Remarks by
FDIC Chairman Sheila Bair
to the
International Institute
Of
Finance Istanbul, Turkey
October 4, 2009

Thanks Charles for your very kind introduction and for inviting me to address your annual meeting. I understand that this is the first time you've heard from the Chairman of the U.S. Federal Deposit Insurance Corporation, or for that matter, from any head of a deposit insurer. I guess that's a sign of our times and our status as the ultimate backstop for the banking system

There's an ancient Turkish proverb that says a shared cup of coffee commits one to 40 years of friendship. It's an expression to remind us that friendships and important commitments should not be taken lightly. They should be taken for the long-term. I hope that your discussions this week here in Istanbul can lead to long term commitments and lay a foundation for a stronger global banking system.

A year after Lehman: complacency sets in

It's been a year since we faced down the biggest financial crisis to hit the world economy in modern times. Thanks to extraordinary action by monetary and regulatory authorities, we're now in a period of relative stability. Credit markets are slowly getting back to normal. Liquidity is improving. Equity markets are staging a comeback.

But this is no time to sit back and relax simply because the worst of the storm appears to be over. Storms and hurricanes like this financial crisis can be very unpredictable. They have a nasty habit of regrouping and coming back with a fury. There's now an active (and I hope ultimately productive) debate in the United States and around the globe about how to repair the financial system.

It's truly a global debate. Virtually no economy went untouched by the financial crisis.

Critical reforms needed

I want to talk today about how to create a more resilient, transparent, and better regulated financial system – one that combines stronger and more effective regulation with market discipline.

The first task is to scrap the "too big to fail" doctrine. To do this, we need to fix weaknesses in our regulatory system, and achieve global reform for effective resolution processes when large firms fail. With these steps, we can foster real market discipline and make international cooperation more successful.

We need macro-prudential reforms so that firms that pose systemic risks hold larger capital and liquidity cushions.

We need disincentives for unbridled growth and complexity that raise systemic concerns.

We must appropriately ensure that off-balance-sheet assets and conduits count as on-balance-sheet risks. These necessary structural changes should also include, among others,

- An end to compensation structures that reward excessive risk taking
- Expanded capital requirements for high risk activities
- Shifting higher risk activities out of insured banks to clearly separate holding company subsidiaries
- Rules for maintaining stable liquidity
- Limits on leverage
- Minimum securitization requirements
- Better oversight of derivatives, and
- Reform of the rating agencies.

To assure better monitoring and avoidance of macro-prudential systemic risks, a council of national regulatory agencies should be assigned the responsibility to identify, monitor and make recommendations on preventing future systemic risks to the financial system.

While the recommendations of such a council may carry great weight with regulators and market participants, it is better to be safe than sorry. So the council should have authority to establish minimum, mandatory macro-prudential standards for such factors as capital, liquidity and leverage when individual regulators fail to act.

However, one of the lessons of the past few years is that regulation alone is not enough.

We need to establish an effective and credible resolution mechanism to ensure that market players will actively monitor and keep a handle on risk-taking.

In short, we need to enforce market discipline for systemically important institutions.

We must ensure that we have the powers to close troubled financial institutions, regardless of their size or interconnectedness, and without propping them up with taxpayer money.

This past week, the G-20 made a very good beginning on capital and compensation.

We must now start filling out these policy decisions with the essential details and get on with the job of completing the necessary reforms.

The FDIC today

Before moving into the details, I would like to say a few words about the FDIC.

To give you a little of our history, the FDIC is a deposit insurer that was established in 1933 at the nadir of the Great Depression to restore confidence in the U.S. banking system. I am proud to tell you that we just celebrated the FDIC's 75th birthday. The FDIC currently guarantees individual deposits up to $250,000, with a total insured deposit base in excess of $5.0 trillion.

This system is funded by risk-based assessments on over 8,000 member banks. And it is also backed by the full faith and credit of the United States, with support from a substantial line of credit from the U.S. Treasury

The banks remain responsible to repay any funds needed from Treasury. When this happened in the early 1990s, the Treasury funds were promptly repaid from bank assessments.

The FDIC has also had a major role in the recent efforts to stabilize financial markets. Last fall, the FDIC created the Temporary Liquidity Guarantee Program (TLGP) to help support banking system liquidity and restore the market for bank debt.

This included an FDIC guarantee of the payment of newly issued bank and bank holding company senior unsecured debt, and of noninterest-bearing bank transaction accounts.

As of July 31, TLGP covered $320 billion of new bank borrowing, and some $740 billion of bank customers' transaction accounts.

Now that conditions appear to be moderating, and the liquidity of financial markets has improved, we are moving together with the Treasury and the Federal Reserve to phase out emergency support programs. No new FDIC-guaranteed debt can be issued after month end and the FDIC's guarantee will expire on December 31, 2012.

To retain flexibility, we have asked for comment on keeping a limited six-month guarantee facility to be available in an emergency after that. The Transaction Account Guarantee component of the TLGP will terminate at the end June 2010

This is very good news. But we still face some difficult problems particularly in the residential and commercial real estate markets.

High levels of unemployment and stressed real estate markets have led to a surge in bank failures in the United States. So far this year, we've had 98 failures.

While we do not expect failures at the pace experienced in the late 1980s and early 1990s, the losses per institution are larger.

As a result, Deposit Insurance Fund is projected to need a new infusion of cash next year, so we're looking to the banks to provide it

Last week, we sought public comment on a proposal to raise an additional $45 billion for the Fund through a prepayment of bank assessments.

Prudential structural changes

The surge in bank failures is a pointed sign of the aftershocks of the financial meltdown and brings back into sharp focus the need for substantial improvements in regulation.

The crisis has called into question the fundamental assumptions about financial institutions and their supervision.

The Institute, in its recent report on "Restoring Confidence, Creating Resilience: An Industry Perspective on the Future of International Financial Regulation and the Search for Stability" provided a thorough analysis of the factors that led to the crisis.

The Institute's analysis, as well as its innovative solutions, should be given careful consideration.

Many others, including governments, academics, and international organizations such as the G-20, the IMF, the Financial Stability Board and the Basel Committee also have these matters under review.

I won't recite what's already been said. But I would stress the need for urgent, comprehensive, and coordinated action.

Let it not be said that when all is said and done that more was said than done. We must not leave the mistakes of the past uncorrected because we lack the will to act.

Problem of too big or too connected to fail

One key issue has not been fully addressed is how to end bail-outs for firms considered too big or too connected to fail.

Large firms are able to raise huge amounts of debt and equity and are given access to the credit markets at favorable terms without ample consideration of the firms' risk profile.

The large firms leverage these funds and become even larger. And in turn, this makes investors and creditors more complacent and more likely to extend credit without fear of losses. In some respects, investors, creditors, and the firms themselves are making a bet that they are immune from the risks of failure and loss.

They believe, and they've been proven correct so far, that government will not allow these firms to fail for fear of the repercussions on the broader market and economy.

However, in a properly functioning market economy there will be winners and losers. When firms are no longer viable, they ought to fail.

Actions that prevent firms from failing ultimately distort market mechanisms.

Unfortunately, the actions taken during the past year have reinforced the idea that some financial organizations are too big or too connected to fail.

We need an end to the too big to fail doctrine.

New resolution mechanism

If anything is to be learned from this mess, it is that market discipline must be a philosophy that applies equally in both good and bad times.

To do this we need a resolution regime that provides for the orderly wind-down of banking and other financial enterprises without imposing costs on the taxpayers.

The solution must involve a practical and effective mechanism for the orderly resolution of these institutions similar to that used for FDIC-insured banks.

This new regime would not permit taxpayer funds to be used to prop up a firm or its management. Instead, senior management would be replaced, and losses would be borne by the stockholders and creditors.

In describing this new resolution mechanism, I would like to focus on five elements: applicability, resolution powers, funding, international cooperation, and a requirement for "living wills."

The resolution mechanism I have in mind focuses on U.S. financial holding companies. While this structure will require some adaptation to the universal banking framework, international analyses through the Basel Committee demonstrate that it is highly adaptable.

The basic rule should be that when an insured bank fails and a receiver is appointed, the holding company of that bank and its non-bank affiliates should also be subject to resolution.

A consistent resolution framework for the bank and non-bank operations of the financial conglomerate is both fully consistent with market realities while allowing a more orderly, and less disruptive, resolution process.

Market confidence in the related companies will evaporate when a related bank fails.

This is also consistent with the normal close relationships and dependencies that exist between banks and non-bank affiliates for essential services - particularly IT services.

U.S. law already allows the FDIC to use the equity of other commonly owned banks if necessary to offset the losses to the insurance fund from a failure of a related bank.

This so-called cross guarantee rule should be extended to apply to the holding company and affiliated firms.

The fact that investment banks and others became bank holding companies to access the federal safety net, including deposit insurance, Federal Reserve lending and FDIC borrowing guarantees, is ample evidence of the value of these facilities and justifies including holding companies and their non bank subsidiaries in the resolution mechanism.

The question then arises: should this resolution regime be confined only to those holding companies that constitute systemic risks or should it apply to all bank holding companies?

Including all bank holding companies would be consistent with market realities, the dependence of affiliated banks on holding company services, and the support holding companies get from the federal safety net.

On the other hand, I am concerned that singling out only large and complex bank holding companies could reinforce too big to fail.

Because of this, I believe that the new regime should apply to all bank holding companies that are more than just shell companies and to their affiliates regardless of whether or not they are considered to be systemic risks.

Applying this resolution mechanism to firms that are not affiliated with banks, such as hedge funds and insurance companies, presents some difficult issues.

These firms have not been subject to prudential regulation and have not been viewed as explicit beneficiaries of the federal safety net.

And, there is the same concern that designating certain firms as posing a potential systemic risk could become a self-fulfilling prophesy.

However, the size and complexity of some of these firms, as well as their interconnections through the financial markets, suggests that applying this resolution process to these firms could be appropriate. It will support market discipline and assure an orderly resolution without safety net support.

Resolution powers

To achieve an orderly resolution, the receiver must have very broad authority to assure an orderly and rapid wind down of covered companies without taxpayer exposure.

Like the broad authority provided to the FDIC, these powers should include the ability to reject burdensome contracts, sell assets, resolve claims, and establish and operate bridge financial companies.

This last power to operate bridge financial institutions is essential to preventing a sudden collapse of large firms. These key powers will provide the receiver with the flexibility to protect the public, but avoid a taxpayer bail-out.

A more far reaching proposal to consider is limiting the claims of secured creditors to encourage them to monitor the riskiness of the financial firm.

This could involve limiting their claims to no more than say 80 percent of their secured credits. This would ensure that market participants always have ‘skin in the game’.

This would be very strong medicine.

It could have a major impact on the cost of funding for companies subject to the resolution mechanism.

A major advantage is that all general creditors could receive substantially greater advance payments to stem any systemic risks without the extensive delays typically characteristic of the bankruptcy process.

Obviously the advantages and disadvantages need to be thoroughly vetted.

In any event, there is a serious question about whether the current claims priority for secured claims encourages more risky behavior.

In a recent paper, the Federal Reserve Bank of Kansas City points out that many commonly used short term instruments, such as commercial paper and repurchase agreements, often increase leverage and make firms more vulnerable to illiquidity and insolvency.

By totally protecting secured claims, and many repo claims as nettable financial contracts, the current priority scheme may encourage greater fragility in the financial markets.

A resolution mechanism that discourages this result by potentially haircutting these claims could help reduce dependence on short-term funding and increase firm, and system, resiliency.

Funding is vital

It is vital that an effective resolution process for larger financial holding companies have adequate funding to provide working capital so that the receiver can prevent a disorderly collapse of these firms from imperiling other firms.

I believe it is most effective to do so with an ex ante fund established and maintained from risk based assessments on large bank holding companies.

It could be useable as working capital to pay the reimbursable expenses of the receiverships, support credit lines, and other operations of bridge financial institutions.

However, the fund should not be available for recapitalizing, re-organizing, or for paying claims against the receivership. Its use for this purpose should be explicitly prohibited by law.

The whole point of the resolution regime is to add a new element of market discipline to the financial system.

We need to end bailouts.

International cooperation

A more resilient resolution process requires greater international cooperation.

The largest financial firms are global firms. However, they operate under national statutes focused on domestic concerns.

Today, there is no international resolution process.

In a crisis, the domestic resolution laws of most countries are simply inadequate to deal with cross-border financial firms.

The financial crisis has demonstrated that individual countries will protect the interests of their citizens. Most governments will likely ‘ring fence’ the banks in their country to do so.

I share the concern that this could have serious consequences for efficient banking and capital markets.

Yet, at the present time, there is no practical alternative.

The FDIC has co-chaired a working group under the auspices of the Basel Committee to evaluate current law and policy and make recommendations for the future.

Its report is now available on the website of the Bank for International Settlements and I urge you to offer your thoughts on it.

It recommends reform and greater harmonization of national laws to achieve more effective tools to resolve cross-border institutions – along the lines I have recommended today – and specific steps to reduce the likelihood that a failure in one country will create a crisis in another.

If we want to move beyond this – to a more ‘universal’ resolution approach – the report makes it clear that we must address difficult issues – such has how to share the costs of a resolution and how to provide an international forum to resolve disputes.

I know that there is considerable interest in this subject within the private sector. I have noted, the prominence given to this topic in the IIF's report on Restoring Confidence, Creating Resilience.

I am also aware that the industry is mobilizing its resources to help develop thinking in the area. I very much welcome this and some sort of public-private collaborative effort could be both helpful and productive.

Today, the lack of any internationally agreed resolution protocols for cross-border financial firms means that it is likely that a ring fencing or territorial approach will control.

The logic seems to suggest that banking activities outside individual home countries or regional grouping should be conducted through subsidiaries rather than branches so that the host country clearly has control. This would be a departure from past practice, but with international cooperation it could achieve near term benefits.

The importance of these issues is reflected in the active work underway, not only in the Basel Committee, but also by the FSB and the G-20.

The Leaders Statement from the G-20 Summit in Pittsburgh last week underscored the vital importance of strengthening the international financial system by, among other things, dealing with the risks created by the currently inadequate process for resolving cross-border firms.

Wind-down plans

One key initiative noted by the Basel Committee working group and the G-20 leaders was development of orderly wind-down plans.

These plans would be developed in cooperation with the resolution authority and reviewed and updated annually.

These plans would be of substantial assistance to the receiver in any resolution.

But I believe they would be of immense assistance to financial institutions by highlighting dependencies, risks, and ways to improve their own resiliency in any crisis.

To make them more effective, perhaps the approved orderly wind down plans should be uploaded on the companies' websites for the information of stakeholders.

Secured and unsecured creditors, counterparties, and shareholders will then have full information on the effect of a wind down on their positions.

These public plans would also serve as a constant reminder to boards of directors and managements of the consequences of their risk taking, structural complexity, and operational fragility.

Bank of England Governor, Mervyn King, in his Mansion House speech last June, colorfully suggested that "[m]aking a will should be as much as part of good housekeeping for banks as it is for the rest of us."

Conclusion

This is a complex subject with critical ramifications for the role of banks and other financial firms operating in the domestic and international economies.

In my remarks today, I have set out some fundamental ideas for improving financial industry regulation, and creating a workable resolution mechanism.

The aim is to greatly enhance prudential supervision, financial firm performance, and market discipline without disrupting financial markets.

We must support market discipline without relying solely on the market to police itself. There must be a better way. And I am confident that we are on the right course to finding it.

In closing, I would like to complement the Institute for recognizing past mistakes and leading the way towards corrective action.

While effective prudential regulation is essential, its goals can best be achieved with the full cooperation of industry. I congratulate you on your constructive efforts to date, and look forward to your cooperation as we move forward.

Thank you.

Last Updated 10/04/2009