Remarks by
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Good afternoon everyone. Thank you, Ron, for that very kind introduction. As a former member of the Exchequer Club, I am very pleased to be back with you today. As I look around the room, I am struck by how many old "Washington hands" I see. Indeed, the Club's membership includes many veterans of the major public policy wars in financial services, both past and present.

It is with your collective public policy experience and expertise in mind, that I want to talk to you about an issue that the FDIC has been working on for a number of years now. It primarily involves the largest banks in the system, but it has important consequences for the competitive balance between the largest banks and community banks. The actions public policymakers take or don't take in this area will have important implications for the stability of the financial system, not just in the U.S., but around the globe. It is fair to say that the FDIC's approach to this issue tends to reflect our unique perspective as deposit insurer. Therefore, it is also fair to say that our view on the subject is not necessarily well-understood or even welcomed by the largest banks.

For those of you who thought I was going to talk about Basel II, you can breathe a sigh of relief. I hope by now my views on Basel are well known and clear. Instead, I want to talk about what the FDIC is doing to be prepared for the possibility, however remote, of the failure of a large bank.

Looking Back at the Crisis Years

To understand where we are today and why we think this sort of planning and preparation is absolutely essential, it is important to review how we got here. In the past twenty-five years, the FDIC has handled more than 1,600 bank failures. The vast majority of these happened during the late 1980s and early 1990s. The crisis period began with the sharp spike in interest rates necessary to rein in double-digit inflation. It became characterized by a series of rolling regional recessions – booms and busts in several key sectors – farmland, energy, and commercial real estate.

The resulting savings and loan failures cost the industry and taxpayers approximately $150 billion. Failures among FDIC-insured banks were also significant and led to sharply higher deposit insurance assessments paid by the industry during the crisis to restore the bank insurance fund.

While the difficult economic environment placed great stress on the banking system, most observers would agree that the problems and costs were compounded by regulatory responses and policy choices, such as inadequate capital standards, lax accounting, and the practice of extending safety net protection beyond insured deposits.

The last of these, the extension of the government safety net, is one of the most challenging issues faced by regulators and policymakers not just in the U.S. but throughout the world. Indeed, the appropriate size and conditions of safety net protections have been the subject of much academic work and policy debate. When a bank fails, there is a tradeoff between minimizing spillover consequences in the short run and increasing moral hazard concerns in the long run.

From Continental to FDICIA

The crisis period was marked by two key events that essentially serve as bookends for the way the U.S. has approached this tradeoff in modern times: the failure of Continental Illinois and the passage of the FDIC Improvement Act of 1991, or FDICIA.

When Continental Illinois failed in 1984, the FDIC had fairly broad discretion to determine whether to extend protection beyond insured depositors. The FDIC exercised this discretion to protect all creditors – even the subordinated debt holders of the bank's holding company. In the aftermath of Continental Illinois – which highlighted the notion of "too-big-to-fail" – it would have been difficult to justify a policy that protected creditors of large banks but allowed the creditors of small banks to take losses.

Thus, over the next eight years, as the bank and thrift crisis was building, the FDIC typically resolved banks, large or small, in ways that protected most, if not all, creditors and, in some cases, even shareholders. In terms of the public policy tradeoff at the time, the scales were tipped in favor of minimizing short-term disruption.

With the passage of the FDIC Improvement Act in 1991, known as FDICIA, Congress sent a clear signal that tipped the scale the other way. The least-cost provision of FDICIA sharply curtailed the FDIC's discretion to extend protection beyond insured deposits. FDICIA makes it the norm, not the exception, that uninsured depositors and creditors of a bank will suffer losses.

The systemic risk provisions of FDICIA also significantly raised the bar for policymakers inclined to favor short-term stability. According to FDICIA, safety net protections can be extended beyond insured depositors only if it can be determined that not doing so would "have serious adverse effects on economic conditions and financial stability." To invoke the systemic risk exception, FDICIA requires a two-thirds majority of both the Boards of the FDIC and the Federal Reserve, as well as the approval of the Secretary of the Treasury, who must first consult with the President. In addition, the banking industry must pay for the additional cost associated with a resolution pursuant to a systemic risk finding through a special assessment. Because the special assessment is to be

proportional to each bank's liabilities, large banks will bear the greatest burden of paying for the extension of the safety net.

The Post-FDICIA Experience

Resolutions of banks that have failed since the passage of FDICIA have met the least-cost test. In most cases, this has meant that only insured depositors have been protected by the deposit insurance funds. The typical failure involves a bank closing on a Friday afternoon and re-opening the following Monday morning, with depositors having uninterrupted access to their insured funds. Since FDICIA, policymakers have not invoked, or even seriously considered, the systemic risk exception.

Consolidation and financial innovation have transformed the industry since the banking crisis. Banks have been able to realize economies of scale and the benefits of diversification. Derivatives and securitization have provided banks with the flexibility to determine which risks to hold, and which to transfer to counterparties and investors. In addition, the past fifteen years have essentially been the "golden age" of banking in the U.S. The banking industry has enjoyed year after year of record profits, strong capital levels and historically low loan losses. Currently there are 50 institutions on the "problem list" – one of the lowest numbers in the history of the FDIC. Unfortunately, the thirty-one month streak of no failures – the longest in FDIC history – ended just last month.

The Case for Readiness

Given where we are today, some might ask why the FDIC is spending any time worrying about such a low probability event as the failure of a large bank. Some may doubt the durability of the FDICIA reforms. Some could argue that large banks are immune to viability problems. Some might assume that bank regulators will revert to a "too-big-to-fail" resolution.

In their book, Too Big To Fail – The Hazards of Bank Bailouts, Gary Stern and Ron Feldman of the Federal Reserve Bank of Minneapolis raise two important issues. First, they argue that the notion of "too-big-to-fail" persists in a post-FDICIA world. According to Stern and Feldman, some question whether, when the chips are down, bank regulators will have the stomach for imposing losses on uninsured depositors and creditors of a large bank even if they have talked tough about doing so over the years. Economists have a fancy term for this. They call it a "time inconsistency" problem.

If I described this situation to my thirteen year old son, he would say – "oh, you mean people think the regulators might chicken out." Stern and Feldman view the systemic risk exception as the likely "out" bank regulators will take if faced with a large bank failure, even if the bank poses no real systemic risk threat, regardless of the significant approval hurdles required by FDICIA.

Second, Stern and Feldman argue that market forces such as industry consolidation, large banks' role in the payment system and the capital markets, and the growing complexity of their operations, have heightened the potential for a "too-big-to-fail" resolution. They point out that unless regulators and policy makers take credible steps to deal with these complicating forces, large banks will have greater incentives to take on more risk, reinforcing the perception of "too-big-to-fail." I couldn't agree more.

I certainly don't have a crystal ball, and I can't predict what the conditions would be in the unlikely event that the viability of a large bank is threatened. However, I am deeply skeptical of the notion of "too-big-to-fail." I am hard-pressed to envision a scenario where policy makers would choose a resolution that provided any significant protection to uninsured creditors. That is why, as the Chairman of the FDIC, I believe we must ensure that we are prepared to move forward in the event of a large bank failure in a manner that supports both the letter and the spirit of FDICIA. To do otherwise, because one discounts the probability of a large bank failure, would suggest that enhancing market discipline and reducing moral hazard are not worthy public policy goals.

With this motivation, the FDIC has been preparing for the policy and operational challenges that a large bank failure could pose. It is simply our duty, our mission, to ensure that in the event of a large bank failure, the FDIC is in a position to maintain public confidence and stability in the banking system. We must, in other words, plan for the worst and hope for the best.

The FDIC has a high-level committee in place to review and direct our readiness planning. This committee considers the full range of issues the FDIC will face should a large bank get into trouble. Operational readiness requires planning and preparation in a number of areas. For example, most large banks are active in the derivatives markets. There are special provisions in FDICIA for handling qualifying financial contracts, or QFCs. These provisions require the FDIC to make quick decisions to preserve the value of the QFCs with what will likely be limited information. In addition, the bank may have foreign operations which could create logistical and jurisdictional challenges at the time of failure. In short, this committee considers everything, from ensuring that personnel are cross-trained in failure-resolution tasks to coordinating with other federal agencies.

Over the past few years, the committee has focused a great deal of attention on the FDIC's ability to make timely insurance determinations. In other words, to be sure we can quickly separate insured and uninsured deposits. This is what we refer to as the claims administration process.

There are two points worth keeping in mind as you consider the task of determining the insured status of accounts. The first is that the three largest bank failures the FDIC has handled in the past would not be considered large or complex by today's standards. Continental Illinois, First Republic, and Bank of New England, each approached $40 billion in assets. While large for the times, a bank of that size would not rank in the top forty today.

The second point is that the three largest bank failures occurred prior to FDICIA and thus were not subject to the least-cost test. Because the FDIC used its discretion to resolve the failures in a way that allowed all depositors to be protected, the operational challenges of sorting out the insured and uninsured deposits did not come into play.

In the event of a large bank failure, the FDIC is likely to establish a bridge bank to provide for as much continuity of banking operations as possible. Franchise value of the bridge bank can be maximized only if its operations are quickly resumed. Therefore, a critical early step in setting up the bridge bank will be deciding which claims are transferred and which claims are left behind in the receivership created by the failure.

This is not a simple matter, for several reasons. The first is that the rules for deposit insurance coverage are complicated. Second, mergers and acquisitions have meant that large banks have multiple deposit systems that may not be fully integrated. Third, the deposit systems of most, if not all, banks are not designed to track the insured amounts of deposit accounts. This is the case because banks see little or no business value in knowing the insured status of accounts and regulators have not required them to keep such records.

Thus, at the time that a large bank is on the brink of failure, policymakers will need to consider a number of significant factors in deciding whether to adhere to a least-cost resolution or to invoke a system-risk exception. The nature of the problems at the bank, the potential for spillover effects and the general condition of the economy and the financial system will certainly need to be evaluated. Without proper planning, the operational aspects of the resolution itself could exacerbate potential "serious adverse effects." It is the FDIC's goal through our readiness efforts to ensure that decision-makers are able to make the policy choice free of operational considerations.

Current Efforts to Ensure Readiness

In December of 2005, the FDIC issued the first of two ANPRs to seek comments on ways to improve the claims administration process. The first ANPR proposed several options that would require certain banks to alter their deposit systems. Not surprisingly, many of the comments we received focused on the cost-benefit tradeoff. The FDIC reviewed the comments, continued discussions with industry representatives, and refined our thinking as to how best to proceed. That led to the second ANPR in December of last year. We believe our revised approach is less costly and burdensome on the industry, but still provides the FDIC with the ability to make an insurance determination in a way that does not disrupt the market place or leave depositors without sufficient liquidity. The public comment period closed on March 13 and we are in the process of evaluating what we heard.

The current ANPR proposes that banks have the ability to place provisional holds on deposits that may not be insured, and to remove them once insurance status has been determined. To take a simple example, provisional holds could be placed on all accounts over $100,000. The amount of the hold could be five percent of the amount

over the insurance limit. So for an account with a balance of $200,000, a hold would be placed on $5,000. What this means is that when the bridge bank opens, presumably the next business day after closing, the depositor would have immediate access to $195,000.

The appeal of the provisional hold approach is that depositors would have uninterrupted access to virtually all their funds, thus diminishing the likelihood that liquidity problems would lead to disruption in the financial system. At the same time, the FDIC would be able to impose a loss of $5,000 if it turns out that the account is not fully insured.

The issues we raise in our ANPR are not unique to the U.S. Through our readiness efforts, we are in contact with other countries that are exploring ways to ensure that they have the tools in place to handle a large bank failure. These tools include finding ways to ensure that deposit insurance determinations can be made as quickly and efficiently as possible to promote resiliency in their system and to avoid disruption at the time of failure.

The Cost-Benefit Tradeoff of Readiness

By raising this issue today, I would hope you could step back and consider the public policy merits of our readiness efforts, particularly our proposed improvements to the claims administration process. As you might imagine, banks are concerned about the costs associated with a mandate to alter their deposit systems to meet an FDIC need that has a low probability of occurring. As someone has put it, banks aren't much interested in helping the FDIC measure them for their caskets. I understand and appreciate their concern. That is why we have and will continue to work with the industry to find the most cost-effective way to meet our needs. But, I don't think we should lose sight of the benefits.

For example, I believe what we are proposing is consistent with a market-oriented approach to bank regulation and consistent with Pillar III of the Basel framework. Given the size and complexity of many banks in the U.S. today, and given their greater reliance on uninsured deposits and non-deposit funding, it is critical that bank supervision is complemented by effective market discipline. Clearly, a credible policy that ensures the FDIC stands ready to execute an orderly resolution in which uninsured creditors suffer losses, regardless of the size of the bank, strengthens market discipline. This is a benefit that enhances our financial system day in and day out - not just when failure occurs.

In addition, from a political perspective, it is in everyone's interest to avoid the perception that banks are "too-big-to-fail." Consider the likely repercussions if the day comes when the systemic risk exception is invoked because policy makers are concerned that the FDIC could not effect a least-cost resolution without causing significant delay or disruption. This outcome, or even its possibility, would raise questions. For example, it would highlight the disparate treatment of large and small banks. It would undermine arguments that as the industry evolves market oversight can

substitute for additional regulation. It would also further the notion that if the government is ultimately responsible for their risk taking, it is appropriate to place greater obligations on large banks.

In other words, I believe it is naïve to think that perpetuating the notion of "too-big-to-fail" is not without its costs – paid every day, not just if a large bank were to fail.

Concluding Remarks

I hope that by sharing the FDIC's perspective on readiness planning – as the insurer and the organization that must deliver in a crisis – you have a sense for why we take our responsibilities in this area so seriously. I hope you can come to appreciate our case for readiness, not simply as one that pays dividends should a large bank ever fail, but one that strengthens our banking system every day.

Despite this case, some have come to believe that the FDIC should not spend any time worrying about or planning for a large bank failure because these banks have become so well diversified and sophisticated in their risk management. While we acknowledge and welcome these and other developments, it does not mean we can rule out potential problems. As a statistician might put it, a large bank has a non-zero probability of failure. I prefer the words of Robert Frost to describe this condition. I think he said it best in the poem, The Black Cottage:

"Most of the change we think we see in life
Is due to truths being in and out of favour."
All banks pose risk to the system, even large banks, AND even if that "truth" is sometimes out of favor.

Stability and public confidence are easy to take for granted, and in good times such as these it is tempting to discount the probability of banking problems and the potential instability. The FDIC is resisting this temptation and is using this time to plan and prepare for what we hope will never happen.

Now, I would be happy to take your questions.

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