Remarks by
FDIC Chairman Sheila C. Bair
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Good morning. I am pleased to have the opportunity to join you for this year's ABA Government Relations Summit.

We are, in many ways, at a crossroads in terms of the future of the commercial banking industry -- how it is regulated, and whether it will in fact fulfill its promise as an engine of growth for the U.S. economy. The past few years have taught all of us some painful lessons.

In 2008, our financial markets and institutions came literally to the brink of systemic collapse. Despite a massive infusion of federal support, our economy still experienced its worst recession since the 1930s. Economists tell us that the recession ended almost two years ago, and it's true that overall business activity has continued to trend higher since then. But 13.7 million people remain officially unemployed, and millions more are underemployed. Six million Americans have been officially out of work for more than six months.

The banking industry is indeed recovering, but that process remains incomplete. Problem loans are declining, as are loan-loss provisions. But bankers remain concerned about rebuilding their earnings capacity in the wake of the crisis. And many of you are pointing to heightened regulatory oversight as a primary source of concern in the earnings outlook. We have heard that higher capital standards will reduce lending and economic growth; that restrictions on capital markets activities will push business overseas; and that the impending Dodd-Frank reforms are both creating unresolved uncertainty for banks and moving along too fast for comfort.

This may be my last opportunity to speak with you before the end of my term in June. I would like to take this opportunity to discuss with you what I think are some real challenges facing the banking industry, and how the industry can play a more constructive role in the economic recovery and the reform process. Despite the sometimes heated rhetoric about the direction of regulation, I think bankers, regulators, and the public really do share many of the same goals and concerns for the future.

Short-Term Challenges and the Long-Term Economic Future

First, I would like to propose to you a radical-sounding notion. And it is that increasing the size and profitability of the financial services industry is not – and should not be – the main goal of our national economic policy. Yes, as we found out in the Fall of 2008, banking is critically important to the ability of our economy to function. And in the wake

of the crisis, it looks like bank lending will have to be an even more important ingredient in financing economic activity than it was just a few years ago.

But, in policy terms, the success of the financial sector is not an end in itself, but a means to an end – which is to support the vitality of the real economy and the livelihood of the American people. What really matters to the life of our nation is enabling entrepreneurs to build new businesses that create more well-paying jobs, and enabling families to put a roof over their heads and educate their children. In our national economic life, your contribution as bankers, and ours as regulators, can only be measured against this yardstick. And let's be completely honest – in the period that led up to the financial crisis we did not get the job done.

FDIC-insured institutions booked record earnings in each of the first six years of the last decade. But in the recession that followed, the U.S. economy lost over 8-and-a-half million jobs, of which only about 1.2 million have been regained in the recovery. There are almost two million fewer private-sector jobs in this country today than there were in December 1999, eleven years ago. More than nine million residential mortgages have entered foreclosure in the past four years, and the backlog of seriously past due mortgages stands at more than two-and-a-half million.

The lesson for policymakers is that having a profitable banking industry, even for years at a time, is not sufficient on its own to support the long-term credit needs of the U.S. economy. Instead, the industry also needs to be stable, and its earnings must be sustainable over the long term. This, quite simply, is why regulatory changes must be made.

Is the Problem Regulation – or Confidence?

While it is clearly recovering, our economy continues to face some significant challenges. The balance sheets of households, depository institutions, state and local governments and the federal government all suffered serious damage as a result of the recession. All of these sectors are taking steps to repair that damage, but in some cases it will be a long, painful process.

In some respects we have seen a dramatic improvement in investor confidence and the functioning of financial markets. Credit spreads are down, stock prices are up, and lending standards have eased a little. We're finding that troubled institutions have recently been better able to raise capital or find an acquirer before failure, and we have also been getting better bids for failed banks that have good retail franchises.

But not every part of our financial system is working the way it is supposed to. The issuance of private mortgage-backed securities last year was just $60 billion, the same as in 2009 and down almost 95 percent from the peak years of 2005 and 2006. Let's be clear – the collapse in this market is not the result of actual or anticipated regulatory intervention. Instead, it is the result of a crisis of confidence on the part of investors who lost hundreds of billions of dollars in the mortgage crisis.

And this is not the only area of lending where volume has declined sharply. The issuance of non-mortgage asset-backed securities is down by well more than half. And in the last three years, the volume of loans for the construction and development of real estate, or C&D loans, held by FDIC-insured institutions also has fallen by half. Net charge-offs of C&D loans during this period now exceed 10 percent of the loans that were on the books at year-end 2007.

There are some who continue to point to over-zealous regulators as the reason for rising charge-offs and declining balances in C&D portfolios. But the truth is that small and mid-sized institutions held record-high concentrations of these loans when U.S. real estate markets began their historic slide in 2006 and 2007. Regulators have done what they can in the wake of the crisis to facilitate loan workouts that help borrowers and banks while conforming to accepted accounting principles. But we cannot make the problem go away overnight.

The Industry Needs Regulation to Prevent Excesses

With the benefit of hindsight, I think we all can agree that the time for action would have been before the crisis – when rapid growth in subprime and nontraditional mortgage loans was undermining the foundations of our housing markets, and poorly-managed concentrations in commercial real estate and construction lending were making many small and mid-sized institutions highly vulnerable to a real estate downturn.

As you will recall, regulators did propose and issue guidance on managing commercial real estate concentrations and on nontraditional mortgage lending in 2006, and then extended the mortgage guidance to cover subprime hybrid loans in early 2007. In retrospect, it could have been very helpful if well-run institutions had supported these proposals.

But a review of comment letters sent to regulators by industry trade associations before the crisis shows a consistent pattern of opposition. With regard to commercial real estate concentrations, comments from the various trade associations asserted that new guidance was not needed and would only increase regulatory burden; that industry practices had vastly improved since the last real estate downturn; and that high levels of commercial real estate lending were necessary in order for small and midsized institutions to effectively compete against larger institutions.

When we issued proposed guidance on non-traditional mortgages, industry comments found the guidance too proscriptive, saying that it "overstate[d] the risk of these mortgage products," and that it would stifle innovation and restrict access to credit. Later, when we proposed to extend these guidelines to hybrid adjustable-rate mortgages, which at that time made up about 85 percent of all subprime loans, we received a letter co-signed by nine industry trade associations expressing "strong concerns" and saying that "imposing new underwriting requirements risks denying many borrowers the opportunity for homeownership or needed credit options."

For our part, I think it is clear in hindsight that while our guidance was a step in the right direction, in the end it was too little, too late. To be sure, most—but not all – of the high risk mortgage lending was originated outside of insured banking institutions. But many large banks funded non-bank originators without appropriate oversight or controls. And CRE lending did not cause the crisis, though poor management of CRE concentrations made far too many institutions vulnerable to the housing market correction when it finally turned. I think we all missed some opportunities before the crisis to help protect well-run institutions from the high-fliers – both within and outside the banking industry – whose risky lending practices were paving the way for the real estate crisis.

This is where I think the regulators and the industry should stand on common ground, in our determination to prevent a race to the bottom in lending practices and portfolio structures. This will protect the Deposit Insurance Fund and well-managed banks from higher assessment rates in the midst of some future industry downturn. And I do see some recent signs of common purpose in the reforming bank regulation.

In comment letters we received earlier this year, the ABA, for example, has expressed its support for the implementation of the Orderly Liquidation Authority and other measures under Dodd-Frank that will help to restore competitive balance to the industry by ending the doctrine of Too Big To Fail. But when I hear some of the public statements of industry leaders about how stronger capital requirements or risk retention in securitization will stifle lending and douse the recovery, I do worry about the depth of that commitment.

I think there is great pressure to restore earnings to pre-crisis levels. As we saw in the years leading up to the crisis, there is always the temptation to try to squeeze out a few more basis points in earnings now by watering down certain regulatory provisions that are designed to preserve the long-term stability of our financial system and the deposit insurance fund.

I'll give one example. Comments received earlier this year on our proposed change in the assessment base under Dodd-Frank said, in part, "it is best to err on the side of collecting less, not more, from the industry." This comment was received at a time when the reported balance of the Deposit Insurance Fund was negative 8 billion dollars.

We need to get past rhetoric that implies that, when it comes to financial services, the best regulation is always less regulation. We need to stand together on the principle that prudential standards are essential to protect the competitive position of responsible players from the excesses of the high-fliers. And I would very much like to hear from the industry a constructive regulatory agenda that would use the provisions of Dodd-Frank to fix the problems that led to the crisis and help to protect consumers and preserve financial stability in the years ahead.

Public Perceptions of Banks in the Wake of the Crisis

This is not just my vision of how the regulators and the industry need to work together. My reading of recent polling data on how the public views banks also speaks to the need for a different approach from your industry.

In April 2010, a Pew Research poll found that just 22 percent of respondents rated banks and other financial institutions as having "a positive effect on the way things are going in this country." This was lower than the ratings they gave to Congress, the federal government, big business, labor unions, and the entertainment industry. Even though Americans remain skeptical about government control over the economy, an April 2010 poll conducted by Pew Research found that some 61 percent of respondents supported more financial regulation, virtually unchanged from the spring of 2009.

If you narrow the focus of the questions just to Wall Street firms, the results are even more striking. In a Harris poll conducted in early 2010, some 82 percent of respondents agreed that "recent events have shown that Wall Street should be subject to tougher regulations."

Despite perennial concerns about the government's role in the economy, only 25 percent of investors polled by Gallup earlier this month agreed that "new financial regulations" were doing a lot to hurt the investment climate. Nearly three times as many felt that the federal budget deficit and high unemployment were major sources of concern. What really seems to stick in the craw of the public is the extraordinary assistance that was provided to financial companies while millions of Americans were losing their jobs and their homes.

A July 2010 poll conducted by the Pew Research Center and the National Journal shows that some 74 percent of respondents believed that government economic policies since 2008 had helped large banks and financial institutions "a great deal" or "a fair amount." Only 27 percent thought these policies had helped the middle class, and only 23 percent felt they had helped small business. A Rasmussen poll published earlier this year shows that fully 50 percent of Americans believe the federal government is more concerned with making Wall Street firms profitable than with making sure the U.S. financial system works well for all Americans.

Manage Your Reputational Risk

Bank regulators are never going to be popular or glamorous in the eyes of the public. But the banking industry seems to have an even bigger image problem in the wake of the financial crisis. What is important for you to recognize is that this type of reputation risk will eventually have implications for your bottom line and the confidence of your investors and customers.

In this light, the biggest risk to the long-term success of the banking industry is not today's difficult economic environment. That will improve over time. And it is not the introduction of new regulatory rules that will curb the excesses that led to the financial crisis. The vast majority of well-run institutions will benefit from these changes. Instead,

the biggest long-term risk to the success of the banking industry would be its failure to support the reforms needed to ensure long-term stability in our financial markets and our economy.

The American people have suffered enormous economic losses as a result of the financial crisis. In the years ahead, they will be asked to make more sacrifices to balance government budgets, repair public infrastructure, and rebuild our economic competitiveness. As this historical era unfolds, public opinion as to the role played by the banking industry seems unlikely to be neutral. It is far more likely that banks will come to be viewed either as a group that supported the restoration of free enterprise and public responsibility in the American economy, or as a group that mainly looked out for its own short-term interests and resisted reforms that could have restored a sense of confidence and fairness in our financial markets.

Conclusion

Every one of your branches prominently displays the FDIC seal. It is a symbol of public confidence that assures the public that their money is safe if your institution should fail. But that seal also carries with it the expectation of your customers that they will be treated fairly and protected from unsuitable loan products and hidden service charges.

That public trust is sacred, and it is the very foundation of the long-term success of your industry.

If bankers and regulators are to uphold that trust, we must demonstrate the ability to work together and engage in long-term thinking that will protect consumers, preserve financial stability, and lay the foundation for a stronger U.S. economy in the years ahead.

Thank you.

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