Remarks by
FDIC Chairman Sheila Bair
to the
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Good afternoon. I'm delighted to be here again for your annual meeting.

I would like to begin with a few comments about the challenges facing our banking industry and the actions we're taking to preserve and strengthen it.

There is no question that this is one of the most difficult periods we have encountered during the FDIC's 75 years of operation. I want to assure you that the FDIC will continue to work together with other federal agencies to respond to the challenges facing the nation's financial system.

Our job is to protect insured depositors and preserve the stability of our banking system. Financial innovations have come and gone over the years. But federally-insured institutions will always play an indispensable role in our economy.

Under the current severe economic conditions, the FDIC's deposit insurance guarantee is more valuable than ever. Well-managed banks that rely on deposit funding should be able to weather the storm. And they will be a key source of lending to help the economy recover.

While many sources of bank funding have dried up in the past six months, deposits have not. In fact deposits are growing. They are a reliable source of funding because depositors know that insured deposits are absolutely safe. No one has ever lost a penny on an insured deposit.

All of the government measures that have been put in place in recent months are designed to ensure that credit flows on sound terms to consumers and business customers. Maintaining a stable banking system and preserving the availability of credit are absolutely critical to getting the U.S. and other major economies back on track.

That said, I have a few comments to make about three specific issues: Where we stand on the Basel Two capital standards, cross-border resolutions, and nationalization.

Basel II: still a big deal

The intense public debate over Basel II seems like a thing of the distant past. And maybe that's understandable with everything else going on in the world. But when we emerge from this crisis, a top priority must be crafting a sound capital framework that helps avoid a repeat of past problems.

So, where do we stand? I still have grave concerns about the advanced approach. The advanced approach assumes banks' internal, quantitative risk estimates are reliable. It also assumes the loss correlations we measured during good times ... which is the backbone of the whole approach ... will hold up in the future.

To say the assumptions turned out to be wrong would be an understatement. They were way wrong in estimating risk. The Basel Committee is changing the rules in a number of areas. These will be improvements. But for most banks, they are unlikely to offset what we see as a capital-lowering bias that is essentially baked into the advanced approach.

A Moody's report in December gives some recent evidence. It looked at Basel II implementation outside the U.S. And it said that almost all the banks using advanced methodologies reported a reduction in risk weighted assets, in many cases material reductions.

So if the advanced approach says banks need less capital at the height of a global banking crisis, imagine the financial leverage it would encourage during good times.

With results like those, and in prior studies...and with the dangers of excessive leverage so clearly demonstrated over the last 18 months ... it would be imprudent to determine regulatory capital based solely on the advanced approach.

I strongly believe that global leverage capital requirements are sorely needed. And they should apply for all systemically important financial firms, regardless of charter.

These two measures would reduce cross-country and cross-sector capital arbitrage.

But more significantly, they would set a capital floor for the advanced approach, which would limit excessive leverage in the future.

Nationalization/need for cross-border process

There has been considerable debate over how to deal with troubled institutions that are systemically important. As you know, the FDIC, the banking regulators, and Treasury recently announced a stress testing and capital program to help ensure that our largest institutions are prepared to support the economy.

The stress testing process is designed to see if they have enough of a capital buffer to get through economic scenarios that are more adverse than what is currently anticipated. If not, then they can raise private capital or, if needed, access a capital funding facility managed by Treasury.

Many have asked: "What happens if a large bank can't continue? Will you nationalize?" Nationalization seems to mean different things to different people.

Whatever you may think it means, I don't see the U.S. government operating a large institution for an extended period.

In fact, based on where we stand today, I would be surprised if the FDIC had to step in as conservator or receiver of a large, systemically important institution. The regulators' Joint Statement last week restated our commitment to preserve the viability of systemically important financial institutions. This will be done through capital injections, if needed, and the supervisory process.

If more direct intervention to take over a large financial group is needed, that will present significant challenges. The main hurdle is that there's no clear process for resolving a large financial holding company with multiple affiliates. We have a process for dealing with large banks, but not financial conglomerates.

FDIC model

Many have pointed to the FDIC's model of resolving failed banks as a possible solution. I believe the FDIC model is tried and true. I take great pride in the fact that bank closings have gone smoothly. And we've been able to return failed institutions to private hands, despite the poor market for distressed financial assets.

But clearly, there would be practical problems if we had to use our resolution process for a large, internationally active institution. First, we do not have authority to resolve financial holding companies. Our powers extend only to federally insured banks.

Second, there is a very real question of whether our current funding mechanism is adequate to deal with the failure of a very large institution. Again our power is limited. Our assessment authority only extends to insured banks. This is something we are trying to get fixed.

Cross-border issues

Another major problem, which has received less attention, is the difficulty in handing a cross-border failure. The key question is: What you do when more than one country is regulating a piece of the institution?

This is an area where the FDIC has been doing some considerable work for over a year. We're co-chairing a Basel Committee working group on cross-border issues. The panel includes members from the G-10 nations, Argentina, and several off-shore countries. And we're coordinating with the Financial Stability Forum, the International Monetary Fund and other international groups.

Let me share what we know so far.

Today, a crisis involving an international company is resolved by domestic laws, in separate countries. The problems that can arise are obvious.

The national legal processes are inconsistent and too slow. The more complex the institution, the more inadequate most national laws become. And as a result, countries have relied on ring fencing and protection of their 'national' banks. So without burden-sharing, you can't stop asset ring-fencing.

Let me go over a few of the problems that this can cause.

After legal intervention, continuity of essential banking operations is virtually impossible under most national laws. The U.S. does have an advantage here, except with financial groups.

Most laws have virtually no provisions to deal specifically with cross-border banking crises. No country has adequate laws to resolve problems in international financial groups that operate through separate legal entities in different jurisdictions. Indeed, few countries even have the tools for resolving domestic financial groups.

Many of the standard ways for dealing with failed banks – such as our bridge bank – will probably not work across borders. Simply put: other countries have no duty to recognize a bridge bank or its actions under U.S. law. Cross-country differences in close-out netting, the unwinding of financial transactions, and the enforceability of secured parties' rights to collateral may add to increased uncertainty. In this environment, ring-fencing – also known as every man for himself – may simply be the only rational response.

A few policy proposals

So, how should we deal with this reality? We're working on proposals to address whether current laws should be changed, or whether there are better ways of responding to the reality of ring-fencing.

Possible areas include: What are the lessons of the current crisis? We're now reviewing – with our U.S. and international colleagues – how the different laws and regulators have responded. Are there better ways to promote private solutions? We clearly need new laws for cross-border financial groups.

What are the key elements in an effective framework? Are there areas where we need a more harmonized international approach? For example, on certain key international linkages, such as the interbank market, clearing and settlement as well as access to collateral and asset transfers.

One fundamental issue remains: burden sharing. Ring fencing is a logical response in the absence of some common framework for sharing burdens. If we are unlikely to get agreement on burden sharing – then: What's the best way to get more effective responses within the reality of ring fencing?

The bottom line is that our 21st century global economy needs a 21st century global banking system that is reliable, and makes economic sense.

Conclusion

Obviously, these are very challenging times for financial institutions. And it's likely that they will remain under pressure for the next few quarters.

But I want to emphasize that most institutions remain in sound financial condition. And the long term outlook for FDIC-insured banks and thrifts is very good.

There will be more challenges ahead before recovery takes hold.

There are no quick fixes. And if you're looking for a quick fix, you're not going to get one. It's going to take time and patience.

But we're going to dig out of this.

Thank you.

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