

**Statement of
Sheila C. Bair, Chairman,
Federal Deposit Insurance Corporation
On
Implementing the Dodd-Frank Wall Street Reform
And
Consumer Protection Act
Before the
Committee on Banking, Housing,
And
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Chairman Dodd, Ranking Member Shelby and members of the Committee, I appreciate the opportunity to testify on the priorities of the Federal Deposit Insurance Corporation (FDIC) for implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act). I also want to thank the Committee members and staff for their hard work to enact this landmark legislation. With new resolution powers for non-bank financial companies, the establishment of the Financial Stability Oversight Council and the creation of the Consumer Financial Protection Bureau (CFPB), the Dodd-Frank Act provides financial regulators with the tools that are needed to protect against future financial crises.

In addition to specific requirements to strengthen our financial system, there are important areas where the Dodd-Frank Act establishes broad policy direction while leaving the details of implementation to financial regulators. Implementing the Dodd-Frank Act in a way that will enhance the stability of our financial system as Congress intended, and not just as a regulatory compliance exercise, is a responsibility that the FDIC views with utmost importance.

The Dodd-Frank Act assigns the FDIC a large number of responsibilities for implementing reform. The FDIC is authorized to write 44 rulemakings – some of which are discretionary – including 18 independent and 26 joint rulemakings, new or enhanced enforcement authorities, new reporting requirements and numerous other actions. Implementation will require extensive coordination among the regulatory agencies and will fundamentally change the way we regulate large complex financial institutions.

It is imperative that regulators work together, with both speed and openness in the implementation of the Dodd-Frank Act in order to dispel uncertainties and foster a smooth transition by the industry. To achieve this end, the FDIC has already taken several steps to enhance the transparency of our rulemaking process. First, we announced that we would hold a series of public roundtables with external parties to discuss particular aspects of implementation and to provide input on draft regulations to carryout the Act. To date, we have held two roundtables. The first focused on the new

orderly liquidation authority provisions of the Dodd-Frank Act. The second roundtable addressed the FDIC's current Deposit Insurance Fund (DIF) management and risk-based assessment system and changes made by the Dodd-Frank Act. Information on our roundtables is posted on our public website.

The FDIC is also disclosing on our website the names and affiliations of private sector individuals who meet with senior FDIC officials to discuss how the FDIC should interpret or implement provisions of the Dodd-Frank Act that are subject to independent or joint rulemaking. Moreover, in addition to the longstanding practice of publishing public comments on our website that are received through our rulemaking process, we are encouraging general input from the public on how the FDIC should implement the new law. The comments already received have been published on our website and we will continue this practice in advance of formal rulemaking.

Implementation of Dodd-Frank

The recent financial crisis exposed the short-comings of the current regulatory regime for addressing large, non-bank financial companies that posed systemic risk. Specifically, the government was forced to either prop up a failing institution with expensive bailouts or allow a disorderly liquidation through the normal bankruptcy process. The bankruptcy of Lehman Brothers triggered a liquidity crisis that led to the bailout of AIG and massive public assistance to most major U.S. banking organizations. An orderly closure and liquidation is essential if we are to prevent such crises from occurring in the future. Many provisions of the Dodd-Frank Act are designed to reduce risk to the financial system and economy by enhancing the supervision of large non-financial companies or by facilitating their orderly closing and liquidation in the event of failure. The Dodd-Frank Act provides a new comprehensive regulatory regime that, coupled with higher capital standards, is designed to reduce risk in both individual firms and the wider financial system. Further, in order to reduce risk in the system to reasonable levels, it must be made clear to these companies that their financial folly could result in losses to shareholders and bondholders and in the dismissal of their senior managers.

My testimony reviews the top priorities of the FDIC in implementing the Dodd-Frank Act, which include: resolution plan requirements and orderly liquidation authority, systemic risk oversight, capital and liquidity requirements, and consumer protection. In addition, I will discuss other important implementation issues with respect to reliance on credit rating agencies, back-up examination and enforcement authorities, supervision of state chartered thrifts and changes to the deposit insurance system that should smooth the effect of economic cycles on IDIs by maintaining steady assessment rates and allowing the FDIC to maintain a positive fund balance during a financial crisis.

Orderly Liquidation Authority and Resolution Plans

The new resolution plan requirements and orderly liquidation authority are fundamental tools necessary to close large, systemically important financial companies and end "Too

Big to Fail." The new requirements will ensure that the largest non-bank financial companies can be wound down in an orderly fashion without costing taxpayers billions of dollars in the form of bailouts. From the FDIC's more than 75 years of bank resolution experience, we have found that clear legal authority and transparent rules on creditor priority – coupled with adequate information and cooperation – are critical tools for the effective advance planning of a large, orderly liquidation.

Legal Authorities for Orderly Liquidation

The Dodd-Frank Act provides for orderly liquidation of covered "financial companies" – that is, those financial companies (including bank holding companies) for which a systemic risk determination has been made that failure and resolution under otherwise applicable law would have "serious adverse effects on financial stability in the United States." Title II of the Act vests the FDIC with legal resolution authorities similar to those for insured depository institutions (IDIs). Once the FDIC is appointed as receiver, it is required to carry out an orderly liquidation of the financial company. In order to implement this authority, the FDIC must determine: how a company will be closed; how assets of the receivership will be sold; how claims will be determined and paid; and what policies and safeguards must exist to ensure that the taxpayers do not bear losses. We are currently establishing processes needed to make these determinations.

In August, the FDIC Board of Directors approved the creation of an Office of Complex Financial Institutions (OCFI), that will, among other things, carry out the FDIC's new authority to implement orderly liquidations of systemically important bank holding companies and non-bank financial companies that fail. I will discuss the new OCFI in more detail later.

Information Necessary for Liquidation

Without access to information, the FDIC's legal authority for liquidation under the Dodd-Frank Act would be insufficient for implementing an effective and orderly liquidation process. For example, the court-appointed trustee overseeing the liquidation of Lehman Brothers found that Lehman Brothers' lack of a disaster plan "contributed to the chaos" of its bankruptcy and the liquidation of its brokerage.¹ This is fully consistent with the FDIC's experience. Without advance planning, the FDIC could not have effectively resolved the many insured banks that have failed. Recognizing this, the Dodd-Frank Act created supervisory and regulatory powers designed to give the FDIC information and cooperation from the largest financial companies and other regulators, and the authority to conduct extensive advance planning.

The new legislation requires the FDIC and the Board of Governors of the Federal Reserve System (FRB) to jointly issue regulations within 18 months of enactment of the Dodd-Frank Act to implement new resolution planning and reporting requirements that apply to bank holding companies with total assets of \$50 billion or more and non-bank financial companies supervised by the FRB. Importantly, the statute requires both periodic reporting of detailed information by the largest financial companies and the

development and submission of a plan "for rapid and orderly resolution in the event of material financial distress or failure." The resolution plan requirement in the Dodd-Frank Act appropriately places the burden on financial companies to develop their own plans in consultation with the FDIC and the FRB.

We are in the beginning phase of implementation and are closely coordinating the development of the resolution plan regulatory requirements with the FRB. This new resolution plan regulation will require financial companies to look critically at the often highly complex and interconnected corporate structures that have emerged within the financial sector. For a resolution plan to be viewed as credible and facilitating orderly resolution under the Bankruptcy Code as required by the Act, it must provide a clear discussion with regard to corporate structure and key business operations. The plan should describe which assets and liabilities belong to which legal entities, identify functions or services provided by third parties and who within the financial firm has the relevant information about these functions.

These large complex firms are continuously growing and changing, which yields complex and opaque legal and operating structures. Over time, these can present obstacles not only to regulators, but also to the firm's management. Resolution plans can clarify a financial firm's risks and lines of authority and control, which can ultimately benefit the firm.

The existence of a resolution plan will generate financial benefits, as inefficiencies associated with resolving a company without sufficient background information will be alleviated, financial system resiliency will be improved, and systemic risk will be reduced. Taken together, the new resolution powers, the enhanced regulatory and supervisory cooperation mandated in the law, and the resolution planning authority provide an infrastructure to end "Too Big to Fail."

In fact, we view resolution planning as such a critical matter that we already have used the FDIC's preexisting authority to propose a requirement for resolution planning for certain large IDIs. In May of this year the FDIC issued a notice of proposed rulemaking which would set forth information-reporting requirements intended to provide the FDIC with key information regarding operations, management, financial aspects and affiliate relationships. Further, the proposed rulemaking would require a contingent resolution plan to be submitted to the FDIC that describes how the IDI could be effectively separated from the rest of the organization. The Dodd-Frank Act goes one step further by mandating an orderly resolution plan for the entire organization.

The Dodd-Frank Act lays out steps that must be taken with regard to the resolution plans. First, the FRB and the FDIC must review the company's plan to determine credibility and utility in facilitating an orderly resolution under the Bankruptcy Code. Making these determinations will necessarily involve the agencies having access to the company and relevant information. If a plan is found to be deficient, the company will be asked to submit a revised plan to correct any identified deficiencies within a time period determined by the agencies. The revisions must demonstrate that the plan is credible

and would result in an orderly resolution under the Bankruptcy Code. The revised plan could include changes in business operations and corporate structure to facilitate implementation of the plan. If the company fails to resubmit a plan that corrects the identified deficiencies, the Dodd-Frank Act authorizes the FRB and the FDIC to jointly impose more stringent capital, leverage or liquidity requirements. In addition, our agencies may impose restrictions on growth, activities or operations of the company or any subsidiary, until such time as an acceptable plan has been submitted. In certain cases we may force divestiture of portions of the non-bank financial firm.

Systemic Risk

The Dodd-Frank Act addresses systemic risk in several ways. As discussed above, each systemically important financial company must submit a periodic orderly resolution plan that is reviewed by the FDIC and the FRB and assessed for its credibility and ability to facilitate an orderly resolution under the Bankruptcy Code. In addition, the FDIC will have the authority to liquidate such entities in the event of failure. The Act also addresses the macro-oversight of the financial industry by establishing the Financial Stability Oversight Council (Council), strengthening liquidity and capital requirements, and prohibiting the use of credit ratings for regulatory purposes.

Financial Stability Oversight Council

The Dodd-Frank Act established the Council and vested it with the responsibility for identifying financial companies and practices that could create systemic risk in the future and taking actions to mitigate identified risks. The Council's success will be determined by the willingness of its members to work together closely and expeditiously to implement the Council's duties and to do so in a way that is not just a "paper exercise." One of the highest priorities for the Council is to establish the criteria for identifying systemically important financial companies to be subject to enhanced prudential supervision by the FRB. The Dodd-Frank Act specifies a number of factors that can be considered when designating a non-bank financial company for enhanced supervision, including: leverage; off-balance-sheet exposures; and the nature, scope, size, scale, concentration, interconnectedness and mix of activities.

This process of identifying the non-bank financial companies that should be subject to FRB oversight is likely to be involved and take considerable time. It may be prudent to begin the process by qualifying a small group of companies that are clearly subject to this provision of the Act while the Council members work through the details necessary to identify the more nuanced cases. Once a non-bank financial company is identified and subject to FRB supervision, the company must file an orderly resolution plan with the FRB and the FDIC, as discussed earlier.

Another key priority for the Council is to identify potentially systemic activities and practices. The Council needs to have a forward-looking focus to identify emerging risks and recommend that the primary regulators take quick action to mitigate those risks. At the same time, the Council members must work together to develop the most effective

recommendations for enhanced prudential standards for the range of potentially systemic financial companies and activities. It is important to remember that the Council was formed to take a long-term, macro viewpoint. It was not meant to interfere with or complicate the ability of the independent agencies to fulfill their statutory mandates and move ahead with clearly needed reforms. We look forward to collaborating with our colleagues to assure continued progress in strengthening the stability of our financial system and utilizing our respective authorities and individual areas of specialized expertise to close regulatory gaps which contributed so greatly to the financial crisis.

In order to accomplish its challenging tasks, I believe that the Council should begin with experienced and capable staff from each of the member agencies to work as a team in implementing the Council's responsibilities. Interagency working groups should be established to take full advantage of the knowledge and unique perspective of each member agency.

To meet these implementation objectives, as I previously mentioned, the FDIC has recently reorganized and established the OCFI to help carry out its responsibilities under the Act. To support the priority of systemic risk oversight, the OCFI will perform continuous review and oversight of bank holding companies with more than \$100 billion in assets as well as non-bank financial companies designated as systemically important by the Council. It will also be responsible for carrying out the FDIC's new orderly liquidation authority over those systemic companies that fail. Further, the OCFI will monitor risks among the largest and most complex financial institutions and develop plans for the contingency that one or more of these companies might fail. The OCFI will work closely with our counterparts at the U.S. Department of the Treasury (the Treasury Department), the FRB, and the other banking agencies to ensure that the Dodd-Frank Act is implemented in a way that makes prudential supervision and orderly liquidation of designated non-bank financial companies as effective as possible.

Bank Capital and Liquidity Requirements

One of the fundamental lessons of the financial crisis was the disastrous economic consequences of insufficient capital in the global banking system. Over time, the regulations that were in place allowed the financial system to become excessively leveraged and insufficiently liquid. Excessive leverage fueled a credit bubble and decreased the ability of financial institutions to absorb losses.

Through the auspices of the Basel Committee on Banking Supervision (Basel Committee), the Federal Reserve Board, the FDIC and our fellow U.S. banking regulators have been working with other supervisors and central bank governors throughout the world to increase both the level and loss-absorption capacity of capital. While important work remains to be done, as I will describe later in this testimony, the agreements reached in July and September by the Basel Committee and its oversight body – the Group of Central Bank Governors and Heads of Supervision (GHOS) – will do much to improve both the quantity and quality of capital and discourage excessive leverage and excessive risk-taking by large international banking organizations.

The agreement sets out new explicit numerical minimum requirements for common equity, calculated for regulatory purposes in a way that is intended to ensure that such equity is fully available to absorb losses. It also includes capital buffers designed to encourage banks to hold capital well above regulatory minimums so they can absorb losses and keep lending during a crisis; increases in capital requirements for the counterparty credit risk arising from derivatives exposures; explicit regulatory liquidity ratios; and of critical importance, an internationally agreed leverage ratio. All of these elements are subject to an extraordinarily long phase-in period.

A great deal of attention has been directed to the potential impact of these requirements. While the agreement does represent a significant strengthening of requirements, we believe achieving the new capital levels will be easily manageable with the extremely long transition period. First, none of these enhancements will take effect until January 1, 2013, over two years from now. At that time, a 3.5 percent minimum ratio of tier 1 common equity to risk-weighted assets is introduced – but without, at that time, a requirement for any of the new regulatory deductions. For U.S. banks, a 3.5 percent common equity requirement is clearly a non-event.

During the five years following January 1, 2013, new regulatory deductions from capital would be phased-in incrementally. In the U.S., the most important of these deductions would come from the phase-out of Bank Holding Companies' tier 1 capital recognition of trust preferred securities. This phase-out is part of both Basel III and the Dodd-Frank Act, and appropriately so since these instruments did not prove to be loss-absorbing in the crisis and their prevalence greatly weakened the capital strength of the U.S. banking industry and increased the FDIC's insurance losses.

There is also a more-stringent cap on the recognition of deferred tax assets in tier 1 common equity. When the value of these assets depends on future income, they are not really available to absorb loss in a severe scenario. It is likely, however, that banks would avoid much of this deduction simply by realizing the value of these deferred tax assets over time through earnings.

Another important deduction includes a tighter cap on the capital recognition of mortgage servicing rights and the deduction of all other intangible assets (goodwill, by far the largest category of intangible assets, has long been deducted from regulatory capital). While the value of mortgage servicing rights can be volatile, they clearly have value and the U.S. delegation argued successfully that the full deduction of this asset proposed by the Basel Committee in December was unwarranted. Finally, deductions of certain large financial equity investments and cross-holdings are designed to reduce the double-counting of capital in the financial system. We anticipate banks will avoid many of these types of deductions simply by selling or restructuring their holdings.

Just as these deductions would be phased in gradually, the higher numerical requirements would also be phased-in, even more gradually. This would include a capital buffer over and above the minimum common equity ratio. The minimum plus

buffer for tier 1 common as a percentage of risk-weighted assets would increase from the 3.5 percent on January 1, 2013 to 7 percent on January 1, 2019. Corresponding figures (minimum plus buffer) by 2019 for tier 1 and total capital would be 8.5 percent and 10.5 percent respectively. The leverage requirement that tier 1 capital be at least 3 percent of the sum of balance-sheet assets and selected off-balance-sheet assets would not take effect until January 1, 2018.

The agreement also includes important new requirements for liquidity. A new Liquidity Coverage Ratio requires banks to hold sufficient high quality liquid assets to meet cash needs during a 30-day stress scenario. While simple in concept, implementing this ratio requires many key assumptions and definitions. The agreement includes an observation period to allow for potential adjustments if needed. Another proposed liquidity ratio, the Net Stable Funding Ratio, in essence attempts to ensure that illiquid assets are not funded with volatile liabilities. This ratio is still under development.

Determining the amount of new capital that banks would ultimately need to retain through earnings or raise externally during the next 8 years under these requirements is extremely difficult. Some of the specific required deductions may be avoidable as noted above. Deductions or extremely high capital charges affecting certain speculative grade or unrated securitizations may be largely avoidable as well, as banks sell, restructure or allow these exposures to pay down over time.

Our own analysis, that assumes no mitigating actions by the banks and that the full increase in risk-weighted assets estimated by the Quantitative Impact Study (QIS) is realized, suggests that overwhelmingly, U.S. banks can meet the new requirements through retained earnings over time, with no need to tap external equity markets.

Our view is that while the evidence supported the case for still higher requirements, the agreement is a major strengthening of current rules and an acceptable compromise given the multiple perspectives represented in the negotiations.

Thus, the requirements agreed by the GHOS would go a long way to strengthen the U.S. banking system, but there is more to be done. First, the GHOS and the U.S. banking agencies have affirmed that further steps will be taken to augment the loss absorbing capacity of systemically important banks. The FDIC places a high priority on these efforts, and believes that they are needed to help avoid a recurrence of the events of the Fall of 2008.

The Dodd-Frank Act establishes a mandate for the largest and most systemically important banks to have capital requirements that are higher than those applying to community banks, for systemically important nonbank financial companies to be subject to strong and appropriate capital regulation, and for depository institution holding companies to serve as a source of financial strength to banks. The Dodd-Frank Act requirement that is most critical to ensuring that all this happens is Section 171.

Section 171 states that the generally applicable capital requirements shall serve as a floor for any capital requirement the agencies may require. Without this provision, the nation's largest insured banks and bank holding companies could avoid being held to higher capital standards, simply by using their own internal risk metrics under the agencies' rules implementing Basel II's "advanced approaches" to compute the risk-weighted assets against which they hold capital. Section 171 also provides that the generally applicable insured bank capital requirements will serve as a floor for the capital requirements of depository institution holding companies, and of nonbank financial companies supervised by the FRB pursuant to the Dodd-Frank Act. These important requirements will help ensure that holding companies do serve as a source of strength for their banks rather than as a vehicle for increasing leverage, and will address gaps and inconsistencies in regulatory capital between banking organizations and systemically important nonbank financial companies.

The FDIC attaches enormous importance to working with our fellow regulators to promptly implement these important requirements of Section 171.

Limitation on Reliance on Credit Rating Agencies

Another lesson of the financial crisis is the importance of performing independent due diligence on the underwriting standards and credit risks posed by credit exposures contained within structured products such as mortgage-backed securities and credit derivative products. To this end, the Dodd-Frank Act requires the regulatory agencies to remove all references to, or reliance on, credit ratings and substitute credit-worthiness standards developed by the agencies.

On August 25, 2010, the banking agencies published a joint Advance Notice of Proposed Rulemaking seeking comment on a number of alternatives to the use of credit ratings within the various U.S. bank regulations and capital standards that reference such ratings. While we are interested in seeing industry comments on the alternatives, we also recognize the significant challenges involved with developing credit worthiness standards for the broad range of exposures and complex securities structures that exist within today's financial system.

Consumer Protection

I have long argued for increased consumer protections and fully supported the creation of the CFPB. Put bluntly, consumer protections need to be beefed up especially for non-bank providers of financial services. There is ample evidence that consumers did not understand the consequences of the subprime and nontraditional mortgages that were sold to them during the buildup of the housing bubble. That is why basic consumer protections are a fundamental piece of our regulatory infrastructure, and the new CFPB has much work to do to bolster these protections.

As you know, under the Dodd-Frank Act, the FDIC maintains compliance, examination and enforcement responsibility for over 4,700 insured institutions with \$10 billion or less

in assets. The CFPB assumes responsibility to examine, and enforce for compliance with Federal consumer financial law, the 46 institutions we now supervise that have more than \$10 billion in assets or that are affiliates of institutions with over \$10 billion in assets. Even for these large organizations the FDIC will have back-up authority to enforce Federal consumer laws and address violations.

The Committee has asked about the transfer of employees to the new CFPB. We recognize the tremendous importance of working closely with our colleagues at the Treasury Department and the other banking agencies to ensure a smooth transition and the need for ongoing agency coordination once the transition is complete. Above all, we are fully committed to a fair transition and the equitable treatment of employees. With these goals in mind, we have taken a number of preliminary steps to begin the transfer process.

Initially, two senior employees are being detailed to the Treasury Department to work on a wide range of examination and legal issues that will confront the CFPB at its inception. We are also actively engaged with the Treasury Department in helping to determine staffing levels and identify skill sets needed for the CFPB. Recognizing that FDIC employees have developed expertise, skills, and experience in a number of areas to benefit the CFPB, we fully expect some employees will actively seek an opportunity to assist the CFPB in its earliest stages, or on a more permanent basis.

Related to the creation of the CFPB, the Dodd-Frank Act changes the composition of the FDIC Board of Directors by replacing the position held by the Director of the Office of Thrift Supervision (OTS) with the Director of the CFPB. Given the importance of consumer protections as part of financial reform, it is appropriate that the Director of the CFPB is a member of our Board.

In addition to this change to the Board's governance structure, the FDIC has taken steps to raise the stature and attention of consumer protections by creating a new division within FDIC with consumer protection as its focus. The new Division of Depositor and Consumer Protection will be created through the transition of staff from our existing Division of Supervision and Consumer Protection. We also will transfer employees from our existing research staff to the new Division to perform consumer research and Home Mortgage Disclosure Act (HMDA)/fair lending analysis. We also are in the process of strengthening our legal workforce dedicated to supporting depositor and consumer protection functions. Finally, to maintain synergies between safety and soundness and consumer protection, FDIC risk management staff will continue to work closely with the FDIC's depositor and consumer protection staff.

Additional FDIC-related Dodd-Frank Act Provisions

The Dodd-Frank Act provides the FDIC with new and enhanced authorities related to examinations and supervision of non-bank financial companies supervised by the FRB, IDIs, and their holding companies. Among other things, the Act provides the FDIC with

back-up examination authority for systemically important non-bank financial companies, and bank holding companies. The Act also transfers regulatory authority over state chartered thrifts from the OTS to the FDIC. In addition, the Act mandates changes to the DIF that will allow the FDIC to more effectively manage the Fund.

Back-up Examination and Enforcement Authority

The Dodd-Frank Act grants the FDIC new authorities to examine systemically important non-bank financial companies and bank holding companies with at least \$50 billion in assets for the purposes of implementing the FDIC's orderly liquidation authority. These back-up examinations may only be conducted in certain circumstances and only if the FDIC Board decides they are necessary to determine the condition of the company and other conditions are met.

Before conducting a back-up examination, the FDIC will review available resolution plans submitted by the company, as well as available "reports of examination." We will coordinate with the FRB to the maximum extent practicable to minimize duplicative or conflicting examinations. However, consistent with FDIC's methods for resolving IDIs, back-up examination authority likely would play a key role in the planning for any potential orderly liquidation of a systemically important financial company under Title II of the Dodd-Frank Act. The information obtained from examinations (along with the information obtained through the resolution plan review process) is crucial for planning an effective liquidation.

Similarly, the Dodd-Frank Act gives the FDIC back-up enforcement authority over a depository institution holding company if the conduct or threatened conduct of the holding company poses a risk to the DIF. This new authority recognizes that the activities and practices of the holding company may affect the safety and soundness of the IDI.

With respect to our existing back-up examination authority for IDIs prior to passage of the Dodd-Frank Act, the FDIC Board voted on July 12 to revise its Memorandum of Understanding (MOU) with the other primary federal banking regulators to enhance the FDIC's existing back-up authorities over IDIs that the FDIC does not directly supervise. The revised agreement will improve the FDIC's ability to access information necessary to understand, evaluate, and mitigate its exposure as deposit insurer, especially to the largest and most complex firms.

The complexity and opaqueness of large, complex depository institutions requires the FDIC to have a more active on-site presence and greater direct access to information and bank personnel in order to fully evaluate the risks to the DIF. The need to revise the existing MOU was previously identified in a report by the Offices of Inspector General of the FDIC and the Treasury Department.² They criticized the then-existing MOU because it limited the FDIC's ability to make its own independent assessment of risk to the DIF and required the FDIC to place unreasonable reliance on the work of the primary federal regulator.

Our new back-up supervision MOU meets the recommendations of the Inspectors' General report and the commitment for action that I made personally in response to the recommendations. Further, I believe that the new agreement strikes a reasonable balance between preserving the role of the primary federal regulator and providing the FDIC with the information that is critical to meet our statutory responsibilities. While much work lies ahead in implementing the terms of the new MOU, the FDIC will benefit from the stronger and more robust agreement. However, we also recognize that our ultimate success will depend heavily upon our ability to work together collectively as regulators and to respect the roles and responsibilities that we have each been given to protect the financial system.

FDIC's Authority over State Chartered Thrifts

We have initiated discussions with the OTS, the Office of the Comptroller of the Currency (OCC), and the FRB to ensure a smooth transition of OTS personnel and the approximately 60 state-chartered OTS institutions that will become FDIC-supervised pursuant to the regulatory realignment in the Dodd-Frank Act. An implementation plan for the transfer of OTS powers and personnel will be developed in coordination with the other federal banking agencies. As you know, the Act sets the transfer date for OTS functions at one year after enactment, with a possibility for a six-month extension. Prior to the implementation date, the FDIC, in consultation with the OCC, will identify and publish a list of OTS orders and regulations that the FDIC will enforce. We plan to use the systems currently in place to communicate with the management of these institutions during the transition phase. We are confident that the FDIC will have the resources needed to effectively supervise these institutions.

Changes to the DIF under the Dodd-Frank Act

The FDIC has experienced two banking crises in the years following the Great Depression. In both of these crises, the balance of the insurance fund became negative, hitting a low of negative \$20.9 billion in December 2009, despite high assessment rates and despite other extraordinary measures in the most recent crisis, including a special assessment of \$5.5 billion. However, prepaid assessments of approximately \$46 billion maintained the fund's liquidity.

The FDIC has long advocated that the deposit insurance assessment system should smooth the effect of economic cycles on IDIs, not exacerbate them. In practice, however, the opposite has tended to occur – rates have been low during prosperous times and high during crises. At the very least, assessment rates should not increase during a crisis.

In the Dodd-Frank Act, Congress granted the FDIC increased flexibility to manage the DIF to achieve goals for deposit insurance fund management that the FDIC has sought for decades but has lacked the tools to achieve. The provisions of the Act, used to their fullest extent, should allow the FDIC to maintain a positive fund balance even during a

banking crisis and maintain steady assessment rates throughout economic and credit cycles.

Specifically, the Dodd-Frank Act raised the minimum level for the Designated Reserve Ratio (DRR) from 1.15 percent to 1.35 percent and removed the requirement that the FDIC pay dividends of one-half of any amount in the DIF above a reserve ratio of 1.35 percent. The new legislation also allows the FDIC Board, in its sole discretion, to suspend or limit dividends when the reserve ratio reaches 1.50 percent. Going forward, the dividend policy set by the Board (combined with assessment rates) will directly determine the size of the DIF.

The FDIC has analyzed various trade-offs among assessment rates, dividend policies and reserve ratio targets. The analysis shows that the dividend rule and the reserve ratio target are among the most important factors in maximizing the probability that the DIF will remain positive during a crisis, when losses are high, and in preventing sharp swings in assessment rates, particularly during a crisis. This analysis also shows that the DIF minimum reserve ratio (DIF balance/estimated insured deposits) should be about 2 percent in advance of a banking crisis in order to avoid high deposit insurance assessment rates when IDIs are strained by a crisis and least able to pay.

The FDIC Board will soon be considering a long-term strategy for DIF management, including assessment rates, a target reserve ratio, and a dividend policy, consistent with long-term FDIC goals and achieving the statutorily-required 1.35 percent DIF reserve ratio by September 30, 2020. It is important to take advantage of this new fund management authority while the need for a sufficiently large fund and stable premiums are apparent to most. Memories of the last two crises will eventually fade and the need for a strong fund will become less apparent. Action taken now by the FDIC's present Board, taking advantage of the tools granted by the Dodd-Frank Act, will make it easier for future Boards to resist inevitable calls to reduce assessment rates or pay larger dividends at the expense of prudent fund management.

In addition, among the various rulemakings that will be required to implement the DIF-related provisions in the Dodd-Frank Act, the FDIC Board will issue notice-and-comment rulemaking later this fall to implement the requirement that we change the assessment base from domestic deposits to average assets less average tangible equity. This change, in general, will result in shifting more of the overall assessment burden toward the largest institutions, which rely less on domestic deposits for their funding than do smaller institutions.

Conclusion

In creating the Dodd-Frank Act, Congress enacted an historic package of financial reforms that will shape the financial industry for decades to come. Not only are these reforms needed to address the problems and abuses that led to the crisis, but they also offer the opportunity to create a financial system that will once again support the

American economy, and not the other way around. A stable, profitable and internationally competitive U.S. financial services industry is in everyone's interest.

This financial reform is about better aligning incentives – internalizing the costs of leverage and risk taking – so that financial institutions can safely and efficiently channel capital to its highest and best use in our economy. If our economy is to prosper and if our nation is to meet the economic challenges looming ahead, our financial sector simply must do its job better.

As we meet today, much remains to be done. The FDIC has begun its rulemaking tasks and is committed to a quick, transparent process to allow the financial industry to readily adapt to the new environment. We have reorganized ourselves internally to produce the focus and accountability needed to ensure the orderly liquidation of non-bank financial entities, the control of systemic risk, and the enhancement of consumer protections. We are working with our regulatory counterparts to quickly and carefully issue regulations to implement the Dodd-Frank Act. We are approaching these complex tasks with both a sense of urgency and a view toward their long-run efficacy.

The stakes are high. If we fail to create effective frameworks now for exercising our authorities under Dodd-Frank, we will have forfeited this historic chance to put our financial system on a sounder and safer path in the future. We must not let this tremendous opportunity go to waste. Thank you for today's hearing. I look forward to answering any questions.

1 See, James W. Giddens, Trustee for the SIPA Liquidation of Lehman Brothers Inc., Trustee's Preliminary Investigation Report and Recommendations, United States Bankruptcy Court Southern District of New York, Case No. 08-01420 (JMP) SIPA, p. 8 ff.

2 Offices of Inspector General of the FDIC and The Treasury, Evaluation of the Federal Oversight of Washington Mutual Bank, Report No. EVAL-10-002, April 2010.
<http://www.fdicigo.gov/reports10/10-002EV.pdf>

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