Remarks by
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We stand today at a critical juncture of the post-crisis period. The seizing up of financial markets that occurred in the fall of 2008 is receding into memory. Urgently-needed reforms of the U.S. financial system are now being implemented, following the passage of the Dodd-Frank legislation last summer. The debate continues as to exactly how these reforms should be implemented.

But this debate is taking place in an economic climate that remains somewhat uncertain. Unemployment stands at 8.8 percent, and a quarter of U.S. mortgage loans are underwater. Annual issuance of private mortgage-backed securities remains largely shut down. Total loans held by FDIC-insured institutions have risen in only one of the past 10 quarters, and only then as a result of accounting changes that brought certain securitized loans back onto the balance sheet.

Paradoxically, one result of this ongoing economic distress – which is the direct and predictable result of the financial crisis itself – has been criticism of the reform process as a threat to the economic recovery. Last summer, we heard that the move toward higher capital requirements under Basel III would kill jobs and stop the economic expansion in its tracks. Last month, our proposal to require 5 percent risk retention in securitization deals was termed an "assault on housing."

A vigorous debate on the details of the reform program is to be welcomed. But this is no time to lose focus on how we got into this situation, and what long-term changes are needed to restore confidence in our financial markets and prevent a costly recurrence of this episode. Let's review some of the major reform initiatives now being implemented under Dodd-Frank and the new Basel III capital regime.

I thought it would be useful to frame this discussion in the context of Hyman Minsky's important contributions to the literature on financial instability. Without a doubt, we now have a clear answer to Minsky's central question: "Can 'It' Happen Again?" "It" can – and it very nearly did. But can we really prevent 'It' from happening again?

I am not going to stand before you and claim that the inherent instability of financial markets can be regulated out of existence. What I will say is that the Dodd-Frank reforms can – if properly implemented – restore market discipline, better align incentives, improve regulation, and greatly reduce the frequency and severity of future crises. This we must do.

Resolving Systemically-Important Firms

The first step is to level the competitive playing field between smaller banks and commercial entities, and the megabanks and nonbank financial companies with which they must compete for resources.

As you know, consolidation in the U.S. financial system in recent decades has led to rising concentration of banking assets in fewer and fewer institutions. The share of banking assets held by the four largest FDIC-insured institutions grew nearly five-fold in the last 20 years to more than 40 percent. This growing concentration of financial activity has outstripped our capacity to regulate the megabanks or, even more importantly, to impose market discipline through the credible threat of failure.

The crisis of 2008 centered on the interactions between large financial institutions and the shadow banking system – a network of financial companies, affiliates and special-purpose vehicles that existed largely outside of prudential supervision. Aside from the lack of supervision, capital standards, and other regulatory limits, the shadow banking system also fell largely outside of the FDIC's process for resolving failed insured financial institutions.

We all learned in 2008 that the large, complex U.S. financial companies at the heart of the crisis could not be wound down in an orderly manner when they became unviable. And we experienced first-hand the awful dilemma that is created when systemically important firms get into serious trouble. Policymakers can either let them fail – and risk destabilizing the entire financial system – or bail them out, imposing costs on the taxpayer and encouraging the type of risky behavior that caused the crisis in the first place. Needless to say, both of these options are highly problematic.

Following the September 2008 bankruptcy of Lehman Brothers we experienced a true "Minsky moment," marked by a collapse of interbank lending and commercial paper issuance, and extreme risk aversion throughout the financial markets. The bailouts and other policy measures that followed were effective in stemming the crisis, but proved to be extremely unpopular with voters, and with good reason. Even with these emergency measures, the economic consequences of the crisis were enormous.

Dodd-Frank Reforms Will End "Too Big To Fail"

That is why the foundation of the Dodd-Frank reforms is a series of measures that will – if properly implemented – put an end to the doctrine of Too Big to Fail. The first measure is an orderly liquidation authority under which the FDIC can resolve large, systemically important firms when they get into trouble and quickly sort out the claims against them so that key financial relationships can be preserved and taxpayers can be protected.

Under this authority, there will be no more bailouts. Shareholders and creditors would bear the losses, not the public, and management will know that it could be replaced. But, the process would be orderly and help prevent a catastrophic collapse of other firms. It would be a conscious departure from the reflexive bailouts that have tended to occur during crises in the absence of such a resolution authority.

Earlier this year, the FDIC issued an interim final rule clarifying how we would handle the claims process under this new authority. Our goal is to provide as much clarity as possible to this process in advance so that creditors and counterparties will know where they stand, and the potential for market disruptions in the wake of a failure will be minimized.

Dodd-Frank also requires all financial companies designated as systemically important to establish and maintain credible, actionable resolution plans that will facilitate their orderly resolution if they should fail. These resolution plans are essentially blueprints for the orderly unwinding of the company if it should run into serious problems.

Credible resolution plans will significantly enhance the FDIC's ability to prepare for and implement an effective and orderly liquidation process for systemically important firms. Importantly, the law also gives the FDIC and the Federal Reserve the authority to require changes in the structure or activities of these institutions before they run into trouble. This may be necessary to ensure that they could be wound down in an orderly fashion in a time of crisis. Rulemaking is underway to implement this new authority.

The bottom line is that the new resolution authority will impose the market discipline that has been lacking over the past several decades. Implementing this authority and ending Too Big To Fail is a game changer in terms of economic incentives. Market discipline will be restored. Financial incentives will be better aligned. Capital and credit will be allocated more efficiently. And taxpayers will no longer be on the hook when financial companies get it wrong.

Macroprudential Supervision

The crisis also made clear that regulators need to do a better job of identifying and assessing systemic risks posed by large, complex institutions that elude comprehensive oversight in part due to gaps in regulatory jurisdictions.

In his 1997 paper on the Minsky approach to bank examinations, Ronnie Phillips, then a visiting scholar at the FDIC, pointed out not only Minsky's emphasis on the critical role of prudential supervision of individual banks, but also the need for regulators to monitor emerging threats to the stability of financial markets – a process that is now referred to as "macroprudential supervision."

Thirteen years and one financial crisis later, the Dodd-Frank Act established a Financial Stability Oversight Council (FSOC) -- made up of the Treasury, the Federal Reserve, the FDIC, and other financial regulators to carry out just such a macroprudential

function. The Council is charged with identifying risks to financial stability and potential gaps in regulation, and making recommendations for primary regulators and other policymakers to take actions that would mitigate those risks.

One of FSOC's key responsibilities is to develop criteria for designating a class of systemically important financial institutions, or SIFIs. We are now in the process of finalizing regulations that will establish these criteria, addressing factors suggested by Congress, such as: leverage, off-balance-sheet exposures, concentration, and interconnectedness. Once designated, these institutions will be subject not only to enhanced prudential supervision by the Federal Reserve, but also to the new orderly liquidation authority.

The other main function of the FSOC is to collaborate across organizational lines to monitor emerging risks in financial markets and institutions, and to make recommendations, if necessary, for regulatory authorities to take action to mitigate them before they cause lasting damage to our financial system and our economy.

This is no easy task. Even if one subscribes to the Minskian notion that the financial system is inherently unstable – and there are surely many more adherents to that view in the wake of the crisis – it is not always a straightforward matter to connect the dots between emerging problems in individual markets that could eventually come together and threaten the core of our financial system.

For example, many saw danger in the unsustainable run-up of home prices during the first half of the last decade. And more than a few connected that trend to the rise in risky subprime and nontraditional loans that were separating mortgage underwriting from considerations of cash flow and making it instead an historic example of speculative financing. But fewer really comprehended the implications of repackaging and obscuring the equity risk of private mortgage pools in collateralized debt obligations. And almost no one saw in advance the critical dependence of the overnight repo and commercial paper markets on private mortgage-backed collateral, which would eventually help turn the subprime credit problem into a wider systemic liquidity crisis.

Containing Financial Leverage

In carrying out the task of macroprudential supervision, one of our central concerns should be a concept on which Minsky placed a high degree of emphasis, and that is financial leverage. In his 1986 monograph Stabilizing an Unstable Economy, Minsky wrote that "…the leverage ratio of banks and the import of speculative and Ponzi financing in the economy are two sides of a coin."

Financial markets and institutions naturally seek higher leverage during good times in pursuit of higher returns. This natural tendency is at the heart of the Minskian idea that periods of financial stability sow the seeds of the instability that often follows.

Just as Too Big To Fail misaligns incentives by undermining market discipline, increased leverage also skews incentives within financial companies by enhancing the upside for equity owners while their downside risks remain limited. They simply have too little at stake. This moral hazard creates incentives for excessive risk taking. If permitted to take place widely, rising leverage and risk taking make our financial system less stable, and invite the crises that frequently follow.

I would like to discuss with you two specific areas where regulators are working to contain leverage and enhance stability.

Strengthening Capital and Liquidity under Basel III

In the case of depository institutions, the Basel Committee provides a forum for reaching international agreement on capital standards. The economic costs of the crisis were very much on the mind of the Basel Committee when it published the December 2009 paper that ultimately led to the new Basel III capital accord. Basel III is not perfect, but it is a great improvement over what came before.

Briefly, 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. Significantly, Basel III includes an international leverage requirement, a concept that was met with derision when I proposed it in 2006. It also provides for a Liquidity Coverage Ratio and a Net Stable Funding Ratio, two new regulatory definitions that address financial institution liquidity.

Finally, the Basel Committee has committed to capital and liquidity requirements for SIFIs that are higher, not lower, than those applicable to small banks. My hope is that, when implemented, the SIFI requirement will call for a meaningful cushion of tangible equity capital. One of the enduring lessons of this crisis, like those that came before it, is that there is really no substitute for tangible equity capital in assuring the stability of financial institutions during a period of market turmoil.

As I mentioned, some see Basel III as an impediment to the economic recovery. But there is a growing body of research showing that higher capital requirements will have a relatively modest effect on the cost of credit and on economic activity. These studies – conducted by economists at Harvard, the University of Chicago, Stanford, 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. Excessive leverage not only creates moral hazard by allowing bank managers to socialize the costs of risk taking, but it also results in a misallocation of scarce capital to unworthy uses, thereby keeping our economy operating below its potential.

Constraining Leverage in Securitization through Risk Retention

Private asset-backed securitization is another area where excessive leverage contributed to the crisis. In the late 1990s and early 2000s, when private mortgage-backed securitization was still a relatively small part of the market, the typical deal structure included non-rated or sub-investment grade tranches reflecting the equity interest in the deal and that were retained by the issuer. These equity slices typically ranged in size from 3 to 5 percent or more of the total value of the deal.

As long as the market required issuers to retain the equity risk, there was at least some incentive for issuers to choose carefully the mortgages they would include in the pool. But by the middle of the decade, the size of these equity tranches had fallen in many cases to one percent or less of the value of the deal.

Moreover, there arose an active market in selling and repackaging these equity tranches in collateralized debt obligations, thereby removing all risk of loss from the original security issuer. Without the need to carry and fund equity claims arising from mortgage securitization, the pure "originate-to-distribute" model of mortgage lending came into being, conferring virtually infinite leverage to the issuers of private mortgage-backed securities.

Predictably, with higher leverage came riskier lending. About 90 percent of the riskiest subprime and Alt-A mortgage loans in the peak years of 2005 and 2006 were privately securitized. More than half of the privately-securitized subprime loans made in 2006 have now defaulted, along with over 40 percent of the privately-securitized Alt-A loans made that year.

For now, excessive leverage and risk taking are no longer pressing matters in private mortgage securitization, because that market has effectively ceased to function. Issuance last year remained 95 percent below the peak levels of 2005 and 2006.

Last month, as required by Dodd-Frank, the FSOC agencies issued a proposed rule to require risk retention of at least 5 percent in the vast majority of future securitization deals. The intent of this rulemaking is to better align economic incentives, restore sound practices in lending and securitization, and bring this market back better than before.

As directed by statute, we have also defined a small subset of very safe Qualifying Residential Mortgages that will be exempt from the general expectation of 5 percent risk retention. Some have suggested that we have defined this QRM carve-out too narrowly, which will result in the denial of reasonably-priced mortgage credit to all but the most highly qualified borrowers. But our expectation is that the general principle of 5 percent risk retention, required by statute, will provide the basis for a large, deep, and liquid securitization market.

We will have mandated a clear and transparent market practice that aligns the incentives of issuers and investors, which is of course, what must be done to bring investors back to this vital capital market.

Leveling the Playing Field in American Banking

A recurrent thread that runs through U.S. political and economic history is antipathy towards undue concentrations of economic and, especially, financial power. Accordingly, ours is a system where financial institutions can be chartered at the state level or the federal level, in a variety of sizes and institutional forms. This is a system in harmony with the entrepreneurial character of the U.S. economy, where more than two-thirds of new jobs are created by small businesses. Small businesses tend to seek credit at community institutions who understand the local economy and also make decisions locally.

Hyman Minsky clearly saw this nexus, writing in 1993 that: "Big banks like big deals. If we wish small deals to get a fair shake, then we need small banks having financing relationships measured in thousands of dollars rather than in millions."

But all too often in the run up to the crisis, large banks and nonbank financial companies were able, through regulatory arbitrage, to evade regulatory controls and market discipline. The resulting competitive disadvantage for community banks can be seen in the fact that their numbers shrank by a quarter over the past decade while their efficiency ratios deteriorated and their profitability lagged compared to the rest of the industry.

This is why one of the most important outcomes of the Dodd-Frank reforms will be a much-needed leveling of the regulatory playing field between community and regional banks and their megabank and nonbank competitors. The FDIC recently implemented the Dodd-Frank mandate to expand the deposit insurance assessment base, which will result in community banks paying 30 percent less in premiums, while large banks pay more. Small banks also benefit from the increase in the deposit insurance limit to $250,000 and the extension of the unlimited guarantee on noninterest-bearing transactions accounts.

Under the new Consumer Financial Protection Bureau, nonbank financial providers will, for the first time, be subject to the same type of federal consumer protection rules that apply to banks. Most importantly, large banks and other financial companies will no longer be subsidized by Too Big To Fail.

Far from being an impediment to the economic recovery, these reforms promise to support small businesses and heartland communities by making local banks more competitive and by making our financial system more stable. Keeping in mind the true causes of the crisis, as well as the economic costs of duplicative or unnecessary regulation, we can work together to guide the ongoing reforms in a direction that helps to transform our financial system from a source of concern to a pillar of strength for a resurgent U.S. economy.

Thank you.