Remarks by
FDIC Acting
Chairman Martin J. Gruenberg
to
George Washington University
Law School
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Thank you for that very kind introduction.

In my remarks today, I will comment briefly on the condition of the banking system and then discuss the FDIC's new responsibilities under the Dodd-Frank Act for the resolution of systemically important financial institutions.

Condition of the Banking Industry

2011 represented the second full year of improving performance by the banking system.

The latest data, released by the FDIC in its Quarterly banking Profile earlier this week, indicate that banks have continued to make gradual but steady progress in recovering from the financial market turmoil and severe recession that unfolded from 2007 through 2009.

During the past two years, the banking industry has undergone a difficult process of balance sheet strengthening. Capital has been increased, asset quality has improved, and banks have bolstered their liquidity. The industry is now in a much better position to support the economy through expanded lending. However, levels of troubled assets and problem banks are still high. And while the economy is showing signs of improvement, downside risks remain a concern.

The FDIC data does show a continuation in the fourth quarter of last year of a trend in overall improvement in the condition of insured financial institutions. Industry earnings have grown over the past eight quarters. The percent of noncurrent loans on the books of FDIC-insured institutions has declined for seven consecutive quarters, reflecting improved credit quality. The number of institutions on the FDIC's problem bank list declined for the third consecutive quarter. The Deposit Insurance Fund moved into positive territory as of June 30 of last year, and continued to increase in the third and fourth quarters. The FDIC is forecasting significantly fewer failing banks this year than last year.

However, most of the improvement in earnings over the last two years has been the result of lower loan-loss provisions reflecting improved credit quality. But future earnings gains will have to be based to a greater extent on increased lending, consistent with sound underwriting. Prudent loan growth is a necessary condition for a stronger economy.

That is why we view the fourth quarter growth in the industry's loan portfolio, the third consecutive quarter of growth, as a hopeful sign.

The loan growth that has occurred so far has been led by lending to commercial borrowers. Loans to medium and large commercial and industrial borrowers have increased in each of the last six quarters. In the fourth quarter, we saw growth in small C&I loans as well. The FDIC began collecting quarterly data on small loans to businesses with the March 2010 Call Report; since that time, this is the first quarterly increase in small C&I loans.

This is a trend the FDIC will be following closely going forward.

Putting the FDIC's New Systemic Resolution Responsibilities in Perspective

The FDIC has been given significant new responsibilities under the Dodd-Frank Act to resolve systemically important financial institutions. Specifically, these include an Orderly Liquidation Authority to resolve the largest and most complex bank holding companies and non-bank financial institutions, if necessary, and a requirement for resolution plans that will give regulators additional tools with which to manage the failure of large, complex enterprises.

Before discussing our efforts to carry out these new responsibilities, I wanted to try to place these responsibilities within the broader framework of the way the FDIC's resolution activities regularly work together with bank supervision in responding to the financial difficulties of FDIC-insured institutions.

It is important to recognize up front that resolution is always the option of last resort. The purpose of the supervisory process is to make sure that institutions manage their risks so that the risk of failure is minimized.

The goal is to have a supervisory process that can recognize problems early and encourage management to address problems in a proactive way. When an institution's supervisory rating or capital adequacy is downgraded, the institution is subject to a variety of supervisory responses intended to encourage management to take prompt action. These supervisory actions may include:

- specific criticisms of risk management practices;
- formal or informal enforcement actions;
- orders to raise capital or seek merger partners that can bring in new capital and management expertise.

Under the current arrangement, should the condition of the institution deteriorate, the FDIC begins its resolution planning process in conjunction with the ongoing supervisory process and in close coordination with the primary supervisor of the institution. This would include undertaking a deposit download for deposit insurance purposes, and developing a detailed resolution plan for the institution.

The goal is to have an integrated process of supervision and resolution that will hopefully avoid closure of the institution, but that will enable the FDIC to prepare to carry out an orderly resolution if necessary.

In such a process – motivated by the credible threat of failure – the managers and investors of problem institutions have an incentive to:

- work with regulators to address their problems sooner rather than later;
- access new sources of capital if available; or
- sell the institution, in part or whole, if necessary to salvage some value in the institution.

Our goal in regard to the FDIC's new systemic resolution responsibilities is to adapt this framework to systemically important financial institutions, including their holding companies and affiliates, as well as designated non-bank financial companies. This will obviously pose significant new challenges that I will discuss in a moment.

But the basic goal is the same. Resolution is the option of last resort. What is needed is an integrated process of supervision and resolution planning for systemically important financial institutions that will provide for early supervisory intervention to avoid resolution, but that will be prepared to carry out an orderly resolution if needed.

The FDIC outlined in a paper how this process might have worked in the Lehman Brothers case. That paper is available on the FDIC website.

Orderly Liquidation Authority, Resolution Planning, and the Office of Complex Financial Institutions

The FDIC has taken a number of steps over the past year to carry out its new systemic resolution responsibilities.

First, the FDIC established a new Office of Complex Financial Institutions to carry out three core functions:

- monitor risk within and across these large, complex firms from the standpoint of resolution;
- conduct resolution planning and the development of strategies to respond to potential crisis situations; and

- coordinate with regulators overseas regarding the significant challenges associated with cross-border resolution.

For the past year, this office has been developing its own resolution plans in order to be ready to resolve a failing systemic financial company. These internal FDIC resolution plans, developed pursuant to the Orderly Liquidation Authority, provided under Title II of Dodd-Frank, apply many of the same powers that the FDIC has long used to manage failed-bank receiverships to a failing systemically important financial institution (SIFI).

If the FDIC is appointed as receiver of such an institution, it will be required to carry out an orderly liquidation in a manner that maximizes the value of the company's assets and ensures that creditors and shareholders appropriately bear any losses. The goal is to close the institution without putting the financial system at risk.

This internal resolution planning work is the foundation of the FDIC's implementation of its new responsibilities under Dodd-Frank.

In addition, the FDIC has largely completed the basic rulemaking necessary to carry out its responsibilities under Dodd-Frank.

In July, the FDIC Board approved a final rule implementing the Orderly Liquidation Authority. This rulemaking addressed, among other things, the priority of claims, and the treatment of similarly situated creditors.

In September, the FDIC Board adopted two rules regarding resolution plans that systemically important financial institutions themselves will be required to prepare – the so-called "living wills."

The first resolution plan rule, jointly issued with the Federal Reserve, implements the requirements of Section 165(d) of the Dodd-Frank Act. This section requires bank holding companies with total consolidated assets of $50 billion or more, and certain nonbank financial companies that the Financial Stability Oversight Council designates as systemic, to develop, maintain and periodically submit resolution plans to regulators. The plans will detail how the top-tier legal entity in the enterprise – as well as any subsidiary that conducts core business lines or critical operations – would be resolved under the U.S. Bankruptcy Code.

Complementing this joint rulemaking, the FDIC also issued an Interim Final Rule requiring any FDIC-insured depository institution with assets over $50 billion to develop, maintain and periodically submit plans outlining how the FDIC would resolve it through the FDIC's traditional resolution powers under the Federal Deposit Insurance Act.

These two resolution plan rulemakings are designed to work in tandem and complement each other by covering the full range of business lines, legal entities and capital-structure combinations within a large financial firm. Both of these resolution plan requirements will improve efficiencies, risk management and contingency planning at the institutions themselves. They will supplement the FDIC's own resolution planning work with information that would help facilitate an orderly resolution in the event of failure.

We expect that the process of developing these plans – or "living wills" -- will be a dialogue between the regulators and the firm. It is not a simple "check-the-box" exercise, and it must take into account each firm's unique characteristics. The planning process must also be an interactive dialogue with the firms especially for the largest and most complicated firms.

Together, these efforts will ensure comprehensive and coordinated resolution planning for both the insured depository and its holding company and affiliates in the event that an orderly liquidation is required.

With the joint rule now final, the FDIC and the Federal Reserve have now started the process of engaging with individual companies on the preparation of their resolution plans. The first plans, for companies with assets over $250 million, will be due in July.

I should note that developing a credible capacity to place a systemically important financial institution into an orderly resolution process is essential to subjecting these companies to meaningful market discipline. Without this capability, these institutions -- which by definition pose a risk to the financial system -- create an expectation of public support to avert failure. That distorts the financial marketplace, giving these institutions a competitive advantage that allows them to take on even greater risk and creating an unlevel playing field for other financial institutions that are not perceived as benefiting from potential public support. There is a very strong public interest in the FDIC developing the capability to carry out its new systemic resolution responsibilities in a credible and effective way.

Thank you very much.

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