Remarks by
FDIC Chairman Sheila Bair
at the
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One of the great things about the financial markets is how they harness the incredible entrepreneurial spirit that made New York the center of the financial world.

This spirit constantly provides cutting edge innovations that are the lifeblood of the capital markets.

And the markets, in turn, are an essential engine for American and world economic growth.

Markets change and adapt.

Amidst current market turmoil, as more issues arise about the 'originate to sell' model, there is intensifying interest on Wall Street in other funding models.

So I am very pleased to be here today at this first covered bond summit.

While new to America, covered bonds are not a new financial product in the global market.

The European covered bond market is well-established and dates back to the 18th century in Germany. Today this market is a central part of Europe's financial system.

In the U.S., as you know, American institutions have already used prime mortgages to back the first U.S.-dollar denominated issues for the European market.

Bank of America and Washington Mutual have successfully gone to the market with substantial covered bond deals. And, I know that more transactions may be in the works.

Banks are looking at this emerging market to determine if this might be a new lower-cost, longer-term way of collateralized borrowing.

At the same time, financial policy makers are interested in sources of liquidity that preserve incentives for strong underwriting and maintain capital.

So far, American banks have looked mostly toward the well-developed European market for potential investors. But we can expect that domestic investors will take an interest in future deals.

We've been following these developments with great interest. But, we haven't adopted any position in favor or in opposition because … along with other regulators … we want to make sure we fully understand the implications for banks' risks.

Let me say, however, that we do support innovation that improves bank liquidity and access to funding.

Our job as supervisor and deposit insurer is to assess any risks that these innovations may pose … and to evaluate the pros and cons. As regulators have done in the past, we must watch carefully as the market develops.

As most of you I'm sure are aware, funding and liquidity are always critical for banks and … for that matter … any other company. And bank funding has changed.

- Today, insured deposits fund well less than half of commercial bank' assets.
- Fifteen years ago, the number stood at nearly 60 percent.

It's no surprise that the industry would be looking for new sources of funding.

But I will leave it to your other speakers to go over the business pros and cons of covered bonds.

I'm sure they will have some interesting perspectives on the future development of this market.

FDIC interest

So, what's our take on this emerging market?

In a market economy such as ours, innovation and openness create tremendous opportunities for success in virtually every line of business.

In financial services, innovation has created a vast array of new products and brought in many new participants.

Banks have realized economies of scale and the benefits of diversification.

And as a result, the last 15 years have been a "golden age" for American banking.

When it comes to a specific market innovation such as covered bonds, the FDIC is agnostic. We neither favor nor oppose particular types of capital market activity beyond their impact on regulatory objectives.

Like any banking supervisor, we support any innovation that improves bank liquidity, provided it does not impair capital or operational position.

But our job -- first and foremost -- is guarding peoples' money with the deposit insurance fund.

That's why we were created 75 years ago to help re-establish public confidence in our banking system during the Great Depression.

And we've had virtually no bank runs since because the public is confident that their money is safe in a federally-insured institution.

When a new product or innovative strategy hits the market, we ask a lot of questions. We ask:

What kind of impact will it have?

How will the transaction function during periods of financial stress?

Does it put the deposit insurance fund at greater risk if a bank fails?

How does it affect a failed bank's depositors?

How will it affect the risks to the banking system?

Do we need to take any action or consult with other banking regulators?

This is the approach we take to market innovation.

We're always cautiously optimistic.

Covered bonds

So what about covered bonds?

As I said, we welcome innovation – particularly when it has significant potential as another tool that provides liquidity.

However, we do want to better understand how they work and their potential risk to our insurance fund.

We'd like to know if they will improve market discipline or raise underwriting standards.

Our recent experience in the subprime market has demonstrated that the "originate to sell" model can create perverse incentives because of the mistaken belief that securitization transfers ALL risks to others.

This can lead to weaker underwriting.

By contrast, if a lender originates loans that it will continue to hold on its balance sheet – it may be more careful.

If covered bonds allow banks to retain originated loans, while accessing financial market funding, this could be a very positive development.

The covered bond market in the United States is in its infancy.

We have questions – as do you. We look forward to getting more information and to evaluating the comparative risks as the market continues to develop.

Conclusion

Finally, I would ask that whatever your involvement with this new product … be responsible and be transparent.

Sure, you want to make money. That's what capitalists in a free market economy are supposed to do.

But our mortgage credit markets are in turmoil today. The housing industry slump affects neighborhoods, homeowners, investors, the markets, and even the broader economy.

And it's largely because of poor underwriting practices, facilitated by a breakdown in market discipline.

As with most problems, there is no single culprit. But it's safe to say that poor lending standards and weak consumer protections are at the root of the current subprime credit meltdown.

The eagerness of investors to buy mortgages led to almost no price difference between more risky and less risky mortgages. And the "originate-to-sell mentality" led to weaker-and-weaker underwriting standards.

It seemed that the market would buy virtually any mortgage for securitization.

Some major subprime lenders simply made bad loans. Some were insured institutions, but many were not. Certainly some unscrupulous mortgage brokers also played a role by misleading borrowers.

I would ask that in making your own deals or investing decisions, whether it's covered bonds or other securities, that you seek out prudent investments that are backed by responsibly underwritten mortgage loans or other assets.

If your investment decisions focus on sustainable mortgages, then your investments are more likely to perform and the mortgage market volatility we have seen will be less likely.

I believe this is in everybody's best interest … lenders, investors, and borrowers. And it's in the national interest.

What's at stake is the health of the U.S. economy. And the ability to build wealth and to preserve the American dream of owning a home … and living in stabile, productive communities and neighborhoods across the country.

Thank you very much.

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