Statement of
Sheila C. Bair, Chairman,
Federal Deposit Insurance Corporation
on
Oversight of Dodd-Frank Implementation:
Monitoring Systemic Risk and Promoting Financial Stability
before the
Committee on Banking, Housing, and Urban Affairs,
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Chairman Johnson, Ranking Member Shelby, and members of the Committee, thank you for the opportunity to testify today on behalf of the Federal Deposit Insurance Corporation (FDIC) on issues related to monitoring systemic risk and promoting the stability of our financial system.

The recent financial crisis has highlighted the critical importance of financial stability to the functioning of our real economy. In all, over eight and a half million jobs were lost in the recession and its immediate aftermath, and over half of these were lost in the six-month period following the height of the crisis in September 2008. While the economy is now in its eighth consecutive quarter of expansion, to date only about 20 percent of the jobs lost in the recession have been regained, and the number of private-sector payroll jobs stands at the same level it did 12 years ago, in the spring of 1999.

A central cause of this crisis -- as has been the case with most previous crises --was excessive debt and leverage in our financial system. At the height of the crisis, the large intermediaries that make up the core of our financial system proved to have too little capital to maintain market confidence in their solvency. The need for stronger capitalization of our financial system is being addressed in part by strengthening bank capital requirements through the Basel III capital protocols and implementation of the Collins amendment. We also learned in the crisis that leverage can be masked through off-balance-sheet positions, implicit guarantees, securitization structures, and derivatives positions. The crisis showed that the problem with leverage is really larger than the bank balance sheet itself. Excessive leverage is a general condition of our financial system that is subsidized by the tax code and lobbied for by financial institutions and borrower constituencies alike, to their short-term benefit and to the long-term cost of our economy.

The ability of many large financial institutions to operate with relatively thin levels of capitalization was enabled by the market's perception that they enjoyed implicit government backing; in short, they were Too Big to Fail. This market perception was ratified in the heat of the crisis when policymakers were faced with the dilemma of providing this assistance or seeing our economy endure an even more catastrophic decline.

As a consequence, the Dodd-Frank Act mandates higher prudential standards for systemic financial entities. Importantly, the Act authorizes the creation of a new resolution framework for systemically important financial institutions (SIFIs) designed to ensure that no institution is too big or too interconnected to fail, thereby subjecting every financial institution to the discipline of the marketplace. My testimony will summarize the progress to date in implementing the elements of this framework and will highlight specific areas of importance to their ultimate effectiveness.

In addition to discussing FDIC efforts to implement provisions of the Dodd-Frank Act that address key drivers of the recent financial crisis, I will also discuss future risks to our system which I believe must be proactively addressed by the government. These include deeply flawed servicing practices which have yet to be corrected and the resulting overhang of foreclosures and looming litigation exposure which is further depressing home prices. Also of concern is interest rate risk and the impact sudden, volatile spikes in interest costs could have on banks and borrowers who rely upon them for credit.

Excessive Reliance on Debt and Financial Leverage

A healthy system of credit intermediation, where the surplus of savings is channeled toward its highest and best use by household and business borrowers, is critically important to the modern economy. Without access to credit, households cannot effectively smooth their lifetime consumption and businesses cannot undertake the capital investments necessary for economic growth. But a starting point for understanding the causes of the crisis and the changes that need to be made in our economic policies is recognition that the U.S. economy has long depended too much on debt and financial leverage to finance all types of economic activity.

In principle, debt and equity are substitute forms of financing for any type of economic activity. However, owing to the inherently riskier distribution of investment returns facing equity holders, equity is generally seen as a higher-cost form of financing. This perceived cost advantage for debt financing is further enhanced by the standard tax treatment of payments to debt holders, which are generally tax deductible, and equity holders, which are not. In light of these considerations, there is a tendency in good times for practically every economic constituency – from mortgage borrowers, to large corporations, to startup companies, to the financial institutions that lend to all of them – to seek higher leverage in pursuit of lower funding costs and higher rates of return on capital.

What is frequently lost when calculating the cost of debt financing are the external costs that are incurred when problems arise and borrowers cannot service the debt. As we have witnessed so many times in this crisis, the lack of a meaningful commitment of equity capital or "skin in the game" feeds subpar underwriting and imprudent borrower behavior that ultimately results in defaults, workouts, repossessions, or liquidations of repossessed assets in order to satisfy the claims of debt holders. These severe adjustments, which tend to occur with high frequency in economic downturns, impose very high costs on economic growth and our financial system. For example, foreclosures dislodge families from their homes, create high legal costs, and, when experienced en masse, tend to lower the values of nearby properties. Commercial bankruptcies impose losses on lenders and tend to remove assets from operating businesses and place them on the open market at liquidation prices. When financial institutions cannot meet their obligations, the result can be, at best, an interruption in their ability to serve as intermediary and, at worst, destabilizing runs that may extend across the financial system.

As demonstrated in the recent financial crisis, the social costs of debt financing are significantly higher than the private costs. When a household, business or financial company calculates the cost of financing its spending, it can no doubt lower its financing costs by substituting debt for equity – particularly when interest costs on debt are tax deductible. In good economic times, when few borrowers are forced to default on their obligations, more economic activity can take place at a lower cost of capital when debt is substituted for equity. However, the built-in private incentives for debt finance have long been observed to result in periods of excess leverage that contribute to financial crisis. As Carmen Reinhart and Kenneth Rogoff describe in their 2009 book This Time It's Different:

"If there is one common theme to the vast range of crises we consider in this book, it is that excessive debt accumulation, whether it be by the government, banks, corporations, or consumers, often poses greater systemic risks than it seems during a boom." 1

This is precisely what was observed in the run up to the recent crisis. Mortgage lenders effectively loaned 100 percent or more against the value of many homes without underwriting practices that ensured borrowers could service the debt over the long term. Securitization structures were created that left the issuers with little or no residual interest, meaning that these deals were 100 percent debt financed. In addition, financial institutions not only frequently maximized the degree of on-balance-sheet leverage they could engineer; many further leveraged their operations by use of off-balance-sheet structures. For all intents and purposes, these off-balance-sheet structures were not subject to prudential supervision or regulatory capital requirements, but nonetheless enjoyed the implicit backing of the parent institution. These and many other financial practices employed in the years leading up to the crisis made our core financial institutions and our entire financial system more vulnerable to financial shocks.

One important element to restraining financial leverage and enhancing the stability of our system is to strengthen the capital base of our largest financial institutions. The economic costs of the crisis were very much on the mind of the Basel Committee on Bank Supervision (BCBS) when it published the December 2009 paper that ultimately led to the Basel III capital accord.2 Basel III is not perfect, but it is a great improvement over what came before. The accord not only addresses the insufficient quality and quantity of capital at the largest banks, but also requires capital buffers over and above the minimums so that the macro-economy is not forced into a deleveraging spiral as banks breach these minimums during a period of high losses. Importantly, Basel III includes an international leverage requirement, a concept that was met with derision when I proposed it in 2006 but has now been embraced by the Basel Committee and the G-20. Finally, the Basel Committee has committed to additional capital and liquidity requirements for large, systemically important institutions that are higher, not lower, than those applicable to small banks. I firmly believe that this extra capital requirement must result in a meaningful cushion of tangible common equity capital. Moreover, I believe we should impose even higher capital charges on systemic entities until they have developed a resolution plan which has been approved as credible by their regulators. This would help ensure that large institutions in all BCBS member countries take seriously their obligation to demonstrate that they can be unwound in an orderly way should they fail.

As the Basel Committee has considered ways to strengthen capital requirements, the financial industry has repeatedly warned of economic harm if it is required to replace debt financing with equity. A 2010 report by the Institute of International Finance argued that the new, higher capital requirements and other reforms will raise bank funding costs, raise the cost of credit in the economy, and have a significant adverse impact on the path of economic activity.3 But the bulk of credible research shows that higher capital requirements will have a relatively modest effect on the cost of credit and economic activity. These studies, conducted by economists at Harvard, Stanford, the University of Chicago, Bank of England and the Bank for International Settlements, account for not only the private costs and benefits of funding through equity capital, but also the social costs and benefits.4 As we saw in 2008, when a crisis hits, highly leveraged financial institutions dramatically contract credit to conserve capital. FDIC-insured institutions as a group have reduced their balances of outstanding loans during nine of the last 10 quarters, and their unused loan commitments have declined by $2.5 trillion since the end of 2007. As we have seen, these procyclical lending policies can have a devastating impact on the real economy. As we move forward with important regulatory changes to improve institutional structures in finance, we must do so with an eye to what is in some ways a larger, built-in distortion in our financial system -- excessive reliance on debt as opposed to equity.

Under the provisions of Section 941 in the Dodd-Frank Act, the FDIC and other agencies recently issued proposed rules to address the excessive risk-taking inherent in the originate-to-distribute model of lending and securitization. These rules require originators of asset-backed securities to retain not less than five percent of the credit risk of those securities, and define standards for Qualifying Residential Mortgages (QRMs) that will be exempt from risk retention when they are securitized. The proposal sets forth a flexible framework for issuers to achieve the five percent risk retention requirement. Together, the risk retention and QRM rules will help to limit leverage and better align financial incentives in asset-backed securitization, and give loan underwriting, administration, and servicing much larger roles in credit risk management. They are an important step in restoring investor confidence in a market where the volume of issuance remains depressed in the aftermath of the crisis.

Ending Too Big to Fail by Facilitating Orderly Resolutions

One of the most powerful inducements toward excess leverage and institutional risk-taking in the period leading up to the crisis was the lack of effective market discipline on the largest financial institutions that were considered by the market to be Too Big to Fail. The financial crisis of 2008 centered on the so-called shadow banking system—a network of large-bank affiliates, special-purpose vehicles, and nonbank financial companies that existed not only largely outside of the prudential supervision and capital requirements that apply to federally insured depository institutions in the U.S., but also largely outside of the FDIC's process for resolving failed insured financial institutions through receivership.

Several large, complex U.S. financial companies at the center of the 2008 crisis could not be wound down in an orderly manner when they became nonviable. Major segments of their operations were subject to the commercial bankruptcy code, as opposed to bank receivership laws, or they were located abroad and therefore outside of U.S. jurisdiction. In the heat of the crisis, policymakers in several instances resorted to bailouts instead of letting these firms collapse into bankruptcy because they feared that the losses generated in a failure would cascade through the financial system, freezing financial markets and stopping the economy in its tracks.

As it happened, these fears were realized when Lehman Brothers—a large, complex nonbank financial company—filed for bankruptcy on September 15, 2008. Anticipating the complications of a long, costly bankruptcy process, counterparties across the financial system reacted to the Lehman failure by running for the safety of cash and other government obligations. Subsequent days and weeks saw the collapse of interbank lending and commercial paper issuance, and a near complete disintermediation of the shadow banking system. The only remedy was massive intervention on the part of governments around the world, which pumped equity capital into banks and other financial companies, guaranteed certain non-deposit liabilities, and extended credit backed by a wide range of illiquid assets to banks and nonbank firms alike. Even with these emergency measures, the economic consequences of the crisis have been enormous.

Under a regime of Too Big to Fail, the largest U.S. banks and other financial companies have every incentive to render themselves so large, so complex, and so opaque that no policymaker would dare risk letting them fail in a crisis. With the benefit of this implicit safety net, these institutions have been insulated from the normal discipline of the marketplace that applies to smaller banks and practically every other private company.

Having recently seen the nation's largest financial institutions receive hundreds of billions of dollars in taxpayer assistance, the market appears to expect more of the same going forward. In February, Moody's reported that its ratings on the senior unsecured debt of eight large U.S. banking organizations received an average "uplift" of 2.2 ratings notches because of the expectation of future government support.

Meanwhile, the largest banks continue to enjoy a large competitive advantage over community banks in funding markets. In the fourth quarter of last year, the average interest cost of funding earning assets for banks with more than $100 billion in assets was about half the average for community banks with less than $1 billion in assets. Indeed, I would also argue that well-managed large banks are disadvantaged by Too Big to Fail as it narrows the funding advantage they would otherwise enjoy over weaker competitors.

Unless reversed, we could expect to see more concentration of market power in the hands of the largest institutions, more complexity in financial structures and relationships, more risk-taking at the expense of the public, and, in due time, another financial crisis. However, the Dodd-Frank Act introduces several measures in Title I and Title II that, together, provide the basis for a new resolution framework designed to render any financial institution "resolvable," thereby ending the subsidization of risk-taking that took place prior to these reforms.

The new SIFI resolution framework has three basic elements. First, the new Financial Stability Oversight Council, chaired by the Treasury Secretary and made up of the other financial regulatory agencies, is responsible for designating SIFIs based on criteria that are now being established by regulation. Once designated, the SIFIs will be subject to heightened supervision by the Federal Reserve Board and required to maintain detailed resolution plans that demonstrate that they are resolvable under bankruptcy—not bailout—if they should run into severe financial distress. Finally, the law provides for a third alternative to bankruptcy or bailout—an Orderly Liquidation Authority, or OLA, that gives the FDIC many of the same trustee powers over SIFIs that we have long used to manage failed-bank receiverships.

I would like to clarify some misconceptions about these authorities and highlight some priorities I see for their effective implementation.

SIFI Designation It is important at the outset to clarify that being designated as a SIFI will in no way confer a competitive advantage by anointing an institution as Too Big to Fail. The reality is that SIFIs will be subject to heightened supervision and higher capital requirements. They will also be required to maintain resolution plans and could be required to restructure their operations if they cannot demonstrate that they are resolvable. In light of these significant regulatory requirements, the FDIC has detected absolutely no interest on the part of any financial institution in being named a SIFI. Indeed, many institutions are vigorously lobbying against such a designation.

We believe that the ability of an institution to be resolved in a bankruptcy process without systemic impact should be a key consideration in designating a firm as a SIFI. Further, we believe that the concept of resolvability is consistent with several of the statutory factors that the FSOC is required to consider in designating a firm as systemic, those being size, interconnectedness, lack of substitutes and leverage. If an institution can be reliably deemed resolvable in bankruptcy by the regulators, and operates within the confines of the leverage requirements established by bank regulators, then it should not be designated as a SIFI.

What concerns us, however, is the lack of information we might have about potential SIFIs that may impede our ability to make an accurate determination of resolvability before the fact. This potential blind spot in the designation process raises the specter of a "deathbed designation" of a SIFI, whereby the FDIC would be required to resolve the firm under a Title II resolution without the benefit of a resolution plan or the ability to conduct advance planning, both of which are so critical to an orderly resolution. This situation, which would put the resolution authority in the worst possible position, should be avoided at all costs. Thus, we need to be able to collect detailed information on a limited number of potential SIFIs as part of the designation process. We should provide the industry with some clarity about which firms will be expected to provide the FSOC with this additional information, using simple and transparent metrics such as firm size, similar to the approach used for bank holding companies under the Dodd-Frank Act. This should reduce some of the mystery surrounding the process and should eliminate any market concern about which firms the FSOC has under its review. In addition, no one should jump to the conclusion that by asking for additional information, the FSOC has preordained a firm to be "systemic." It is likely that, after we gather additional information and learn more about these firms, relatively few of them will be viewed as systemic, especially if the firms can demonstrate their resolvability in bankruptcy at this stage of the process.

The FSOC issued an Advanced Notice of Proposed Rulemaking (ANPR) last October and a Notice of Proposed Rulemaking (NPR) on January 26, 2011 describing the processes and procedures that will inform the FSOC's designation of nonbank financial companies under the Dodd-Frank Act. We recognize the concerns raised by several commenters to the FSOC's ANPR and NPR about the lack of detail and clarity surrounding the designation process. This lack of specificity and certainty in the designation process is itself a burden on the industry and an impediment to prompt and effective implementation of the designation process. That is why it is important that the FSOC move forward and develop some hard metrics to guide the SIFI designation process. The sooner we develop and publish these metrics, the sooner this needless uncertainty can be resolved. The FSOC is in the process of developing further clarification of the metrics for comment that will provide more specificity as to the measures and approaches we are considering using for designating non-bank firms.

SIFI Resolution Plans A major – and somewhat underestimated – improvement in the SIFI resolution process is the requirement in the Dodd-Frank Act for firms designated as SIFIs to maintain satisfactory resolution plans that demonstrate their resolvability in a crisis.

When a large, complex financial institution gets into trouble, time is the enemy. The larger, more complex, and more interconnected a financial company is, the longer it takes to assemble a full and accurate picture of its operations and develop a resolution strategy. By requiring detailed resolution plans in advance, and authorizing an on-site

FDIC team to conduct pre-resolution planning, the SIFI resolution framework regains the informational advantage that was lacking in the crisis of 2008.

The FDIC recently released a paper detailing how the filing of resolution plans, the ability to conduct advance planning, and other elements of the framework could have dramatically changed the outcome if they had been available in the case of Lehman.5 Under the new SIFI resolution framework, the FDIC should have a continuous presence at all designated SIFIs, working with the firms and reviewing their resolution plans as part of their normal course of business. Thus, our presence will in no way be seen as a signal of distress. Instead, it is much more likely to provide a stabilizing influence that encourages management to more fully consider the downside consequences of its actions, to the benefit of the institution and the stability of the system as a whole.

The law also authorizes the FDIC and the Federal Reserve Board to require, if necessary, changes in the structure or activities of these institutions to ensure that they meet the standard of being resolvable in a crisis. In my opinion, the ultimate effectiveness of the SIFI resolution framework will depend in large part on the willingness of the FDIC and the Federal Reserve Board to actively use this authority to require organizational changes that promote the ability to resolve SIFIs.

As currently structured, many large banks and nonbank SIFIs maintain thousands of subsidiaries and manage their activities within business lines that cross many different organizational structures and regulatory jurisdictions. This can make it very difficult to implement an orderly resolution of one part of the company without triggering a costly collapse of the entire company. To solve this problem, the FDIC and the Federal Reserve Board must be willing to insist on organizational changes that better align business lines and legal entities well before a crisis occurs. Unless these structures are rationalized and simplified in advance, there is a real danger that their complexity could make a SIFI resolution far more costly and more difficult than it needs to be.

Such changes are also likely to have collateral benefits for the firm's management in the short run. A simplified organizational structure will put management in a better position to understand and monitor risks and the inter-relationships among business lines, addressing what many see as a major challenge that contributed to the crisis. That is why—well before the test of another major crisis—we must define high informational standards for resolution plans and be willing to insist on organizational changes where necessary in order to ensure that SIFIs meet the standard of resolvability.

Orderly Liquidation Authority (OLA) There also appear to be a number of popular misconceptions as to the nature of the Orderly Liquidation Authority. Some have called it a bailout mechanism, while others see it as a fire sale that will destroy the value of receivership assets. Neither is true. While it is positioned as a backup plan in cases where bankruptcy would threaten to result in wider financial disorder, the OLA is actually a better-suited framework for resolving claims against failed financial institutions. It is a transparent process that operates under fixed rules that prohibit any bailout of shareholders and creditors or any other type of political considerations, which can be a legitimate concern in the case of an ad-hoc emergency rescue program. Not only would the OLA work faster and preserve value better than bankruptcy, but the regulatory authorities who will administer the OLA are in a far better position to coordinate with foreign regulators in the failure of an institution with significant international operations.

The FDIC has made considerable progress in forging bilateral agreements with other countries that will facilitate orderly cross-border resolutions. In addition, we currently co-chair the Cross Border Resolutions Group of the Basel Committee. It is worth noting that not a single other advanced country plans to rely on bankruptcy to resolve large, international financial companies. Most are implementing special resolution regimes similar to the OLA. Under the OLA, we can buy time, if necessary, and preserve franchise value by running the institution as a bridge bank, and then eventually sell it in parts or as a whole. It is a powerful tool that greatly enhances our ability to provide continuity and minimize losses in financial institution failures.

While the OLA strictly prohibits bailouts, the FDIC could use the authority to conduct advance planning, to temporarily operate and fund the institution under government control to preserve its value as a going concern, and to quickly pay partial recoveries to creditors through advance dividends, as we have long done in failed-bank receiverships. The result would be a faster resolution of claims against the failed institution, smaller losses for creditors, reduced impact on the wider financial system, and an end to the cycle of bailouts.

The history of the recent crisis is replete with examples of missed opportunities to sell or recapitalize troubled institutions before they failed. But with bailout now off the table, management will have a greater incentive to bring in an acquirer or new investors before failure, and shareholders and creditors will have more incentive to go along with such a plan in order to salvage the value of their claims. These new incentives to be more proactive in dealing with problem SIFIs will reduce their incidence of outright failure and also lessen the risk of systemic effects arising from such failures.

In summary, the measures authorized under the Dodd-Frank Act to create a new, more effective SIFI resolution authority will go far toward reducing leverage and risk-taking in our financial system by subjecting every financial institution, no matter its size or degree of interconnectedness, to the discipline of the marketplace. Prompt and effective implementation of these measures will be essential to constraining the tendency toward excess leverage in our financial system and our economy, and in creating incentives for safe and sound practices that will promote financial stability in the future. In light of the ongoing concern about the burden arising from regulatory reform, I think it is worth mentioning that none of these measures to promote the resolvability of SIFIs will have any impact at all on small and midsized financial institutions except to reduce the competitive disadvantage they have long encountered with regard to large, complex institutions. There are clear limits to what can be accomplished by prescriptive regulation. That is why promoting the ability of market forces to constrain risk taking will be essential if we are to achieve a more stable financial system in the years ahead.

Macroprudential Supervision

Beyond the regulatory steps to ensure that the core of our financial system is more resilient to shocks, we also need a regulatory process that is much more attuned to developing macro risks and how they may affect systemically important institutions. This task, generally referred to as macroprudential supervision, has been assigned collectively to the FSOC. Among other things, the Dodd-Frank Act directs the FSOC to facilitate regulatory coordination and information sharing among its member agencies regarding policy development, rulemaking, supervisory information, and reporting requirements. The FSOC is currently working on a number of fronts to better identify and respond to emerging risks to our financial system. The Dodd-Frank Act requires that the FSOC produce annual financial stability reports and that each voting member submit a signed statement stating whether the member believes that the FSOC is taking all reasonable actions to mitigate systemic risk.

The success of the FSOC in accomplishing its goals will depend on the diligence and seriousness about those goals on the part of the members. So far, the FDIC believes that the FSOC member agencies are committed to the success of the Council, and we have been impressed with the quality of staff work in preparation for the meetings as well as the rigor and candor of the discussions. We also believe that the FSOC has provided an efficient means for agencies to jointly write rules required by the Dodd-Frank Act and to seek input from other agencies on independent rules. The FDIC strongly supports the FSOC's collective approach to identifying and responding to risks. Conducting multidisciplinary discussion and review of issues that cut across markets and regulatory jurisdictions is a highly effective way of identifying and mitigating risks, even before they become systemic.

In response to the Committee's request for additional information on potential risks to the financial stability of the U.S., I would like to offer some observations on two specific topics: problems in mortgage servicing documentation and interest rate risk at financial institutions in light of rapid growth in U.S. government debt.

Problems in Mortgage Servicing Documentation Mortgage servicing is a serious area of concern and one which the FDIC identified years ago. As early as the Spring of 2007, we were speaking to the need for mortgage servicers to build programs and resources to restructure troubled mortgages on a broad scale. When, over a year ago, we proposed a new safe harbor for bank-sponsored securitizations, we included requirements for effective loss mitigation and compensation incentives that reflect the increased costs associated with servicing troubled loans. In my testimony at the end of last year, in the wake of mounting problems with mortgage servicing and foreclosure documentation at some of the nation's largest servicing companies, I emphasized the need for specific changes to address the most glaring deficiencies in servicing practices, including a single point of contact for distressed borrowers, appropriate write-downs of second liens, and servicer compensation structures that are aligned with effective loss mitigation.

The FDIC believes that mortgage servicing documentation problems are yet another example of the implications of lax underwriting standards and misaligned incentives in the mortgage process. In particular, the traditional fixed level of compensation for loan servicing proved wholly inadequate to cover expenses required to implement the high-touch and specialized servicing on the scale needed to deal with the huge increase in problem mortgage loans caused by risky lending practices.

We now know that the housing bust and the financial crisis arose from a historic breakdown in U.S. mortgage markets. While emergency policies enacted at the height of the crisis have helped to stabilize the financial system and plant the seeds for recovery, mortgage markets remain deeply mired in credit distress and private securitization markets remain largely frozen. Serious weaknesses identified with mortgage servicing and foreclosure documentation have introduced further uncertainty into an already fragile market.

The FDIC is especially concerned about a number of related problems with servicing and foreclosure documentation. "Robo-signing" is the use of highly-automated processes by some large servicers to generate affidavits in the foreclosure process without the affiant having thoroughly reviewed facts contained in the affidavit or having the affiant's signature witnessed in accordance with state laws. The other problem involves some servicers' inability to establish their legal standing to foreclose, since under current industry practices, they may not be in possession of the necessary documentation required under State law. These are not really separate issues; they are simply the most visible of a host of related problems that we continue to see, and that have been discussed in testimony to this Committee over the past several years.6

As you know, even though the FDIC is not the primary federal regulator for the largest loan servicers, our examiners participated with other regulators in horizontal reviews of these servicers, as well as two companies that facilitate the loan securitization process. In these reviews, federal regulators cited "pervasive" misconduct in foreclosures and significant weaknesses in mortgage servicing processes.

Unfortunately, the horizontal review only looked at processing issues. Since the focus was so narrow, we do not yet really know the full extent of the problem. The Consent Order, discussed further below, requires these servicers to retain independent, third parties to review residential mortgage foreclosure actions and report the results of those reviews back to the regulators. However, we have heard concerns regarding the thoroughness and transparency of these reviews, and we continue to press for a comprehensive approach to this "look back."

I want to underscore that the housing market cannot heal and begin to recover until this problem is tackled in a forthright manner and resolved. As the insurer of the deposits at these banks, we will not know the full extent of the problems and potential litigation exposure they face until we have a thorough review of foreclosed loan files.

These servicing problems continue to present significant operational risks to mortgage servicers. Servicers have already encountered challenges to their legal standing to foreclose on individual mortgages. More broadly, investors in securitizations have raised concerns about whether loan documentation for transferred mortgages fully conforms to applicable laws and the pooling and servicing agreements governing the securitizations. If investor challenges to documentation prove meritorious, they could result in "putbacks" of large volumes of defaulted mortgages to originating institutions.

There have been some settlements regarding loan buyback claims with the GSEs and some institutions have reserved for some of this exposure; however, a significant amount of this exposure has yet to be quantified. Given the weaknesses in the processes that have been uncovered during the review, there appears to be the potential for further losses. Litigation risk is not limited to just securitizations. Flawed mortgage banking processes have potentially infected millions of foreclosures, and the damages to be assessed against these operations could be significant and take years to materialize. The extent of the loss cannot be determined until there is a comprehensive review of the loan files and documentation of the process dealing with problem loans. This is one reason that I have urged the servicers and the state Attorneys General to reach a global settlement. We believe that the FSOC needs to consider the full range of potential exposure and the related impact on the industry and the real economy. FSOC members have a range of relevant expertise in regulating the various participants and processes associated with the foreclosure problem. We need to fully understand the potential risks and develop appropriate solutions to address these deficiencies.

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 remedy the foreclosure backlog, which has become the single largest impediment to the recovery of U.S. housing markets.

Interest Rate Risk At the end of 2010, the U.S. domestic financial and non-financial sectors owed credit market debt totaling just over $50 trillion, a figure that is some 92 percent higher in nominal terms than it was just a decade ago. Much of this debt was issued during the recent period of historically low interest rates. Not only did the Federal Open Market Committee lower the federal funds target rate to a 49-year low of one percent for a 12-month period in 2003 and 2004, but it has continuously held the fed funds target rate at an all-time low of 0 to 0.25 percent since December 2008. Long-term rates have also been at historic lows during this period. The average yield on 10-year Treasury bonds over the past decade was the lowest for any 10-year period since the mid-1960s. It is clear that the most likely direction of interest rates from today's historic lows is upward. The question is how far and how fast interest rates will rise, and how ready lenders and borrowers will be to cope with higher rates of interest.

In theory, rising interest rates will represent a zero-sum game in which the higher interest payments demanded of borrowers will be perfectly offset by the higher interest income of savers in the economy. In practice, however, rising interest rates can impose considerable distress on borrowers or lenders depending on how debts are structured. Floating-rate or short-term borrowers will see their interest costs rise over time with the level of nominal interest rates. Not only will this have an effect on their bottom line, but higher borrowing costs could lead them to demand a lower volume of credit that they did at lower rates. However, in the case of long-term, fixed-rate debt, it is often the lender that suffers a capital loss, a decline in operating income, or both as interest rates rise. Depository institutions are traditionally vulnerable to losses of this type in times of rising interest rates because their liabilities are typically of shorter duration than their assets.

Given the prospect for higher interest rates going forward, effective management of interest rate risk will be an essential priority for financial institution risk managers in coming years. Unfortunately, there is a tendency during periods of high credit losses, such as the past few years, for risk managers to focus their attention mostly on credit risk, and to divert their attention away from interest rate risk at just the time that their portfolio is becoming more vulnerable to rising rates. It was just this type of inattention to the implication of rising interest rates that contributed to growth in structured notes in the early- to mid-1990s, when a number of banks took on complex and interest-rate-sensitive investments that they did not understand in search of higher yields.

The FDIC has been actively addressing the need for heightened measures to manage interest rate risk at this critical stage of the interest rate cycle. In January 2010 we issued a Financial Institution Letter (FIL) clarifying our expectations that FDIC-supervised institutions will manage interest rate risk using policies and procedures commensurate with their complexity, business model, risk profile, and scope of operations.7 That same month, the FDIC hosted a Symposium on Interest Rate Risk Management that brought together leading practitioners in the field to discuss the challenges facing the industry in this area.8

Effective management of interest rate risk assumes a heightened importance in light of the recent high rates of growth in U.S. government debt, the yield on which represents the benchmark for determining private interest rates all along the yield curve. Total U.S. federal debt has doubled in the past seven years to over $14 trillion, or more than $100,000 for every American household. This growth in federal borrowing is the result of both the temporary effects of the recession on federal revenues and outlays and a long-term structural deficit related to federal entitlement programs. In 2010, combined expenditures on Social Security, Medicare and Medicaid accounted for 44 percent of primary federal spending, up from 27 percent in 1975. The Congressional Budget Office (CBO) projects that annual entitlement spending could triple in real terms by 2035, to $4.5 trillion in 2010 dollars. According to CBO projections, federal debt held by the public could rise from a level equal to 62 percent of gross domestic product in 2010 to an unsustainable 185 percent in 2035.

The U.S. has long enjoyed a unique status among sovereign issuers by virtue of its economic strength, its political stability, and the size and liquidity of its capital markets. Accordingly, international investors have long viewed U.S. Treasury securities as a haven, particularly during times of financial market uncertainty. However, as the amount of publicly-held U.S. debt continues to rise, and as a rising portion of that debt comes to be held by the foreign sector (about half as of September 2010), there is a risk that investor sentiment could at some point turn away from dollar assets in general and U.S. Treasury obligations in particular.

With more than 70 percent of U.S. Treasury obligations held by private investors scheduled to mature in the next five years, an erosion of investor confidence would likely lead to sharp increases in government and private borrowing costs. As recent events in Greece and Ireland have shown, such a reversal in investor sentiment could occur suddenly and with little warning. If investors were to similarly lose confidence in U.S. public debt, the result could be higher and more volatile long-term interest rates, capital losses for holders of Treasury instruments, and higher funding costs for depository institutions. Household and business borrowers of all types would pay more for credit, resulting in a slowdown in the rate of economic growth if not outright recession.

Over the past year, the U.S. fiscal outlook has assumed a much larger importance in policy discussions and the political process. Members of Congress, the Administration, and the Presidential Commission on Fiscal Responsibility and Reform have all offered proposals for addressing the long-term fiscal situation, but political consensus on a solution appears elusive at this time. It is likely that the capital markets themselves will continue to apply increasing pressure until a credible solution is reached. Already, the cost for bond investors and others to purchase insurance against a default by the U.S. government has risen from just 2 basis points in January 2007 to a current level of 42 basis points.

Financial stability critically depends on public and investor confidence. Developing policies that will clearly demonstrate the sustainability of the U.S. fiscal situation will be of utmost importance in ensuring a smooth transition from today's historically low interest rates to the higher levels of interest rates that are inevitable in coming years. Government policies to slow the growth in U.S. government debt will be essential to lessening the impact of this shock and reducing the likelihood that it will result in a costly new round of financial instability.

Conclusion

The inherent instability of financial markets cannot be regulated out of existence. Nevertheless, many of the Dodd-Frank Act reforms, if properly implemented, can make the core of our financial system more resilient to shocks by restoring market discipline, limiting financial leverage, and making our regulatory process more proactive in identifying and addressing emerging risks to financial stability.

Working together on these reforms, regulators and the financial services industry can improve financial stability and minimize the severity of future crises. With this in mind, the FDIC will continue to carefully and seriously perform its duties as a voting member of FSOC, expeditiously complete rulemakings, and actively exercise its new authorities related to orderly liquidation authority and resolution plans.

The stakes are extremely high. To continue the pre-crisis status quo would be to sanction a new and dangerous form of state capitalism, where the market assumes that large, complex, and powerful financial companies are in line to receive generous government subsidies in times of financial distress. The result could be a continuation of the market distortions that led to the recent crisis, with all of the attendant implications for risk-taking, competitive structures, and financial instability. In order to avoid this outcome, we must follow through to fully implement the authorities under the Dodd-Frank Act and thereby restore market discipline to our financial system.

Finally, I would like to emphasize that many of the problems and challenges confronting the financial sector are beyond the control of the regulatory community. Obviously, restoration of fiscal discipline is the province of the executive and legislative branches. Similarly, tax code changes that could reduce or eliminate incentives for leverage by financial institutions and borrowers must be acted upon by Congress. So it is my hope that Senate Banking Committee members can play a leadership role in making sure that the ongoing budget and tax discussions include consideration of the ramifications of different policy options for the stability of the financial system going forward.

Thank you again for the opportunity to testify about these critically important issues. I would be pleased to answer any questions.

1 Reinhart, Carmen and Ken Rogoff. This Time Is Different: Eight Centuries of Financial Folly. Princeton: Princeton University Press. 2009. p. xxv.

2 See http://www.bis.org/publ/bcbs164.htm

3 See: "Interim Report on the Cumulative Impact on the Global Economy of Proposed Changes in the Banking Regulatory Framework," Institute of International Finance, June 2010. http://www.iif.com/press/press+151.php

4 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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5 "The Orderly Liquidation of Lehman Brothers Holdings under the Dodd-Frank Act," FDIC Quarterly, Vol. 5, No. 2, 2011. http://www.fdic.gov/regulations/reform/lehman.html

6 Hearings before the U.S. Senate Committee on Banking, Housing, and Urban Affairs: July 16, 2009; November 16, 2010; December 1, 2010.

7 See http://www.fdic.gov/news/news/financial/2010/fil10002.html

8 See http://www.fdic.gov/news/conferences/symposium_irr_meeting.html

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