Remarks by
Chairman Donald E. Powell
Federal Deposit Insurance Corporation
Before the Federal Reserve Bank of Atlanta

Thank you for the opportunity to speak tonight.

There can be no doubt that we are living in remarkable and challenging times – times that are full of risk and uncertainty. We are at war. And this war has made real, for many of us, our nation's struggle to understand, define, and react to the challenges of a new century. We are also in a period of economic uncertainty – uncertainty fueled by geopolitical concerns, to be sure, but uncertainty also fueled by continued concerns about the state of corporate America. Just as 9/11 forced us to rethink the geopolitical landscape, the corporate governance scandals of the past two years are forcing us to rethink the economic landscape. Learning and applying the lessons of both these events is critical to overcoming the challenges we face and maintaining our unmatched prosperity as a nation.

In spite of the continued sluggishness of our economy, there remains a bright spot on the economic horizon: the performance of FDIC insured financial institutions. Last year, banks in this country posted record earnings of more than $100 billion dollars. And while we continue to monitor risks in the subprime sector, and in isolated pockets of commercial real estate, it is fair to say banks have come through a severe corporate recession relatively unscathed. This is a remarkable accomplishment and we should take a moment and be thankful – we all know how bad things can get for our industry. As a Texas banker in the 1980s, I remember well what it is like to live through a crisis.

So, how is it that banks have escaped? How have they done so well in the face of such stiff headwinds? I think there are several answers. First of all, we had to take some bitter medicine. The Congress and the regulators put in place reforms – like prompt corrective action and more stringent capital regulations – to prevent a recurrence of the systemic problems that plagued the industry during the 1980s. In response to the widespread bank and thrift failures of that era, the FDIC and the RTC worked hard to quickly and efficiently move half-a-trillion dollars worth of failed bank assets off the government's books and back into the private sector where they belong.

Second, the bankers themselves learned the vitally important lessons of the crisis. They managed their growth and their portfolios better. They instituted tighter and more effective internal control systems. They diversified their holdings to avoid hitching their institutions to any one sector of the economy. And they took advantage of new technologies and new innovations to better manage their banks and their risks.

One banker even told me recently that he attributed part of this remarkable strength to the fact that banking is a regulated industry. Some would question that – I'm sure – but I

do think he has a point. The scrutiny received by the industry can sometimes be a blessing as well as a curse.

The transformation of banking a decade ago was critical to the industry's future success. Had bankers failed to digest and remedy the problems exposed by the crisis, they would have been doomed to repeat their mistakes. As it happened, they positioned themselves not only to weather the current downturn, but weather it in record fashion. That is no small achievement.

We are now emerging from an altogether different crisis. The corporate scandals that emerged in the wake of the stock market collapse, and the large bankruptcies that followed, exposed new weaknesses in our system. Aside from the failure of some big-named companies – and, in some cases, the ethical failings and criminal behavior of the people running them – we've seen an increasing wave of scrutiny aimed at third parties: accounting firms, rating agencies, lawyers, and sometimes banks themselves in their capacity as financial advisors.

The abuses have been well-documented. There will probably be more before this is all over. The reforms enacted last year have been – and continue to be – pored over and carefully interpreted. I will confess to you that I am haunted, from time to time, by the fact that it often seems to take a full-blown crisis to lay bare the weaknesses in the system. Without Enron and the others, would we even be discussing this today? Probably not. I would like us to be more vigilant – every day, not just during a crisis – about how we spot and root out problems before they dissolve into a full-blown front page embarrassment to our capitalist system.

At any rate, what remains to be seen is how well these affected industries will work these reforms into their day-to-day practices. This will be key to ensuring the abuses do not re-emerge. We all know the vast majority of American businesses and business people are honest and straightforward in their dealings. But while we are not all responsible for the problems, we all do have a hand in the solutions – each of us, individually must take on this responsibility by keeping to high standards of corporate and professional behavior.

This transformation of law and regulation into fundamental industry practice is a vitally important part of the process of re-establishing confidence – and I know many of you are doing just that. Will the reforms of the past year result in an improved culture of transparency and disclosure in these firms? Will the corporate governance reforms result in corporate boards that are more effective, competent and better informed – or will these measures simply make it harder to recruit good board members? Some of you may be experiencing this, and I am sympathetic. All of this would be an academic debate for me – and for the FDIC – were not these third parties so critical to the continued health of the banking industry.

It is no secret to anyone in this room that we are living in a time of increasing complexity. Capital is flowing around the world with the greatest of ease – searching

with more and more efficiency those areas of 'highest and best use'. This is a wonderful development. We now have the ability to tap resources undreamed of when I first started in the banking business thirty years ago. Money flows in, from across the country and around the world, into areas and sectors that need it. This promotes economic growth and the continued improvement of our standard of living relative to prior generations. We certainly don't want to do anything, in the name of 'reform', to impede or stifle innovation and creativity in our markets.

But this new financial environment, beneficial as it is, is tremendously complex. It is bound to become more complex as we explore the limits of technology in the brave new financial world we've created over the last decade. This development vastly increases the challenges faced by accountants, attorneys and rating agencies as they design, test and evaluate increasingly complex financial arrangements. The system works now – and will continue to work in the future – on the foundation of assessments and judgments of these third parties. And it also rests on the scruples of the individuals that put together the deals. The faraway investors rely mostly on the internal parties – management, boards of directors, and internal auditors to safeguard the process. But, to an increasing degree, they also rely on intermediaries to structure deals that will stand up to regulatory and investor scrutiny. They rely on accountants to evaluate whether the beneficiaries of capital have the ability to continue as a going concern. And they depend on rating agencies to delineate the relative solvency of the borrowers, and the quality of the credits themselves.

Today, there are almost 12,000 public, SEC-reporting, companies in the United States – including more than a thousand SEC-reporting financial institutions. Each of them must be audited. Throughout most of my career there were the "Big Eight" accounting firms. Mergers and the demise of Andersen left us with only four. As someone who believes more competition and choice in the marketplace leads to better products and services, I am concerned by this growing concentration. Nothing would please me more than if we had a 'Big 25' or a 'Big Thirty'. In our zeal to curb excess, we must also be mindful of the competitive consequences of our actions – and fairly evaluate whether the investor, at the end of the day, is being better served as a result. Accountants, in my view, should be held to a high standard because we depend on them. But the standard should not be so high, and so stringent, that we stifle innovation, impair audit quality, and discourage bright and talented individuals from joining the profession.

Many point to the Sarbanes-Oxley law as a potential cure for many of the weaknesses exposed by the failures of the last several years – and I agree. Many of these reforms were needed, and the Public Company Accounting Oversight Board was given wide latitude to provide investors assurance about the integrity of the audits they depend upon. No matter how useful this setup, however, Sarbanes-Oxley alone cannot cure the problems of confidence in corporate America without the accounting industry's willingness to make the tough calls – and stand behind their decisions.

In the last twenty years, technology has made it possible for the players in the financial arena to do business at ever-greater distances. Securitizations and structured

financings are the method most used to join distant sources of capital with marketplace needs. The securitization market is currently about $4.7 trillion dollars. The rating agencies are key participants in this marketplace because investors and lenders depend on them to provide independent judgement about the issuers of securities, and the securities themselves. And we all know that their evaluations can differ – they don't always agree. As the allocation of credit has become more impersonal in recent years, this function has taken on ever-increasing importance.

Further, credit ratings have become an integral part of banking. Large banks cannot issue holding company debt without a rating and all forms of securitization are dependent on credit ratings. Banks' risk-based capital ratios can be affected by the ratings of the asset-backed securities they hold, and other risk positions in securitizations they have retained or assumed. Under the proposed new Basel accord, banks' internal risk ratings, and hence their capital, would be influenced by agency ratings and methodologies.

The market's use of credit ratings has the potential for creating significant disruptions in certain markets. For instance, many derivatives contracts require that the counter-party maintain an investment grade rating. The downgrading of a large banking organization with a substantial derivatives business could cause dislocations in both the bank and the derivatives market. Financial covenants in lending arrangements that are tied to external ratings --- commonly referred to as debt rating triggers -- could exacerbate the deterioration in a borrower's creditworthiness. Such debt rating triggers increase the cost of borrowing or result in the demand for funds at a time when the company is least able to pay.

Thus, it is only natural that these entities have come under scrutiny in the wake of well-publicized ratings breakdowns during corporate failures such as Enron. In fact, the House Financial Services Committee recently held hearings on the state of transparency and competition in the ratings business.

I welcome this scrutiny because I am concerned that there is no clear standard of accountability for these firms. I believe one way to get at this problem is to increase their transparency, root out any conflicts of interest, and expose the industry to market discipline through more competition.

Further, as a bank supervisor, I believe that we especially need to consider these issues as we continue to incorporate external ratings even further into our own processes. As supervisors, we are responsible for ensuring the safety and soundness of the institutions under our watch. External ratings, if subject to rigorous standards and used properly, can help us do our job. However, if ratings are not based on sound analysis and free from conflicts of interest, then our reliance on them simply leads to a system in which risks cannot be adequately monitored, measured or managed.

It is important that regulators and bankers not take credit agency ratings as a given. Rather, they should simply be one evaluation among many in their business that must

be rigorously tested for accuracy. Some have suggested that every banking organization – and indeed every regulator – should subject these ratings to the same scrutiny we currently give loan portfolios. In this way, banks and regulators will develop more independent analysis of rated debt, and the debt's risk to the underlying portfolio. This idea and others should be fully debated by all of us who depend on these ratings to manage risk and ensure the smooth and efficient operation of the financial markets. I know the SEC is currently working on these and other issues related to the rating agencies. I support their efforts, and the efforts of others in the policymaking arena, to bring more accountability and transparency to this segment of the marketplace.

Now a word or two about the lawyers. I know you'd be disappointed if I did not include a word or two about them. I can assure you that more competition is not the solution to our problems with the lawyers.

That being said, however, we all know that most transactions start with a contractual obligation. It is important for legal advisors working on these transactions to understand the business purpose behind the deal – and they must have the courage and the integrity to speak up if the business purposes, or the details of the deal itself, do not make sense or raise ethical concerns. Moreover, attorneys must recognize that the duties they owe, in representing an insured depository institution, run to the institution itself, not the individuals who manage the institution. When it appears the managers or insiders are breaching their fiduciary duties, or have interests adverse to the institution, it is the lawyer's responsibility to take appropriate steps to advise managers as to their duties.

Where a transaction might result in substantial injury to the institution or result in violations of law, the attorney has the obligation to take steps to prevent the conduct – if necessary by proceeding up the corporate ladder up to the board of directors.

Because the markets are evolving faster that the regulations can keep up and banking transactions are becoming increasingly complex, a burden falls to the players deeply involved in the development of the transactions, and who most understand their terms, to ensure all participants are playing by the rules of the game. Investors depend on these important players in the financial marketplace to know the difference between the letter and the spirit of the law.

Equally important are banks themselves – in their role as financial advisors. Earlier this year, a U.S. Senate committee released a report detailing how financial institutions structured three complex transactions to distort Enron's financial statements. Further, ongoing investigations have exposed additional concerns about financial services firms and their role in other high-profile corporate failures.

Indications are that the banks involved in these difficulties are learning valuable lessons and are working to put that era behind them. I hope they do. Despite the complexity of today's financial products – and the pressures of the financial marketplace – I remain convinced that a banker's good name is a precious intangible asset. A healthy dose of

conservatism is critical if banks are to protect their good name and safeguard their role as honest brokers.

As we consider all these issues, we should never forget one important, fundamental premise. The object of our national policy – from the SEC to the bank regulators to the self-regulatory organizations – is to protect financial stability by protecting individuals, whether they are bank depositors or investors in the national stock markets. It causes me some concern when third parties subvert this policy, and threaten confidence in our system by pursuing deals that dance on the edge of legality.

I outline my concerns here tonight because the problems I've raised have the ability to directly impact our business at the FDIC. Just like ordinary investors, we too rely on third parties – accounting firms, rating agencies, lawyers, and bankers – as lines of defense for our deposit insurance funds. We depend on these important market participants to help us understand and manage our risk. Like every investor and bank customer in America, we know our success is due, in part, to the effective functioning of the marketplace and to the confidence we place in the professional judgement of third parties.

So I will close where I began. We are destined, it seems, to live in uncertain times. We are working through an uncomfortable, but vitally important, period of restructuring and renewal in many sectors of our economy. Yet, we must not let pass the opportunity to take stock of where we are, to correct the problems of the past, and set the stage for a more certain and prosperous future.

Part of this recovery will happen when we resolve the geopolitical situation – we all pray for a quick resolution to the war and the safe return of our fighting men and women. And part of this recovery will be in continuing the steady progress we've made over the last year, slowly rebuilding confidence in the financial markets and in our economy.

There are efforts underway in a number of places – the bank regulators, the SEC, and in Congress – to learn these lessons and develop appropriate oversight and accountability going forward. The FDIC – like all of you – has an interest in this effort succeeding. We will do all we can to ensure it does.

Thank you.

Last Updated 04/10/2003