**Remarks by**
**FDIC Chairman Sheila C. Bair**
**to the**
**Council of Institutional Investors-Spring Meeting**
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I am pleased to have the opportunity to speak with you today at a time when we face so many important decisions regarding the future of our financial system. We have just experienced the worst financial crisis and the longest and deepest recession since the 1930s. As an immediate response to the crisis, the various agencies of the federal government undertook some extraordinary policy steps to restore economic and financial stability.

To this point, those policies appear to have been successful in stabilizing markets and setting the stage for economic recovery. But the balance sheets of households and financial institutions remain under pressure, in large part due to the decline in real estate prices and the scale of household borrowing over the past decade. As a result, we expect this recovery to be relatively slow compared with those that followed previous recessions.

In time, however, the economic concerns of the present – and the intense fear that characterized financial markets in the Fall of 2008 – will recede from memory. When economic conditions return to normal, risk aversion on the part of investors will decline and risk taking by banks will return. What this means is that unless we act now on financial reform, we could soon be planting the seeds of the next crisis.

This is not just our problem in Washington. This is not just your problem in the marketplace. This is a problem that belongs to all of us. We need to work together, putting aside parochial short-term interests, and to start thinking more about the long-term interest we all have in financial stability and an economy that works for all Americans.

## Regulatory Reform Agenda

The FDIC has been very specific in recent months about what we see as the three main priorities of financial regulatory reform. We need to: end Too Big to Fail, plug gaps in the regulatory structure, and protect consumers from unsuitable financial products and unscrupulous lenders. Let me discuss each of these elements in turn.

First, we must never again ask taxpayers to bail out a large, failing financial firm. "Too big to fail" exists because we lack a viable way to close large non-bank financial companies without risking a market collapse.

Over its 76-year history, the FDIC has handled thousands of bank resolutions of all manner of size and complexity. Our resolution mechanism closes the bank and sells it back to a stronger, better-managed institution. It gives the government the right to repudiate executive contracts, eliminate bonuses, and require derivatives counterparties to perform on their obligations. Most importantly, it imposes losses where they belong – on shareholders and creditors.

Both the House and Senate reform bills would create a resolution authority that specifically applies to large, complex non-bank financial firms. Bankruptcy would be the normal process. But, for the very largest firms, there would be the option for an FDIC-style resolution that would liquidate the firm while protecting the public from the consequences of a disorderly collapse. This orderly liquidation process – funded by the firms themselves – would, for the first time, force them to internalize the full costs of the systemic risks they create. Shareholders and creditors would have to do their own due diligence before investing, rather than relying on the implicit backing of the U.S. taxpayer.

Some have argued that the existing bankruptcy laws are already sufficient to handle large and complex failures. The reality is very different. Lehman Brothers was by far the largest financial firm ever resolved under bankruptcy. Its September 2008 collapse interrupted key credit flows and set off a chain of events that severely shocked the global economy. The Lehman bankruptcy process took 18 months to produce a blueprint for reorganization, at a cost of more than half-a-billion-dollars in fees for Lehman's attorneys and experts alone. Thousands of derivative contracts were left unresolved for months, contributing to the virtual collapse of that market. And hundreds of companies found their brokerage positions frozen.

These disruptions in the wake of the Lehman failure show why it is the only non-bank financial company with assets greater than $100 billion to ever be put into bankruptcy. Everyone knows that the consequences of letting large, complex financial companies go into bankruptcy are too terrible to contemplate. That's why governments around the world have usually been forced to bail them out when they get into trouble.

This situation undermines market discipline, promotes excessive risk taking, and raises the odds that we will have a similar crisis in the future. By contrast, the FDIC resolution process for insured banks has proven over time to be an effective alternative mechanism that provides continuity of credit functions while liquidating the operations of a failing firm. We have recently seen some badly misinformed criticisms of the legislative reforms that appear to have no other purpose than to obfuscate the issues and delay enactment.

But there is no defending the status quo on Too Big to Fail. We support any constructive improvements to the bills which will reinforce market discipline and preclude future bailouts, while providing the FDIC with the necessary tools to market and sell a failed institution in a way that maximizes recoveries and protects the government against loss. But the legislation must remove all doubt that bailouts are an option.

Again, this is not just Washington's problem. All financial companies have been tainted by the government bailouts, even though many were healthy enough to survive without them. We need to arrive at a national consensus on some sensible regulatory changes.

We need to send a strong signal to the American public that we are not going to put them on the hook for more bailouts and we are not going to subject them to the kind of economic instability they have had to endure over the last two years.

**Plugging Gaps in Regulation**

Another critical reform is to address the gaps between existing regulatory jurisdictions where risk-taking has tended to migrate. How do we do this? I think the consensus points to a systemic risk council.

Under this approach, the agencies that currently have authority and expertise in specific areas would come together to share data and knowledge. This would help in identifying systemic risk early on before it can cause serious damage to our economy. It would also help address regulatory arbitrage in key areas such as capital and leverage.

A good example of where regulators need to come together with a common approach is the oversight of derivatives activities. We need consistent internal controls, risk management, and reporting, and – where possible – we need to move standardized derivatives onto central counterparty systems and exchanges.

We need to make sure that capital and margining requirements do not create perverse economic incentives for derivative to be traded over-the-counter, instead of on more transparent exchanges. Derivatives oversight is just one example where a systemic risk council can incorporate both the accountability and the diversity of opinion that is needed to establish sensible standards across markets ... and to promptly identify and respond to emerging risks in the financial sector.

**Rethinking Consumer Protection**

Finally, we must restore the central role of consumer protection in financial services. To some, regulating consumer finance is heavy-handed interference in otherwise well-functioning markets in order to achieve a social or political objective at the expense of investors. I disagree. There is ample evidence that consumers did not understand the consequences of the subprime and nontraditional mortgages that were sold to them. A strong case can be made that basic consumer protections can help markets function better by reducing the information gaps between lenders and borrowers.

Let me put it a different way. Where standards are not uniform, and consumers are not well informed, there will be a race to the bottom in terms of credit practices. The losers in this race include both legitimate financial providers and the consumers that the system is supposed to be serving. In short, consumer protection is a fundamental piece of our regulatory infrastructure.

It's time we had a level playing field. We need strong rules that apply -- and that are enforced -- across the board for banks and nonbanks. Let us recognize that consumer abuses were one of the root causes of the financial crisis and that regulatory reform legislation should squarely address this problem.

**Properly Aligning Incentives in Compensation...**

As urgent as it is to address the regulatory deficiencies that contributed to the crisis, I believe it is just as important for the financial industry to reform some of its own practices. Specifically, I am referring to the need to properly align incentives in compensation and deal structures to curb the excessive risk taking that led to this crisis.

I know it's unsettling to hear Washington policymakers talk about private-sector compensation. But let's review the facts as they stand. In 2006, the average total compensation for CEOs at 57 of the largest banks was $10 million.

The highest-paid bank CEO in this group earned $46 million. More than 60 percent of CEO pay at these companies took the form of incentive compensation. Also, in the decade leading up to the crisis, the total assets of U.S. financial companies rose by 89 percent after inflation, while the S&P financial index increased by 92 percent. But, as you know too well, the end result of this process was a historic collapse in credit performance and earnings ... as internal risk-management processes proved unable to detect and mitigate the growing level of financial risk in the system.

The earnings of FDIC-insured institutions in 2008 and 2009 declined by more than 90 percent from the previous two-year period, as the industry set aside some $424 billion in provisions for loan losses. Clearly, financial industry compensation practices have been more effective in promoting growth and innovation than in promoting effective risk-management practices. This is a serious problem. The stability of our financial system requires that the interests of management be aligned with all financial stakeholders in the firm – including debt and equity holders – in order to prevent the type of excessive risk-taking that led to this crisis.

This is why the FDIC Board earlier this year approved an Advanced Notice of Proposed Rulemaking on how employee compensation might be considered in the FDIC's risk-based deposit insurance premiums. We solicited input on how to develop acceptable standards for structuring compensation so as to align employee performance with the long-term interests of the firm and its stakeholders, including the FDIC.

We are not seeking to impose a specific level of compensation that institutions may pay their employees. But the FDIC operates under a statutory mandate to establish an assessment system that considers all relevant factors that may drive the risk of loss to the insurance fund. To the extent that compensation structures shape the incentives of bank management, we must consider this factor in our premium system.

You, too, have a vital interest in making sure executive pay is properly structured. The better that incentives are aligned to discourage excessive risk-taking, the less we will need to rely on regulation alone to constrain risky banking practices.

**Mortgage Deal Structures**

In a similar vein, one of the key drivers of the risky subprime and nontraditional mortgage lending that triggered the crisis was the "originate to distribute" model of mortgage finance, and the private-label securitization process that financed most of these loans. Did securitization alone cause the crisis? No. There were many factors. But securitization encouraged a focus on deal production and fee generation at the expense of consumer protection and sound underwriting.

And, let's be clear, investors themselves were all too willing to rely on model-driven ratings that proved to be woefully inaccurate. In the aftermath of the crisis, private securitization has virtually shut down. Restarting mortgage-backed securitization on a sounder footing is essential to a real-estate market recovery. That's why the FDIC is using its receivership authority to develop securitization standards that can help restore the confidence of investors and revive MBS issuance.

The FDIC's current rules for the treatment of securitizations under conservatorship or receivership provide important safe harbor protections for securitizations by confirming that the FDIC will not try to reclaim loans transferred into a securitization, so long as an accounting sale had occurred. But changes in the accounting treatment for securitizations have required the FDIC to modify its prior rules governing this safe harbor.

Late last year, the FDIC Board approved a transitional safe harbor for securitizations or participations to clarify the circumstances when the FDIC will grant sale treatment to such a transfer. We also sought comment on what standards we should set to help ensure that securitization will strengthen – not weaken – banks that are insured by the FDIC. Our proposal outlined fundamental requirements for securitization structures, disclosures and reporting, compensation arrangements, and risk-sharing by deal sponsors.

We're hopeful that our proposal will allow insured banks and thrifts to profitably securitize loans in a way that aligns incentives to support sustainable lending. We look forward to continuing to work with the investor community to achieve that objective. We believe that our advanced notice of proposed rulemaking is consistent with the direction of legislation in the House and Senate. And we recognize the need to achieve consistency and prevent arbitrage among various regulatory jurisdictions.

The Securities and Exchange Commission's vote last week to propose new securitization standards for transparency, loan quality, risk-retention and investor due-diligence is a major step forward. I strongly support their initiative, and believe that our two proposals will work together in helping to establish clear, industry-wide standards that can restore investor confidence and revitalize this key segment of our capital markets.

Ultimately, however, the quality of market practices depends on market participants like you. Only your commitment to – and insistence on – appropriate transparency, disclosure, deal structure and compensation can ensure that this market will achieve its potential in terms of confidence and stability in the years ahead.

**Conclusion: Taking the Longer View**

As we look to the future, all of us need to acknowledge that there were things we could have done better in the years leading up to the crisis. Bank management needed to take a longer view of the consequences of their decisions instead of focusing on short-term financial incentives. Regulators needed to stick to their guns and ask the hard questions even while the industry was profitable and everything seemed fine. And investors, too, needed to question the wisdom of the ratings agencies and analyst community, and perform their own due diligence which, in the end, is what you are paid to do.

As leaders in government, in industry, and in finance, we need to acknowledge our responsibility in this episode because we face challenges in the years ahead that could prove even more daunting. If we continue to focus solely on our short-term political or financial concerns, we will leave our nation vulnerable to financial crises, fiscal instability, and economic decline.

I am not asking you to make decisions that run counter to your interests or those of the people who have entrusted trillions of dollars to your care. But I am asking you to do what you can to create a new market culture that promotes the long-term stability and fairness of our economy.

I believe the time has come for all of us to take a larger, longer-term view of what truly is in our self-interest as individuals and as a nation. Thank you.

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