less likely that authorities would be able to act quickly, creating the kind of public panic a new independent authority was supposed to prevent.

Conclusion

Let me conclude by saying again that we cannot effectively solve the problems caused by the "too big to fail" notion unless we overhaul how we regulate and supervise big institutions, and how we resolve them when they implode. Closing down a big name company is never pleasant. It's a messy business but a necessary one in a market economy.

To move forward, we can't let ourselves be prisoners of out-dated authorities, trapped in a resolution regime which pre-dated the evolution of the "shadow banking sector"—crafted in a prior era when insured banks overwhelmingly dominated financial services. The sooner we modernize our resolution structure, the sooner we can end too big to fail, and clear the way for a stronger, brighter and more stable economic future.

Thank you very much.

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