Statement of
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Federal Deposit Insurance Corporation
on the
State of the FDIC: Deposit Insurance,
Consumer Protection, and Financial Stability
before the
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Chairman Johnson, Ranking Member Shelby, and members of the Committee, thank you for the opportunity to testify today on the state of the Federal Deposit Insurance Corporation. The past five years, marking my tenure as FDIC Chairman, have been among the most eventful for U.S. financial policy since the 1930s. During this time our nation has suffered its most serious financial crisis and economic downturn since the Great Depression. The aftereffects are still being felt and will likely persist in some measure for years.

Despite the challenges, I am pleased to report significant progress in the recovery of FDIC-insured institutions and the Deposit Insurance Fund (DIF), as well as in implementing regulatory reform measures as authorized under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act). Following through on these reforms will be crucially important to the type of long-term financial stability that will be necessary to support economic growth in the years ahead.

In my testimony today, I would like to summarize the progress that the FDIC has made in ensuring the safety and soundness of our banking system, protecting depositors, resolving failed institutions, and rebuilding the financial health of the DIF. I will highlight, in particular, efforts we are making to enhance consumer protection in the wake of a crisis where risky retail lending practices played a leading role. I will briefly summarize our progress in implementing the resolutions framework for systemically-important financial institutions (SIFIs) that was authorized under the Dodd-Frank Act, and conclude with some additional thoughts on the importance of financial regulatory reform to the nation's long-term economic health.

Condition of the Industry and the Deposit Insurance Fund

Since my term began in June 2006, the landscape of the banking industry has undergone dramatic change. When I arrived, the industry was in the midst of its sixth consecutive year of record earnings. The ratio of noncurrent loans to total loans was a record-low 0.70 percent.1 There were only 50 problem banks, and we were in the midst of a record period of 952 days without a bank failure. However, as we soon learned, the apparently strong performance of those years in fact reflected an overheated housing market, which was fueled by lax lending standards and excess leverage throughout the financial system.

The industry quickly shifted from a period of apparently strong performance to record credit losses and some of the worst earnings quarters in U.S. banking history. The deterioration began with the onset of recession in late 2007. The trend worsened after the peak of the financial crisis, and the industry reported a record loss of $37 billion in the fourth quarter of 2008. By early 2010, the ratio of noncurrent loans to total loans had risen nearly eight-fold to 5.5 percent. The FDIC went from a long stretch of no failures to resolving 373 institutions since the start of 2007, including the largest bank failure in U.S. history. In addition, the federal government and U.S. banking regulators had to provide assistance to our largest financial organizations to prevent their failure from causing an even more severe economic disaster.

After showing signs of a turnaround in 2010, performance of FDIC-insured institutions continued to strengthen in the first quarter of 2011. Earnings have recovered to levels that remain lower than their pre-recession highs, and asset quality indicators have also improved somewhat. However, problem assets remain at high levels, and revenue has been relatively flat for several quarters.

Banks and thrifts reported aggregate net income of $29 billion in the first quarter, an increase of 67 percent from first quarter 2010 and the industry's highest reported quarterly income in nearly three years. Industry earnings have registered year-over-year gains for seven consecutive quarters. More than half of institutions reported improved earnings in the first quarter from a year ago, and fewer institutions were unprofitable.

The main driver of earnings improvement continues to be reduced provisions for loan losses. First quarter 2011 provisions for losses totaled $20.6 billion, which were about 60 percent below a year ago. Reduced provisions for losses reflect general improvement in asset quality indicators. The volume of noncurrent loans declined for the fourth consecutive quarter, and net charge-offs declined for the fifth consecutive quarter. All major loan types had declines in volumes of noncurrent loans and net charge-offs. However, the ratio of noncurrent loans to total loans of 4.71 percent remains above levels seen in the crisis of the late 1980s and early 1990s.

The positive contribution from reduced loan-loss provisions outweighed the negative effect of lower revenue at many institutions. Net operating revenue – net interest income plus total noninterest income – was $5.6 billion lower than a year ago. This was only the second time in the more than 27 years for which data are available that the industry has reported a year-over-year decline in quarterly net operating revenue. Both net interest income and total noninterest income reflected aggregate declines. More than half of all institutions reported year-over-year increases in net operating revenue, but eight of the ten largest institutions reported declines.

The relatively flat revenues of recent quarters reflect, in part, reduced loan balances. Loan balances have declined in ten of the past eleven quarters, and the 1.7 percent decline in the first quarter was the fifth largest percentage decline in the history of the data. Balances fell in most major loan categories. Recent surveys suggest that banks have been starting to ease lending standards, but standards remain significantly tighter than before the crisis. Surveys also indicate that borrower demand remains sluggish. Growth of well-underwritten loans will be essential not only for banks to build revenues but also to provide a stronger foundation for economic recovery.

The number of "problem banks" remains high, at 888.[2] However, the rate of growth in the number of problem banks has slowed considerably since the end of 2009. As we have repeatedly stated, we believe that the number of failures peaked in 2010, and we expect both the number and total assets of this year's failures to be lower than last year's.

In all, the failure of some 373 FDIC-insured institutions since 2006 has imposed total estimated losses of $84 billion on the DIF. As in the last banking crisis, the sharp increase in bank failures caused the fund balance, or its net worth, to become negative. In the recent crisis, the DIF balance turned negative in the third quarter of 2009 and hit a low of negative $20.9 billion in the following quarter. By that time, however, the FDIC had already moved to shore up its resources to handle the high volume of failures and begin replenishing the fund. The FDIC increased assessment rates at the beginning of 2009, which raised regular assessment revenue from $3 billion in 2008 to over $12 billion in 2009 and almost $14 billion in 2010. In June 2009, the FDIC imposed a special assessment that brought in an additional $5.5 billion from the banking industry. Furthermore, to increase the FDIC's liquidity, the FDIC required that the industry prepay almost $46 billion in assessments in December 2009, representing over three years of estimated assessments.

While the FDIC had to impose these measures at a very challenging time for banks, they enabled the agency to avoid borrowing from the U.S. Treasury. The measures also reaffirmed the longstanding commitment of the banking industry to fund the deposit insurance system. Since the FDIC imposed these measures, the DIF balance has steadily improved. It increased throughout 2010 and stood at negative $1.0 billion as of March 31 of this year. We expect the DIF balance to once again be positive when we report the June 30 results. Over the longer term, the FDIC has put in place assessment rates necessary to achieve a reserve ratio (the ratio of the fund balance to estimated insured deposits) of 1.35 percent by September 30, 2020, as the Dodd-Frank Act requires.

The FDIC has also implemented the Dodd-Frank Act requirement to redefine the base used for deposit insurance assessments as average consolidated total assets minus average tangible equity. As Congress intended, the change in the assessment base, in general, will result in shifting some of the overall assessment burden from community banks to the largest institutions, which rely less on domestic deposits for their funding than do smaller institutions. The result will be a sharing of the assessment burden that better reflects each group's share of industry assets.

The FDIC has used its new authority in setting reserve ratio targets and paying dividends to adopt policies that should maintain a positive DIF balance even during possible future banking crises while preserving steady and predictable assessment rates throughout economic and credit cycles. The FDIC also revised its risk-based premium rules for large banks. The new premium system for large banks goes a long way toward assessing for risks when they are assumed, rather than when problems materialize, by calculating assessment payments using more forward-looking measures. The system also removes reliance on long-term debt issuer ratings as required by the Dodd-Frank Act.

Consumer Protection and Economic Inclusion

I would also like to address the various efforts underway at the FDIC that are focused on consumer protection. It is important to recall that a fundamental cause of the financial crisis from which the country is still emerging was a failure of consumer protection in the mortgage market. While the FDIC was at the forefront of efforts before the crisis to identify and try to address the implications of both subprime and nontraditional mortgage lending, the regulatory guidance on these loan products – which only applied to insured banks – came too late to prevent mortgage lending weaknesses from undermining the foundations of our housing and financial systems. Many other weaknesses – including inadequate capital resulting in too much leverage, lack of transparency in the derivatives markets, and poor coordination among regulators – magnified and expanded the problems created in the mortgage markets. If the rules now in place had been in existence in 2004, the crisis would have been less severe, if not averted.

The new Consumer Financial Protection Bureau (CFPB) can play an important role in making consumer protections both simpler and more effective. Already, CFPB proposals for simplifying mortgage disclosures currently made under the Truth in Lending Act (TILA) and the Real Estate Settlement Procedures Act (RESPA) have been well received by industry and consumer groups alike. More broadly, the CFPB also can fill an important void by ensuring that nonbank consumer financial companies are subject to the same rules and a similar regime of supervision and enforcement as are insured depository institutions. Many of the unsustainable mortgages made during the boom years were originated by nonbank mortgage companies. These firms simply were not subject to the kind of regular examination that FDIC-insured institutions must undergo. Leveling this playing field is extremely important to prevent regulatory arbitrage.

As you know, the law mandates that banks with assets of less than $10 billion continue to be examined for consumer protection compliance by their primary federal regulators. In our case, this means that the FDIC will continue to examine about 4,500 state-chartered, non-member banks for compliance with consumer laws and regulations. To ensure that consumer protection continues to receive appropriate focus, the FDIC established a Division of Depositor and Consumer Protection (DCP) that will be able to work with the new CFPB to ensure consistent application of consumer rules.

Moreover, the Dodd-Frank Act requires the CFPB to consult with the FDIC and other prudential regulators in the development of its regulations. This is a role we take very seriously. Along with our Division of Risk Management Supervision, DCP will ensure that we are institutionally prepared to engage in this consultation. An important part of the consultation process will involve making sure the CFPB understands the inter-relationship between consumer protection and safety and soundness, and also takes into account the potential impacts of its regulations on small, community banks. Simpler, clearer consumer protection rules will not only help consumers better understand their legal rights, but also help community banks engage in a broader array of consumer lending without burdensome legal compliance costs. The FDIC has many years of experience in supervising community banks for compliance with consumer laws and is highly supportive of the CFPB's goal of simplifying consumer rules, which should reduce regulatory burden on community banks. In addition, the Director of the CFPB will be a member of the FDIC's Board of Directors. This will further ensure the coordination of prudential regulation and consumer protection.

Early in my term, the FDIC Board created the Advisory Committee on Economic Inclusion to provide advice and recommendations on expanding access to mainstream banking services for underserved consumers. The Committee's objective is to explore ways to lower the number of households without access to mainstream financial services by identifying appropriate incentives or removing obstacles to the provision of financial products that meet the needs of these households, with an emphasis on safety and affordability for consumers and economic feasibility for banks. These consumer protection initiatives are integral to the FDIC's mission to promote public confidence, access to the banking system, and the benefits of deposit insurance. Economic inclusion is about promoting widespread access to safe, secure, and affordable banking services so that everyone has the opportunity to save, build assets, and achieve financial security.

Implementing Reforms to Promote Financial Stability

As I have testified several times over the past year, the Dodd-Frank Act, if properly implemented, will not only reduce the likelihood and severity of future crises, but will provide effective tools to address large company failures when they do occur without resorting to taxpayer-supported bailouts or damaging the financial system.

Our highest near-term regulatory priorities are two-fold: 1) implementing the various regulatory mandates that make up the new resolution framework for SIFIs, and 2) strengthening and harmonizing capital and liquidity requirements for banks and bank holding companies under the Basel III protocol and Section 171 of the Dodd-Frank Act, the Collins Amendment. The FDIC is also engaged in implementing the other important Dodd-Frank Act reforms where we have been given authority to do so. The following is a brief summary of our implementation activities and how we see them influencing the future course of the banking sector.

SIFI Resolution Framework. The problem of financial companies that are Too Big to Fail has been around for decades. But the bailouts of troubled SIFIs that occurred in the crisis removed all doubt that this was a central problem facing our financial system.

The bailouts were made necessary by the absence of an effective resolution process for bank holding companies and their nonbank affiliates. Without those powers, the failure of an FDIC-insured subsidiary would likely have resulted in the costly and disorderly bankruptcy of the holding company and a significant widening of the financial crisis. This was not a risk policymakers were willing to take at the time.

The crisis of 2008 showed the overwhelming pressure that develops to provide government bailouts when information is sketchy, when fear is the prevailing market sentiment, and when there is no clear sense of how bad things might get before the system begins to stabilize. But bailouts have consequences. They undermine market discipline. They inhibit the restructuring of troubled financial companies and the recognition of losses. They keep substandard management in place and preserve a suboptimal allocation of economic resources.

In contrast, smaller banks are fully exposed to the discipline of the marketplace. Some 373 FDIC-insured institutions have failed since I became FDIC Chairman. This is how capitalism is supposed to work. Failed companies give way to successful companies, and the remaining assets and liabilities are restructured and returned to the private sector. That is why bailouts are inherently unfair. They violate the fundamental principles of limited government on which our free-enterprise system is founded. They undermine trust in governmental functions that most people would agree are necessary and appropriate.

This is why the FDIC was so determined to press for a more robust and more effective SIFI resolution framework as the centerpiece of the Dodd-Frank Act. We were early advocates for a SIFI receivership authority that operates like the one we have applied thousands of times in the past to resolve failed banks. We pushed for liquidation plans by the SIFIs that would prove they could be broken apart and sold in an orderly manner, and for greater oversight and higher capital in relation to the risk these companies pose to financial stability.

Titles I and II of the Dodd-Frank Act authorize the creation of just such a resolution framework that can make the SIFIs resolvable in a future crisis. These provisions are designed to restore the discipline of the marketplace to the megabanks, to end their ability to take risks at the expense of the public, and to eliminate the competitive advantage they enjoy over smaller institutions. In January, the Financial Stability Oversight Council (FSOC), of which the FDIC is a voting member, issued a Notice of Proposed Rulemaking describing the processes and procedures that will inform the FSOC's designation of nonbank financial companies under the Dodd-Frank Act. In April, the Federal Reserve Board (FRB) and the FDIC issued a request for comment of a proposed rule that implements the Dodd-Frank Act requirements regarding SIFI resolution plans and credit exposure reports. The FDIC Board has also approved a

Notice of Proposed Rulemaking and an Interim Final Rule intended to provide clarity and certainty about how key components of the Orderly Liquidation Authority will be implemented. These measures will ensure that the liquidation process under Title II reflects the Dodd-Frank Act's mandate of transparency in the liquidation of covered financial companies.

Despite the timely progress that has been made in implementing these authorities, there remains skepticism as to whether the SIFIs can actually be made resolvable in a crisis. I believe the skeptics underestimate the benefits of having so much more information about these institutions in advance, as well as the authority to require, if necessary, organizational changes that better align business lines and legal entities well before a crisis occurs. I have also tried very hard to dispel the misconception that the Orderly Liquidation Authority is a bailout mechanism or, alternatively, a fire sale that will destroy the value of receivership assets. It is neither. The Orderly Liquidation Authority strictly prohibits bailouts. It is a powerful tool that greatly enhances our ability to provide continuity and minimize losses in financial institution failures while imposing any losses on shareholders and unsecured creditors. It will result in a faster resolution of claims against a failed institution, smaller losses for creditors, reduced impact on the wider financial system, and an end to the cycle of bailouts.

Strengthening Capital Requirements. The other major lesson of the crisis involves the dangers of excessive debt and leverage. The single most important element of a strong and stable banking system is its capital base. Capital is what allows an institution to absorb losses while maintaining the confidence of its counterparties and its capacity to lend.

After the last banking crisis, in the early 1990s, Congress passed a number of important banking reforms that included stronger capital requirements. However, capital requirements were watered down over the years through rules that permitted use of capital with debt-like qualities, that encouraged banks to move assets off the balance sheet, and that set regulatory capital thresholds based on internal risk models. The result was an increase in financial system leverage – particularly at bank holding companies and nonbank financial companies – that weakened the ability of the industry to absorb losses during the crisis and that has led to a dramatic deleveraging of banking assets in its wake.

As the crisis has shown, overreliance on leverage is a short-term strategy with a big downside over the longer term. That is why the FDIC has been so committed to following through on the capital reforms that are taking place through the Basel III international capital accord. That is also why we have been such strong supporters of other measures to enhance capital, including the Collins Amendment to the Dodd-Frank Act and the SIFI capital surcharge.

Last weekend, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision (BCBS), agreed to some important changes in the capital rules that will strengthen the resilience of the largest global systemically-important banking firms – known as G-SIBs – and will create strong incentives for them to reduce their systemic importance over time. The assessment methodology for G-SIBs is based on an indicator-based approach, and comprises five broad categories: size, interconnectedness, lack of substitutability, global (cross-jurisdictional) activity and complexity. The agreement provided for capital requirements ranging from 1 percent above the Basel 3 minimums to 2.5 percent, depending upon the degree of systemic risk posed by each firm.

Importantly, the agreement requires that the enhanced capital requirements be fully satisfied with common equity. The FDIC strongly supported this decision to require common equity since it is the only instrument which proved to have loss absorbing capacity during the crisis. Alternatives such as contingent capital and so-called "bail-in" debt are worthy of further study, but remain untested in crisis situations. Our experience and judgment strongly suggest that these instruments still represent debt. The only proven buffer against the kind of widespread financial distress our system experienced in the crisis is tangible equity capital.

Some banking industry representatives are claiming that higher capital requirements will raise the cost of credit and could derail the economic expansion. However, we believe the costs of higher capital are overstated, and the benefits understated. Recent research that shows higher capital requirements, in the range that we are talking about, will have a very modest effect on the cost of credit.3 Higher capital requirements will create a large net improvement in long-term economic growth by lessening the frequency and severity of financial crises that have historically proved devastating to economic growth. Over the long-term, these efforts to strengthen the capital base of the industry will benefit all parties concerned – including banks – by making our system more stable and less procyclical.

The fact is that the capital requirements U.S. banks now face are mostly the same as those that were in existence before the crisis. The reason banks are not lending more is a combination of risk aversion on their part and reduced borrower demand. Most banks have plenty of capacity to lend. Large banks have been raising capital since the crisis started, and most either already meet the new Basel III standards, or are well positioned to do so solely through retained earnings. Banks that need more time will benefit from the extended phase-in periods designed to ensure seamless transition to the new standards, including any SIFI surcharge.

Proprietary Trading and the Volcker Rule. The traditional function of banks has been to transform shorter maturity or more liquid liabilities into longer-term, less liquid loans. The economic value of this function, combined with its inherent susceptibility to depositor runs, has long been the justification for government structures such as deposit insurance, the discount window, and federal bank regulation that are designed to preserve stability in banking.

It is harder to explain why the government should subsidize a trading operation with deposit insurance and other support. This question became particularly pointed in the wake of the crisis. Losses in banks' trading books were extremely large in the early part of the crisis. These losses seriously weakened institutions and contributed to a loss of confidence by counterparties, driving the crisis in its early stages.

The Volcker rule bans proprietary trading by banking organizations, and prevents them from simply moving proprietary trading operations into off-balance sheet vehicles by imposing meaningful limitations on bank investments in hedge funds and private equity funds. The statutory definition of prohibited proprietary trading is subject to important exceptions. In addition to risk-mitigating hedging, the most important of these exceptions involve market-making and securities underwriting. Notwithstanding the various permissible activity exceptions in the Volcker rule, in no event may the regulators permit activities that create material conflicts of interest, expose institutions to high-risk trading strategies, or threaten financial stability. The regulators have considerable discretion in how to interpret and implement the Volcker rule. The agencies' staffs have been working intently at crafting a proposed rule to implement this important mandate in an appropriate manner.

I view the Volcker rule as a conceptually well-founded limitation of the federal government's safety-net support of trading operations by banking organizations, and I do not believe it presents concerns for the competitiveness of the U.S. economy. Any restrictions on activities under the rule will affect where risky trades are housed. Unlike credit intermediation, where the federal safety net plays an important role in assuring a stable funding base through deposit insurance and access to the discount window, there is no public policy rationale for government support of proprietary trading.

OTC Derivatives Reform. At the June 2010 G-20 Summit in Toronto, the leaders reaffirmed a global commitment to trade all standardized OTC derivatives contracts on exchanges and clear through central counterparties (CCPs) by year-end 2012 at the latest. Further, the leaders agreed to pursue policy measures with respect to haircut-setting and margining practices for securities financing and OTC derivatives transactions to enhance financial market resilience. Through the Dodd-Frank Act derivatives legislation, the U.S. is taking a leadership role in proposing concrete and actionable measures to accomplish these international commitments.

Making good on these commitments is important to avoiding another derivatives-related crisis. During the decades leading up to the crisis, the perceived wisdom in the regulatory community was that OTC derivatives reduced risk in the financial system. The use of these essentially unregulated financial products grew exponentially pre-crisis but, at least in the case of credit default swaps (CDS), these products proved to hide and concentrate risks rather than mitigate them. Though CDS instruments did not cause the crisis, they helped to disguise the risks building in mortgage securitizations and greatly magnified the losses once securitized mortgages began to default.

The Dodd-Frank Act has given the SEC and the CFTC important roles in addressing the lessons that the financial crisis taught us about CDS. For the CDS instruments they regulate, each Commission will require standardized CDS instruments to be traded on an exchange and cleared through a clearinghouse. They also are charged with setting margin and capital requirements for customized CDS instruments that cannot be cleared though a clearinghouse. When Section 716 of the Dodd-Frank Act, the Lincoln amendment, becomes effective, dealer activity in uncleared CDS instruments is expected to migrate from banks to non-bank dealers that will be subject to the Commission's rules.

While the SEC and the CFTC have been given important responsibilities, they have not been given the resources needed to discharge them. Earlier this month, both Commissions announced that they would not meet the 1-year deadlines for many of the regulations needed to address CDS and other risks in the system. They are now projecting completing such rules by December of this year.

The Greek sovereign debt crisis has renewed scrutiny over the CDS market and who will bear the risk in the event of a default. While there has been some improvement in information available to regulators, risks in this market are highly inter-related, and it is difficult to know with certainty the capacity of counterparties to make good on their obligations in the event of a major credit event and where the ultimate exposure may reside. It is essential that the SEC and CFTC be able to move forward with needed reforms in this market. I strongly encourage you to ensure that the SEC and the CFTC have the resources needed to do their jobs.

The Importance of the Dodd-Frank Reforms to the Economic Recovery

As the reform process continues, there is understandable concern about the slow pace of the economic recovery. The U.S. economy has been growing continuously for two years now. However, adjusted for inflation, consumer spending and non-real estate business investment remain near the levels that had been reached just prior to the recession, almost three-and-a-half years ago. By almost any measure, the real estate sector remains depressed. Meanwhile, the U.S. economy has regained just over 20 percent of the 8.75 million payroll jobs lost as a result of the recession. In fact, there are over 1 million fewer U.S. private sector payroll jobs today than there were in December 1999, more than 11 years ago.

While the economic situation merits the utmost concern of policymakers, it is important that this concern not be misplaced. The challenges facing our economy are not the result of financial reform. Instead, they are largely the result of the enormous and long-lasting impact the financial crisis has had on U.S. economic activity. The pattern of excessive leverage and subsequent financial collapse is not unique to the recent U.S. financial crisis but has been repeated many times, in many places.

A Greater Focus on Real Estate is Needed. One factor that greatly complicates the recovery from the crisis is that it is rooted in the real estate sector. According to CoreLogic, approximately 10.9 million residential mortgage loans – or more than one out of every five outstanding – are currently underwater, meaning that the borrower owes more than the property is worth.4 Underwater borrowers are at high risk of default in the event of financial distress because they lack the ability to satisfy the loan through the sale of the property. Underwater borrowers are also frequently unable to move in order to find work when it is available elsewhere.

The fact that so many residential and commercial properties are currently underwater goes a long way to explaining the continuing weakness of the small business sector, which is so important to the creation of new jobs. Almost half of the liabilities of nonfarm noncorporate businesses are secured by real estate, both residential and commercial. The large and persistent declines in real estate values in many areas of the country have hurt both the demand for small business products on the part of their Main Street customers as well as the ability of small businesses to borrow against the real estate collateral they own.

Although the real estate market downturn is now entering its sixth year, signs of recovery remain elusive. Approximately 2.25 million mortgages remain mired in a foreclosure process that has been slowed by inefficiencies on the part of mortgage servicers, by deficiencies in the their handling of the legal paperwork, and by a frustrating inability to move quickly enough to modify troubled loans while there is still a chance to keep them out of foreclosure.

In April 2011, the federal banking agencies ordered fourteen large mortgage servicers to overhaul their mortgage-servicing processes and controls, and to compensate borrowers harmed financially by wrongdoing or negligence. The enforcement orders were only a first step in setting out a framework for these large institutions to remedy deficiencies and to identify homeowners harmed as a result of servicer errors. The enforcement orders do not preclude additional supervisory actions or the imposition of civil money penalties. Also, a collaborative settlement effort continues between the State Attorneys General and federal regulators led by the U.S. Department of Justice. It is critically important that lenders fix these problems soon to contain litigation risk and remedy the foreclosure backlog, which has become the single largest impediment to the recovery of U.S. housing markets and our economy. In addition, our combined regulatory and enforcement efforts should focus on helping to clear the market through streamlined modification protocols, write-offs of second liens where appropriate, and, for borrowers who cannot qualify for a loan modification, alternatives to the costly and time consuming foreclosure process such as "cash-for-keys" programs and short sales.

Returning Banking to the Business of Lending. Over the longer term, the highest regulatory priority should be placed on returning the banking industry to a primary focus on safe and sound lending that supports real economic activity.

A strong and stable financial system is vital to the economic and fiscal health of the U.S. and our competitiveness in the global economy. A well-functioning financial system supports economic growth by channeling savings into productive investment, allows consumers, businesses, and market participants to engage in financial transactions with confidence, and is a source of credit to the broader economy even in times of stress. The crisis exposed the vulnerabilities of an unevenly regulated and highly leveraged

U.S. financial system that proved to be anything but strong and stable. The excessive leverage in the financial system entering the crisis forced a massive deleveraging after the credit losses associated with the crisis began to be realized in earnest.

Since the beginning of the recession in December 2007, FDIC-insured institutions have set aside some $644 billion in loan loss provisions. During this period, loans and leases held by FDIC-insured institutions have declined by nearly $750 billion from peak levels, while unused loan commitments have declined by $2.7 trillion. This deleveraging, resulting from insufficient capital at the outset of the crisis, has been accompanied by the virtual disappearance of some important forms of non-bank credit intermediation. For example, while annual issuance of private mortgage-backed securities exceeded $1 trillion in both 2005 and 2006, it averaged just $62 billion per year in 2009 and 2010 – almost 95 percent below peak levels.

Stronger capitalization and stronger financial practices will be necessary to restore confidence in our banking system, the lending capacity of the banking industry, and the vitality of important non-bank credit channels like private mortgage-backed securitization. One of the strengths of our financial system is the presence of almost 7,000 community banks with assets less than $1 billion and over 500 mid-sized banks with assets of between $1 billion and $10 billion. These institutions are, on average, much better capitalized than the largest institutions, and they earn profits primarily by lending to the local small businesses and households that represent the core strength of our economy.

But the competitive position of small and mid-sized institutions has been steadily eroded over time by the government subsidy attached to the Too Big to Fail status of the nations largest banks. In the first quarter of this year, the cost of funding earning assets was only about half as high for banks with more that $100 billion in assets as it was for community banks with assets under $1 billion. Stronger and more uniform capital requirements, and a resolution framework that subjects every institution – no matter its size – to the discipline of the marketplace, are necessary steps to level the competitive playing field and help return the focus of our banking system to making good loans that serve the needs of households and businesses of all sizes in every part of the nation.

Similarly, new rules recently proposed by the FSOC to require issuers of asset-backed securities to retain at least five percent of the credit risk, as mandated by the Dodd-Frank Act, are necessary to restore investor confidence in private securitization markets where issuance has virtually disappeared since the crisis began. Requiring that securitization deals have at least some equity behind them is necessary to give issuers a long-term interest in the performance of the underlying loans and to align their incentives with investors. Unless the interests of investors are protected in this way, we may not see a meaningful recovery in the private issuance of asset-backed securities, thereby forcing the vast majority of mortgage lending to take place either on bank balance sheets or through government-sponsored programs.

The small extra cost associated with requiring that five percent of the mortgage pool be funded with equity instead of debt is trivial compared to the costs that have already been incurred due to the millions of defaults and foreclosures we have experienced in the crisis and the ensuing collapse of private securitization. Here again, the lesson is clear. Rules that align incentives and that enhance the transparency and stability of our financial markets and institutions are necessary to restore the capacity of the financial sector to support the real economy.

Conclusion

Through its approval of the reform package embodied in last year's Dodd-Frank Act, the Committee took an important step forward in making our financial system stronger and more stable over the long-term. Amid the controversies that accompany implementation of the Act, I urge the Committee to maintain this long-term perspective and see essential reforms through to completion.

The implementation process has many facets, and a vigorous debate of the details is to be welcomed. But the central lessons of the crisis remain clear. The animal spirits that lead private financial institutions to new innovations and new efficiencies need clear regulatory rules within which to operate. These rules must check the inherent tendency of these markets to pursue excessive leverage that renders our financial system unstable. Every financial company, no matter how large, complex, and interconnected, also must be constrained by the discipline of the marketplace and face the credible threat of failure.

The regulators charged with carrying out the implementation of these reforms will need your full support and encouragement if they are to be successful in their work. The work they have ahead of them is considerable, and without proper funding and, where needed, the confirmation of qualified leadership, the result could be needless uncertainty about the regulatory environment and failure to instill confidence in our financial markets and institutions.

Thank you. I will be glad to take your questions.

1 Noncurrent loans are those that are on nonaccrual status or are 90 or more days past due.

2 "Problem banks" are those assigned a CAMELS composite rating of 4 or 5.

3 See: Admati, Anat, Peter M. DeMarzo, Martin R. Hellwig and Paul Pfleiderer. "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive." Stanford Graduate School of Business Research Paper No. 2065, March 2011. http://www.gsb.stanford.edu/news/research/Admati.etal.html

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4 See: "New CoreLogic Data Shows Slight Decrease In Negative Equity," July 7, 2011. http://www.corelogic.com/uploadedFiles/Pages/About_Us/ResearchTrends/CoreLogic_Q1_2011_Negative_Equity.pdf

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