Remarks by
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Good morning. I am pleased to be with you this morning at the opening of NABE's Washington Policy Conference. The last time I spoke before NABE was at your 50th Annual Meeting, on October 6th, 2008. It was at the height of the financial crisis, when a range of extraordinary policy actions were being undertaken by the federal government to restore order to our financial markets.

The Federal Reserve had already introduced a number of special liquidity programs, and would subsequently create more. President Bush had just signed into law the Emergency Economic Stabilization Act, establishing the TARP, but at that time it was envisioned primarily as a way for the Treasury to buy mortgage-related assets, not make government investments in banks. One week later, the FDIC would announce its Temporary Liquidity Guarantee Program, whereby participating institutions could purchase a guarantee on certain of senior unsecured debt and on transactions accounts above the deposit insurance ceiling.

As we meet today, the initial crisis has receded. Money market spreads have returned to normal levels, and banks are holding record amounts of liquid assets. Most of these emergency programs are being gradually unwound. But we continue to deal with the aftermath of that crisis, which includes persistent high unemployment, impaired household balance sheets, and high levels of problem loans and troubled financial institutions. We still face many immediate challenges, and the FDIC is working on a number of fronts to address those challenges. But what I would like to discuss this morning is our longer-term future and how it is being shaped on Capitol Hill. As needed financial regulatory reforms are being considered, we need to maintain our focus on the lessons of this crisis.

Regulatory Arbitrage

The last major financial crisis—the thrift and banking crisis of the 1980s—resulted in enactment of far-reaching laws designed to improve the financial regulatory system. These laws strengthened bank regulation and provided banks with incentives to operate at higher capital levels with less risk. The reforms of the early 1990s were designed in large part to limit moral hazard, or the incentive for banks to take risks at the expense of the deposit insurance fund. They set the stage for a period of remarkable stability within the insured banking industry.

But these reforms also created incentives for financial services to grow outside of the regulated sector, in the so-called shadow banking system. Credit intermediation continued to move outside traditional banking as businesses found more and more of their funding from commercial paper and other market mechanisms. Homeowners too found more and more of their mortgages with non-bank mortgage firms. This regulatory arbitrage undermined our financial stability by allowing risk to migrate toward gaps in our regulatory structure where oversight was minimal.

Behind the Excesses in Mortgage Lending

Mortgage lending provides some prime examples of regulatory arbitrage. In 2002 and early 2003, encouraged by record low interest rates, there was record volume of mortgage originations. Origination platforms grew to accommodate the surge in mortgage demand. By 2004, house prices were rising at double-digit rates, setting the stage for dramatic changes in the structure and funding of mortgage loans. Because many prime borrowers had locked in their loans by 2003, the mortgage industry shifted its attention — and its ample lending capacity — toward less creditworthy borrowers and home buyers struggling to cope with the high cost of housing.

One result was a rapid increase in subprime loan originations, which peaked in 2005 at just over 20 percent of all originations. Declining affordability in high-priced housing markets also contributed to a shift toward nontraditional mortgages, such as interest-only and pay-option loans. The lack of strong consumer protection for mortgage borrowers, especially in the non-bank sector, encouraged the spread of these increasingly complex loan types. Combined with opaque marketing and disclosure practices, these products proved toxic to consumers.

We continue to see the consequences of these practices. About 5 million homes have entered foreclosure in the past two years alone. The causes of foreclosures are many -- and they have evolved over time -- but we must remember that the problem began with the risky financial practices that first surfaced on the fringes of our regulated financial system. For example, subprime and nontraditional mortgages were originated and securitized primarily by brokers, mortgage companies, and by nonbank affiliates of FDIC-insured institutions.

Securitization

Securitization provided much of the funding for these loans. The share of U.S. mortgage debt held by private issuers of asset-backed securities more than doubled between 2003 and 2006 to over 20 percent of the market. Growth in these private-label mortgage-backed securities was facilitated by the use of complex and opaque CDO and CDS instruments. Virtually all of these mortgage instruments performed well as long as home prices continued to rise.

The rating agencies ratified this performance by granting these instruments their highest ratings, thereby encouraging a misplaced confidence in their quality. But the performance of these instruments was highly dependent on an indefinite continuation of the housing boom, which was never a plausible outcome. When the boom ended, and the credit losses in those instruments became apparent, they had become embedded throughout the financial system in a way that undermined confidence in general.

Large, Complex Institutions

The story of regulatory arbitrage and mortgage-related instruments leads us to the large, complex banks and non-bank companies that packaged and sold so many of these securities. The capital-market activities behind the growth of securitization and derivatives could only be undertaken by the largest financial firms. And the compensation schemes employed by many of these firms were based primarily on deal volume, not the quality of risk management.

As a result of their too-big-to-fail status, several large firms enjoyed funding at below-market rates that did not reflect the risks they were taking. Indeed, the credit rating agencies themselves recognized this implicit guarantee, providing two ratings for major financial institutions ... one with, and one without, government support. In short, market discipline was ineffective as a disincentive to risk taking in the run-up to the crisis.

Standing before a group of economists, as I am today, it is worth asking why market forces failed to rein in the risk taking that led to the crisis. Over the past two decades, the prevailing world view has been that markets are generally self-regulating and self-correcting. Have we overstated the ability of markets and private firms to arrive at optimal decisions? Does this mean that the only way our financial system can effectively operate is under heavy-handed regulation? I would offer a different perspective.

Markets remain the best mechanism for making decisions that involve risk – but only if they operate under an institutional structure that requires all firms to bear the downside consequences of the risks they take. We have long recognized that deposit insurance can skew these incentives. This is why we charge deposit insurance premiums and cap deposit insurance to protect primarily smaller, "retail" depositors. And this is why FDIC-insured institutions are subject to both prudential supervision and rules that require their chartering authority to close them when they become critically undercapitalized. Most importantly, in resolving these institutions, the FDIC is required to choose the least costly method, which typically involves imposing substantial losses on debt holders and shareholders.

Our receivership powers provide a clear priority of claims, and our ready access to funding allows us to pay those claims promptly -- thereby minimizing the disruptions that occur in the wake of a bank failure. However, as it stands now, when large non-bank financial firms and bank holding companies get into trouble, they are subject to the commercial bankruptcy process. In contrast to receivership, bankruptcy is not well attuned to the speed of financial operations in the largest financial firms. It is designed to protect creditors, not the public.

The disruptions caused by forcing large, non-bank financial institutions through bankruptcy can create significant risks for the real economy, as we saw in the case of Lehman Brothers in the Fall of 2008. The potential for these disruptions – and the lack of a credible process to unwind large non-bank institutions and bank holding companies – helps explain why there is such overwhelming pressure to bail them out when they are threatened with failure in the midst of a crisis.

The irony is this: The very measures put in place after the last crisis to limit moral hazard in banking helped to push risk taking outside traditional banking into the shadow banking system. There, on the periphery of our banking system, where there were gaps between regulatory jurisdictions and inadequate protections for consumers, the risks grew unchecked. The lack of a credible process to close large, complex non-bank institutions led to an inability to close these financial behemoths without creating grave disruption in our financial system. The resulting bailouts reinforced the notion of too big too fail, and dramatically increased moral hazard.

Based on the combination of events that led to the crisis, it is clear that we must take a more holistic approach to regulation. To be sure, we can improve oversight of insured depository institutions. But if reforms only layer more regulation upon traditional banks, they will just create more incentives for financial activity to move to less-regulated markets. Such an outcome would only exacerbate the regulatory arbitrage that fed this crisis. What's needed now is fundamental reform in three key areas: ending too big to fail, plugging gaps in the regulatory structure, and protecting the consumer

Ending Too Big To Fail

First, we need to get serious about leveling the playing field and protecting the taxpayer by ending Too Big To Fail. This is not an impossible goal. One way to ensure that financial companies bear the full consequences of the systemic risks they create is to make the largest firms bear the burdens of the risks they pose to the financial system. This can be done with higher capital requirements, or various types of regulatory limits. But what we need most is a pre-funded resolution mechanism, similar to the FDIC's receivership authority for failed banks ... and a clear mandate to close large, systemically important firms when they get into trouble and to quickly sort out the claims against them so that key financial relationships can be preserved and the taxpayer and can be protected.

Let me be clear – this would not be another bailout mechanism. Shareholders and creditors would bear the losses, not the public. But, the process would be orderly and help prevent a catastrophic collapse of other firms. It would be a conscious departure away from the reflexive bailouts that have tended to occur during crises in the absence of such a resolution authority. The lack of a resolution mechanism for these companies is not some minor loophole that needs to be closed. On the contrary, it was a fundamental cause of the financial crisis and the enormous economic costs resulting from it. We cannot afford to let the status quo continue. Unless Too Big To Fail is addressed now, we will surely repeat this episode down the road.

Plugging Gaps in Regulation

We also need to address the gaps between existing regulatory jurisdictions where risk-taking arose under inadequate oversight. As for how to 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 of financial regulation would come together to share data and knowledge. This would help to ensure that risks do not go undetected because of regulatory gaps between these jurisdictions.

We need to do a better job of assessing macro-level changes in our financial markets that can ultimately disrupt individual institutions and, as we have seen, our economy as a whole. But it is also essential that we do this without taking a "one size fits all" approach to our diverse and innovative financial sector.

Rethinking Consumer Protection

Finally, we must re-establish the central role of consumer protection in financial services. An unfortunate by-product of the prevailing world view about the self-regulating and self-correcting nature of markets is a misconception about the value and purpose of consumer financial regulation. To some, the regulation of consumer finance represents heavy-handed interference in otherwise well-functioning markets in order to achieve some social or political objective. This bears some rethinking.

There is ample evidence that consumers did not understand the consequences of the subprime and nontraditional mortgages that were sold to them. Economists understand a great deal about the effects of asymmetric information, and how it can prevent markets from existing in the first place or from operating efficiently. In this light, I think there is a strong case to be made that basic consumer protections help markets function better by reducing information gaps between lenders and borrowers.

Let me put it a different way. If lightly regulated companies at the periphery of our regulated financial system are pushing complex and risky mortgage products that consumers really do not understand ... they are exploiting this information gap at the expense of companies who wish to do legitimate business in more suitable financial products. Where standards are not uniform, and consumers are not well informed, there will be a race to the bottom in credit practices. The losers in this race will include both legitimate financial providers and the consumers that the system is supposed to be serving. From this perspective, you can see that basic consumer protections are a fundamental piece of our regulatory infrastructure. The market cannot function efficiently without them.

It's time we had a level playing field for all market players. 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.

Rebalancing the U.S. Economy

Financial service reforms now winding their way through Congress could go a long way toward preventing another crisis. But as the Congress puts together its financial reform package, I urge you to think about other long-standing U.S. economic policies that may have contributed to the problem. This crisis is the culmination of a decades-long process where national policies have skewed economic activity, away from savings and toward consumption, away from investment in our industrial base and public infrastructure and toward housing, and away from the real sectors of our economy and toward the financial sector. Examples of these policies include: federal tax and credit subsidies for housing; a tax code that can unduly favor short-term profit; and implied government backstops for financial firms that have now, in many cases, been made explicit.

No single policy is responsible for these economic distortions, and no one reform can restore balance to our economy. We need to examine national policies from a long-term view and ask whether they create the incentives that will lead to a sustainable, higher standard of living. Our financial sector has grown disproportionately in relation to the rest of our economy. Whereas the financial sector claimed less than 15 percent of total U.S. corporate profits in the 1950s and 1960s, its share grew to 25 percent in the 1990s and to 34 percent by 2008.

We know that a vital and innovative financial sector has long been one of the key competitive advantages of the U.S. economy. But we must also recognize that the excesses of the past decade were a costly diversion of resources from other sectors of the economy. We must avoid policies that encourage such economic distortions. Fixing regulation can only accomplish so much. Rules and regulations can help constrain our "animal spirits", but unless economic incentives are also appropriately aligned, regulation alone will fail. Longer term, we must develop a more strategic approach that utilizes all available policy tools —fiscal, monetary, and regulatory — to lead us toward a longer-term, more stable, more widely-shared prosperity. Thank you.

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