Remarks by
FDIC Chairman Sheila C. Bair
To the
Native Sons and Daughters
Of
Kansas, Distinguished Kansan Award,
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I can't tell you how pleased and honored I am to be with you tonight. I was deeply disappointed when I was unable to join you last year to stand alongside Secretary Gates to accept this Distinguished Kansan Award. The financial crisis has put many demands on my schedule. And for those of you who pay attention to the timing of our bank closings, you can understand why Friday-night events can be challenging for the Chairman of the FDIC. But things definitely worked out well, because this year I can stand alongside my former law professor and early role model, Judge Deanell Reece Tacha.

I had Deanell for first-year torts when I attended the University of Kansas School of Law. Not only was she an unbelievably effective and dynamic teacher, she also was an early and courageous model of work-life balance, teaching our class while she was pregnant - right up to her delivery date, swollen ankles and all! Years later, when I was pregnant with our first child while a Commissioner of the Commodity Futures Trading Commission, I would think back to her example as I undertook such challenges as testifying at a four-hour hearing without a bathroom break or waddling into the rough-and-tumble futures pits at the Chicago Mercantile Exchange to scrutinize the adequacy of their audit trail system.

It is not always easy to "have it all" — a career and a family — neither emotionally nor physically. But Deanell showed me early on that it could be done with grace and style. Deanell made a lasting impression on me, so much so that as a counsel to Senator Dole on the Senate Judiciary Committee, I was among those who proposed and pushed for her candidacy to the 10th Circuit Court of Appeals, and I had the privilege of working on her confirmation hearing.

Coming on the heels of the confirmation of Justice Sandra Day O'Connor's nomination to the U.S. Supreme Court — another of my heroes — women were just coming into their own as jurists. Deanell's was one of the easiest confirmations I had worked on. And she has made all of us so proud with her decades of service on the Court, and her strong record of thoughtful, balanced, and fair jurisprudence.

Making a difference

Like Deanell, and many of the other distinguished Kansans you have honored over the years, I have spent most of my life in public service. I chose that career path because I share Senator Dole's view that, "When it's all over, it's not who you were … It's whether you made a difference."

I have an old-fashioned view of government. I believe that you work in government because you want to help people; you want to make a difference. Throughout my career, I like to think that I have helped people in their daily lives. That is one of the reasons why I have found my tenure at the FDIC so rewarding, notwithstanding the severe pressure, long hours, and high stakes.

As the financial system came unglued, people on Main Street knew that the FDIC was there for them, keeping their insured deposits safe. We gave them peace-of-mind and assurance, just as we have for more than 77 years. And by providing that stability, people kept their money in the banks and we avoided the massive bank runs and failures that occurred during the Great Depression. Indeed, less than 4 percent of insured depository institutions have gone into receivership. And when they have failed, the FDIC has worked hard to make sure that insured depositors have had virtually seamless access to their money.

Challenging times for public servants

As rewarding as I have found my tenure at the FDIC, I must tell you that this is not an easy time to be in government service. Washington has become a much more partisan place than it was in 1981, when I joined Senator Dole's Judiciary Committee staff. It has always been a tough town. But today disagreements have become more personal and, yes, at times, nasty. Red-hot political rhetoric, as well as pot-stirring media commentary on both the left and the right, have fueled an already inflamed, anti-government sentiment.

The reality is that most of us who serve in high profile positions in government have received hostile communications, if not direct or implied threats of physical harm. At the FDIC we have received our share of threats from people who have lost money in failed banks. Just recently, a disgruntled trader whose registration was revoked put out a $100,000 bounty on the lives of the heads of the SEC and CFTC. Public figures are not the only ones who have been demonized in the current political climate.

Among the great villains of the financial crisis have been "greedy" Wall Street bankers, "shifty" mortgage brokers, and "deadbeat" homeowners, to name a few. Don't misunderstand. I am not excusing anyone's behavior. Plenty of people inside and outside of government made mistakes in the years leading up to this crisis, and they deserve to be held to account.

But accountability is one thing; vilification is quite another. Vilification can lead to the kind of tragedy we saw in Arizona. It can also distract us from the real problems facing our country. It debases debate by making our problems seem like they are solely an outgrowth of bad people and venal intentions, when in fact some widely accepted government policies created the environment that allowed our problems to fester and grow.

Causes of the housing bust

Did greed play a role in the housing debacle? Yes. Were regulators sufficiently vigilant in supervising our financial markets? No. But let's take a step back. Let's take a look at the government policies that fueled the unsustainable housing boom, and the complex financial instruments that turned hundreds of billions of dollars in troubled mortgages into trillions of dollars of losses.

If we are to fix the problems that led to the financial crisis, we must acknowledge and change the government policies that created incentives for risk taking — incentives that broadly influenced behavior in ways that harmed us all. Take the policy of too big to fail. I'm looking over this audience, and I'm guessing that there are a lot of business people out there. I'm also guessing that most of you receive no government support for your businesses. You sink or swim on your own.

Now imagine that the government had given you reason to think that it would bail you out if you got yourself into trouble. Not only that, but your creditors — your bank, your investors — also thought that the government would never let you fail. How would that change your behavior? For one thing, it would make it easier for you to get a loan or raise capital; to perhaps offer an untested new product or expand into a new, unfamiliar market. And maybe you wouldn't even consider the risks, because of the notion that the government would bail you out, no matter what.

My point is, this policy would likely change your behavior. Subtly or not, it would encourage you to take on risks that you would be less willing to tackle if you and your creditors knew that you would be on the hook for losses. This is exactly what happened with Fannie Mae, Freddie Mac, and some of our largest financial institutions. They became reckless in part because they assumed that the government would never let them fail. And some of them were proven to be right. Because large financial institutions were viewed as pretty safe bets by investors, those investors didn't do their homework, and market discipline was lost.

Their investment dollars freely flowed into these large financial behemoths, resulting in a misallocation of economic resources — resources that could have been used to support manufacturing, domestic energy, physical infrastructure, and new technologies, to name just a few alternatives.

And when the chickens came home to roost, there was no process to put these financial giants into receivership. Bankruptcy is not equipped to deal with large financial institutions, and the FDIC receivership process at that time was limited to insured banks. So bailouts became necessary to stabilize the system. Yes, they were necessary, but they were — and still are — wrong. This is why the FDIC made it our highest priority to secure authority from Congress that that would enable the government to put large financial institutions into an orderly liquidation process if they got into trouble again — so that they would have to accept the same risks of failure as the rest of us. The FDIC is now in the process of implementing this new authority. And we are determined to end too big to fail.

Securitization: faulty incentives

Securitization provides another good example of upside-down economic incentives that were encouraged by government policies. As most of you probably know, securitization is the process whereby those who originate mortgages or other loans do not retain ownership in them. Rather, the loans are sold to investors who bear the risk if the borrower doesn't repay the loan.

Years ago, to encourage and foster this market, the government gave securitization vehicles preferred tax status as well as favorable regulatory treatment. Looking back, we can now clearly see that because loan originators didn't have to worry about absorbing the losses if borrowers failed to repay, they lost the incentives to properly underwrite loans. Let me again ask the business people in the audience: How would your behavior change if someone else always had to take the loss when a product you sold to your customer went bad? In other words, you could keep the money you made when you sold the product, and never worry about the repercussions if it later proved to be defective?

My guess is that some of you might be tempted to sell as much of the product as possible to make as much money as possible, with perhaps less attention to product quality. That's exactly what mortgage originators did in the years leading up to the financial crisis. They made millions of unaffordable mortgages, which eventually threw the financial system into crisis. Borrowers had tax incentives to take out these loans, many of which were cash-out re-financings, because of the full deductibility of mortgage interest. These loans remain a drag on our economic recovery and will for years to come.

Mortgage servicing crisis

This same misalignment is now causing dysfunction in the servicing of mortgage loans and, in turn, fueling the ongoing foreclosure crisis. Those who service loans are charged with collecting principal and interest payments and passing them along to mortgage investors. They are also charged with trying to restructure loans when a borrower becomes delinquent, in order to avoid a more costly foreclosure. It used to be that the lender who originated a mortgage also retained ownership and servicing for the life of the loan. And when borrowers started having financial difficulties, the servicer would work with them to restructure the loan and lower the payments, knowing that modifying the loan would be less costly than sending the family into foreclosure.

But most of today's troubled mortgages are not owned by those who service them, and servicers are compensated the same amount for each loan, whether the borrower is current on the loan or not. So these servicers have little if any economic incentive to try to work with delinquent borrowers and modify their loans. They are not compensated for making the extra effort, and they don't have to worry about taking the losses in a foreclosure. As a result, far too many homes are going into foreclosure instead of being saved by a mortgage modification. That further depresses the housing market.

Excess leverage

A final example I'll raise of government-encouraged risk taking is the excessive leverage many of our largest financial institutions used prior to the crisis. What do I mean by "excess leverage"? Quite simply, I am talking about borrowing a lot of money to take on increased risks, without having enough equity capital on hand to absorb losses if things go bad. Debt, as anyone with a mortgage or credit card knows, has to be repaid. Money raised through equity sold to shareholders, on the other hand, operates like a rainy day fund. There's no obligation to repay it, so it's there to fall back on if unexpected losses mount up.

Many of our large institutions did not have enough capital to absorb losses when the crisis hit. This led to either destabilizing bankruptcies — as we saw with Lehman Brothers — or stabilizing but distasteful government bailouts as we saw with AIG. One of the reasons why large financial institutions engaged in excess leverage was because the tax code makes it cheaper to fund operations with debt than with equity, and because debt holders felt protected from the risk of failure. This creates strong incentives for banks and others to finance operations using debt, and it contributes to continued industry resistance against regulatory efforts to increase bank capital cushions.

These are all government policies that I would like to see fixed. Because I fear that if they are not fixed or tempered in some way, they will ultimately again encourage the kind of short-sighted, risky behavior that led us into the financial crisis, independent of the people involved.

Conclusion

William Allen White, a renowned Kansan if ever there was one, observed that since "others have to tolerate my weakness, it is only fair that I should tolerate theirs." There will always be greedy people and imperfect regulators. We must tolerate and accept their weaknesses. And we can write thousands of pages of government regulations to help compensate. But if government is providing the wrong economic incentives in the first place, regulation is doomed to fail. Only by tackling these problems at their core can we truly correct what went wrong with our financial infrastructure.

Pointing fingers and assigning blame might make us feel better, temporarily. But it won't solve anything going forward. We need to work together to support government policies that reward behavior which contributes to our long-term economic prosperity. Such polices will reward the virtuous and help prevent the weak or unscrupulous from taking excessive risks at the expense of others. And in the process, hopefully make better citizens of us all. Thank you and God bless.

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