Remarks by
FDIC Chairman Sheila C. Bair
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Video of Remarks by FDIC Chairman Sheila C. Bair to the National Press Club (Courtesy of C-SPAN.org)

Thank you, and good afternoon. I'm deeply honored that you invited me here to the National Press Club to deliver my last speech as FDIC Chairman.

As I prepare to close out my term, I cannot help reflect on the challenges we have faced over the past five years and some of the lessons we have learned in the process. Our nation has suffered its most serious financial crisis and economic downturn since the Great Depression. The aftereffects will be felt for years to come.

There are many causes of this crisis, some of which I will address in my remarks today. But, in my opinion, the overarching lesson of the crisis is the pervasive short-term thinking that helped to bring it about. Short-termism is a serious and growing problem in both business and government. I would like to devote my remarks to explaining what I mean by this, and discussing how I think it plays into the policy challenges arising from the crisis.

The Challenge Posed by Short-Termism

What is short-termism, and why does it arise? Short-termism refers to the long-observed tendency – which we all share, to one degree or another – to unduly discount outcomes that occur far in the future.

Myopic decision making is a familiar concept. The emerging field of behavioral economics delves further into patterns of inconsistency in economic decision-making. Investors systematically over-value short-term payoffs and pass up investment opportunities that could leave them much better off in the longer term. Too much short-term thinking can be very costly. It is a market failure that leads to underinvestment in valuable projects with long payoff periods.

Part of our tendency toward short-termism appears to be biological. While the mathematical side of our brain makes careful calculations of risk and reward over time, the more primal, emotional parts of our brain tend to focus on the here and now. Which part of the brain do you think becomes active when research subjects are presented with real-life decisions involving risk and reward? You guessed it: The more primitive system, which understands greed and fear, but is less focused on long-term consequences.1

Short-termism also grows out of the institutional rules that govern our behavior. When executive compensation varies according to current-year earnings or stock prices, it creates incentives to maximize short-term results even at the expense of longer-term considerations. Short-term incentives tend to feed on each other through the chain of accountability. If an investment fund earns fees based on volume, and if volume varies – as it often does – with current performance, then the path of least resistance is to compensate fund managers based on current results. But ask yourself: If this investment fund is part of your 401(k), wouldn't you prefer that your fund manager be compensated at least in part based on long-term performance?

I probably don't need to tell you that short-termism also holds sway in the realm of politics. The virtue of our electoral process is that the incumbents face market discipline at regular intervals. The drawback is that those facing re-election have little incentive to take a longer view of the issues than their constituents do. If the voting public doesn't regard the runaway federal debt as their highest concern, then elected leaders probably won't either. It's a particular challenge under our system to find leaders who will commit to projects that will pay off long after they have left office.

Americans are naturally cautious when it comes to the ability of government to direct capital to long-term investments with uncertain outcomes. Yet we can easily think of many examples where far-sighted government investments have yielded large returns for generations to come. Think of the set-aside of land for national parks that permanently preserves the beauty and grandeur of our natural landscape. Government investments have linked our country through the interstate highway system and the internet. As a nation, we have made investments that have allowed us to defend the peace, explore the moon, eradicate disease, and decode the human genome.

While we can clearly see the wisdom of those investments in retrospect, there are many areas of our national life, both public and private, where short-termism appears to be on the rise. The average holding period of an equity share traded on the New York Stock Exchange fell from seven years in 1940 to just seven months by 2007. The average tenure of departing CEOs declined by nearly 30 percent between 1995 and 2009.[2] Not surprisingly, CEO turnover was found to be highest among companies whose stock-price performance lagged their industry.[3]

One powerful force behind the rise in short-termism is technology. We may simply have more latitude to express our innate short-term preferences than we once did. For example, a well-developed consumer debt market provides more options for households to act on their inclination to borrow from the future to meet short-term needs. As we know, credit cards can be either extremely useful or highly destructive tools, depending on how they're used. Well-developed capital markets have expanded the opportunities for financial companies to earn returns from transaction fees and trading activities, as opposed to the patient work of lending and long-term investing. The term "patient capital" seems quaint in the era of hedge funds and high-frequency trading.

Finally, unless you have been too busy updating your Facebook status, you have probably already inferred that short-termism is also driven by informational factors. In a 24-hour news cycle, we are constantly bombarded with information that compels action, not patience. Given the built-in pressures faced by corporate executives and investment managers, the constant flow of information only heightens their obsession with short-term performance at the expense of longer-term goals.

The Role of Short-Termism in the Financial Crisis

At this point, you may be asking what all of this has to do with the financial crisis. The answer is: plenty.

As has been the case with most previous crises, a central cause of this crisis was excessive debt and leverage across our financial system. In the decade leading up to 2006, when U.S. home prices reached their peak, total U.S. mortgage debt increased by 180 percent, and average U.S. home prices rose by almost 190 percent. Rising home prices prompted mortgage lenders to focus on temporarily inflated collateral values, while they relaxed underwriting standards that traditionally ensured that the borrower could repay the loan over time.

Most of the subprime loans made at the height of the boom imposed a large upward adjustment in the interest rate and monthly payment after two or three years, frequently making the loans unaffordable. As long as home prices kept rising, these borrowers could usually refinance. But after prices leveled off, and then began falling, subprime borrowers defaulted in record numbers.

The reason that lenders were willing to make these risky loans, and the reason that securities issuers were willing to fund them, is that they knew they would be paid up front. Mortgage investors and the homeowners themselves would end up bearing the long-term consequences. Arrangements like this gave rise to the acronym I-B-G-Y-B-G – meaning "I'll be gone; you'll be gone" – a watchword for short-termism in the mortgage industry during the boom.4 Homeowners, too, responded to rising home prices, flexible terms, and the tax advantages of mortgage debt to raid their home equity, cashing out to the tune of more than half-a-trillion dollars per year at the peak of the boom.

Meanwhile, financial institutions frequently sought to maximize their balance-sheet leverage. They could sometimes move assets to shadowy off-balance-sheet structures where regulation and capital requirements were less stringent. That strategy worked brilliantly until the eventual collapse of investor confidence and market liquidity forced these assets back onto the balance sheet, where there was not enough capital on hand to support them.

Leading financial companies proved adept at creating innovative new loan structures and funding strategies in the years leading up to the crisis. But all too often these innovations left participants with badly misaligned economic incentives. The compensation of loan officers, portfolio managers and bank CEOs was typically based on current-year loan volume, earnings or stock price, with little regard for the risks that were building up in the system.

Most damaging of all, some of the largest and most complex financial companies were made exempt from the discipline of the marketplace because their size, complexity, and interconnectedness made them Too Big to Fail under the resolution processes in place at that time. The expectation that the largest financial companies enjoyed the implicit backing of the federal government allowed the managers of those companies to book short-term profits while ignoring the build-up of "tail risk" inherent in the complex mortgage instruments they held.

In the financial market chaos that followed the September 2008 bankruptcy of Lehman Brothers, the expectation of government support for systemically-important financial institutions, or SIFIs, became a reality. Government assistance to financial institutions took on a variety of forms, amounting to a total commitment of almost $14 trillion by the spring of 2009.5 Direct assistance to the largest financial institutions eased the short-term crisis of confidence in the interbank market, and our financial system began to function again. But policymakers failed to effectively attack the root cause of the problem, which was the enormous backlog of unaffordable and underwater mortgage loans that continues to slow the recovery of our housing markets and our economy.

Bailouts result in a host of adverse consequences for our financial system over the long term. They undermine market discipline and promote risk-taking. 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 capital. They are inherently unfair to well-run banks.

The bailouts of 2008 tainted the reputation of the entire banking industry and tilted the competitive balance in favor of some megabanks. 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. In the end, bailouts violate the principles of limited government on which our free-enterprise system is founded.

Financial Reform for Long-Term Stability

That's 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 financial reform legislation that was enacted last summer. Titles I and II in Dodd-Frank authorize the creation of just such a resolution framework that can make the SIFIs resolvable in a future crisis. This starts with the authority to designate large banking organizations and certain non-bank companies as SIFIs, and then to subject them to heightened oversight and higher capital requirements in relation to the risk they pose to the financial system. These companies will also be required to maintain liquidation plans, or living wills, that show how they could be resolved in a crisis without a bailout and without blowing up the financial system.

Far from being an assault on the free market, 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.

Some of the rhetoric in the financial reform debate has been either short-sighted or simply inaccurate. As part of the reforms, we advocated an Orderly Liquidation Authority for SIFIs, like the authority we have used for years to resolve FDIC-insured institutions. The OLA is expressly designed to facilitate the failure of one of these companies without a bailout – which is expressly prohibited by the new law. But what is the sound-bite we keep hearing about this provision? "Bailouts as far as the eye can see."

We need to spread the word as to what the SIFI resolution framework is really all about, and what is at stake if we don't see that the new authority is fully implemented before the next crisis. The resolution plans required of the SIFIs under Dodd-Frank will be critically important to obtaining the information we need to carry out an orderly resolution that places losses on shareholders and debtholders, which is where they belong. The FDIC and the Federal Reserve are going to need to stick to their guns and insist that these companies simplify their structure, if necessary, to ensure that they can be resolved without a bailout in some future crisis. That debate will most likely take place when markets are calm and the possibility of crisis seems remote. Once again, people are going ask "Why now? Why are we making putting such onerous demands on private-sector financial institutions?" It will need to be explained that the alternative is to risk another financial crisis that could someday throw millions of people out of work and wreck our public finances.

Short-termism is also alive and well in the ongoing debate over bank capital requirements. Some banking industry representatives are claiming that higher capital requirements will raise the cost of credit and could derail the economic expansion. This is a terrific example of the sort of static, short-term thinking that got us into this mess in the first place. There is a lot of recent research that shows higher capital requirements, in the range that we are talking about, will have a very modest effect of the cost of credit. It will create a large net improvement in long-term economic growth because having more capital lessens the frequency and severity of financial crises.6 If your time horizon is anything longer than six months or so, I think that's a pretty good tradeoff.

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. They 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.

Another Dodd-Frank mandate is a rule requiring issuers of mortgage-backed securities to retain five percent of the credit risk of the pool. Risk retention is necessary to give issuers a long-term interest in the performance of the underlying mortgages. But given the controversy that has surrounded this rule, I have to say I regret that Congress carved out an exemption for ultra-safe mortgages as defined by the regulatory agencies. Everyone, it seems, believes that their mortgage should receive this Qualifying Residential Mortgage, or QRM, status and thus be exempt from the small premium in their mortgage rate that will result from risk retention. The connection they're not making is that this small extra cost is the price we must pay in the short term to put a little equity behind these mortgages, to ensure that incentives are properly aligned, and to avoid a costly repeat of the mortgage crisis in the future.

Taking the Long View on Broader Policy Issues

We also need solid, long-term thinking on other important national policy issues. Too often, the response to subpar economic growth has been another tax credit or a cut in interest rates that feels good for awhile but does nothing to enhance the long-term performance of our economy. Deep political divisions appear to have sapped our will to make the type of long-term investments in education and public infrastructure that will pay dividends over many years. Programs of national service, like the Civilian Conservation Corps, once provided job skills to young people in need as they worked to conserve and develop our natural resources. We still see the CCC's handiwork in national parks and forests throughout the country. The sense of pride and purpose instilled by programs like this is certainly greater than costly stimulus programs designed to put a few extra dollars in consumer pockets, much of which is used to purchase foreign-made goods.

We need to get serious about entitlement reform that will make our system of old-age insurance and healthcare sustainable over the long-run, as longevity rises and the baby boomers retire. The longer and healthier life that most of us will lead compared to previous generations is a wonderful – and much under-appreciated – historical development. With this blessing comes the need to make some choices that involve short-term sacrifices. We may have to work longer, pay more into the system, impose means tests on benefits, or -- more likely -- all three.

Similarly, our loophole-ridden tax system, which favors debt financing over equity and homebuilding over other long-term investments, is badly in need of an overhaul. Closing the loopholes will result in a more efficient allocation of capital and allow us to reduce marginal tax rates while raising more revenue that can be used to help to pay down our national debt. But some of us are going to have to give something up in the short term in order to secure those long-term advantages.

Where will the focus be when this question is debated in Congress, reported on in newspapers, and ranted about in the blogs? In a world obsessed with instant gratification and lightening-round debates, we are in dire need of leadership, both public and private, that will champion patience and sacrifice now in return for a brighter and more stable future for us and our progeny.

Challenging the Rhetoric

The media plays a critical role in this. You report the facts so others can make informed decisions. And you know better than anyone that getting a story factually correct requires going beyond the sound-bites to verify the accuracy of claims. There is no shortage of rhetoric for you to investigate. Your efforts to dig down to the truth of the story will help the public get beyond the sound-bite of the day, and think about the long-term consequences of the policy choices and the personal choices that all of us must make.

Fortunately, there are signs that the mood of the public is already changing direction, at least in terms of their personal decision making. Total household debt is down by almost 5 percent from pre-crisis levels, while the personal savings rate has risen to its highest level in more than 15 years.

Conclusion

Speaking to you today in this historic venue, I am reminded of some advice I received when I took the job as FDIC Chairman five years ago. It came from one of my predecessors, the late Bill Seidman. The FDIC's foremost responsibility is to maintain public confidence in the banking system, he said. We are the ultimate guarantor of the peoples' money. Today, we insure the some 6.4 trillion dollars on deposit in thousands of banks across America. While literally thousands of FDIC-insured institutions have failed over the years, nobody has ever lost a penny in insured deposits.

Bill emphasized to me that one of the keys to public confidence is transparency. As you would expect, much of what the FDIC does in bank supervision and bank closings is confidential, as it pertains to individual institutions. But the FDIC Chairman needs to be visible to the public, accessible to journalists, and fully engaged in the policy debates of his or her time.

I took his advice to heart. As many of you know, I have tried my best to reach out to the media, to talk with reporters, and to be a reliable source for the information that you need to tell stories with accuracy and perspective. I think it has been a constructive relationship that has served the public interest.

Even at the height of the crisis – easily the worst since the 1930s – you didn't see massive runs on banks. Working together, we averted a panic. People left their money in their insured deposits. It was a good example of how Americans can still be counted on to make wise choices that benefit themselves and their country when they are armed with the facts and encouraged to consider the long view.

Thank you.

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[6] Hanson, Samuel, Anil Kashyap and Jeremy Stein, "A Macroprudential Approach to Financial Regulation." Working paper (draft) July 2010. http://www.economics.harvard.edu/faculty/stein/files/JEP-macroprudential-July22-2010.pdf

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