

**Statement Of
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Federal Deposit Insurance Corporation
on the
Condition of the Banking Industry
Before the
Committee on Banking, Housing and Urban Affairs U.S. Senate
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Mr. Chairman, Senator Sarbanes and members of the Committee, thank you for the opportunity to testify on behalf of the Federal Deposit Insurance Corporation regarding the condition of FDIC-insured institutions and the deposit insurance funds. My testimony will briefly review the recent record earnings and outstanding financial performance of FDIC-insured institutions and the condition of the deposit insurance funds, touch upon potential risks to the industry, and discuss the implications of industry consolidation and some related questions that we believe will drive discussions among banking policymakers going forward.

Condition of FDIC-Insured Institutions and the FDIC Insurance Funds

I am pleased to report that FDIC-insured institutions are as healthy and sound as they have ever been. The industry earned a record \$31.1 billion in the fourth quarter of 2003, marking the fourth quarter in a row that earnings set a new high. The results for the fourth quarter also brought the industry's earnings for the full year to a record \$120.6 billion, surpassing the previous annual record of \$105.1 billion set in 2002. The return on assets (ROA) in the fourth quarter and for the entire year was 1.38 percent, equaling the quarterly record set earlier in the year and easily surpassing the previous all-time annual high of 1.30 percent in 2002.

Underlying the current financial strength of the industry have been the cumulative effects of the ten-year economic expansion of the 1990s and certain factors that tended to insulate banks from the most severe effects of the 2001 recession. Improvements in underwriting and risk management practices helped to limit the effect of credit losses on industry earnings during and after the recession. Meanwhile, strong growth in mortgage loans, a steep yield curve, new sources of fee income and cost containment efforts by banks helped boost the net operating income of the industry. Record earnings two years in a row, record returns-on-assets, and a strong capital foundation are all indicators that banks not only weathered the recent economic downturn - but have been a source of significant strength for the economy and for the American consumer.

This strength is mirrored in the strength of the FDIC's insurance funds. As of December 31, 2003, the balance of \$33.8 billion in the Bank Insurance Fund (BIF) represented 1.32 percent of estimated BIF-insured deposits, well above the statutory target reserve ratio of 1.25 percent. The Savings Association Insurance Fund (SAIF) ratio stood at 1.37 percent at year-end 2003, with a balance of \$12.2 billion. The BIF reserve ratio

rose during 2003 as expected losses fell, while the SAIF reserve ratio remained essentially unchanged from year-end 2002. A combined BIF and SAIF fund would total \$46 billion with a reserve ratio of 1.33 percent of estimated insured deposits.

In November 2003, the FDIC Board of Directors voted to maintain the existing BIF and SAIF premium rate schedules for the first half of 2004. The FDIC's analysis indicates that it is unlikely the reserve ratio for either fund will fall below the statutory target of 1.25 percent in the near future. For example, with the BIF ratio at 1.32 percent, assuming no deposit growth, insurance losses on the order of \$1.8 billion dollars would be required to drop the ratio to 1.25 percent. For insured deposit growth alone to reduce the ratio to this level, assuming no change in the BIF fund balance, growth of nearly six percent would be required. Neither BIF insurance losses nor BIF deposit growth has approached these magnitudes recently, and we do not foresee any combination of insurance losses and deposit growth that would drive the reserve ratio near 1.25 percent in the coming months, although these forces could result in a decline from current ratios. As a result, we do not foresee a need for additional premium income at this time.

As you are aware, the FDIC's concerns about the deposit insurance system relate to the way it is structured. We cannot price deposit insurance based on risk, we cannot manage the fund's size relative to our exposure, and we maintain two funds even though the historic rationale for doing so has gone away. There is broad agreement on the key elements of a deposit insurance reform package and the FDIC remains willing to work with this Committee to achieve reform as soon as possible.

Potential Risks

We cannot assume that the economic environment of the next decade will necessarily be as favorable to the industry as our recent experience. The world is changing in unprecedented ways and the FDIC continuously monitors economic conditions and emerging risks in the banking industry in order to maintain its preparedness. The primary vehicle for monitoring and addressing risk is the supervisory process, which has been enhanced significantly over the past decade. Moreover, as the banking industry has become more sophisticated, the FDIC has created cutting edge risk management techniques to identify, measure, and manage risk to the insurance funds. The cornerstone of FDIC's risk management philosophy and practice is an integrated, multidisciplinary approach that brings together economists, examiners, financial analysts and others to analyze and respond to risks in the system.

Using this approach, the FDIC expects continued good performance for the banking sector, based on the industry's solid fundamentals and generally favorable economic conditions. The economy grew at a six percent annual rate during the last half of 2003 and is expected to grow at a four percent pace this year.

Despite the generally positive recent economic news, our integrated analysis reveals several trends that could pose difficulties for the banking industry and the FDIC in the future. The FDIC analyzes risks that are generally known to exist as well as risks that

appear to have a low probability of occurring, but would have a high impact if they did. The intent of our analysis is to ensure we are capturing all risks that could affect the banking industry and the deposit insurance funds.

It is important to recognize the volatility of financial markets and the potential for disturbances to spread throughout the system. In today's interconnected financial system, problems that initially appear to be localized could lead to a more widespread loss of confidence with a resulting impact on liquidity throughout the system. This issue bears watching to ensure that financial market disruptions do not produce significant banking problems going forward. The major actors in the financial markets are large, well-diversified organizations that continue to grow. Later in my testimony, I will discuss the increasing shares of industry assets, deposits and revenues held by just a few large banking organizations and the implications of this trend for the future of banking.

Another area of concern is household balance sheets. The household sector has been the engine for banking growth through the 2001 recession and beyond, but sources of concern include the near record pace of personal bankruptcies – exceeding 1.5 million in 2003 – and rising household indebtedness. Total household debt is at an historical high of 112 percent of disposable personal income. The lowest mortgage rates in more than a generation have prompted households to take out \$1.4 trillion in new mortgage debt since the end of 2001. Household indebtedness also increased as a result of a market and technology-driven revolution in consumer lending that created a system with unprecedented access to credit and convenience in its use.

Perhaps even more important than the absolute level of debt is the fact that the amount of money households must pay to keep debts current is increasing. This is occurring despite the prolonged period of low interest rates, which would normally be expected to lower debt service. Homeowners now use about 14 percent of disposable income to meet their major financial obligations, versus about 12 percent in 1993. The increase in renters' financial obligations is even more striking at about 31 percent of disposable income versus about 24 percent in 1993. Escalating household indebtedness raises concerns about the sustainability of the growth in consumer spending, especially when interest rates rise. A trail-off in consumer spending could also occur once the effects of the 2003 tax cut and 2003 mortgage refinancing boom run their course.

Escalating household debt raises concerns about the sustainability of consumer spending and the ability of borrowers to meet obligations when interest rates rise. In particular, households that have a greater exposure to variable rate consumer loans and adjustable rate mortgages, and those with weaker credit histories and balance sheets, could experience some problems meeting their obligations. A related concern is that rising interest rates could cause some stress in certain housing markets, where prices have been more volatile than the rest of the nation.

However, this is uncharted territory. The commoditization of credit has created a much more sophisticated financial economy that may be able to tolerate higher and rising debt

levels. Our concerns are tempered, however, by the strength of household assets and the strengthening job and wage data we have seen in recent months.

In particular, I am concerned that those at the margins of the credit system will be adversely affected. Households that have greater exposure to variable rate consumer loans and adjustable rate mortgages and those with weaker credit histories and balance sheets could experience some problems meeting their obligations. Often, these are consumers who lack a basic understanding of how money works in our society - and therefore lack the tools necessary to save and manage money. That is why I believe that promoting the financial education of our society's unbanked segment is one of the FDIC's most important goals, and why the FDIC has developed the Money Smart financial literacy program.

Since the rollout of Money Smart, FDIC has distributed more than 111,000 copies of the curriculum and trained over 5,000 instructors. Money Smart is currently available in English, Spanish, Chinese, Korean and Vietnamese.

The FDIC has taken the lead in establishing financial education partnerships with communities and bankers. The FDIC has entered into over 600 local Money Smart Alliances across the country, including national partnerships with the U.S. Department of Labor, the U.S. Department of Housing and Urban Development, the Association of Military Banks of America, Goodwill Industries International, the National Coalition for Asian Pacific American Community and the Internal Revenue Service. Last year, for example, the FDIC's work during the 2002 tax season with the "Back of the Yards" voluntary income tax assistance site in Chicago helped over 600 families file tax returns and receive \$1.1 million in earned income tax credit refunds. Many of these families also opened their first bank accounts through this initiative.

Another challenge facing banks is high concentrations in commercial real estate. As of the fourth quarter 2003, national vacancy rates for office, retail and warehouse space stood at or near historic highs of 17.9 percent, 12.9 percent, and 10.5 percent, respectively, and were even higher in some markets. Nevertheless, commercial real estate concentrations at banks are high and increasing. The national median concentration of commercial real estate to capital is 164 percent, up from 92 percent in 1993. Moreover, concentrations are particularly heavy in the West and Southeast. In our San Francisco and Atlanta Regions, the median commercial real estate concentrations are 327 percent and 284 percent, respectively.

So far, poor commercial real estate fundamentals have not resulted in loan performance problems at banks — national charge off rates are below 0.1% and the nonperforming ratio is 0.8%. Improved underwriting and regulatory requirements, increased public ownership and transparency of commercial real estate transactions, and low interest rates have all acted to buffer banks from commercial real estate losses. Despite the good performance to date, given the significant problems that resulted from commercial real estate in the late 1980s and early 1990s, the FDIC has implemented enhanced

commercial real estate monitoring programs, particularly in areas with very heavy concentrations.

As with the household sector, there are concerns that some commercial real estate borrowers could be affected if debt service increases due to a rise in interest rates. On the other hand, rising interest rates are normally accompanied by resurgence in economic activity. For commercial real estate, that could mean an increase in potential renters and rental rates. Nevertheless, the high and rising “twin deficits” – national and trade debt – coupled with the ongoing fall of the dollar have raised some concerns about a dollar collapse. While a collapse seems unlikely, given foreign reliance on dollar holdings, among other factors, it could lead to a rise in rates without concurrent economic growth.

Implications of Industry Consolidation

The ongoing consolidation of the banking industry means that there are a few very large institutions that represent an increasingly significant share of the FDIC’s exposure. Once the recently announced mergers are complete, there will be three banking companies whose assets are in the range of one trillion dollars each. Their combined assets will account for approximately 30 percent of the assets of FDIC-insured institutions. The next four largest holding companies will have assets in the range of \$200 to \$400 billion, and they will account for another 13 percent of industry assets. The top 25 banking companies hold over one-half of industry assets, while the top 100 hold almost three-quarters.

The largest banking institutions are global, highly diversified organizations. They are positioned well to absorb losses from local economic problems or idiosyncratic risks in any particular lines of business. The external risks posed to these firms are essentially macro risks – reflecting the same factors that could threaten the entire financial system. Thus, the major risk that the deposit insurance system faces is the risk that the economy or the financial system would suffer extreme deterioration.

In the absence of extreme economic or financial disruption, the risk from these companies arises from the challenges of managing such large, complex organizations. Should these internal risks result in significant problems at a large bank, the situation could also pose risks to the system as a whole. This is why it is so important for owners, managers and directors of these organizations to adhere to the standards of good corporate governance and risk management and for regulators to ensure that these standards are met.

To enhance our understanding of the risks these institutions may pose, the FDIC has placed dedicated examiners in the eight largest institutions. These dedicated examiners work closely with the resident examination staff of the primary federal regulator.

One question we face is whether the consolidation of the banking industry has gone too far or will go too far in the future. Or conversely, is the ten-percent deposit cap increasingly an impediment to the appropriate market evolution of the industry?

First I would note that the degree of consolidation is a relative notion. Compared to the industry twenty years ago, banking is certainly more consolidated. But compared to other industries or banking systems in other countries, it does not appear to be. We are not close to having a banking organization with branches in all fifty states. A standard measure of industry concentration is the market share of the top five firms in an industry. Table 1 provides this measure for major U.S. industries. As the table shows, banking is a relatively unconcentrated industry by this measure. In fact, banking is less concentrated than the table would indicate, since the table compares only publicly traded companies and less than 10 percent of banks and thrifts are publicly traded.

Table One
Percentage of Market Value of Publicly Traded Firms Held by the Top 5 Firms

	Top 5 in 2002 Market Value
Telecommunication Services	77.5%
Automobiles & Components	73.7%
Securities	70.7%
Software & Services	63.2%
Energy	63.1%
Pharmaceuticals & Biotechnology	63.1%
Technology Hardware & Equipment	60.9%
Insurance	54.6%
Health Care	43.1%
Hotels Restaurants & Leisure	40.5%
Commercial Banks and Savings Institutions	35.8%
Transportation	28.2%
Utilities	26.4%

Source: Standard & Poor's Compustat

The universe of firms is all publicly traded U.S. companies listed in the Compustat database.

Note: Figures are estimates due to the existence of missing data and some undetected double counting of subsidiaries.

There appear to be several public policy reasons for the ten-percent deposit cap. One purpose of the cap is to protect bank customers from anti-competitive behavior that can result from a highly concentrated industry. This makes sense, but it is not clear why banks should be treated differently in this regard from other firms. The banking industry is highly competitive, and standard anti-trust measures appear sufficient to ensure that it will continue to be competitive.

Another purpose for limiting banks to a ten-percent share of national deposits is to limit the concentration of risk that any one bank poses to the deposit insurance system and the financial system in general. As mentioned earlier, the most significant risk to these banks is the risk of severe economic disruption, and I would offer two observations here. The first is that during the past two decades the economy has experienced longer periods of expansion and a milder recession. This reflects: 1) the benefits of what has been called the free-market consensus; 2) the ability of a transformed financial system to absorb economic shocks; and 3) generally sound monetary and fiscal policies. So long as these factors remain in place, it seems reasonable to expect performance over the business cycle to be generally favorable.

Of course, we cannot rule out adverse scenarios. The question, then, is whether it matters under such scenarios if the assets of the industry are largely concentrated in a dozen or so banks or in just a handful.

Putting aside risk stemming from the economy or overall financial system, the next question involves the risk posed by a single banking organization. The risk would seem to hinge on the tradeoff between the benefits of scale and diversification and the challenges of managing large complex organizations. The performance of large banks in recent years suggests the tradeoff has thus far been favorable.

As we move forward, my sense is that regulators, policymakers, and market participants will be able to assess whether the tradeoff remains favorable. Put simply, if these banks show signs of becoming too-big-to-manage, I would expect the market to slow, if not reverse, the course of consolidation and regulators to impose stricter sanctions. Ultimately, if these measures are absent or ineffective, I would expect policymakers to step in. This approach seems to be a better gauge of the appropriate scale of banking organizations than does an arbitrary fixed cap.

My bias is to let market forces determine the evolution of the banking industry. I believe this has served us well in the post-crisis period and I expect that it will continue to be the best way to ensure that banks are meeting the needs of households and businesses.

Having said that, it is apparent that continued consolidation will present challenges to how the FDIC administers the deposit insurance system. The fact that our risk is increasingly concentrated in the largest banks has implications for how we assess risk,

the appropriate way to fund deposit insurance, and the implications of problems at, or the failure of, a large bank.

In terms of assessing risk, the FDIC obviously relies heavily on the efforts of the bank examiners and supervisors at the FDIC and our sister agencies. This has served us well and I expect it will continue to do so. From a purely financial point of view, however, it seems that the risk the FDIC faces is not that dissimilar from the risks that the market prices on a regular basis. As large banks evolve, the FDIC could look more to market instruments – like reinsurance contracts or catastrophe bonds – to help us assess our large-bank exposure.

With respect to funding deposit insurance, one question that often arises (and indeed did so the last time this panel appeared before this committee) is whether the deposit insurance funds are adequate to handle the failure of a large bank. Some rough numbers may be helpful here. We have historical data on the losses per dollar of assets at failed banks. This loss rate has been lower for large banks than for smaller ones. The loss rate for larger banks has been in the neighborhood of five to ten percent, although there are some caveats to note here. The first is that the largest failures involved banks in the range of \$40 billion in assets – nothing approaching the size of the largest banks today. Second, this experience is largely from the period before prompt corrective action, least-cost resolution, and depositor preference. With that in mind, assuming a loss rate of five percent, the failure of a one trillion dollar bank would cost \$50 billion. This is just slightly more than the two deposit insurance funds combined.

Of course, if a large bank were to fail, the question arises as to whether it should be handled under the systemic risk exception provided for in FDICIA. As you know, this provision requires that the FDIC Board, the Federal Reserve Board and the Secretary of the Treasury be in agreement that the bank should be handled outside the bounds of the normal “least-cost” manner. I should stress that even if this judgment were made, it does not mean that shareholders and all creditors will be protected from loss.

Suppose that, in our example, the finding of systemic risk resulted in a loss rate that approached the higher end of the range mentioned above. A ten percent loss rate would result in a cost of \$100 billion. Congress in FDICIA made it clear that this additional \$50 billion would be funded by an ex-post assessment on the banking industry and placed more heavily on the larger banks.

To put these amounts in perspective, FDIC-insured institutions earned \$120 billion last year and hold additional capital above the well-capitalized level in the amount of nearly \$200 billion. This capital stands behind the funds and would be available to shield taxpayers in the event of a large failure.

Related Questions for Policymakers

While we are certainly pleased with the current condition of the industry and the strength of the bank safety net, banking is in the midst of a profound transformation.

The role of banks in the marketplace has changed in the past twenty years and this transformation continues apace. There are some concerns that banks' share of the financial pie has been shrinking. While some have argued that banks are 'dinosaurs,' banks actually have been reforming their intermediary role in important ways that have propelled them to a more competitive position in the financial marketplace. They now provide better products and services for their customers, and deliver record earnings for their shareholders. Banking organizations remain a critical part of the modern flow of funds that has broadened the availability of credit in the U.S. economy.

Nonetheless, while banking organizations have prospered, traditional banking – the combination of deposit taking and commercial and industrial lending – has become a smaller part of the financial system and of banking organizations themselves. Bank commercial and industrial lending has declined sharply relative to total lending, falling from about 25 percent of total nonfinancial business sector debt 50 years ago to slightly more than 15 percent. Traditional business lending also makes up a smaller share of commercial banking's loan portfolio. Operating loans to businesses now constitute less than a fourth of total commercial bank lending – down from 40 percent twenty years ago. Moreover, banks have lost ground in the competition for savers' funds. Since 1980, the total value of money market, mutual fund and deposit instruments in the U.S. grew from just under \$2 trillion to some \$11.6 trillion. During this time, the share of these instruments issued by money market funds and mutual funds increased from seven percent to 55 percent, while the share issued by banks fell from 90 percent to 41 percent.

Along with the consolidation trend, these developments raise some fundamental questions for policymakers that relate to safety-net arrangements as well as bank regulation and supervision.

Federal deposit insurance was designed specifically to protect traditional bank intermediation. A continuing challenge is how best to protect the stability of the system as savers' choices continue to expand and bank deposits become less important in the overall financial system. Federal deposit insurance works well for traditional community banks. For the largest banking organizations, as they increasingly engage in diverse, nontraditional activities, it makes sense to consider whether different safety-net arrangements might be more suitable for this segment of the industry. Since some aspects of our regulatory system already are tailored to recognize the differences between large and small institutions, we should consider the explicit creation of a two-tiered safety net that better addresses these differences.

In many respects, we already have the makings of a two-tiered approach. First, large banks are supervised by teams of examiners who are in residence year-round while small banks are visited at regular intervals by either Federal or state regulators. Second, large banks are much more exposed to the discipline of the capital markets and the ratings agencies – both of which serve to assist regulators in gauging the banks' conditions. Third, current law permits a two-tiered system of pricing deposit insurance. Fourth, we are negotiating a capital accord, Basel II, which will result in a

two-tiered system of capital regulation – one for large, internationally active institutions and one for all others. Finally, if a large bank gets into trouble and threatens the overall system, our laws contemplate the possibility that it could be resolved outside the bounds of our current ‘least cost’ resolution procedures.

We expect the gulf between large and small institutions – and the gulf between the kinds of business they are engaged in – to continue growing. This consolidation of the banking industry will pose interesting questions for policymakers. For example, I believe that we should now begin to think through the merits of moving further toward an explicit, two-tiered system that includes the possibility of having larger institutions in a separate risk pool. There are many issues to consider, including funding arrangements for problems that may arise in the separate risk pool for large institutions. The FDIC could also look more to market instruments – like reinsurance contracts or catastrophe bonds – to help us assess our large-bank exposure.

We also should ensure that regulatory burden does not weigh too heavily on community banks and stifle the innovation and consumer choice that are hallmarks of our system. This can be unduly burdensome for community banks and threatens to deter new entry into banking. Low barriers to entry are key to ensuring continued innovation and customer service in the industry. From my own personal experience as a banker, I know all too well how heavy this burden can be.

The FDIC is taking action to reduce undue regulatory burden to a minimum for institutions of all sizes. In addition, FDIC Vice Chairman John Reich is leading an interagency effort to identify unnecessary burden, duplication, and outmoded restrictions on both large and small financial institutions. Under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA), Congress required the federal banking agencies and the National Credit Union Administration to review all regulations every ten years for areas that are outdated, unnecessary or unduly burdensome.

The agencies have jointly published the first two of a series of notices soliciting comment on regulations in a number of areas, and have been conducting outreach sessions with bankers and consumer/community groups. Armed with this input, the agencies will conduct a comprehensive review of banking regulations and will report to Congress on their findings and the actions they have taken, or plan to take, to reduce the level of burden. The agencies also anticipate sending this Committee a list of legislative areas for consideration.

Another broad question facing policymakers will likely be how to handle the convergence of interests between banks and firms operating in the larger marketplace. As pointed out earlier, barrier after barrier has come under pressure over the years as the market provided the means to produce and deliver more innovative products to financial consumers. The repeal of branching laws and the Glass-Steagall Act is part of a market driven continuum that will lead us to the doorstep of the last remaining barrier – the barrier between banking and commerce.

Linkages between banking and commerce exist for a number of grandfathered thrift holding companies, CEBA banks and some industrial loan companies. From a public policy standpoint, the benefits of this limited experimentation with the mixing of banking and commerce include a more competitive banking marketplace, more choices for consumers, and, to a limited extent, the existence of a laboratory for alternative modes of regulation. Concerns also have been expressed about allowing any expansion of the mixing of banking and commerce. These concerns have centered on concentrations of economic power, conflicts of interest, and a transfer of a subsidy from the insured bank to affiliates. These issues are present, of course, for any large financial conglomerate. Conflicts of interest are possible even for stand-alone community banks, where majority shareholders may have commercial business interests. The challenge is to ensure that supervisory and regulatory structures achieve the best of two worlds—both allowing for continued market innovation and providing adequate protection for the bank safety net.

Just as many structural and procedural concerns were addressed during the development of the Riegle-Neal Act and the Gramm-Leach-Bliley Act, I believe the same is possible in this instance. As the market continues to mature in this area, the appropriate boundaries between banking and commerce will be a significant matter for discussion among policymakers going forward.

A final fundamental question for policymakers in the area of bank supervision concerns the future of capital regulation. Capital is perhaps the single most important part of a bank's balance sheet. It promotes confidence in the organization as a going concern and enhances and diversifies the options available to bank management. Capital allows the bank to continue functioning in the face of unexpected events and errors in judgment, and in times of crisis or systemic difficulty.

The challenge for policymakers, in this dynamic and complex financial services marketplace, is to get capital right. We must actively work to ensure that our definition of capital is limited only to those instruments that are able to effectively cushion the bank during times of distress. And we must ensure capital adequacy – that there is enough to absorb losses, ensure ongoing operations, and promote customer confidence during stressful periods.

As the sophistication of the financial markets grows, and innovations allow for more complex transactions, the regulators must be vigilant and ensure that our core Tier 1 capital elements have the ability to cushion banks against loss on a going-concern basis. Tier 1 should be the regulatory standard reserved for the highest quality of capital, and there is no secret of my concern about continuing to allow trust preferred securities to be included in that select category. Trust preferred securities are issued by bank holding companies and carry a cumulative obligation to pay dividends. Under a recent accounting change, they are now categorized explicitly as debt. For insured institutions, the appeal of these and other similar instruments is that they combine the tax advantages of debt with the regulatory stamp of approval of equity. Community banks that are members of holding companies like the idea of being able to tap capital

markets with these securities. Yet they result in a regulatory definition of capital that is, under new accounting rules, more lenient than GAAP. If the bank regulators do not acquiesce to allowing banks this favorable capital treatment directly, there is the issue of regulatory capital rules that appear to provide an advantage to holding company membership.

Weaning the banking system from reliance on a previously approved element of Tier 1 capital would, of course, raise a host of difficult transitional and grandfathering issues. We should make these difficult judgments with the benefit of industry comment, and arrive at a conclusion as to what types of hybrid capital instruments provide meaningful capital support against the prism of what truly is in the long term best interest of banks, the financial system as a whole, and the bank safety net.

With respect to the Basel II negotiations, the FDIC supports the underlying premise of the agreement and is working hard to complete our work and move toward implementation. Nevertheless, there remain some important issues at stake for the bank safety net, the regulatory structure, and Congress. The implementation of the Basel II agreement will certainly trigger an intensive public discussion of the workings of our domestic Prompt Corrective Action (PCA) framework – the underlying law that governs our system of capital regulation in America. I know of no disagreement among my U.S. regulatory colleagues that the outcome of this public debate will be a capital regulatory structure that combines the best elements of the PCA framework with the enhanced risk metrics of Basel II. Indeed, as the FDIC has indicated on many occasions, this must be the outcome.

While policymakers must carefully navigate the intersection between PCA and Basel II in order to protect the safety net, we also believe our banking system would benefit from strong capital adequacy in other ways as well. Our banks are among the most well-capitalized in the world – and they are second to none in competitiveness, innovation and market share. Yet their complexity seems to be attracting more and more oversight and regulation – and not necessarily only from the consumer protection side. A strong industry capital base will allow the regulators some room to permit the marketplace to take its course – both in terms of innovations that better serve consumers, but also in remaining competitive with firms overseas. Lowering capital in these institutions will increase the risk of an institution's failure and will lead to significant regulatory intrusion into the business of these large firms – and perhaps stifle many of the market driven benefits we've come to expect from the financial services industry.

Conclusion

While America's banks – and the deposit insurance funds – are as healthy as they have ever been, it is nonetheless clear that the industry is undergoing significant structural change. Accordingly, our system of bank regulation will also have to change in order to meet the challenges posed by this dynamic financial environment.

Banks are positioned to continue to play a vibrant role in the free-market economy and perform vital intermediary functions through the development of future products and

services that are well beyond anything we can imagine today. As this process evolves, accompanying structural and regulatory changes will be needed to ensure the bank safety net remains effective and able to fully meet its public policy purpose. Further, our role as regulators is to protect consumers from abusive practices and promote safe and sound banking practices. This underlying mission will remain the same regardless of what is occurring in the marketplace, and our job is to ensure the right balance is struck as these innovations continue.

Because so many of these changes could impact the deposit insurance funds, the FDIC will continue to provide this Committee with our analysis and views as we work together in the coming years to ensure the safety and soundness of a changing industry.

This concludes my testimony. I will be happy to address any questions that the Committee might have.

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