FDIC OVERSIGHT: EXAMINING AND EVALUATING THE ROLE OF THE REGULATOR DURING THE FINANCIAL CRISIS AND TODAY

HEARING

BEFORE THE

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OF THE

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FDIC OVERSIGHT: EXAMINING AND EVALUATING THE ROLE OF THE REGULATOR DURING THE FINANCIAL CRISIS AND TODAY

Thursday, May 26, 2011

U.S. House of Representatives,
Subcommittee on Financial Institutions
and Consumer Credit,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:38 a.m., in room 2128, Rayburn House Office Building, Hon. Shelley Moore Capito [chairwoman of the subcommittee] presiding.

Members present: Representatives Capito, Renacci, Royce, Manzullo, McHenry, Westmoreland, Luetkemeyer, Huizenga, Duffy, Canseco, Grimm, Fincher; Maloney, Baca, Scott, Velazquez, and Carney.

Chairwoman Capito. First of all, I want to apologize for the delay. We are having a little organizational issue here.

So this hearing will come to order. And I would like to thank the members of the subcommittee and our witness, the chairman of the FDIC, for coming today.

It sounds like we are going to have our first series of votes around noon or 12:30, so we will hopefully have this concluded by then, because we are going to be in a lengthy series of votes. That is the plan for this hearing.

Today we are joined, as we know, by FDIC Chairman Sheila Bair, who will be leaving her position in July of this year.

First of all, I would like to thank the chairman for her dedicated service. I think one thing you could say is that it hasn't been a dull 5 years for you. You have had a lot of activity. And I thank you for your service to our country.

It is my hope that this will provide a forum for our members to gain a better understanding of the role of the FDIC in the financial crisis, the Corporation's new role in the regulatory regime presented by the Dodd-Frank Act, and the current state of FDIC-insured banks in general.

The recent passage of Dodd-Frank further enhances the role of the FDIC in our Nation's regulatory structure, as they will be charged with unwinding failed large financial institutions as provided in the Orderly Liquidation Authority, or OLA.

I am interested to hear from Chairman Bair about the FDIC's ability to balance these new powers with the traditional role of a prudential regulator.

Insuring deposits is the FDIC's duty with which most people are familiar. An unfortunate effect of the financial crisis has been an increase in bank failures across the country. The rate of bank failures has increased dramatically over the last 2 years, with 140 failing in 2009, and 157 in 2010.

These failures have significantly depleted the Deposit Insurance Fund, known as the DIF, and the FDIC has been forced to utilize emergency assessments on banks to replenish the fund, as well as requiring banks to pre-pay premiums for the years 2010 through 2012.

Despite these efforts, the Deposit Insurance Fund still has significant challenges. I look forward to hearing from Chairman Bair on this and the status of the Deposit Insurance Fund.

Although I fully understand the need to replenish the Fund, I am concerned about the future needs for pre-payments of premiums. This could have an unintended consequence, I believe, of reducing the amount of funds available for lending.

The one common thing I hear from the community banks across my district is that they feel hamstrung by the regulators in their ability to lend. So we need to find a balance here to ensure we have a safe and sound Deposit Fund, while not encumbering lending by our institutions.

Regulatory burden is not limited to the assessments placed on banks. I am very interested to learn what measures Federal financial regulators are taking to ensure new regulations are not duplicative with other agencies or existing regulations.

We need to ensure that new regulations provide enough flexibility for small institutions to meet the needs of their customers and not be encumbered by a one-size-fits-all regulation geared to the largest institutions in our Nation. A diverse financial institution is good for all market participants.

I am very interested to hear from Chairman Bair how she envisions the FDIC working with the newly created Consumer Financial Protection Bureau on enforcement of consumer protection regulation.

Finally, I would like to touch on the Orderly Liquidation Authority that was granted to the FDIC by the Dodd-Frank Act. I know that Chairman Bair sincerely believes that these new powers effectively end too-big-to-fail. And I sincerely hope that she is correct.

I still have reservations about this resolution authority and would prefer to see a different form—and we have talked about this several times—of resolution where there is absolutely no taxpayer exposure.

Let us work together to ensure that the message is clear to market participants: There will be no more government bailouts.

I would now, if she is ready, like to introduce the ranking minority member, the gentlelady from New York, Mrs. Maloney, for the purpose of making an opening statement.

Mrs. MALONEY. I just want to join you, Madam Chairwoman, in welcoming our distinguished and outstanding Chairman Bair. I know that this is her last appearance before our committee.

And I wanted to express my deep appreciation for your service, especially during the most recent financial crisis and your attention to communities, to details, to Members of Congress. I truly believe you have done an incredibly outstanding job.

Thank you.

The FDIC was forced to take significant measures during the crisis, and continues to act in the wake of the crisis to ensure the health of our banking system.

Your involvement and leadership was critical during this difficult time. We can now say that we are recovering from a crisis, not a depression. And I think you played a meaningful and significant role in our being able to say that.

This hearing is very timely because it is happening during your last few weeks in your tenure at the FDIC, but also because it is happening during a period of recovery, when we have the benefit of hindsight.

During this most recent crisis, we saw 8.5 million jobs lost and over $15 trillion in household wealth lost in America. And although we are trending up in terms of job creation, it is slower than any of us would like.

This crisis highlighted how important it is to have a sound financial system in terms of the functioning of our overall economy. We know of the fear that can set in on Main Street when institutions on Wall Street are challenged and in some cases failing.

And we know that overleveraged, overcapitalized financial institutions contribute to the problem. Structured finance products that were unregulated, opaque, and highly risky ran rampant. And you, the regulators, did not have the tools you needed to rein them in.

Congress changed that with the enactment of Dodd-Frank last year. The law now gives the regulators the authority to wind down failing institutions and more power to regulate the institutions.

And we made significant changes that directly affect FDIC-insured institutions. For example, we made the $250,000 deposit insurance limit permanent to increase public confidence in their financial institutions. And you played a meaningful role in helping to make that happen.

We changed the formula for deposit insurance assessment, so larger institutions that are engaged in riskier activities will pay more than smaller institutions that pose less of a potential threat to the FDIC.

And we increased the minimum level required in the DIF to provide a better cushion in troubled economic times so that smaller banks are protected from having to foot the bill if there is a need to raise additional funds.

All of the actions we took in Dodd-Frank were meant to both help prevent another economic crisis and to help soften the blow when unanticipated things happen.

So I am looking forward to hearing from Chairman Bair, because I know there are a number of new requirements on regulators, how you believe the system has fared since the crisis, what you see as challenges going forward, and to hear any words of wisdom you have for us before you leave your position.

I just want to underscore again how much I appreciate your service. I am looking forward to the next chapter. I know you will continue to make meaningful contributions to our great country.

Thank you for your leadership and your service.

Chairwoman CAPITO. Thank you.

I would like to recognize Mr. Royce for a minute-and-a-half for the purpose of an opening statement.

Mr. ROYCE. Thank you, Madam Chairwoman.

And, Chairman Bair, I would just like to welcome you. Thank you for your years of service. I have enjoyed our conversations. As you know, I am still concerned that Dodd-Frank hasn't ended too-big-to-fail, but has left us with a number of massive institutions with a much lower cost of capital, that are going to continue to expand at the expense of their competitors because their borrowing costs are lower.

There is a 78-basis-point advantage, I think, according to the studies that you have done.

And, at the end of the day, it is a system that enables the use of government funds in resolving an institution, and relies on the prudence of regulators during a crisis to avoid overpayment to creditors and counterparties.

I think that the very fact that you have that lower cost of capital just shows that it is human nature—that the way we set this up; there is the presumption. We have created additional moral hazard in the equation.

So while I hope that this committee works to eliminate the Orderly Liquidation Authority in a move to a more objective enhanced bankruptcy, I believe we can take steps in the near term, in the meantime, to tighten up the resolution authority and minimize some of the unintended, and frankly probably some of the intended, consequences of this legislation.

I appreciate your efforts in this regard and certainly your thoughts today, especially on this particular theme.

Thank you very much.

Chairwoman CAPITO. Thank you.

I would like to recognize Mr. Luetkemeyer for a minute-and-a-half for the purpose of an opening statement.

Mr. LUETKEMEYER. Thank you, Madam Chairwoman.

Years ago in another life, when I was a bank examiner, our mission was to work in cooperation with institutions to ensure that they understood the regulations to which they are subjected. There now seems to be a shift in the attitude of the regulators. Instead of a partnership, I hear time and time again that relationships between financial institutions and the regulators are more like a game of "gotcha."

Like many of my colleagues, I have heard stories of overzealous examiners who practice little or no regulatory forbearance. One bank in my district has been profitable and sound for many years but was put on the problem list at a recent examination.

And it was noted to me that the examiner had been scolded the previous day for having not done a good enough job in predicting another bank that he had recently been in be put on the list. That bank, by the way, since then has had no problems since it was put on the problem list, similar to what it was prior to that.

The bottom line is we need regulators to do their job. We need the FDIC and other agencies to promote sound financial practices and ensure consumer protections. No more, no less.

What we do not need are overzealous examiners who have no regard for any sort of forbearance or upper management to stick its head in the sand and refuse to recognize what is going on in the field or in our economy.

I urge the FDIC to take a look at your practices, communicate with your examiners, and work with institutions so that together we can work to get our economy moving again.

I look forward to the discussion. I yield back.

Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

I would like to recognize the gentleman from Texas, Mr. Canseco, for 1 minute, for the purpose of an opening statement.

Mr. CANSECO. Thank you, Madam Chairwoman, for holding this hearing on the oversight of a very important Federal agency.

My hope is that today's hearing addresses a simple yet very important question: Did the Dodd-Frank Act institutionalize too-big-to-fail or did it really level the playing field and disallow further taxpayer bailout, as some politicians and regulators have argued?

I am concerned that recent developments, including market data showing borrowing costs are currently much lower at big banks than small ones, and the continuing questions surrounding the FDIC's new authority lead us to believe that too-big-to-fail is still very much alive, and the taxpayers could yet again be asked to pick up the bailout tab in the future.

I look forward to hearing from Chairman Bair today on this important and ongoing issue.

Thank you.

Chairwoman CAPITO. Thank you.

I would like to recognize our newest member of the subcommittee, and welcome him to the subcommittee, Mr. Fincher from Tennessee, for 1 minute for the purpose of an opening statement.

Mr. FINCHER. Thank you, Madam Chairwoman.

And thank you, Chairman Bair, for coming today and taking time for us.

It is a privilege to be here this morning to discuss the issues and concerns regarding the FDIC and its role during the financial crisis of 2008.

As the newest member of the Financial Services Committee, I am pleased to have the opportunity to deal with, hopefully, what are going to be things that are going to fix the problems in the future.

I was not in Congress in 2008 when the financial crisis roared across the communities of our district. However, as a small business owner, I felt its effects firsthand as the bottom dropped out of our economy.

One major principle that I did take away from those terrible days was that access to credit is vital in helping our small businesses function. Until our financial institutions, in my opinion, are allowed to responsibly do their jobs again and loan money to qualified borrowers, we are not going to see businesses creating new jobs.

But too many times, Washington is not the answer. It is the problem. We need to make sure that we do what is right.

Again, thank you for your service. And I look forward to hearing what you have to say today.

I yield back.

Chairwoman CAPITO. Thank you.

I would like to recognize Mr. Westmoreland, from Georgia, for 2 minutes for the purpose of an opening statement.

Mr. WESTMORELAND. Thank you, Chairwoman Capito, for calling this hearing. I think this is a very important hearing.

I would like to throw out some numbers for Chairman Bair: 63, that is the number of banks that have failed in Georgia since 2008; 12, that is the number of bank failures in Georgia in just 2011; and 10, that is the number of banks headquartered in my district that have failed since 2008, including on this past Friday.

This number is much larger if you factor the banks that have failed that only have branches in the district.

Chairman Bair, these numbers are unacceptable. Therefore, today I will be introducing a bill directing the FDIC Inspector General to study FDIC's loss share agreements, banks failing due to paper losses, the lack of an ability to modify or work out an application of the FDIC policies by examiners in the field.

This study is not only vital for surviving banks. It is so the FDIC and this committee can learn from the problems that have faced Georgia over the last 3 years.

It is my hope that the FDIC and my colleagues will support this bill so we can have an honest assessment of the FDIC's handling of this bank crisis. Georgia is in a vicious cycle right now, going the wrong way. Failures begot more write downs and more failures.

I have borrowed a lot of money from banks in my business career, and I know there will be more failures in Georgia this year.

But I am here to say that when a Georgia bank fails, my office will be here asking why, searching for answers, and holding the appropriate regulators accountable.

And with that, Madam Chairwoman, I yield back.

Chairwoman CAPITO. Thank you.

That concludes our opening statements.

I would like to now introduce Ms. Sheila Bair, Chairman of the Federal Deposit Insurance Corporation, for the purpose of making an opening statement.

And, again, thank you for coming today.

STATEMENT OF THE HONORABLE SHEILA C. BAIR, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)

Ms. BAIR. Chairman Capito, Ranking Member Maloney, and members of the subcommittee, thank you for the opportunity to testify today on the state of the banking industry and the Federal Deposit Insurance Corporation and on future challenges to our economic and financial stability.

Much has been written and said about the events associated with the recent financial crisis and the factors that led up to it. My written testimony summarizes four factors that I consider the most important: excessive reliance on debt financing; misaligned incentives in finance; regulatory arbitrage; and an inadequate resolutions framework that allows some financial companies to become too-big-to-fail.

The FDIC was created in 1933 in response to the most serious financial crisis in American history to that time. Our mission then, as now, is to promote financial stability and public confidence in banking through bank supervision, deposit insurance, and the orderly resolution of failed banking institutions.

Working with our regulatory counterparts, the FDIC has played an instrumental role in addressing the recent crisis. Our actions have helped restore financial stability and pave the way for economic recovery. My written testimony includes a comprehensive account of those actions.

I am proud of all that the FDIC has accomplished during the past 5 years. My greatest satisfaction lies in the knowledge that through 368 failures, including the largest failures in FDIC history, we kept pace with the depositors we were established to protect.

We have maintained the FDIC's 78-year record of no losses to any insured depositor. And we did it without borrowing a penny from taxpayers.

But we still have important work to do. Our first task must be to follow through on the Dodd-Frank Act reforms that will end too-big-to-fail. At the height of the crisis, we lacked the necessary tools to resolve large, complex financial companies in an orderly manner and were forced to authorize government bailouts that further insulated these companies from the market discipline that applies to smaller banks and practically every other private company.

Too-big-to-fail really represents state capitalism. Unless reversed, the result is likely to be more concentration and complexity in the financial system, more risk-taking at the expense of the public, and in due time, another financial crisis.

The Dodd-Frank Act provides the tools to restore market discipline and put an end to the cycle of government bailouts under too-big-to-fail. These tools will be effective and the large systemically important institutions, or SIFIs, will be resolvable in the next crisis only if regulators show the courage today to fully exercise their authorities under the law.

The success of this new resolution framework critically depends on the ability to collect information about potential SIFIs to determine whether they are, in fact, resolvable under bankruptcy. It will also require the willingness of the FDIC and the Federal Reserve Board to actively use their authority to require structural changes at SIFIs that better align business lines, legal entities, and funding well before a crisis occurs.

Unless organizations are rationalized and simplified in advance, there is a real danger that their complexity could make a SIFI resolution far more costly and more difficult than it needs to be.

These authorities are being shaped now in the interagency rulemaking process. If properly implemented, they can make our financial system more stable by restoring market discipline to systemically important institutions.

But if we fail to follow through on these measures now, when market conditions are relatively calm, we will have no hope of preventing bailouts in the next crisis.

My testimony describes the role played by excessive leverage among both banks and non-bank financial companies in bringing the crisis about. Strong capital standards are of fundamental importance in maintaining a safe and sound banking system that supports economic growth.

Supervisory processes will always lag innovation and risk-taking to some extent. And restrictions on activities can be difficult to define and enforce. Hard and fast objective capital standards, on the other hand, are easier for supervisors to enforce and provide an additional cushion to absorb losses when mistakes are inevitably made.

Skeptics argue that requiring banks to hold more capital will raise the cost of credit and impair economic performance. But the experience of the crisis shows that the social costs of debt financing are extremely high in such a downturn, and that the lack of an adequate capital cushion makes lending highly procyclical.

While there will always be business cycles, the massive deleveraging which occurred during the financial crisis led to the most severe downturn since the Great Depression.

Loans and leases held by FDIC-insured institutions alone have declined by nearly $750 billion from peak levels, while unused loan commitments have declined by $2.5 trillion. Trillions more in capital flows were lost with the collapse of the securitization market and other shadow providers of credit.

I would also like to highlight the urgent need for Congress and the Administration to address the rapid growth in U.S. Government debt, which has doubled in just the past 7 years. Financial stability critically depends on public investor confidence, which can never be taken for granted.

There is no greater threat to our future economic security and financial stability than an inability to control the size of U.S. Government debt.

But as strongly as I feel about this issue, I feel just as strongly that a technical default on U.S. Government obligations would prove to be calamitous.

Any signal that policymakers might fail to make good on these obligations risks permanently destroying the inviolable trust that investors have placed in our Nation for more than 2 centuries.

I urge Congress to reaffirm this trust by committing to a responsible increase in the debt ceiling.

As I conclude, I would like to share with you one of the central lessons I have drawn from my experience as FDIC chairman. It is that the most important attribute of effective regulation is the courage to stand firm against weak practices and excessive risk-taking in the good times.

It is during a period of prosperity that the seeds of crisis are sown. It is then that overwhelming pressure is placed on regulators to relax capital standards, to permit riskier loan products, and to allow higher concentrations of risk both on and off balance sheets.

The history of the crisis shows many examples when regulators acted too late or with too little conviction, when they failed to use authorities they already had or failed to ask for the authorities they needed to fulfill their mission. As the crisis developed, many in the regulatory community were too slow to acknowledge the danger and remained behind the curve in addressing it.

The fact is that regulators are never going to be popular or glamorous, whether they act in a timely manner to forestall a crisis or fail to act and allow it to take place. The best they can hope to achieve is the knowledge that they exercised the statutory authority entrusted to them in good faith and to its fullest effect in the interests of financial stability and the broader economy.

Thank you very much. I would be happy to answer your questions now.

[The prepared statement of Chairman Bair can be found on page 46 of the appendix.]

Chairwoman CAPITO. Thank you, Chairman Bair.

We will now begin the questioning portion of the hearing. And I will begin my 5 minutes of questioning.

We have had ongoing discussions with you and your staff concerning the relationship of the FDIC and the CFPB for consumer protection. It is my understanding that the FDIC just recently announced a new consumer division within the Corporation.

I am interested in how that is going to work in relation to CFPB. If the CFPB comes down with regulations understanding that smaller institutions are exempted out in theory, do you envision a consumer protection within the FDIC that then takes the regulations that come from the CFPB and modifies them for the other institutions?

There has to be some coordination here. Are we creating a two-tiered system here?

Ms. BAIR. Under the statute, for institutions with assets less than $10 billion, the supervision and enforcement remains with the primary banking regulators.

Chairwoman CAPITO. Right.

Ms. BAIR. And we have most of the smaller banks. So the lion's share of our institutions stay with us in terms of examination and enforcement of rules.

We have never had the authority to write consumer rules. That authority has been with the Federal Reserve. And now most of that is being transferred to the CFPB. So this coordination issue for us is not new. We have never had the ability to write the rules. The Fed has written the rules.

We have coordinated with them. We provide input to them and comment, and obviously, examine and enforce the rules that they promulgate.

The CFPB Director, when that person is installed, will be on the FDIC board. And I think that will help assure coordination, appropriately so.

I am hoping that this will help also increase the understanding of the CFBP's Director about broader banking regulatory issues on the safety and soundness side, some of the concerns of the FDIC, and our perspective on the various issues that we have to deal with on a day-to-day basis.

In terms of creating the new division, I do want to emphasize that we did not create new examination staff. Actually, the examination staff reporting structures in the regions stay the same.

This is an organizational change. There were a very few additional administrative staff to support the organizational separation of consumer and depositor protection from risk management. It was really more to make sure that the FDIC had an appropriate policy focus on consumer protection.

And I would say the focus is for more effective consumer regulation.

I am sensitive to the concerns of community banks that have been expressed, that perhaps sometimes under consumer compliance, as well as risk management, there has been more of a focus than there should be on the kind of "gotcha" violations that other members expressed concern about, such as reporting violations or what have you.

We have tried to refocus the examination force on those areas where there is actually consumer harm. And I think that has been a good outcome of this new policy-level focus of the FDIC on consumers.

This will be a way for us to have a better focus on consumer protection, making consumer protection supervision more effective as applied to banks, and enabling better coordination with the new consumer agency, which, again, I think will have somewhat of an advantage because the Director of the CFPB eventually will be on our board.

Chairwoman CAPITO. Okay. I want to go to another question quickly. But it sounds like the structure that is being enacted while these institutions under $10 billion are exempted—it sounds as though they really aren't going to be exempted, which is their fear, because—or not their fear, their fear of the unknown more than anything else—because it will be coordinated through your institution.

Ms. BAIR. That is right. The exemption is just with regard to examination and enforcement. It is not really an exemption. It preserves what we have always done. The primary banking regulator will be the entity that examines and enforces for compliance with consumer rules.

The consumer agency now has rule-writing for all institutions. So whatever rules they write, those will apply to all institutions.

Chairwoman CAPITO. Right.

Ms. BAIR. They can, on their own, exempt small banks. I have spoken in favor of a two-tiered regulatory structure. I think in certain areas it is appropriate. We will have an ability to engage and have input with the new consumer agency because eventually that person will be on our board as well.

Chairwoman CAPITO. Okay. Over the last several years, there has been increasing consolidation of the banking industry.

Ms. BAIR. Right.

Chairwoman CAPITO. Some of the opening statements talked about the advantages that the larger institutions have. The smaller banks, the smaller institutions and community banks are concerned about being able to staff the regulatory issues, the legal issues that they now see in front of them because of Dodd-Frank.

How do you see this playing out, the consolidation? Is this a concern for you? And I think it is a concern for, really, Main Street America.

Ms. BAIR. Right, right. It is a concern. We have a Community Banking Advisory Committee. And we have talked with them a lot about this.

I think on the process side, the Dodd-Frank Act did have some important reforms for community banks. Certainly, raising the deposit insurance limit to $250,000 had been long advocated by community banks and will help them address funding disparities by having a higher deposit insurance limit.

Also, the change in our assessment base is going to probably save them about $4 billion in assessments over a period of time in assessment fees. So there were some process improvements in the Dodd-Frank Act that will benefit community banks..

However, there are some concerns with the Durbin amendment. And I commend you on your leadership on that issue.

We are trying very hard to make sure that the law is implemented as Congress intended, which was to insulate community banks from the lion's share of the reforms that really were targeted at larger institutions. And we will continue that focus.

We are obviously very concerned about the differentials in funding costs as well. That existed pre-crisis. It has existed for far too long.

The rules need implementation. We will talk more about that later. Title II can help get these funding costs up for large banks, as will higher capital requirements.

Chairwoman CAPITO. Thank you.

Mrs. Maloney?

Mrs. MALONEY. Thank you.

Thank you, Madam Chairwoman, for holding this hearing and giving us this opportunity to be with Sheila Bair one last time.

I would like to ask you to respond to what critics have claimed, that the new Orderly Liquidation Authority promotes bailouts because it allows the FDIC to pay creditors 100 cents on the dollar.

Ms. BAIR. Right.

Mrs. MALONEY. And isn't it true that this is erroneous in light of the fact that the law requires the FDIC to ensure that creditors bear losses?

Ms. BAIR. That is right.

Mrs. MALONEY. And secondly, the FDIC's authority to pay creditors more than they would have received in a liquidation bankruptcy is very limited and is subject to the requirement that creditors bear losses.

So your comments, please, Madam Chairman.

Ms. BAIR. Thank you.

I think it is important and we clearly have a job ahead of us in terms of educating folks about our process and assuring them that it is every bit as harsh as bankruptcy. It is basically the same creditor priority that you see in bankruptcy.

The statute limits our ability very narrowly to differentiate among creditors in a way that is consistent with our traditional receivership powers.

And basically, that is two situations. First, to continue with essential operations—things like paying the IT folks to keep IT services going; paying your security people; and paying the employees. That is also recognized in bankruptcy.

The second situation relates to maximizing value, and is simply a mathematical determination. We see this in bank resolutions. Frequently when we bid out a bank, the potential acquirers will pay us a premium to cover all insured and uninsured deposits, because it impairs franchise value to impose losses on their larger uninsured depositors.

So it actually maximizes our recoveries to cover the uninsured deposits and sell all the deposits to the acquirer, as opposed to imposing a loss on those uninsured depositors, because we are making more money with the premium that the acquirer pays.

That is an example where you would maximize value by differentiating. And again, that is pretty much a mathematical formula. To emphasize it more, we have said in an interim final rulemaking that we don't think there would ever be any situation where a longer-term creditor—that is one longer than a year—would either maximize value or be necessary for essential operations.

And for unsecured creditors with shorter terms, they are probably going to take losses as well. But again, they would have to meet these narrow tests.

We have tried very hard to assure people that the losses imposed on creditors will be every bit as harsh as it is in bankruptcy. The 97 cents on the dollar issue, I think that comes from an analysis that our staff did on the Lehman bankruptcy and how it might have been resolved under Title II.

So the 97 cents was simply a reflection of what we think the recoveries would be for the senior debt holders based on the capital cushions and subordinated debt cushions that existed in Lehman at the time of its failure, and our prediction of what the losses would have been on their bad assets.

The recovery in Lehman, as it would be with any other Title II resolution, will be driven by the extent of losses and the amount of equity and subordinated debt under their senior debt holders.

But I would say, as a matter of market discipline, if senior debt holders want to protect themselves, they should look at the equity capitalization levels and the sub-debt below them.

Mrs. MALONEY. To put it in a framework that is helpful to us, could you explain the extent to which having the Orderly Liquidation Authority during the financial crisis could have prevented bailouts and mitigated systemic effects?

Ms. BAIR. It would have. We have the ability, if you have time, and there was a lot of time with Lehman. There were months of alarm signals before the institution finally failed.

Firstly, under the Dodd-Frank Act, all systemic entities, including all bank holding companies above $50 billion, are required to have resolution plans on file with us. So we we will have a blueprint on resolvability well before any time that they would get into trouble.

The bankruptcy trustee and others who have analyzed the Lehman bankruptcy have all spoken to the need for advanced planning to resolve these larger complex financial institutions. So there would have been a game plan in place.

We would have been in the institution months in advance. We anticipate having an ongoing presence in these large SIFIs, just as we do with larger bank holding companies now.

I think just the fact that there was a resolution process that would have imposed losses on shareholders and creditors, would have replaced the board, and would have replaced management, that, in and of itself, would have been a strong incentive for the leadership of Lehman to right their own ship and go out and sell themselves at a reasonable price, which they were unwilling to do.

We see this all the time with banks. Banks know that if they fail and they go into our process, their shareholders are wiped out; their unsecured creditors are wiped out; their boards are gone; and their executives lose their jobs.

It is a powerful incentive to take care of yourself. About 25 percent of banks that are on our projected failure list end up not failing because they go out and they recapitalize. They are very motivated. And I think that would be an important factor that we didn't have during the crisis.

It also, frankly, provides us a defense against blackmail, right? During the crisis, a lot of institutions were coming in and saying, "You know, if we go down, you are going to have all these problems." And there was no orderly process to put them into.

Now, we have a process. Even if it is an emergency situation, we can put them into a bridge and provide temporary liquidity support, but their shareholders and unsecured creditors are all exposed to loss and their boards are gone. And actually under the Dodd-Frank Act, there is a claw-back of up to 2 years of compensation for management if you have a failed entity.

Chairwoman CAPITO. The gentlewoman's time has expired. Sorry.

Ms. BAIR. There are just a lot of tools that we would have in the future that we didn't have going into the crisis.

Chairwoman CAPITO. The gentleman from Ohio, Mr. Renacci?

Mr. RENACCI. Thank you, Madam Chairwoman.

And thank you, Chairman Bair, for being here.

I want to focus today on the composition of your board of directors, and under Dodd-Frank the new composition, which includes the Director of the CFPB being one of the members on your board.

Coming from the private sector and the business sector and sitting on many boards, I was always concerned. And I think the setup of all boards, there was always concern about apparent, perceived, direct, indirect conflict of interest.

Knowing that you are going to have to work on a regular basis with one of the individuals who would be the Director of the CFPB, I am a little concerned that there is a conflict of interest, especially when it comes to your seat on the FSOC, basically.

Because as we know right now, FSOC can review, stay, and block a CFPB rule, but it takes two-thirds to do that.

Ms. BAIR. Right.

Mr. RENACCI. I know my colleague, Mr. Duffy, introduced some legislation last week or the week before to try and talk a little bit about this.

But when you have to work with somebody on your board on a regular basis, and then you go over to FSOC and you have a vote, and it takes today 7 out of 10 to block a rule by the Director who sits on your board—

Ms. BAIR. Right.

Mr. RENACCI. —and that person also has a vote out of the 10, and you would have a vote out of the 10, you start to limit down the ability to really have oversight by using the Financial Stability Oversight Council.

Ms. BAIR. Right.

Mr. RENACCI. So my concern is, when you have that kind of conflict of interest, is it good policy? Is it good procedure? I have actually drafted a bill that I am going to introduce next week which would simply replace the Director of the CFPB with the Chairman of the Fed.

And the reason I am doing that is because I believe we need to focus on safety and soundness, and get any perceived conflict of interest out of the way.

Ms. BAIR. Right.

Mr. RENACCI. I just want to hear your thoughts on that potential conflict of interest.

Ms. BAIR. I think it is a good question. I think a lot of people had suggestions during the consideration of Dodd-Frank about who should replace the OTS on the FDIC's Board, and the Fed was one option. I was supportive of that. I said I would like some reciprocity. I think that would be helpful.

The advantage and the argument for putting the consumer bureau head on the FDIC Board is that perhaps it might help sensitize that person to some of the safety and soundness issues that are associated with deposit insurance and the intersection with consumer protections.

Frankly, there is a close connection. They are really two sides of the same coin. To the extent people were worried about the consumer bureau head not being aware of the larger context of bank regulation, it might help educate that person to have them on the FDIC Board. That is the argument for it.

Again, we wouldn't mind some reciprocity. If you go to a commission structure for the CFPB, that might be a nice thing to have as well.

But, we are fine with it. Again, earlier iterations did have the Fed on the Board. We were fine with that, too. We would have liked some reciprocity if that was the structure.

But in terms of the conflict, I would also point out, though, that FSOC actually has the ability to intercede with pretty much all the regulators, if they think one of the regulators is doing something that could create systemic risk or is not appropriately addressing systemic risk.

So arguably, there could be a conflict for the OCC for instance, as well. If the OCC wasn't doing as good a job as they should in regulating large banks, and the FSOC was going to intervene in that, I guess you could make the same argument there.

So these are difficult questions. And I think we can certainly live with what is in the law right now.

Mr. RENACCI. It is interesting, as you mentioned, you would bring on that Director so they can be briefing on the safety and soundness aspect.

Ms. BAIR. Right.

Mr. RENACCI. And I read the CFPB's mission statement yesterday, and out of the 764 words, there is no talk about safety or soundness in their mission, which is—

Ms. BAIR. A safe and sound bank—a bank that doesn't fail—is the best bank for customers. As good a job as we do with protecting depositors, it is always better to avoid a failure.

Similarly, consumer abuses eventually, as we saw with the mortgages, can have profound safety and soundness ramifications, too. So there really needs to be a lot of cross-communication and collaboration on this. I couldn't agree more.

Mr. RENACCI. Thank you.

In regard to the Orderly Liquidation Authority, there have been a number of examples. And I have Continental Illinois Bank, $400 billion in assets, 57 offices in 14 States. It took 7 years to resolve at a cost of $1 billion to the fund.

The Bank of Clark County, Washington, $440 million in assets, 50 bank employees, a 3-day weekend to resolve.

Citigroup, $1.9 trillion in assets, the time, the energy, the staff that you needed—and I know I am running out of time, but maybe I can catch you on the second round.

I would like to find out how you believe that the manpower, time, and strain on the fund will take to wind down simple institutions, and how you will be able to be able to exercise authority over much larger institutions.

So I will yield back.

Chairwoman CAPITO. We will give you lots of time to think about that.

Mr. Baca, from California, for 5 minutes.

Mr. BACA. Thank you, Ms. Blair, for being here.

I understand that the FDIC has issued an internal financial final report and proposed rule to implement an Orderly Liquidation Authority.

Could you briefly discuss these rules, particularly to the extent to which they would align an orderly liquidization process without a bankruptcy or a failed bank resolution, and ensure that creditors bear losses and the institution itself does not survive?

Ms. BAIR. The statute is very clear: It bans bailouts. And the claims priority that we follow is pretty much the same claims priority that is followed in bankruptcy.

To the extent the government would need to provide liquidity support to keep the institution operational as it is broken up and sold off, those are administrative expenses that are paid off the top back to the government before any other expenses are paid.

So it really is a process that is every bit as harsh as bankruptcy. It resembles bankruptcy in the claims priority. And I think we need to reassure folks on that.

The purpose of this was to end too-big-to-fail, not to reinforce it. We have engaged with the rating agencies on this. Some have decided to continue or have sought comment on whether they should continue to have a bump up for large institutions.

And we say to them: read the statute. The statute prohibits bailouts. They actually think the Congress is going to do it. They just can't imagine that the Congress, even if the regulators can't, that the Congress would not step in.

So I know you don't want to do that. I know you don't want to face the Secretary of the Treasury and the Chairman of the Federal Reserve coming up and asking for $700 billion to do a lot of things that none of us like to do.

The tools are there to require credible resolution plans. The tools are there to require structural changes as well as downsizing if they cannot come up with a plan that shows that they can be resolved in an orderly way.

Mr. BACA. But do you think they will downsize?

Ms. BAIR. I think some of them may need to. I think some of them are already.

Mr. BACA. And who will enforce that?

Ms. BAIR. It is jointly with the Fed and the FDIC. And the FSOC as a group can also, with a supermajority vote, require a divestiture if that is necessary.

Mr. BACA. It seems that many people overlook or underestimate the importance of the rapid resolution or living will requirement, which the Feds and the FDIC jointly are in process of implementing.

Could you please discuss the importance of a living will, both as an ongoing regulatory tool that will help ensure appropriate risk management and that mitigate against failure of large complex financial institutions as a planning took that will make disorderly resolutions less likely and hopefully a rare event at large and financial failures.

Ms. BAIR. It is a statutory requirement jointly of the Fed and the FDIC. It requires that the institutions have plans in place that can show the orderly resolution through a bankruptcy process. It is a very high standard.

For several institutions, this is going to require some structural changes. I think they have thousands of legal entities that have been accumulated over the years, through acquisition activity or what have you, that they just never bothered to rationalize.

And so getting their business operations aligned with their legal structure—so that if they start to fail, there is a strategy to be able to break them up and market them in marketable-size pieces—is going to be a key part of this.

I think for those with international operations, there may be some level of subsidiarization that is required. That is that they need to separate themselves as a separate legal entity in certain foreign jurisdictions, perhaps where they have significant business activities.

There are several banks, though, in particular Santander and HSBC, that already operate with a subsidiarization model, and they do so quite profitably.

So it may not be required for all of them, but I think it is the kind of thing that we need to look at and may be required for some if they can't otherwise show that they could be resolved on an orderly way even in an international context.

Mr. BACA. Thank you. I yield back the balance of my time.

Chairwoman CAPITO. Thank you.

Mr. Luetkemeyer for 5 minutes for questions.

Mr. LUETKEMEYER. Thank you, Madam Chairwoman.

Chairman Bair, recently the FDIC completed a pilot program on small dollar loans and had a couple of different programs, one for under $1,000, and another one for under $2,500. Can you just recap some of your findings on that?

Ms. BAIR. Our small dollar loan pilot program?

Mr. LUETKEMEYER. Yes, on your pilot program.

Ms. BAIR. We were very pleased. It was very successful. The delinquency rates were a little bit higher than they are for other forms of lending. But the default rates and losses were very much in line.

The banks that participated in the pilot were very pleased and gave us the information, which we have, in turn, made more broadly available to banks in general.

There is a particular need for small dollar credit right now. The options for a lot of consumers are not good. They can be very high cost.

Having proven models to provide reasonably priced small dollar lending was important to us. We were very pleased, as well as the banks, with their success.

Mr. LUETKEMEYER. Okay. What interest rate did you see on the small dollar loans actually worked?

Ms. BAIR. What industry?

Mr. LUETKEMEYER. Yes, what interest rate?

Ms. BAIR. These were consumer loans. Oh, interest rate. I am sorry.

Mr. LUETKEMEYER. Interest rate, yes. What interest rate did—

Ms. BAIR. They were all below 36 percent, which is pretty high. We have guidance out that says that we will actually give CRA credit for those who can offer this—

Mr. LUETKEMEYER. Did they think they could make any money at that?

Ms. BAIR. Sorry?

Mr. LUETKEMEYER. Did they think that they could make any money at that?

Ms. BAIR. They did make money. Most of them were significantly lower than 36 percent, usually around 18, 16, 12 percent. And they did make money, because they all—

Mr. LUETKEMEYER. My information says that after 2 years, the FDIC, according to your report, found that the interest rate cap was not profitable for the participating bank.

Ms. BAIR. Was not what? I am sorry.

Mr. LUETKEMEYER. I said that after 2 years, the FDIC program—my information says that after 2 years, your pilot program showed that the interest rate cap was not profitable for participating banks.

Ms. BAIR. There was no interest rate cap. There is guidance that says for the pilot, we wanted them to stay below 36 percent. But that is a voluntary program.

And, I am sorry, Congressman. If we could take a look at the document you are looking at, because those were profitable. And they were significantly below 36 percent.

Mr. LUETKEMEYER. Okay. We will work out the differences on that later. Thank you.

Ms. BAIR. Sure.

Mr. LUETKEMEYER. With regards to the insurance fund, how solid are we right now?

Ms. BAIR. We are still in negative territory, but we should be in positive territory by June 30th, by the end of the second quarter.

The fund at the end of the first quarter was a negative $1 billion. That is up from a trough of negative $20.9 billion in 2009.

So it is improving. That represents our equity position, not our cash position. Our cash position is a positive $45 billion.

But the fund's equity position should be in positive territory by the end of the second quarter.

Mr. LUETKEMEYER. Do you anticipate any future assessments—

Ms. BAIR. No.

Mr. LUETKEMEYER. —to make up the difference in that—

Ms. BAIR. No. No. As a matter of fact, we had a scheduled 3 basis point increase that we did not impose because the industry is recovering and our projected losses are going down.

Mr. LUETKEMEYER. Okay. With regards to interchange fees, the other day we had Chairman Bernanke in front of us and asked him a question, whenever your regulators go in and you take a look at a bank, and they have to chalk off 13 percent of their income, are you going to forget about that lost income? Or are you going to require them to make that up somewhere?

And he really had no answer to that.

Ms. BAIR. Yes.

Mr. LUETKEMEYER. He said, well, it is up to the bank to decide how they want to do that, but we certainly want to see them to continue to be capitalized.

Yes, that is true. But his regulation is going to have—when he comes up with his interchange fee regulation, it is going to have a dramatic impact on the bottom line for a lot of the institutions.

Ms. BAIR. Right.

Mr. LUETKEMEYER. What are your thoughts on that?

Ms. BAIR. We are concerned about it. In fairness to the Fed, they are implementing a provision that was in the Dodd-Frank Act.

Mr. LUETKEMEYER. Right.

Ms. BAIR. —and doing it as they see is consistent with the statute.

We are very concerned about it, especially for the community bank impact. The statute specifically says, community banks under $10 billion in assets are supposed to not be subject to this cap.

As a practical matter, can you really protect them, particularly if network providers are not required to take the higher fees they could continue to charge.

Mr. LUETKEMEYER. Right.

Ms. BAIR. We also think the 12 cents is too low. We filed a comment letter which I am happy to share with you. We think they should take anti-fraud measures into account. And that can be a significant expense.

We also think they should do more to take in the incremental costs of small banks that provide for debit card usage. I think the cost structure they considered was mainly for the large institutions. Obviously, their incremental costs are less than the smaller banks.

I don't know how they are going to come out with it. I think Congress may or may not still take some more time with this. If they don't, I am hoping that if this goes final, that 12 cent-limit is raised, and that they can find a legal justification for requiring that networks accept two-tier pricing to protect the smaller banks.

Mr. LUETKEMEYER. Thank you. And just a comment: I appreciate your comment on the capital requirements.

Ms. BAIR. Right.

Mr. LUETKEMEYER. I think that is important, even during good times, to retain adequate level of capital—

Ms. BAIR. That is right.

Mr. LUETKEMEYER. My dad told me that a long time ago. He lived through the Depression. And he lived to be able to explain why it was a good thing and show here with this last crisis why it actually worked.

Thank you very much for your comment.

Chairwoman CAPITO. Thank you.

Mr. Scott, from Georgia?

Mr. SCOTT. Thank you very much.

Chairman Bair, I just want to first of all start off by thanking you for the excellent service you have done as the Chairman of the FDIC, and especially for responding to me. Each time I call your office, you get right on the phone and talk with me and help us to handle things.

As you know, my State of Georgia has had just a plethora of very serious problems. Unfortunately, we have led the Nation in bank closures.

But I want to ask you this first question: A number of banks, community banks especially, in my State of Georgia, are under regulatory orders from the FDIC. And I understand these orders are driven primarily by the performance of their loan portfolios and capital levels.

These regulatory orders often require a bank to reduce their concentration in real estate loans to some artificial level. And that is forcing them to not renew even performing loans for some borrowers. That seems to hurt everyone, especially in States like Georgia that are so centered on real estate.

The borrower has to find a new bank, which we know is difficult in these economic times, while the bank loses a performing loan.

Surely there is a better way to enforce FDIC rules and regulations so that they don't hurt the very consumers that they are designed to protect and the banks that they are designed to oversee.

What might you say would be a better way?

Ms. BAIR. Congressman, thank you for asking that question, because I think our policies are not consistent with what you are being told.

And, again, I will say this to all members here: If there are specific examples where you feel that our policies are not being applied by our examiners, I personally want to know about it.

I do stay engaged with the examiners. I do conference calls. I visit the regions. I cannot tell you how focused I personally have been on this.

And the rule is quite simply this: if the loan is performing, if you have a creditworthy borrower with cash flow to keep making payments on that loan, it doesn't matter what the collateral is. If the loan is a good loan, it doesn't need to be written down, no additional reserves, nothing, it is a fine loan.

If you are just refinancing the unpaid principal, and you have a creditworthy borrower who can continue to make payments, you don't have to write down that loan, even if the collateral has declined in value.

If you are extending new credit, new money, yes, the bank needs to go make an appraisal of the collateral, because you are expending new money. That is just a basic tenet of banking.

But regarding existing loans or refinancing of existing loans, if the borrower is creditworthy and can make the payments, you do not have to do an appraisal and you do not have to do a write-down.

That is the rule. I went through this again yesterday as part of my hearing prep because I hear this a lot. And it is very frustrating to me.

And, again, if you have specific examples, I do want to know about it.

Mr. SCOTT. Okay, let me just ask you specifically then, what should my banks in Georgia do? You are saying that is not the way it should be. They are saying it is the way it is. So what should they do?

Ms. BAIR. They could call me directly. Or, we have an Ombudsman that is set up as a confidential process. So, they can do it on a confidential basis.

Also, they can call Sandra Thompson, the head of our Division of Risk Management.

Mr. SCOTT. Who was that again, please?

Ms. BAIR. Her name is Sandra Thompson. She is the head of our Division of Risk Management.

There are any number of avenues to bring this to our attention. We do want to know about it.

I have found a couple of cases where policies were misapplied, and we corrected it very quickly.

I will tell you, though, other times when we drilled down, what we found was that the borrower really did have some problems. There may be a different perception about what a creditworthy borrower is, and sometimes that can be a judgment call.

We individually review every single allegation. I promise you that.

Mr. SCOTT. Right. Thank you very much.

Just last week, two more banks failed in my home State of Georgia: First Choice Community Bank; and Park Avenue Bank. And this brings the number of banks that have closed this year to 10, which is by far the most of any other State.

And unfortunately this is not unusual news, as banks in Georgia continue to struggle.

Can you tell me what, in your opinion, makes small banks especially vulnerable to closure?

Ms. BAIR. Early on, we had a lot of failures of banks that had grown too fast. They had taken deposits and grown their balance sheets very quickly, had not adhered to good underwriting, and had clearly made a lot of out-of-area lending, which is something that generally is not good, unless you very carefully manage that exposure.

Later, as we progressed into economically troubled times, more problems arose from weaknesses in risk management. But, they were succumbing to economic conditions as well.

If the losses are mounting and the capital is insufficient to curb those losses and if they can't raise additional capital, there is not a lot we can do about it. Under the statute, we have a prompt corrective action process that we follow. It is fairly rigid about when the banks—

Mr. SCOTT. Very quickly, are there any specific things you could say right now that the FDIC can do to assist them?

Ms. BAIR. I think we do try to work with them. I know we have a different role than they do. But it is not a confrontational role, and we don't want that.

We tell our examiners they need to understand what is going on in the bank. They need to talk to management. They need to listen to management.

They must exercise their own independent judgment about the health and safety of that bank. But that should be informed by robust conversations with the bank management and the board. And we do that.

Certainly, anything that we can do with an appropriate balance to help them recapitalize is in our interest. We don't want these banks to fail. It costs us money every time it happens.

But, nonetheless, if they can't raise their capital and the losses are mounting, if you delay the closing of the bank for a long time, the losses will go even higher. That was the lesson learned during the S&L crisis, and which is why we have prompt corrective action now, and why we follow it.

Mr. SCOTT. Thank you, Chairman Bair.

And thank you, Madam Chairwoman, for your generosity of time.

Chairwoman CAPITO. Thank you.

Mr. Westmoreland, from Georgia, 5 minutes.

Mr. WESTMORELAND. Thank you, Madam Chairwoman.

Ms. Bair, in a meeting I had 2 weeks ago with your staff, they informed me that it is unlikely that the FDIC will wind down the use of loss share agreements in Georgia.

Setting aside my strenuous objection to this, I have serious concerns about the loss-share agreements that will begin to mature in 2 years. As the stop-date of a loss-share agreement approaches, I have serious concerns that the banks with these agreements will begin to rapidly sell off assets to take advantage of the agreement.

This could lead to yet another downturn in real estate and make it harder for people to obtain loans.

What is the FDIC's plan for these maturities of loss-share agreements?

Ms. BAIR. I am not sure where you got this 2-year figure. In practice, the terms of the loss-share agreements generally coincide with the tenure of the loans.

But there is no cut-off point in 2 years where there is no longer any loss-share and it is going to get dumped on the market. That is not how it works.

Actually, we think that the loss-share prevented a lot of property going onto the market, because it facilitated our ability to sell the whole bank, with the deposits and the assets, to another insured depository institution. If we had not provided loss-share, the bank probably wouldn't have taken the assets.

We would have had to sell it on the open market at an extreme liquidation discount, or held it ourselves and managed it, which is inefficient and costly and difficult.

So actually, I think the loss-share has helped keep a lot of assets in the hands of other, better-capitalized, stronger depository institutions. It has kept the property off the market. Also, I want to emphasize that we have very stringent rules in loss-share agreements about loss mitigation.

If a loan restructuring will have greater value than a foreclosure, we want the loan restructured. We have very specific rules about that. And we audit that. If they don't do that, they can lose their loss-share payment.

Mr. WESTMORELAND. You all might want to send some folks out with your regulators who actually go out and do the work in the field, and see where the disconnect is. There is certainly—

Ms. BAIR. I would. I do hear this. And again, if you have some specific examples, we would love to hear them—

Mr. WESTMORELAND. The problem with giving examples is these banks are afraid to death of retaliation.

Ms. BAIR. Yes.

Mr. WESTMORELAND. And so we would be glad to give you examples, but trying to get some of these guys to come forward—I have been trying to do it for a long time now, and they are—I am being serious. They are desperately afraid of retaliation.

And if you all think loss-share agreements are helping—

Ms. BAIR. Right.

Mr. WESTMORELAND. —then that could be the problem, because they are not.

But let me ask before—and I don't want to cut you off, but I do want to ask you one other question.

Despite the occasional lip service that some of these regulators give for talking about they want these community banks to continue to be able to provide service to small business and local customers, the examiners continue to second-guess bank management policies and downgrade loans based not on the current status of the loan. In other words, some of these loans are performing loans.

But based on a scenario where there is no economic recovery, and virtually every examination ends with significant downgrades not supported by professional outside loan review or by independent accountants, if the FDIC is serious about allowing banks to serve their customers, why are the banks being second-guessed on even the best-documented loans?

And I don't understand how a bank can get all "A's" on a report card, and 6 months later get all "F's" and do everything but call the board members crooks.

Ms. BAIR. Again, it is hard to respond without knowing what the facts would be in the individual case. I would say that if the loan is performing, if the borrower has success, and the loan continues to perform, it is a good loan, even if the collateral has gone down in value. Even if it needs to be refinanced, it is a good loan.

Again, if you have examples, I do want to know about them. I will personally assure the banker that there will not be any retribution by bringing this to our attention.

So I really don't know what else I can say. I think examiners do need to exercise independence of judgment. They need to listen to bank management, and understand their reasoning. But bank managers are not always right. There have been some big mistakes.

I think we are, hopefully, for the most part, through this. But early in this crisis, we did have a lot of very dramatic downgrades from banks that had very good supervisory ratings to ones that went to troubled status. And for that reason, we are putting more of an emphasis on what we call "forward-looking CAMELS" and asking banks to stress their portfolios and stress conditions.

But that is just from a risk-management perspective. That doesn't mean if the economy tanks unexpectedly that they have to start holding more capital now. No, we just want them to be prepared and think through all the scenarios.

Mr. WESTMORELAND. And listen, I appreciate those comments. But I really hope that some of your senior management, or whatever, can go into some of these banks. And as my colleague from Georgia mentioned, we have a tremendous amount of them that are either under consent orders, cease-and-desist, on the problem bank list, that is still to come.

And this is sucking wealth out of these communities.

And the loss-share agreement and the immediate write-down is doing a reverse situation on our local economies. It is killing us. We need some help.

Thank you, Madam Chairwoman, for your generosity.

Ms. BAIR. If I could just indulge the Chair, I am actually going to be in Atlanta soon. I will go you one further. I am happy to go to your district and meet with a group of bankers personally if that would be helpful to you.

Mr. WESTMORELAND. I may take you up on that.

Chairwoman CAPITO. Mr. Carney, from Delaware, for 5 minutes.

Mr. CARNEY. Thank you, Madam Chairwoman.

And thank you for being here today, Chairman Bair.

I would just like to add my voice to those who have expressed concern about banks being told that they had to do away with performing loans and creditworthy borrowers not getting access to that. So I would like to take you up on your offer to entertain those kinds of referrals and that discussion.

I have heard it a number of times from the borrowers and from the banks themselves.

I would just like to touch on and follow up on a couple of questions. And the first one is you addressed the issue of bailouts of banks and what the tools are that you have today that you didn't have under Dodd-Frank.

And the question really is, are you better positioned today? Are the regulators better positioned today to prevent government bailouts of those troubled financial institutions then they were before?

And you did it a minute ago, but if you could just highlight some of those things, how the incentives have changed, how your tools have been strengthened, and so on.

Ms. BAIR. Yes, they have. We now have the authority to resolve the entire financial institution, whereas before, our receivership authority only went to the insured bank. And so now, at least for large bank holding companies, there is a whole list of authorities to put them into receivership, into our process, if that would avoid systemic consequences.

And as I said before, the process is very rigorous, every bit as harsh as bankruptcy. Any temporary liquidity support that might be provided is paid off the top. There is no guarantee of liabilities. All unsecured creditors are exposed to loss.

On the remote chance that there could be some remaining loss for the government—that has to be assessed against the industry. There is no way that taxpayers would pay—there are bells and whistles on this thing, and belts and suspenders. We pushed for that.

We actually wanted a pre-funded reserve. We wanted an assessment to actually provide a pool of liquidity in advance, so we wouldn't even have to borrow from the U.S. Treasury for even that temporary liquidity support. We didn't get that.

But nonetheless, even if there is temporary borrowing that is necessary, that gets paid off the top. In the unlikely event there would be losses after being paid off the top, that would be assessed against the industry.

Mr. CARNEY. You mentioned some things that management—some incentives management has to resolve it themselves.

Ms. BAIR. Yes, the boards are gone. The executive management is gone.

Mr. CARNEY. These are really strong, you know—

Ms. BAIR. It is quite harsh. Yes it is. And, there is the 2-year claw-back—a potential for a 2-year claw-back of compensation, too, for senior executives. So, yes. Which is why, again, I think a lot of the benefit is prophylactic as well. Managers, knowing what this process is now, don't have the option of going to a bailout. The fact that this process is there and will be the scenario if they fail is going to give them a strong incentive to go out, raise capital, and sell themselves if necessary.

Mr. CARNEY. The second question is really to follow up on my friend, Mr. Renacci's, question about the conflict between the CFPB, potentially, and the safety and soundness regulators. What is your view on that? And as it relates as well to the governing bodies that you discussed with my colleague from the other side?

Ms. BAIR. Right. I think there is a close intersection. And it will require a lot of collaboration with the new consumer head. There is a statutory requirement that the consumer agency consult with the bank regulators in writing rules.

Again, I think the fact that the consumer head would be on our board will help further that sensitivity and knowledge and awareness of the intersection of safety and soundness with consumer protection.

So I think it can work. Again, it is all about—

Mr. CARNEY. Do you have some reservations? You seem to express some.

Ms. BAIR. Not really, no. Early on when the Congress was considering this, we were sympathetic to a board approach. We have a board. I like boards. Even though it is more difficult for me, I am not a dictator. I have to go get my five votes.

The chairman of a committee has to do that. But I think it is a good process. Either way, though—you have the OCC with a single head—so you have both models in the financial regulatory sphere.

So, no, I wouldn't say I have reservations. I think there are arguments pro and con for either approach. But the statute provides an approach that we support and one we think we can work with.

Mr. CARNEY. So the kinds of things that the CFPB might be doing around consumer protections, do you see a big conflict with safety and soundness issues?

Ms. BAIR. No. There actually can be some safety and soundness advantages, particularly with regard to the ability of the consumer bureau to now examine and enforce consumer protection rules for non-banks. One of the things that put pressure and led to a lot of bad lending by insured banks was competitive pressure from the non-bank sector.

You had a lot of non-bank mortgage originators who really had no regulation whatsoever. They were selling these loans to the securitization trusts. They weren't retaining any of the risks of these loans which was really driving down lending standards.

Having a more robust enforcement mechanism for the non-banks I think will actually help level the competitive playing field and make sure we don't have competitive pressure on banks to lower their standards.

Mr. CARNEY. Thank you. I see my time has expired. Thank you for your service. I appreciate it.

Chairwoman CAPITO. Thank you.

I would like to recognize Mr. Canseco, from Texas, for 5 minutes for questioning.

Mr. CANSECO. Thank you, Madam Chairwoman.

Good morning, Madam Chairman.

Lehman Brothers, the FDIC's report on the possible orderly liquidation; the FDIC said that had the resolution authority granted to them under Dodd-Frank been in place in September of 2008, the estimated losses to Lehman's creditors would have only been 3 cents on every dollar.

However, officials at the Federal Reserve, including Chairman Bernanke, have stated that one of the primary reasons that the Fed did not step in to save Lehman was because the estimated losses were so large and Lehman did not have sufficient collateral to post to the Fed.

Chairman Bernanke stated in his testimony to the Financial Crisis Inquiry Commission, "There was not nearly enough collateral to provide enough liquidity to meet the run on Lehman. The company would fail anyway. And the Federal Reserve would be left holding the very illiquid collateral, a very large amount of it."

So my question to you is, the FDIC seems to think that there was significant value in Lehman while the Federal Reserve thought that the risk was too large to lend to it.

How could the FDIC and the Federal Reserve come to such different conclusions?

Ms. BAIR. I think a couple of things. First of all, the 97 cents on the dollar as the senior debt holder, that assumes that the sub-debt and equity is wiped out. So it is not all Lehman creditors. As you do with bankruptcy, you work your way up the capital stack with equity at the bottom, and sub-debt later.

Because of the significant equity and sub-debt cushions, we think that the senior bond holders would have taken very small haircuts. That is based on very aggressive assumptions about what the loss rates would have been on their bad assets.

I think there is a difference between what collateral was available to the Fed to lend, as well as the Fed's legal constraints against lending into a failing institution. That really drove Chairman Bernanke's comments.

But the value of available unencumbered assets shouldn't be confused with the broader franchise value of the institution and the ability of significant sub-debt and equity to absorb losses, which the Fed could not rely on because there was no resolution process, which we have now.

Mr. CANSECO. Was this difference of conclusions between the two agencies discussed when the Federal Reserve and the FDIC issued the proposed rule for living wills?

Ms. BAIR. Congressman, I don't think there really is a difference. I think Chairman Bernanke was talking about the availability of quality collateral—they have very high standards for collateral when they lend. And they actually lent well over $100 billion into the broker-dealer.

Because of the bankruptcy process, the derivative counterparties had the ability to pull all their collateral out—the Fed lent a lot already for liquidity needs and it was still a very disruptive process.

I don't think we are inconsistent in what we are saying. But we certainly, to your question about living wills, have closely collaborated on the living will rule. It is a joint proposal.

Mr. CANSECO. Going back to the Lehman bankruptcy, the FDIC called its past experience with orderly wind downs of financial institutions "instructive." The paper argues that the FDIC is readily equipped to handle the authority given it under Dodd-Frank because from 1995 through 2007, the agency was responsible for the orderly wind-down of 56 financial institutions.

But a closer examination begs questions as to just how ready the FDIC is to handle its new responsibilities. According to data from the FDIC's Web site, the total asset of those 56 financial institutions wound down from 1995 to 2007 was about $12.23 billion, or an average of $218 million per bank. Most of the banks were much smaller than that.

So Lehman Brothers had $639 billion in assets when it failed. This was the largest bankruptcy in American history. And Lehman's assets were 50 times greater than all the combined assets of the banks the FDIC shut down over a 12-year period.

What makes the FDIC think it has the resources available to wind down such a large institution?

Ms. BAIR. More recent history may better attest to our capabilities. We have moved about $650 billion in failed bank assets over the past 2½ years, since the beginning of 2008. WaMu, obviously, was over $300 billion and was resolved over a weekend in a process that would have been very similar to the process we would have used for Lehman.

We insure these banks. We understand them. And, Congressman, I get this question sometimes—people try to paint us as understanding only little banks. But, we insure these big banks. We, regrettably, participated in some of the bailouts of these very large banks. Nobody questioned our expertise or authority to do that.

So, I think we are quite prepared. I will match the expertise of my staff on capital markets, on derivatives, on complex financial structures against anybody at the Fed or the OCC or the Treasury. We have very smart people who do this for a living.

We really are the only agency in the world that has the long experience in resolving large and small financial institutions.

And others look to us. We are doing training in Europe and China. Others look to us for expertise as they are setting up their own resolution regimes.

Mr. CANSECO. I notice that my time is up. But I sure hope that the FDIC has changed its own personnel and operating structure for the benefit of our financial system.

Ms. BAIR. Congressman, I am very sensitive to this. We are designed to expand and contract very quickly. We also have reservoirs of contractor help, because our work is cyclical. And we are used to it.

We are not perfect. This is a challenge for us. But, I think certainly compared to the expertise shown in the bankruptcy process—you saw what happened with Lehman—this is a good approach. And I want to prove to you that it can work.

Mr. CANSECO. Thank you.

Chairwoman CAPITO. The gentlewoman from New York, Ms. Velazquez, for 5 minutes.

Ms. VELAZQUEZ. Thank you, Madam Chairwoman.

Thank you, Honorable Sheila Bair.

Last Congress, this committee held a hearing to examine community bankers' concern that regulators were being overly restrictive. How has the FDIC addressed these concerns to work with banks that want to increase small business lending?

And I am concerned, as the ranking member of the House Small Business Committee, we held a joint hearing with this committee to address the lack of access to affordable capital for small businesses. So I would like for you to comment on this.

Ms. BAIR. I think this has been a major impediment in the broader economic recovery. And, certainly, given your expertise with the small business sector, you know that much better than I do.

I think there are a variety of reasons. Risk aversion, perhaps, is part of it. But I think borrower demand is part of it, as well. Borrower demand is driven by a couple of different factors. One is, I think, uncertainty about how robust the economic recovery is. If they borrow money and commit capital to expand, or if we are in another downturn a year from now, I think this is the problem that is dampening borrower demand.

I also think because so much small business lending is collateralized by real estate, and real estate values have dropped so substantially, they don't have the collateral anymore to borrow against as they did pre-crisis.

We encourage lending. We focus on it. I was very disappointed when small business loan balances were down in the first quarter and even though C&I lending was up, small business lending was down. Commercial and industrial lending, the broader category, was up.

We are trying to strike a very strong balance. We want our banks to lend. We especially want them to lend to small businesses. But, I think they obviously need to find creditworthy borrowers to do that, and a lot of the creditworthy borrowers are still standing on the sidelines.

Ms. VELAZQUEZ. Okay.

The FDIC recently implemented the Dodd-Frank mandate to expand the deposit insurance assessment fee, which will result in community banks paying 30 percent less in premiums while large banks pay more. What effect on small business lending will the new assessment systems will have?

Ms. BAIR. I think if you are doing this for small banks, this is small business. I think it will help them. It will ease their assessment burden in a way that is quite consistent with our loss exposure based on the funding structures that larger institutions employ.

So I think it will certainly help them. To the extent the small banks do about 40 percent of the small business lending done by insured depository institutions, it should free up resources to help them in that regard.

Ms. VELAZQUEZ. Under the proposed rules for qualified residential mortgages, home buyers will have to put down 20 percent of the purchase price. As a Member who represents New York, we are very much concerned about this because it will have a significant potential impact in high-cost areas like New York City.

Should QRM requirements be based on local market conditions instead of an across-the-board increase?

Ms. BAIR. No. The QRMs are meant to be an exception to the general rule that if you are issuing a securitization, you need to retain 5 percent of the risk.

And I think that 5 percent risk retention is important. The fact that securitizers did not have skin in the game with these loans, by and large, or meaningful skin in the game, led to a lot of the lax underwriting and abuses that we saw in the mortgage market.

So the 5 percent risk retention, in my view, should be the rule. The QRM is the exception. As such, it is meant to be a narrow niche part of the market, not what the more broadly available standards will be.

If you retain 5 percent of the risk or if you retain all of it with a portfolio loan, you have broad flexibility to underwrite the loan within prudential standards. So it only applies to what I think is going to be a small slice of the market.

Ms. VELAZQUEZ. Have you looked at any other alternatives to a 20 percent downpayment that could reduce the number of defaults in the future?

Ms. BAIR. The staff of all the agencies looked at this very carefully. Loan to value ratios are a significant driver of whether a loan defaults and what the losses are when the loan does default. And so no, we are out for comment on exactly that question, among others. And I anticipate this is a huge issue. We will get a lot of comments on it.

But, the analytical work that the staff did indicates that a 20 percent downpayment is a really strong indicator of credit quality.

Ms. VELAZQUEZ. But you understand my point that it is not fair—

Ms. BAIR. I do understand your point.

Ms. VELAZQUEZ. —for places like Massachusetts—

Ms. BAIR. I think for low- and moderate-income families, this is a huge issue. And I think, what is a meaningful downpayment for a lower-income person can be very different from what a meaningful downpayment is for those with other means.

The question is, how do we meet those needs?

And I think, again, my view is that with the 5 percent risk retention, you will have a robust market that will have prudent but more flexible underwriting standards to meet that swath. And, of course, we have the continuation of FHA programs.

Ms. VELAZQUEZ. Thank you.

Chairwoman CAPITO. Thank you.

I would like to recognize Mr. Royce, from California, for 5 minutes for questioning.

Mr. ROYCE. Thank you, Madam Chairwoman.

Chairman Bair, let me first say that I think a lot of my colleagues here have been pretty impressed over time with the straightforward way that you respond to questions. It is not always the rule around here.

Second, let me just say that I have laid out for you the arguments that I think are made by the studies that there is this 88 basis point advantage, this presumption that is out there—

Ms. BAIR. There is.

Mr. ROYCE. —in terms of the systemically significant firms.

And I think that the studies of the FDIC show the same relative—

Ms. BAIR. They do, absolutely.

Mr. ROYCE. —magnitude.

So to go back to the markup or the conference committee, I put forward several amendments to try to overcome this tendency. One in particular required the FDIC to estimate at the outset of the resolution process what creditors would have received in bankruptcy and limit payment to bankruptcy less a haircut of 20 percent, which would act as sort of an insurance mechanism against future write-downs.

If following the resolution process under that scheme there were additional funds, then the FDIC would have the authority to pay back all or part of that 20 percent premium. But I thought that might solve out in the market this presumption.

Let me go through the two arguments I made during the conference committee. We didn't carry this argument, but I think it still holds true.

First, there is this strong presumption that the regulators are going to err on the side of bailouts, especially for the most interconnected and largest firms that will likely get preferential treatment through the resolution process.

With this understanding, creditors—and we are talking especially here about short-term creditors. Those creditors, by the way, are going to be considered essential under the FDIC's proposed rule, right?

So they are going to know that lending to these large complex financial firms, subject to the resolution authority, is basically risk-free or it is very close to that, because if these firms fail, creditors are going to be made immediately whole or very close to whole.

And as a result, these firms are going to be able to borrow more cheaply. They are going to grow even larger. They are going to become more significant, systemically significant. And that is going to compound the too-big-to-fail problem.

Now, there is a second problem also that arises. And that, to go back to it again, is the claw-back provision. Once that money is out the door to creditors, it is going to be very difficult to recover. And I think that is, again, why you see this basis point difference, bankruptcy over here for these firms versus resolution authority for the large one.

It is not hard to foresee a situation where a recently bailed-out creditor strongly argues that handing over these sums may jeopardize their unstable firm. And this is an argument that regulators, having just bailed out these same creditors in the name of preserving financial stability, may find very difficult to resist.

Additionally, there is no guarantee that a given creditor will be able to pay back the difference between the advances and what they would have received in bankruptcy under the Bankruptcy Code and under this mandate.

So, I am just going to go to the Dallas Fed President, Richard Fisher, who recently said this about these arguments that I have made in the past: "A credible big bank resolution process that imposes creditor losses will be difficult to enforce, especially when regulators are explicitly directed to mitigate disruptions to the financial system, as they are in the reform bill."

So I understand that you believe regulators need broad authority to handle a crisis, but I think that the unintended consequences here have to be considered. And if we were to look to tightening the language while working with the resolution authority mechanism, are there steps we can take to minimize the potential for abuse down the road? And the argument, the amendment I made earlier, does that hold water with you? Is there a way to get at that?

Ms. BAIR. So, a couple of things.

We are all for tightening as much as we can. We do not want bailouts. We want market discipline back.

As deposit insurer, there is obviously moral hazard associated with providing deposit insurance for these entities that have insured banks. So we need market discipline to complement the regulatory process as a weapon against excessive risk-taking.

So whatever we can do to tamp this down, believe me, we will work with you.

We are trying to do a lot of this through regulation. We put a rule out that basically said that if you hold debt with a term over a year, forget it, there will never be any differentiation. Please do not interpret that to mean that if you hold debt with a term less than a year, you are going to get it, because you are not. Short-term creditors are very much subject to loss absorption.

I think one of the advantages of the government being able to provide liquidity is, for instance, if you had unsecured commercial paper, you could haircut that. Even though you would lose the funding, you replace it with government funding, and those creditors absorb the losses.

The presumption for the short-term creditors should be that they are taking losses, too. Again, the only time I can see that wouldn't happen is if the acquirer wanted to maintain those customer relations.

And you might then find that, for instance, with a derivatives book. If they want to buy the failed institution's derivatives book, maybe we don't need to impose losses—even if there are some counterparties that are unsecured or undercollateralized. We find that now with uninsured deposits.

But that is going to be a mathematical determination. Whatever is going to maximize recoveries, that is what we will do.

So I do think we want it narrow. The statute does have some significant limitations. We are trying to tighten those even more with regulation. I am happy to look at language and talk with you about this further.

Believe me, there is no entity more so than the FDIC that wants to end too-big-to-fail.

Mr. ROYCE. Thank you, Chairman Bair.

Chairwoman CAPITO. Thank you.

Mr. ROYCE. Thank you, Madam Chairwoman.

Chairwoman CAPITO. Mr. McHenry, from North Carolina, for 5 minutes.

Mr. MCHENRY. I thank the Chair.

And, Chairman Bair, thank you so much for being here. I echo Mr. Royce's comments. I appreciate your forthrightness. I know you have testified many times during your government service. And we thank you for your service.

I wanted to ask you, based on something you had in your written statement, the Dodd-Frank Act, you said, "if properly implemented, will not only reduce the likelihood of future crises, but will provide effective tools to address large company failures when they do occur without resorting to taxpayer-supported bailouts or damaging the financial system."

I think we would like to believe that we won't have future taxpayer bailouts. Many of us have concerns that, as constructed, it still leaves that door open. And I think that is Mr. Royce's point.

But we look at the breakneck pace of rulemaking, and you see regulators in many respects overwhelmed with the volume and the pace.

Ms. BAIR. Right.

Mr. MCHENRY. Do you have concerns about the pace and the quality of the rulemaking?

Ms. BAIR. I think from the FDIC's perspective, we are comfortable with it. We did not have the huge number of rulemakings that the SEC and the CFTC did. So I think we feel like we are proceeding at a reasonable pace. And for anything major, we are giving 60-day comment periods.

And so I think, at least from the FDIC's perspective, we are comfortable with implementation so far.

I do understand, especially in the derivatives area, some of the market regulation issues. There is a lot being done there at once. Frankly, there were a lot of problems, especially with the derivatives oversight.

So I think the rulemaking needs to continue. Whether perhaps some sequencing could be done, that might have some merit. But, on the other hand, it is important to continue to proceed. And I do think the market needs to understand that at some point these rules will be in place.

And I think, frankly, they need that to adapt as well. Markets can be very resilient. Once they know what the rules are, our financial sector is pretty good at complying with them and figuring out how to do it.

But, some sequencing might well have some merit.

Mr. MCHENRY. What about harmonization?

Ms. BAIR. I think we are doing a pretty good job there, even on the international front. I know you hear different things from some. The FSOC is still getting its sea legs, but I think it is forcing all of us to get together and talk regularly and have our staffs talk regularly.

And so I think there has been a good deal of harmonization, including on the international front. I think we have made a lot of progress in harmonizing international capital standards. In addition to resolution authority, I can't overemphasize the need for strong capital buffers.

So I think there has been some good work on harmonization, and we should continue to focus on that. But I know there is concern about treatment of commercial end users in the derivatives rules. And we are talking with each other about that.

I do think, though, it may be that at some times you want some differentiation among end users. For instance, you are probably going to want more risk aversion with an insured bank than you are with an entity that is completely outside the safety net.

So there may be some reasons for differentiation. But I think we are working hard at harmonization.

Mr. MCHENRY. You mentioned two things that are of interest, this international harmonization—

Ms. BAIR. Right.

Mr. MCHENRY. —Basel III, ensuring sort of an international level playing field.

Ms. BAIR. Right.

Mr. MCHENRY. You also mentioned capital standards. I hear a lot from my community banks about their concern about—

Ms. BAIR. Right.

Mr. MCHENRY. —raising capital standards. And I understand there is a balance here. We want to make sure that we have safety and soundness. But we also want to ensure lending and economic recovery.

Are you wrestling with that? Do you believe that is—

Ms. BAIR. I—

Mr. MCHENRY. Do you weigh that when you are going through this process?

Ms. BAIR. You do need to weigh it. But I think the primary focus has been with large institutions' capital requirement—getting that sector to deleverage.

And I think, back to the earlier point Congressman Royce was making about funding differentials, if you have higher capital standards, since capital is more expensive than debt, that will not only provide a better buffer for loss absorption, but it will help differentiate funding costs, or reduce the differentiation in funding costs.

So I think the capital discussions have been targeted primarily at the larger institutions. There have been a few issues with smaller institutions' holding companies, regarding the quality of capital.

A lot of the holding companies—not the banks; it is not allowed for banks—use something called trust preferred securities that ended up to not have loss-absorbing capacity in the crisis. And I know there have been some concerns there. That is really the only capital issue relating to small institutions.

Mr. MCHENRY. My time is short, but I want to ask you about the QRM. I think that private mortgage insurance should be a part of this to ensure a lower downpayment and an insured product that should be a part of the QRM. Can you comment on that?

Ms. BAIR. Again, that is out for comment. My only caution on that—I started worrying when the government was relying on credit rating agencies, for instance.

And so then we say, we will have better standards, review standards, if there is a private sector mortgage insurer. We need to know, who are the mortgage insurers? How well are they regulated? How good are their resources if we get into a down cycle?

I think those are the things really to think about. And mortgage insurance can be a good product, but do we want demand for it driven by markets or driven by regulations, giving them an extra penny, frankly, for having a lower downpayment.

I know you care about the markets the way I do. I think that may be the trade-off that we should think hard about.

Mr. MCHENRY. Thank you.

Chairwoman CAPITO. Thank you.

Mr. Duffy for 5 minutes.

Mr. DUFFY. Thank you, Madam Chairwoman.

Good morning, Chairman Bair.

Was it you who said that you thought that consumer protection and safety and soundness were two issues on the same side of the coin?

Ms. BAIR. Right. Yes, it was me.

Mr. DUFFY. Why is that?

Ms. BAIR. I think because consumer abuses generally will end up costing banks money. Mortgages are the prime example for any financial institution, not just banks. Mortgages are a prime example.

Banks and other entities were making loans that the consumers couldn't afford—and more of it was done outside of the banks. Eventually, the loans defaulted and a lot of losses occurred. So it didn't help the consumer. It didn't help the financial institution either.

Mr. DUFFY. And so when we see these two going together, and we want to make sure our consumers are protected and treated fairly, and they are engaging in transactions that are transparent. And we also want banks to be profitable, and make sure that they are not going under.

Do you have a concern when we separate consumer protection from safety and soundness? I think it was Mr. Renacci who commented that in the mission statement of the CFPB, there is no reference to safety and soundness.

Ms. BAIR. Right.

Mr. DUFFY. Does that give you some pause or some concern? Or are you okay with the oversight that comes from FSOC? It has been a political issue.

Ms. BAIR. Right.

Mr. DUFFY. And I don't mean—I don't want to—

Ms. BAIR. No, I know. Yes, we support the consumer agency. There were different iterations of its structure early on in the process, but we support the final outcome.

We think it is a positive thing, actually, that the consumer bureau will be on our board, because that will provide additional interaction to make sure that safety and soundness and consumer protection are considered together.

That will work both ways, too, I think.

Mr. DUFFY. But it is not on the CFPB.

Ms. BAIR. I am sorry?

Mr. DUFFY. The CFPB doesn't have that consideration for safety and soundness—

Ms. BAIR. Right. We are all for reciprocity.

But, given that, we are fine with how the Dodd-Frank Act came out. And I do think it is important to understand, for the rule-writing piece of this, that has always been separate from the examination and enforcement process.

Mr. DUFFY. But if you look at the—I know you have talked about reciprocity. And you really don't have reciprocity, but for your FSOC, right, to review the rules that are coming from the CFPB.

Ms. BAIR. Right.

Mr. DUFFY. And one of my concerns is that the standard is so high. You need 7 out of 10 votes—

Ms. BAIR. Right.

Mr. DUFFY. —to overturn a rule from the CFPB. And the Director is one of the voting members. So it is really seven out of nine.

Ms. BAIR. Right.

Mr. DUFFY. It is incredibly high. And the risk there, it has to be systemic risk. We are talking about playing Russian roulette with our economy.

Ms. BAIR. Right.

Mr. DUFFY. I introduced a bill that would reduce the requirement to just a simple majority, and take the director off, a 5–4 majority of some pretty significant folks who sit on FSOC.

Ms. BAIR. Right.

Mr. DUFFY. And we talked about reducing the standard that if the rule was inconsistent with the safe and sound operation of United States financial institutions, it could be overturned.

Do you think that is reasonable that we have a little different standard in how we can coordinate consumer protection with safety and soundness?

Ms. BAIR. There are a lot of things about the Dodd-Frank Act that all of us would have written differently. At the end of the day, it was a compromise product.

But we can support the final product. I think it can work.

Mr. DUFFY. But can we improve upon it?

Ms. BAIR. Sorry?

Mr. DUFFY. Can we improve upon it?

Ms. BAIR. I fear you are going to draw me into a situation where—

Mr. DUFFY. I will be gentle with you.

Quickly, I am from a more rural district, with all community banks and credit unions. We don't have big Wall Street banks in my district.

And I hear this nonstop from my local bankers. They are talking about how they are crushed by so many rules and so many regulations, and the impact that it has on them, as they say, "Listen, we don't have the ability to diversify this cost over a large base. And you make me hire a lawyer or a compliance officer—"

Ms. BAIR. Yes.

Mr. DUFFY. —"and our costs go up. It makes it more difficult for us to compete with bigger banks." Or sometimes they will go on, "We can't even stay in the market anymore." And that is the lifeblood of our economy.

Ms. BAIR. Right.

Mr. DUFFY. And this is nonstop coming from them. I don't know if you are hearing the same thing or trying to figure out how can we still be safe—

Ms. BAIR. Right.

Mr. DUFFY. —but still have rules that allow our local bankers, who didn't have anything to do with the financial crisis, to do business.

Ms. BAIR. I think they have a point. I think every time you have a new rule or a new compliance requirement for safety and soundness or a consumer requirement, the incremental costs of doing that are going to be significantly higher than they are for a large institution.

We can and should do a better job of taking that into account.

I have said this, and I will say it again; all the problems we have had with servicing, and we have had a lot of them, but as near as we can tell, these are problems of scale that affect the very large servicers. So, we should have two tiers of regulation.

If there are going to be a lot of new rules for servicing, we don't see a basis for layering all of that on the smaller banks as well.

From a diversification standpoint, smaller banks have really been relegated to specialty commercial real estate lenders.

We would love to see them diversify their balance sheets, start doing more mortgages again or car loans or whatever.

But the regulatory barriers to getting back into those lines of business may be an impediment.

And servicing is one example. I would love to see community banks start making more mortgages again. I think they do a better job with the customer.

So I am very sensitive to this. And I think we should look at more structured, two-tiered regulation, because the issues are completely different

Mr. DUFFY. So that is something you are looking at?

Ms. BAIR. Absolutely. And we have an advisory committee on community banking. They have given us a number of good ideas for making regulations more effective and streamlined when it comes to smaller banks.

When we do a FIL, we already, at the very top, say whether this even applies to community banks or not. I require the staff to do an analysis of community bank impact and why we need this to apply to community banks.

We are looking at more automation, too, in the forms banks have to fill out, putting those all on a system we have called FDICconnect. So instead of doing a new form every year, they can go in and update the old one.

So we are trying on a number of fronts to deal with this.

Mr. DUFFY. And I appreciate that, because, again, we hear that from the community banks and the credit unions.

Ms. BAIR. Yes.

Mr. DUFFY. To get them to agree on some issues, it is pretty impressive. That interchange are two things that they will talk about. And I appreciate you looking at that. Thank you.

And I yield back.

Chairwoman CAPITO. Thank you.

The Chairman has consented to go to a second round of questioning, if that is—you were consented upon.

And we are still going to be called for votes here in the next probably 15 to 20 minutes.

So I will go ahead and start the second round, and I appreciate you spending the time with us.

We had a recent hearing and we also had a discussion in the markup for the bill for the CFPB on the differences or the interchangeability or not of safety and soundness and profitability for banks.

One witness said that safety and soundness is used as a code word by the institutions as profitability. And so by trying to reshape or reform maybe in the CFPB or something and using safety and soundness, we were being accused of protecting the profits of an institution.

And while a safe and sound bank may realize a profit, and I think that is a good thing, a profitable bank is not necessarily safe or sound.

Could you comment on this assertion in the interchangeability of that and how you see those two different phrases differently?

Ms. BAIR. I do think they are—and I have said this throughout my career—two sides of the same coin. I think if a product does not serve consumers or your customers long-term benefit, this is going to be a product that eventually loses money for you and could result in significant litigation exposure as well.

We certainly saw that with all the lax funding on mortgages. We are seeing a lot of additional litigation on overdraft protection. So I think having some sensitivity of good business practices for the consumer side is important. Products that don't serve consumer needs are eventually going to lose money.

They will probably default, or the customers will start abusing them, or they could result in litigation exposure.

On the other hand, since these are insured banks, you need to have a full analysis of changes, whether it is safety and soundness or consumer protection, of how that is going to impact the financial health of the institution, I would say, not the profitability.

And so I think both factors need to be weighed. But again, I think with the consumer bureau needing to consult with the bank regulators and also serving on our board, I think there are ways now built into Dodd-Frank to facilitate that kind of communication and consideration of those factors.

Chairwoman CAPITO. So, safe and sound consumer products will in the long run, in your opinion, and I agree with this, bring about a profitability for the institution?

Ms. BAIR. Sustainable profitability.

Chairwoman CAPITO. Yes. And I think that while there is a distinction between safety and soundness and profitability, I think that, as you said, the unsafe product or the non-well research product or the one that takes it too far is eventually going to be a nonprofitable instrument for the institution.

My final question, we have talked a little bit about a commission—and I don't want to draw you into a big political argument on that. But in looking at your own commission or corporation, you serve as the chair. The vice chair—you have a vice chair. You have an OCC, who is acting. We have no appointment there.

Ms. BAIR. Right.

Chairwoman CAPITO. We have the OCS, which is going to be grandfathered out, or however, in July, no longer exist on July 21st.

We have the CPFB chair, but we don't have one. And I think I wouldn't be stretching the imagination to say it is going to have to be—it can't be a Senate-confirmed—it would be highly unlikely that it would be Senate-confirmed because of the timing.

And then we have your independent director who has also is on an expired term.

This really concerns me. We are losing your expertise and longevity and history. And I know you are not really going far, but in all fairness to you and to the Corporation, this needs to live on.

Ms. BAIR. Right.

Chairwoman CAPITO. What are we going to do about it? I guess for me, it is a political statement. I say to the President, get these appointments out. Get them Senate-confirmed. Let us have some stability here. Or we are going to end up in—not a la la land kind of situation, but an ever-changing transitional situation where it causes me concern.

Do you have concerns about that?

Ms. BAIR. I have profound concerns. I am frustrated that there is not greater urgency and prioritization of this issue on the part of the Administration, as well as on the part of the Senate.

And I am very worried about my agency. We could go down to three or two board members after I leave.

There are some nominations in process. But the names are not up yet. There are still some vacancies where, as far as I know, no candidates have been vetted.

And so thank you for flagging that, because I think that this is very urgent, when the financial system is healing, but it is not out of the woods yet. There are a lot of unknown factors out there. We need strong people in these jobs. And there are still reforms to be implemented in a commonsense, effective way.

And you are right, having a two-member or three-member board making these kinds of decisions is not a good thing.

Chairwoman CAPITO. Mrs. Maloney?

Mrs. MALONEY. Thank you.

And I thank you for raising your concern on having a Director of the CFPB in place on July 21st. This is a grave concern to me also.

The difficulty is that 44 Senators have signed a letter saying that they will not confirm anyone unless bills that they want, that passed out of this committee, and other policy positions that they want such as moving the funding of the CFPB to the political appropriations process, which if we look at what happened to the SEC and the CFTC, they were basically cut, making it more difficult for them to do their job.

So in other words, politicizing the funding of it. They said that they would not confirm anyone. I believe this is a tremendous abuse of the confirmation process, basically holding the entire Congress hostage, that you have to write legislation like we want.

In this case, not what I am saying, but roughly five or six major editorial boards from the United States have said in their editorials, and good government groups and others have said, to remove it from politics or the Democratic and Republican perspective, that these bills would gut, dismantle, disrupt, and destroy the CFPB, the Consumer Financial Protection Agency.

So this is a huge problem. They basically have given the President no choice but to make an interim appointment because they are saying they will have to gut the entire agency and make it basically a non-performing, toothless situation.

So I believe the CFPB has a role to play in protecting consumers. Too often, consumers' concerns were a second thought, a third thought, or not thought about at all. And we maybe would have been able to prevent the subprime crisis. I can't imagine any consumer agency approving products that the degree of probability that they would end up on the street or hurting the family and the overall finances of our country were greater than the mortgage working them.

The joke in New York during this time was if you can't afford your rent, go out and buy a house. It was so easy to get a mortgage, a faulty mortgage, that became clogged in the system and helped bring down the financial crisis that we had.

So we have a disagreement, a basic choice. It is a basic disagreement between the Republican Party and the Democratic Party. The Democratic Party supports the CFPB. The Republican Party has come forward with a series of bills that would dismantle, destroy, and gut the CFPB.

And you have Republican Senators saying, "We will not confirm anyone unless you do exactly what we want," using it, taking hostage the entire legislative process to get what they want.

They have forced the President, really with no other choice, since he supports the CFPB. And I would say the overwhelming majority of the American people do. The American people would like someone looking at their loans, at their credit cards, at their student loans, and making sure that they are fair; not giving anyone an advantage, but making sure that there is a fair playing field that consumers can understand what the terms are; that they are in plain print out there for everyone to understand.

So we have a basic disagreement between the Republican and Democratic Parties.

But I do want to address my questions to our distinguished guest today in the area in which she has played such a fundamental role. I would like to go back to the too-big-to-fail, which is a huge issue. And I understand it is the next focus of the hearings we will be having on this committee.

Some have argued repeatedly that the financial reform law, particularly the Orderly Liquidation Authority, perpetuates, rather than eliminates, too-big-to-fail. So I would like to ask you, what is your assessment of the allegation that the Authority perpetuates too-big-to-fail?

Ms. BAIR. I do not believe it in any way perpetuates too-big-to-fail. Too-big-to-fail was with us pre-crisis. It was reinforced by the bailouts. And we need to end too-big-to-fail now.

And the Dodd-Frank Act gives us the tools to end it. It quite specifically bans the bailouts in language that we supported and wanted in.

So I think it is there. The tools are there. The clear legislative intent is there. And I think, as I indicated in my testimony, implemented effectively, it will end too-big-to-fail.

Mrs. MALONEY. My final question, and my time is running out, is which parts of the financial reform law do you think are the most critical to ending too-big-to-fail?

Ms. BAIR. I think Title I and Title II, which gives us the Orderly Liquidation Authority powers for systemic non-banks. We already have it for banks. Title I is important, which requires the Fed to impose higher prudential standards and particular capital requirements on larger entities, as well as requires, jointly with the FDIC, living wills or resolution plans where they must demonstrate that they are resolvable.

Mrs. MALONEY. I thank you for your testimony today. I thank you for your distinguished service to our country.

And I thank you for your really nonpartisan response to questions and policies. I think you have done a magnificent job for our country.

Thank you.

Chairwoman CAPITO. Thank you.

Mr. Renacci, from Ohio?

Mr. RENACCI. Thank you, Madam Chairwoman, again.

And Chairman Bair, I do want to thank you again for being here, and your testimony, and your service to our country also.

The one question I asked before, several people have already asked you, and I heard your answer. So I am going to move to another topic. And it regards the Orderly Liquidation Authority. I know several times in your testimony today, you have talked about how you believe—or at least the impression I got was that you believe the FDIC's authority over liquidation is better than bankruptcy.

Ms. BAIR. Yes.

Mr. RENACCI. There are a number of—

Ms. BAIR. —for financial institutions.

Mr. RENACCI. —for financial institutions.

There are a number of people in the bankruptcy community who believe that if the bankruptcy laws were changed, that bankruptcy would be better.

Ms. BAIR. Right.

Mr. RENACCI. And I know a lot of it deals with derivatives and making sure there is some timing on derivatives.

Can you give me some ideas or thoughts where you might believe that bankruptcy would be better? Because one of the issues of bankruptcies, of course, is that we are looking out for the creditors as we wind things down. So I would like to hear your thoughts on some things that could be changed in the Bankruptcy Code that would actually make bankruptcy better.

Ms. BAIR. I think you are right. How derivatives are treated is really very important. First of all, we would love to work with this committee and the Judiciary Committee on this. We deal a lot with bankruptcy courts because banks that we resolve are frequently part of holding company structures that go into bankruptcy. So we are quite familiar with some of the strengths and weaknesses of the process.

I think how bankruptcy treats derivatives is a big problem. And having the ability to require counterparties to continue to perform on their derivatives contracts is important. Now they have the ability to terminate their contract and claim their collateral, which can be quite disruptive and was a major factor in the disruptions that surfaced with Lehman.

So we would love to work with the Congress to make bankruptcy work better. For most of these financials companies—for instance CIT, we were opposed to any kind of bailout assistance for CIT. We didn't think they were systemic. They weren't. They went into a bankruptcy process.

It was just fine. It was financial. They relied on a lot of short-term funding through commercial paper, but they were the size where their bankruptcy was not systemic. And bankruptcy worked just fine. And I think there are ways to make bankruptcy work even better.

For the larger entities, though, I think there will be a couple of things that we can do that bankruptcy courts will never be able to do. First, we will be able to have a continuing on-site presence with these entities. We will be able to plan.

We will have ongoing access to information about their counterparty exposures and the concentration of their overseas operations. The bankruptcy court is just never going to be able to do that.

Similarly, we will be able to pre-plan and work with the international regulatory community, as an institution becomes more troubled, to find and identify any potential obstacles to resolving our domestic entity if they have foreign operations.

We do that now. We resolved banks with international operations.

We had a West Coast bank that owned branches through a subsidiary in China and Hong Kong. Several months in advance, we contacted the regulatory authorities there. We identified what we needed to do to make sure there was a smooth sale in our receivership process.

And we did. We were able to keep the branches and subsidiary in Asia open. We got the regulatory approvals for the new buyer to take the failed bank.

So it is hard to see how the bankruptcy court could ever engage in that kind of bilateral international coordination in the event of a failure, or be involved in pre-planning.

Finally, we can provide immediate liquidity support, which can be very important to maintaining franchise value. They have debtor-in-possession financing mechanisms in bankruptcy, but generally those cannot be done immediately the way liquidity support can be provided by the FDIC.

Mr. RENACCI. Thank you.

I yield back.

Chairwoman CAPITO. I am going to take the liberty and ask a question before I go to Mr. Carney, real quick, to piggyback on his question.

When you say you can provide immediate liquidity support, is that through the ability to go to the Treasury?

Ms. BAIR. That is. Under the bill, yes. For banks, we have the Deposit Insurance Fund that we use. But yes, for non-banks, it would be through the credit with Treasury. Yes.

Chairwoman CAPITO. And I think that is where the rub is, really, in terms of the perception. Because if you—

Ms. BAIR. I think that is right.

Chairwoman CAPITO. —if you can go to the Treasury, you are going to the taxpayer.

Ms. BAIR. Right.

Chairwoman CAPITO. And can you help with that distinction?

Ms. BAIR. Again, we wanted a pre-funded reserve, and that passed the House, but didn't pass the Senate. But I do think it is very important to emphasize that any funds that are provided through that Treasury line are paid back and have priority over everything else. As assets are sold, they are paid off the top.

I can't believe there would ever be any losses on that because you are not guaranteeing any liabilities for the non-bank institutions. So whatever assets are sold, those recoveries go to Treasury first.

And if in the unlikely event there would be losses, there would be an assessment on the industry, just the way we assess now for deposit insurance.

So I really think there are a lot of safeguards against taxpayers ever taking exposure on this. And I would say in turn, the fact that the industry would have to pay for any losses if that would occur, in and of itself will create industry pressure against any creditor differentiation, because they will know that if the receiver—we would never do this anyway—but if the receiver started trying to show favoritism, those losses would be assessed against the industry. And there will be a lot of industry pressure not to do that.

Chairwoman CAPITO. Mr. Carney, from Delaware.

Mr. CARNEY. Thank you, Madam Chairwoman. I am happy to yield any time you might need.

Chairman Bair, thank you again. I have been really enjoying the hearing this morning. And I want to reiterate the comments that my colleagues have made on both sides of the aisle about your candor and straightforward answers. We don't always get that.

And I think it has a positive effect on the Members and the questions they ask, by the way, as well.

You said a minute ago that you thought the financial system was healing, but not out of the woods yet. Could you expand a little bit on that?

Ms. BAIR. Yes. I think they are still working some troubles out.

Loan volume is down. And, again, I think there may too much risk aversion with some banks, but I think there is also a lack of borrower demand. And banks need to make loans to make money.

That is what they are supposed to be doing with their funds, and that is what they need to do to make money.

I think, longer term, as I have said in testimony and as I said in an op-ed last November, I think we are worried about the fiscal situation. We are in a very low-interest-rate environment and have been for some period of time.

That means there are more low-interest assets on banks' balance sheets. And even though the maturities have been shortening, obviously banks are heavily exposed to interest-rate volatility because, particularly, their liabilities are shorter than their assets.

So I think anything that would undermine confidence in the fiscal strength of the United States Government could have an adverse, potentially volatile impact on interest rates.

And so we are very much worried about that and hope very much that these discussions can produce a long-term deficit reduction plan.

Also, as I mentioned in my testimony, we are not out of the woods with the housing market yet, either.

Mr. CARNEY. Yes, that was my next, kind of, line of questioning. You said that we need to get mortgages—mortgage lending going on. What are the barriers there?

I hear, as I said a minute ago, from my bankers and from borrowers that the regulators are tightening down, not allowing them to make those loans.

Ms. BAIR. Actually, I think I would put more of a priority on business lending and small business lending. I think certainly mortgages and housing is an important part of our economy, but

I think we need to accept, going forward, it will be a smaller part of our economy—

Mr. CARNEY. Right.

Ms. BAIR. —and probably needs to be. It got bloated and overheated. But I do think ultimately, there needs to be a GSE exit strategy. We know that model didn't work. And I think—

Mr. CARNEY. Do you have a view on what model might work?

Ms. BAIR. I think what we have said is that it is really outside my portfolio to—

Mr. CARNEY. That is okay. There are just a few of us here now.

Ms. BAIR. I will say this. I think it could go one way or the other. Regarding this hybrid model where you had a private for-profit shareholder-return-driven entity with an implied government backstop—providing this government support was absolutely the wrong model. What you got was the privatization of gains and the socialization of losses.

So going forward, I would say if you are going to continue to have government support, make it explicit; charge for it up front, the way we do at the FDIC. Make sure it is actuarially sound, in terms of what is being charged for the credit support. And make that explicit.

These implicit backstops—

Mr. CARNEY. Explicit and narrower?

Ms. BAIR. Explicit the way the FDIC charges insurance premiums for deposit insurance. If you are going to be guaranteeing mortgages, have the government determine the amount and charge a guarantee fee that accurately reflects risk. Yes. Or get out, one way or the other.

Mr. CARNEY. And so, what about—there was some back-and-forth about lending standards.

Ms. BAIR. Right.

Mr. CARNEY. What is your view of that? Twenty percent is a huge—

Ms. BAIR. Again, Congressman—

Mr. CARNEY. I don't see how that works.

Ms. BAIR. That is supposed to be the exception, not the rule.

There are mortgages out there with 20 percent downpayments, but that is meant to be a niche exception to the general rule that if you are going to securitize mortgages, you need to retain 5 percent of the risk.

So the QRM standard is a way to get around the 5 percent risk retention. If you retain 5 percent risk, you have a lot of flexibility on the underwriting side.

Mr. CARNEY. Okay.

What sounds reasonable to you, in terms of the downpayment or—

Ms. BAIR. I think it is a combination of factors. Clearly, with a borrower with a strong credit history, with a low debt-to-income, there may be other flexibilities that you can provide. And we provide that with banks now, with portfolio lending.

I think you need to have some downpayment. I don't want to—

Mr. CARNEY. Let me squeeze one more question in. I only have a short amount of time.

Ms. BAIR. Sure.

Mr. CARNEY. It is about credit agencies. You mentioned credit agencies. Do you have a view of what we should be doing there?

Ms. BAIR. I think that one thing we are doing is getting rid of all references to credit rating agency ratings in our regulation. That is required by the Dodd-Frank Act. Pre-Dodd-Frank, we had already started telling banks that they needed to do their own independent analysis of the creditworthiness of the securities they invest in. They can't rely just on the ratings.

We used to use ratings for our deposit insurance assessments. We have gotten rid of that. So I think that has been in process for some time.

If you are not using credit ratings, what are you going to replace them with?

And so, that is really the hard question. And I don't think we have figured that out yet.

Mr. CARNEY. Thanks very much.

Ms. BAIR. Sure.

Chairwoman CAPITO. Thank you. This concludes our hearing. The Chair notes that some members may have additional questions for this witness which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to this witness and to place her responses in the record.

Again, thank you so much—

Ms. BAIR. Thank you.

Chairwoman CAPITO. —for, I think, a very productive hearing today. Good luck to you. And we appreciate, again, your great service to our country.

This hearing is adjourned.

[Whereupon, at 11:41 a.m., the hearing was adjourned.]

A P P E N D I X

May 26, 2011

EMBARGOED UNTIL DELIVERY

STATEMENT OF

SHEILA C. BAIR
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

FDIC OVERSIGHT: EXAMINING AND EVALUATING THE ROLE OF THE REGULATOR DURING THE FINANCIAL CRISIS AND TODAY

before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

May 26, 2011
2128 Rayburn House Office Building

Chairman Capito, thank you for the opportunity to testify today on the state of the banking industry and the Federal Deposit Insurance Corporation, and on future challenges to economic and financial stability.

Shortly after taking the oath as FDIC Chairman almost five years ago, I came to realize that we would face significant challenges in a number of areas. Although the FDIC was still in the midst of a two-and-a-half year period without a failed institution, the longest such period in our history, there were signs that not all was well with the banking industry. Predatory lending practices and unsuitable mortgage products, which were already an area of focus for me at the Treasury Department when I served as Assistant Secretary for Financial Institutions in 2001 and 2002, became even more prevalent as the decade progressed. Rising concentration in the banking industry was leading to the emergence of large, complex organizations that encompassed bank subsidiaries, special-purpose vehicles, and nonbank affiliates, while a greater share of financial activity was migrating to nonbank financial companies. Not only did these non-bank affiliates and financial companies exist largely outside of the prudential supervision and capital requirements that apply to federally insured depository institutions in the U.S., but they were also not subject to the FDIC's process for resolving failed insured financial institutions through receivership. Meanwhile, many small and mid-sized banking institutions had, over time, accumulated large concentrations of loans backed by commercial real estate and construction projects that were vulnerable to a weakening of U.S. real estate markets following a record boom in home prices.

Despite the warning signs, few at the time foresaw the extent of the emerging threat to our financial stability—a threat that was realized in the fall of 2008 when we experienced the worst financial crisis since the 1930s. While the emergency policy measures that were put in place in late 2008 and early 2009 helped to prevent an even larger catastrophe, the macroeconomic consequences of the financial crisis have been enormous. Even as the danger to the banking industry begins to recede, we are faced with the twin tasks of rebuilding our financial infrastructure on more solid ground and implementing safeguards that will help to prevent a costly recurrence of this disaster.

Today, as I prepare to wrap up my term as FDIC Chairman, I am pleased to have the opportunity to discuss with you what I see as some of the most important causes of the crisis, the steps that the FDIC took to deal with the problem, the reforms we are putting in place to make our system less vulnerable to costly instability in the future, and some of the broader policy challenges we must address to secure our economic future.

The Roots of the Financial Crisis

Much has been said and written about the causes of the financial crisis. In previous testimony, I have described in some detail the combination of factors that led to the crisis of 2008 and motivated the legislative reforms that are now being put in place. Today, I would like to summarize these causes under four broad themes.

Excessive Reliance on Debt and Financial Leverage

A healthy system of credit intermediation, where the surplus of savings is channeled toward its highest and best use by household and business borrowers, is critically important to the modern economy. A starting point for understanding the causes of the crisis and the changes that need to be made in our economic policies is recognition that the U.S. economy has long depended too much on debt and financial leverage to finance all types of economic activity.

In principle, debt and equity are substitute forms of financing for any type of economic activity. However, owing to the inherently riskier distribution of investment returns facing equity holders, equity is generally seen as a higher-cost form of financing. This perceived cost advantage for debt financing is further enhanced by the standard tax treatment of payments to debt holders, which are generally tax deductible, and equity holders, which are not. In light of these considerations, there is a tendency in good times for practically every economic constituency – from mortgage borrowers, to large corporations, to startup companies and the financial institutions that lend to all of them – to seek higher leverage in pursuit of lower funding costs and higher rates of return on capital. What is frequently lost when calculating the cost of debt financing are the external costs that are incurred when problems arise and borrowers cannot service the debt. Credit defaults, which tend to occur with high frequency in economic downturns, frequently lead to severe adjustments—including foreclosure, repossession, and distressed asset sales—that impose very high costs on economic growth and our financial system.

Thus, as demonstrated in the recent financial crisis, the social costs of debt financing are significantly higher than the private costs. In good economic times, when few borrowers are forced to default on their obligations, more economic activity can take place at a lower cost of capital when debt is substituted for equity. However, the built-in private incentives for debt finance have long been observed to result in periods of excess leverage that contribute to a financial crisis. As Carmen Reinhart and Kenneth Rogoff describe in their 2009 book *This Time It's Different*:

> *"If there is one common theme to the vast range of crises we consider in this book, it is that excessive debt accumulation, whether it be by the government, banks, corporations, or consumers, often poses greater systemic risks than it seems during a boom."* [1]

This is precisely what was observed in the run up to the recent crisis. Mortgage lenders effectively loaned 100 percent or more against the value of many homes without underwriting practices that ensured borrowers could service the debt over the long term. Securitization structures were created that left the issuers with little or no residual interest, meaning that these deals were 100 percent debt financed. In addition, financial institutions not only frequently maximized the degree of on-balance-sheet leverage they could engineer; many further leveraged their operations by use of off-balance-sheet structures. For all intents and purposes, these off-balance-sheet structures were not subject to prudential supervision or regulatory capital requirements, but nonetheless

[1] Reinhart, Carmen and Ken Rogoff. *This Time Is Different: Eight Centuries of Financial Folly.* Princeton: Princeton University Press. 2009. p. xxv.

enjoyed the implicit backing of an affiliated insured bank. These and many other financial practices employed in the years leading up to the crisis made our core financial institutions and our entire financial system more vulnerable to financial shocks.

Misaligned Incentives in Financial Markets

Financial markets are ideally deep, liquid, efficient markets where observable prices convey useful information to market participants. However, informational asymmetries, conflicts of interest, or other misaligned incentives can significantly impair the liquidity and efficiency of financial markets. One of the enduring legacies of the financial crisis will be how misaligned incentives led to devastating instability in our financial system.

I explored some of the implications of misaligned incentives in our financial system in my January 2010 testimony before the Financial Crisis Inquiry Commission (FCIC).[2] Overall, financial institutions were only too eager to originate mortgage loans and securitize the loans using complex structured debt securities. Investors purchased these securities without a proper risk evaluation, as they outsourced their due diligence obligation to the credit rating agencies. Consumers refinanced their mortgages, drawing ever more equity out of their homes as residential real estate prices grew beyond sustainable levels. Formula-driven compensation at financial institutions allowed high short-term profits to be translated into generous bonus payments, without regard to any longer-term risks. These developments were made possible by a set of misaligned

[2] Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation on the Causes and Current State of the Financial Crisis before the Financial Crisis Inquiry Commission, January 14, 2010. http://www.fdic.gov/news/news/speeches/archives/2010/spjan1410.html

incentives among and between all of the parties to the securitization process—including borrowers, loan originators, credit rating agencies, loan securitizers, and investors.

Misaligned economic incentives within mortgage securitization transactions and the widespread use of such securitizations to fund residential lending combined to play a key role in driving the precipitous decline in the housing market and the financial crisis. Almost 90 percent of subprime and Alt-A originations in the peak years of 2005 and 2006 were privately securitized. During this period, the originators and securitizers seldom retained meaningful "skin in the game." These market participants received immediate profits with each deal while assuming that they faced little or no risk of loss if the loans defaulted. As a result, securitizers had very little incentive to maintain adequate lending and servicing standards.

The substantial and immediate profits available through securitization skewed the incentives toward increased volume, rather than well underwritten, sustainable lending. In the late 1990s and early 2000s, when private mortgage-backed securitization was still a relatively small part of the market, the typical deal structure included non-rated or sub-investment grade tranches reflecting the equity interest that was retained by the issuer. These equity slices typically ranged in size from 3 to 5 percent or more of the total value of the deal. As long as the market required issuers to retain the equity risk, there was at least some incentive for issuers to more carefully choose the mortgages they would include in the pool. But by the middle of the decade, the size of these equity tranches had fallen in many cases to one percent or less of the value of the deal.

Moreover, an active market arose in selling and repackaging these equity tranches in collateralized debt obligations, thereby removing all risk of loss from the original security issuer. Without the need to carry and fund equity claims arising from mortgage securitization, the pure "originate-to-distribute" model of mortgage lending came into being, conferring virtually infinite leverage to the issuers of private mortgage-backed securities. Predictably, with higher leverage came riskier lending, and increased numbers of borrowers—encouraged by lenders and brokers—received loans that they simply could not repay. When housing prices reached unsustainable levels and began to decline, the house of cards collapsed and revealed the inherent flaws in the incentives of the prior securitization model. More than half of the privately-securitized subprime loans made in 2006 have now defaulted, along with over 40 percent of the privately-securitized Alt-A loans made that year.

The mortgage servicing documentation problems that were uncovered last year are yet another example of the implications of lax underwriting standards and misaligned incentives in the mortgage industry. Since the servicers of securitized mortgages do not own the mortgages, they lack economic incentives to mitigate losses through effective loan restructuring. In addition, the traditional, fixed level of compensation for loan servicing paid under typical securitizations has proven to be wholly inadequate to implement appropriate policies and procedures to effectively deal with the volume of problem mortgage loans. As a consequence, inadequate resources and lack of economic self-interest led mortgage servicers to cut corners in all aspects of mortgage servicing and documentation. Thus, the incentive problems that helped to spawn the crisis are now among the most important impediments to resolving it. Clearly, financial risk managers and financial regulators must pay much closer attention in the future to incentive and information problems that inhibit the efficiency of financial markets and raise the risk of market instability.

Failures and Gaps in Financial Regulation

The regulatory reforms put in place for federally-insured depository institutions following the banking crisis of the 1980s and early 1990s helped to constrain risk-taking on bank balance sheets. But in a process known as regulatory arbitrage, risk began to migrate into the so-called shadow banking system—a network of large-bank affiliates, special-purpose vehicles, and nonbank financial companies that existed largely outside of the prudential supervision, capital requirements, and receivership powers that apply to federally insured depository institutions in the U.S. The migration of essential banking activities outside of regulated financial institutions to the shadow banking system ultimately lessened the effectiveness of regulation and made the financial markets more vulnerable to a breakdown.

Many of the structured finance activities that generated the largest losses were complex and opaque transactions undertaken at the intersection of the lightly regulated shadow banking system and the more heavily regulated traditional banking system. For instance, private-label MBSs were originated through mortgage companies and brokers as well as portions of the banking industry. The MBSs were subject to minimum securities disclosure rules that are not designed to evaluate loan underwriting quality.

Moreover, those rules did not allow sufficient time or require sufficient information for investors and creditors to perform their own due diligence either initially or during the term of the securitization. For banks, once these loans were securitized, they were off the balance sheet and no longer on the radar of many banks and bank regulators.

Outside of the largest and most complex institutions, traditional banks and thrifts continued to rely largely on insured deposits for their funding and most focused on providing core banking products and services to their customers. Eventually, these traditional institutions also suffered extensive losses as many of their loans defaulted as a consequence of collateral damage from the deleveraging effects and economic undertow created by the collapse of the housing bubble.

The Erosion of Market Discipline Due to "Too Big to Fail"

One of the most powerful inducements toward excess leverage and institutional risk-taking in the period leading up to the crisis was the lack of effective market discipline on the largest financial institutions that were considered by the market to be Too Big to Fail. Several large, complex U.S. financial companies at the center of the 2008 crisis could not be wound down in an orderly manner when they became nonviable. Major segments of their operations were subject to the commercial bankruptcy code, as opposed to bank receivership laws, or they were located abroad and therefore outside of U.S. jurisdiction. In the heat of the crisis, policymakers in several instances resorted to bailouts instead of letting these firms collapse into bankruptcy because they feared that the losses generated in a failure would cascade through the financial system, freezing financial markets and stopping the economy in its tracks.

As it happened, these fears were realized when Lehman Brothers—a large, complex nonbank financial company—filed for bankruptcy on September 15, 2008. Anticipating the complications of a long, costly bankruptcy process, counterparties across the financial system reacted to the Lehman failure by running for the safety of cash and other government obligations. Subsequent days and weeks saw the collapse of interbank lending and commercial paper issuance, and a near complete disintermediation of the shadow banking system. The only remedy was massive intervention on the part of governments around the world, which pumped equity capital into banks and other financial companies, guaranteed certain non-deposit liabilities, and extended credit backed by a wide range of illiquid assets to banks and nonbank firms alike. Even with these emergency measures, the economic consequences of the crisis have been enormous.

Under a regime of Too Big to Fail, the largest U.S. banks and other financial companies have every incentive to render themselves so large, so complex, and so opaque that no policymaker would dare risk letting them fail in a crisis. With the benefit of this implicit safety net, these institutions have been insulated from the normal discipline of the marketplace that applies to smaller banks and practically every other private company. This situation represents a new and dangerous form of state capitalism, where the market expects these companies to receive generous government subsidies in times of financial distress. Unless reversed, we could expect to see more concentration of market power in the hands of the largest institutions, more complexity in financial structures and relationships, more risk-taking at the expense of the public, and, in due time, another financial crisis. However, as described later, the Dodd-Frank Act introduces several measures in Title I and Title II that, together, provide the basis for a new resolution framework designed to render any financial institution "resolvable," thereby ending the subsidization of risk-taking that took place prior to these reforms.

In summary, the roots of the financial crisis lay under four main areas: excessive debt, misaligned incentives in financial markets, failures and gaps in financial regulation, and the undermining of market discipline by To Big to Fail. Any one of these problems in isolation would have weakened the long-term performance of our financial system and made it more vulnerable to shocks. In combination, they led to the worst U.S. financial crisis and economic downturn since the 1930s. The following section discusses how the FDIC responded to the immediate challenges posed by these developments.

FDIC Responses to the Challenges of the Financial Crisis

The FDIC was created in 1933 in response to the most serious financial crisis in American history to that time. Our mission then—as now—is to promote financial stability and public confidence in banking through bank supervision, deposit insurance and the orderly resolution of failed banking institutions. Working with our regulatory counterparts, the FDIC has played an instrumental role in addressing the recent crisis. Our actions have helped to restore financial stability and pave the way for economic recovery. We have done so by effectively carrying out our core missions as described above, and by undertaking some unprecedented emergency actions necessary to restore stability to our financial system. The appropriateness and effectiveness of these actions is evidenced both by the gradual recovery we are seeing in financial markets and institutions, as well as the 19 consecutive unqualified audit opinions the FDIC has received from the Government Accountability Office (GAO). This section summarizes the FDIC's actions during the crisis and highlights some important organizational changes and new initiatives we have undertaken to enhance our effectiveness.

Bank Supervision

The FDIC is the primary federal supervisor for most community banks in the U.S. These institutions provide credit, depository, and other financial services to consumers and businesses on Main Street, and are playing a vital economic role as cities and towns recover from the recession. As primary federal supervisor for these institutions, the FDIC seeks to maintain a vigilant but balanced posture with regard to both safety and soundness and consumer compliance supervision. Such an approach is in keeping with our longstanding belief that consumer protection and safe and sound banking are two sides of the same coin.

During the financial crisis, the FDIC initiated a number of enhancements to its supervisory program and issued a broad spectrum of guidance to the banking industry to establish, and clearly reaffirm, safety and soundness expectations. The FDIC's Division of Risk Management Supervision (RMS) responded quickly to the rapid deterioration of insured depository institutions by expanding off-site monitoring activities, accelerating on-site examinations, performing on-site visitations between examinations, and strengthening the workforce through permanent and temporary hiring. At the same time, we provided examiners with greater latitude to expand the scope of examinations when necessary and training updates on fundamental aspects of bank supervision and real estate lending. From a policy perspective, the FDIC independently issued and joined interagency issuances of much-needed regulatory guidance. This guidance dealt with significant risk management issues that became central themes of the crisis such as subprime and nontraditional mortgage lending, commercial real estate lending, incentive compensation practices, liquidity and funds management, and regulatory/charter conversions. Importantly, we also actively encouraged banks to continue prudently originating and, when appropriate, modifying loans to creditworthy borrowers.

As the Committee is well aware, the most important element of prudential bank supervision is on-site examination activity. Given the significant weaknesses in real estate lending and increasing volume of problem banks over the past several years, the frequency and scope of FDIC supervisory activities expanded. In 2010 alone, the FDIC conducted over 2,700 regular examinations and 2,210 on-site visitations. We have also exercised our special examination authority to evaluate risks posed to the Deposit Insurance Fund (DIF) by insured institutions that are not directly supervised by the FDIC. While our core examination procedures have not changed, the FDIC is working smarter through a significantly enhanced off-site monitoring and surveillance program that has helped us to more quickly address emerging signs of financial deterioration. When signs of deterioration are identified, we typically perform an on-site visitation to assess the emergent weaknesses, whether a regular examination should be accelerated, the appropriateness of currently-assigned CAMELS ratings, and potential risk to the Fund.

As a result of the increased volume of problem institutions nationally, we accelerated the process for initiating corrective programs that address financial or managerial concerns. We implemented a process that ensures the initiation of most corrective programs within 60 days of the completion of an examination. This has helped banks act on supervisory recommendations expeditiously. The FDIC also strengthened its internal standard for performing supervisory activities at institutions rated '3', '4', or '5' so that we conduct not only a regular examination every twelve-months, but also on-site visitations every six months, at a minimum. Moreover, we actively communicate with banks that are subject to a corrective program and ensure that their related progress reports are reviewed and followed-up on in a timely manner.

To achieve the goals of our supervisory mission, the FDIC hired additional examiners and technical specialists. As of April 30th, our risk management examination force stands at approximately 1,900 examiners, up from 1,200 at the end of 2007. This staffing increase improved our ability to conduct supervision and special examination activities as well as responding to complex and emerging risks. RMS has also provided training to the examination staff to update and reinforce credit, real estate appraisal, and other bank supervision fundamentals. Through this training, we have emphasized a forward-looking, balanced approach to supervision that promotes fairness and effectiveness in our role as regulators.

The FDIC issued a variety of timely supervisory guidance both before and during the crisis on important risk management issues affecting the banking industry. As the Committee will recall, subprime and non-traditional residential mortgage loans were one of the first lending fields negatively impacted by the real estate bubble. In response, the FDIC joined the other regulatory agencies in issuing *Interagency Guidance on Nontraditional Mortgage Product Risks* in 2006, and led the development of the joint *Interagency Statement on Subprime Lending* in 2007 to establish regulatory expectations about the risks and oversight of these credit products.[3] We believe that these and subsequent related issuances helped banks improve their credit risk management and consumer protection process for higher-risk mortgage lending.

With respect to commercial real estate (CRE) lending, we issued a number of Financial Institution Letters addressing the need for strong risk management practices and appropriate capital and reserve levels for institutions with CRE loan concentrations. For example, in 2008, the FDIC issued a Financial Institution Letter titled *Managing Commercial Real Estate Concentrations in a Challenging Environment* that emphasized the importance of these tenets.[4] This Letter followed up on the 2006 joint *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, which outlined how strong risk management practices and appropriate levels of capital

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[3] See: *Interagency Statement on Subprime Mortgage Lending*,
http://www.fdic.gov/news/news/financial/2007/fil07062.html
and *Interagency Guidance on Nontraditional Mortgage Product Risks*
http://www.fdic.gov/news/news/financial/2006/fil06089.html
[4] See: *Managing Commercial Real Estate Concentrations in a Challenging Environment*
http://www.fdic.gov/news/news/financial/2008/fil08022.html

were essential elements of a sound commercial real estate lending program.[5] Institutions that adhered to the risk management tenets in these issuances have tended to weather the crisis and remain well positioned to originate new loans as demand returns to the market.

In response to significant concerns about the regulatory position relative to CRE loan workouts and restructures, we joined the other banking agencies in issuing the 2009 *Policy Statement on Prudent Commercial Real Estate Loan Workouts* which encouraged prudent and pragmatic CRE workouts within the framework of financial accuracy, transparency, and timely loss recognition.[6] This issuance has led to a better understanding of regulatory expectations and an encouragement to banks to engage in prudent restructures when appropriate. The FDIC has also been a strong proponent of reforms to address front-loaded compensation structures that provide incentives for short-term excessive risk taking. We joined the other agencies to issue the *Interagency Notice of Proposed Rulemaking Incentive-Based Compensation Arrangements* earlier this year.[7] This proposed rulemaking seeks to strengthen the incentive compensation practices at covered institutions by better aligning employee rewards with longer-term institutional objectives.

[5] See: *Commercial Real Estate Lending Joint Guidance*
http://www.fdic.gov/news/news/financial/2006/fil06104.html
[6] See: *Policy Statement on Prudent Commercial Real Estate Loan Workouts*
http://www.fdic.gov/news/news/financial/2009/fil09061.html
[7] See: *Interagency Notice of Proposed Rulemaking on Incentive-Based Compensation Arrangements*
http://www.fdic.gov/news/news/financial/2011/fil11007.html

Managing the Deposit Insurance Fund

Shortly after my tenure at the FDIC began in 2006, we moved to implement a new law that eased statutory restrictions on the FDIC's ability to build up the DIF balance when economic conditions were favorable. The earlier restrictions had prevented the FDIC from charging most banks a premium based on risk when the fund balance exceeded $1.25 per $100 of insured deposits. The 2006 reforms permitted the FDIC to charge all banks a risk-based premium and provided additional, but limited, flexibility to manage the size of the DIF. The FDIC changed its risk-based pricing rules in response to the new law, but the onset of the recent crisis prevented the FDIC from increasing the DIF balance. In all, the failure of 365 FDIC-insured institutions since year-end 2007 has imposed total estimated losses of $83 billion on the DIF.

As in the earlier banking crisis, the sharp increase in bank failures caused the fund balance, or its net worth, to become negative. In the recent crisis, the DIF balance turned negative in the third quarter of 2009 and hit a low of negative $20.9 billion in the following quarter. By that time, however, the FDIC had already moved to shore up its resources to handle the high volume of failures and begin replenishing the fund. The FDIC increased assessment rates at the beginning of 2009, which raised regular assessment revenue from $3 billion in 2008 to over $12 billion in 2009 and almost $14 billion in 2010. In June 2009, the FDIC imposed a special assessment that brought in an additional $5.5 billion from the banking industry. Furthermore, in December 2009, to increase the FDIC's liquidity, the FDIC required that the industry prepay almost $46 billion in assessments, representing over three years of estimated assessments.

While the FDIC had to impose these measures at a very challenging time for banks, they enabled the agency to avoid borrowing from the Treasury. The measures also reaffirmed the longstanding commitment of the banking industry to fund the deposit insurance system.

Since the FDIC imposed these measures, the DIF balance has steadily improved. It increased throughout 2010 and stood at negative $1.0 billion as of March 31 of this year. Barring unforeseen circumstances, the DIF balance at June 30 should again be positive, after seven quarters in the red. The FDIC has put in place assessment rates necessary to achieve a reserve ratio (the ratio of the fund balance to estimated insured deposits) of 1.35 percent by September 30, 2020, as the Dodd-Frank Act requires.

The FDIC has also implemented the Dodd-Frank Act requirement to redefine the base used for deposit insurance assessments as average consolidated total assets minus average tangible equity. As Congress intended, the change in the assessment base, in general, will result in shifting some of the overall assessment burden from community banks to the largest institutions, which rely less on domestic deposits for their funding than do smaller institutions. The result will be a sharing of the assessment burden that better reflects the relative loss exposure to the DIF.

The Dodd-Frank Act also provided the FDIC with substantial new flexibility in setting reserve ratio targets and paying dividends. The FDIC now has the ability to achieve goals for deposit insurance fund management that we sought to achieve for many years but lacked the tools to accomplish. The FDIC has used its new authority to enable the agency to adopt policies that should maintain a positive DIF balance even during a banking crisis while preserving steady and predictable assessment rates throughout economic and credit cycles. The FDIC also revised its risk-based premium rules for large banks. The new premium system for large banks goes a long way toward assessing for risks when they are assumed, rather than when problems materialize, by calculating assessment payments using more forward-looking measures. The system also removes reliance on long-term debt issuer ratings consistent with the Dodd-Frank Act.

Resolution of Failed Institutions

Between 2003 and 2007, only 10 FDIC-insured institutions failed – the lowest five-year failure total in the history of the FDIC. As it happened, this was the calm before the storm. Since the end of 2007, the FDIC has been called upon to resolve 365 failed banks and thrifts, marking a wave of failed institutions second only to the banking crisis of the 1980s and early 1990s.[8] The institutions that have failed since 2007 held $659 billion in total assets and managed 30.6 million deposit accounts with $427 billion in total deposits. These failures included some of the largest and most challenging resolutions the FDIC has ever undertaken. While just 25 institutions failed in 2008, they included IndyMac Bank, with $32 billion in assets, and Washington Mutual Bank, with $299 billion in assets and some 2,239 branches located in 15 states. The total of 140 failure resolutions in 2009 included the sudden failure of Colonial Bank, a $25 billion

[8] See: *History of the Eighties — Lessons for the Future*, FDIC, 1997.
http://www.fdic.gov/bank/historical/history/

bank with 346 branches located in five states. Also in 2009, the FDIC successfully resolved United Commercial Bank, an institution with 63 bank branches in the U.S., an office located in Hong Kong, and a subsidiary bank headquartered in Shanghai, China.

Following the string of large failures in 2008 and 2009, the recent trend has been toward the failure of smaller institutions. From 2009 to 2010, the average size of failed institutions fell by about half, to around $600 million in assets. However, the number of failed institutions increased in 2010 to 157. While the number of failures remains elevated, we expect that 2010 will ultimately prove to have been the peak year for bank failures in this cycle. Through May 20, a total of 43 institutions had been resolved so far in 2011.

To meet the challenge posed by large numbers of failed institutions and the failure of several large institutions within a relatively short timeframe, the FDIC has applied innovative resolution strategies, effectively leveraged its existing resources, and relied on the expertise and commitment of FDIC staff and management to ensure that failed bank resolutions were a non-event for insured depositors and to minimize further disruptions to other bank stakeholders and the wider financial markets.

Throughout the crisis, the FDIC has offered innovative resolution and asset sales transactions, such as loss sharing and structured transactions, to help preserve value, to maximize returns for the failed bank receiverships, and to return banking assets to the private sector. In all, 253 of the 365 recent bank failures were resolved via loss sharing resolution transactions, where the acquirer assumes most or all of the problem assets of the failed institution and shares the losses with the FDIC. These structures provide downside protection to investors in a risk-averse environment while preserving incentives for the acquirer to maximize returns on those assets over time, and to modify problem mortgages where this strategy can be shown to enhance value.

The FDIC is now also offering failed bank assets through securitizations. In July 2010, the FDIC issued a securitization of $470 million of performing single-family mortgages. This transaction was the first single-family securitization in the history of the FDIC and the first time the FDIC sold assets in a securitization in the current financial crisis. The transaction broke new ground in several areas including the alignment of the servicer's compensation with performance, independent third party oversight and the ability to adapt servicing standards to changes in the performance of the underlying collateral and market conditions.

The increased rate of failures has forced the FDIC to quickly scale up its resources in bank resolution. Our Division of Resolutions and Receiverships (DRR) began 2008 with 223 permanent employees. By December 2010, DRR's total authorized permanent staff had increased to 442. While additional FDIC staff resources were being hired and trained, we made use of temporary contractors to help meet the additional staffing needs. Also, in 2008 and 2009, the FDIC Board authorized the establishment of three Temporary Satellite Offices (TSOs), staffed with approximately 1,000 term employees, to address the temporary increase in resolution workload in the West, the

Southeast, and the upper Midwest regions of the country. Based on projections for declining resolution activity in the Western states, the FDIC has already announced plans to sunset our West Coast TSO in January 2012, and we will announce plans to close the two remaining TSOs as soon as conditions warrant.

The Role of Public Outreach

In mid-2008, in connection with the observation of our 75th anniversary, the FDIC announced an education campaign designed to raise public awareness of federal deposit insurance and its limits. This effort included national advertising, a multi-city outreach effort and an award program for outstanding work in financial education. A series of advertisements ran in selected national newspapers and magazines, encouraging consumers to learn more about their FDIC insurance coverage, with the goal of raising awareness of deposit insurance and instilling confidence in the stability of the insured banking system. As part of the anniversary commemoration, advertisements were placed in major media and online publications and I participated in public roundtables and media interviews around the country to discuss deposit insurance, the costs and benefits of banking services, and the importance of consumer protection in financial services.

Later in 2008, the FDIC launched a second major initiative to raise public awareness of the benefits and limitations of federal deposit insurance through public service announcements (PSAs) and the enhancement of our online tools that enable bank customers to determine whether their deposits qualify for FDIC insurance. The success of this campaign led us to extend it to Spanish language PSAs and brochures, and to conduct further outreach to the Asian American and African American communities. These award-winning efforts to bolster awareness of deposit insurance would prove valuable in preserving public confidence as the number of failed institutions mounted.[9]

Emergency Systemic Assistance

Following the passage of the FDIC Improvement Act (FDICIA) of 1991, the statute governing the FDIC's resolution authority required us to undertake the least-cost method to resolve failed institutions. Under such a scenario, insured depositors are made whole, equity holders are wiped out, and the returns to general creditors and uninsured depositors are determined by the level of recoveries on receivership assets. However, FDICIA also provided emergency powers to suspend the least-cost requirement when imposing this requirement would pose a systemic risk to the financial stability of the U.S. Invoking this systemic risk exception required the recommendation of the FDIC Board and the Board of Governors of the Federal Reserve System, and the approval of the Secretary of the Treasury, in consultation with the President.

At the height of the financial crisis, in late 2008 and early 2009, uncertainty among financial institution counterparties had created a situation of generalized illiquidity in short-term funding markets. Perhaps the best barometer of risk aversion and illiquidity in overnight funding markets is the so-called TED spread, or the difference between three-month Eurodollar rates and the yield on three-month Treasury instruments. Normally fluctuating around a level of 25 basis points, the TED spread had spiked to

[9] "FDIC: Celebrating 75 Years, Not a Penny Lost" won PRWeek's Public Sector Campaign of the Year in 2009. "The More You Know, the Safer Your Money" won PRWeek's Public Sector Campaign of the Year in 2010.

levels exceeding 100 basis points with the onset of financial market turmoil in late 2007, and then peaked at over 450 basis points in early October 2008, following the bankruptcy of Lehman Brothers. This and other clear signs of critical illiquidity in short-term money markets prompted the FDIC and the other federal regulatory bodies to undertake a range of emergency measures to restore confidence and liquidity to financial markets.

On October 13, 2008, the FDIC Board voted to recommend invoking the systemic risk exception in order to implement a Temporary Liquidity Guarantee Program (TLGP). The TLGP improved access to liquidity through two programs: the Transaction Account Guarantee Program (TAGP), which fully guaranteed noninterest-bearing transaction deposit accounts above $250,000, regardless of dollar amount; and the Debt Guarantee Program (DGP), which guaranteed eligible senior unsecured debt issued by eligible institutions.

All insured depository institutions were eligible to participate in the TAGP. Institutions eligible to participate in the DGP included insured depository institutions, U.S. bank holding companies, certain U.S. savings and loan holding companies, and other affiliates of insured depository institutions that the FDIC designated as eligible entities. Although financial markets improved significantly in the first half of 2009, the Board subsequently extended both the DGP and TAGP since portions of the industry were still affected by the recent economic turmoil. The deadline for issuance of guaranteed debt was ultimately extended to October 31, 2009, with the expiration date of the guarantee extended to as late as December 31, 2012. While the FDIC Board also voted to extend the TAGP through the end of 2010, the Dodd-Frank Act subsequently provided similar deposit insurance coverage for noninterest bearing transactions accounts above the normal deposit insurance limit through the end of 2012.

The TLGP did not rely on taxpayer funding or the DIF; both the TAGP and the DGP were paid for by direct user fees. Through year-end 2010, some $10.4 billion in fees for debt guarantees and surcharges had been collected under the DGP, and another $1.1 billion in fees had been collected through the TAGP. At year-end 2010, more than 5,100 participating FDIC-insured institutions reported an average of 198,361 noninterest-bearing transaction accounts over $250,000. The deposit balances in these accounts totaled $164 billion, of which $114 billion was guaranteed under the TAGP. Also at year-end, some 64 participating issuers reported senior unsecured debt guaranteed under the DGP in the amount of $247 billion.

By providing the ability to issue debt guaranteed by the FDIC, institutions were able to extend maturities and obtain more stable unsecured funding. This calmed what was becoming a "perfect storm" whereby creditors refused to roll their debt beyond weeks, days or even overnight and demanded more collateral at the exact time that banks needed these funds to continue to finance their operations. Along with the other extraordinary measures taken by the Treasury Department and the Federal Reserve Board in the fall of 2008, the FDIC's TLGP helped to calm market fears and encourage lending during these unprecedented disruptions in financial markets in the U.S. and abroad. Most important, these programs were pre-designed to have a limited life, so that the FDIC guarantee can return to its proper, limited scope as financial market conditions normalize.

Loan Modification Programs

Since the early stages of the mortgage crisis, the FDIC has made a concerted effort to promote the timely modification of problem mortgages as a first alternative that can spare investors the high losses associated with foreclosure, assist families experiencing acute financial distress, and help to stabilize housing markets where distressed sales have resulted in a lowering of home prices in a self-reinforcing cycle.

In 2007, when the dimensions of the subprime mortgage problem were just becoming widely known, I advocated in speeches, testimony and opinion articles that servicers not only had the right, but the contractual obligation, to carry out modifications that would maximize value and protect subprime borrowers from unaffordable interest-rate resets. It was clear in most cases that doing so would benefit investors by enabling them to avoid foreclosure costs that could run as high as 40 percent or more of the value of the collateral. In addition, the FDIC and other federal regulators jointly hosted a series of roundtables on the issues surrounding subprime mortgage securitizations to facilitate a better understanding of problems and identify workable solutions for rising delinquencies and defaults, including alternatives to foreclosure.

The FDIC had an opportunity to pioneer the implementation of such an approach as conservator at IndyMac Federal Bank in 2008. At IndyMac, the FDIC inherited responsibility for servicing a large pool of past due first-lien mortgages, both owned by the bank and serviced for others. Consistent with our fiduciary duty to maximize collections on the receivership-owned loans and to maximize recoveries for loans serviced for others, we implemented an interest-rate and term loan modification program to convert as many of these distressed loans as possible into performing loans that were more affordable and sustainable over the long term, where doing so would maximize the expected net present value (NPV) of the mortgages. In total, over 23,000 mortgages were modified using the FDIC protocol at IndyMac, almost all of which reduced the borrower's monthly payment by 10 percent or more.

At IndyMac, we developed some useful methods and learned some important lessons about how to pursue modification on a large scale. We learned that modifying loans early in their delinquency gives the best chance of success. We saw that larger payment reductions result in more successful modifications. Among the loans modified at IndyMac, we saw that increasing the size of the payment reduction from 10 percent to 40 percent or more can cut redefault rates by half. We also demonstrated that communication and follow-through with borrowers is critical. If the borrower can be contacted and the modification completed before there is an extended period of delinquency, the chances for a successful modification are greatly enhanced. Above all, we learned once again how important it is to keep the program simple. Modification programs must be relatively straightforward if servicers are to be able to apply a streamlined approach and if borrowers are to understand their options and act accordingly.

The FDIC has also continued to support prudent workout arrangements through its examination review process. In addition, we require acquirers of failed institutions who manage mortgage loans under loss sharing agreements with the FDIC to implement loan modification programs similar to the one developed at IndyMac.

Over the past year, with the emergence of the mortgage servicing crisis as a key operational risk for banks and an impediment to the recovery of U.S. housing markets, the need for effective servicing and appropriate modifications has become even more apparent. The FDIC has consistently advocated for broad agreements among the major stakeholders, including large mortgage servicers, their regulators, and the state attorneys general, that would include the systematic modification of problem mortgages in order to prevent needless foreclosures. The large backlog of seriously past-due mortgages has created an overhang of uncertainty for our housing markets that is inhibiting the inflow of new buyers that will be needed to help these markets move back toward a more stable equilibrium. It is our hope that all parties to the mortgage servicing crisis will respond in a way that both helps families stay in their homes and hastens the recovery of our housing markets.

The FDIC Advisory Committee on Economic Inclusion

Early in my term, the FDIC Board created the Advisory Committee on Economic Inclusion to provide advice and recommendations on expanding access to mainstream banking services for underserved consumers. Census data show that some 17 million adults do not have a checking or savings account, and another 43 million adults do have an account but also rely on non-bank financial products to make ends meet. This problem disproportionately affects specific minority groups and lower-income consumers, and has a real impact on their household finances. The Committee's objective is to explore ways to lower the number of underserved households and to increase the supply of financial products targeted to these households, with an emphasis on safety and affordability for consumers and feasibility for banks. Consisting of 20 individuals from banks, academia, government, and consumer and philanthropic groups, the Committee has advised us on some of the initiatives at the FDIC of which I am most proud. One of these was the *FDIC Model Safe Accounts Pilot*, which is currently evaluating the feasibility of banks offering safe, low-cost, overdraft-free transactional and savings accounts. In 2008, the Committee recommended that the FDIC publish a list of best practices for mortgage lending to low- and moderate-income (LMI) households.[10] In March of this year, we met again to discuss LMI mortgage lending in the wake of the crisis and the Dodd-Frank Act.

Perhaps most notably, the Committee recommended the establishment of the *FDIC Small-Dollar Loan Pilot*, a case study designed to illustrate how banks can profitably offer affordable small-dollar loans as an alternative to high-cost credit products, such as payday loans and fee-based overdraft protection.[11] Under the pilot, some 28 volunteer institutions made more than 34,400 small-dollar loans with a total principal balance of $40.2 million. Most pilot bankers indicated that small dollar loans

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[10] These best practices were communicated in FDIC Financial Institutions Letter FIL-88-2008, Best Practices from the FDIC'S Forum on Mortgage Lending for Low- and Moderate-Income Households, http://www.fdic.gov/news/news/financial/2008/fil08088.html

[11] For more details on the FDIC Small-Dollar Loan Pilot Program and the Small-Dollar Loan Template, see: http://www.fdic.gov/smalldollarloans/

were a useful business strategy for developing or retaining long-term relationships with consumers. Following the conclusion of the Pilot, we developed a *Small-Dollar Loan Template* for others to use, that is relatively simple to implement and requires no particular technology or other major infrastructure investment. Moreover, the template could help banks better adhere to existing regulatory guidance in offering alternatives to fee-based overdraft protection programs.

These initiatives are integral to the FDIC's mission to promote public confidence in the banking system. Economic inclusion is about ensuring that all Americans have access to safe, secure, and affordable banking services so that everyone has the opportunity to save, build assets, and achieve financial security.

The FDIC Advisory Committee on Community Banking

In May 2009, the FDIC Board of Directors established the FDIC Advisory Committee on Community Banking to provide the FDIC with advice and guidance on a broad range of important policy issues impacting small community banks throughout the country, as well as the local communities they serve, with a focus on rural areas. The Advisory Committee has been able to provide valuable input on examination policies and procedures, credit and lending practices, deposit insurance assessments, insurance coverage issues, regulatory compliance matters, and obstacles to the continued growth and ability of community banks to extend financial services in their local markets in the current environment. As discussed later in my testimony, the Advisory Committee has played an integral role in addressing issues related to regulatory burden that can disproportionately affect community banks.

In the six meetings we have held with the Advisory Committee since late 2009, we have considered the impact of the financial crisis on community banks, how the financial reform legislation affects community banks, options for funding the deposit insurance system, a variety of examination issues, bank resolutions, and the future role of the community banks as an engine of growth for small businesses and the U.S. economy.

FDIC Organizational Changes

As part of the process of preparing the FDIC to effectively confront future challenges, the FDIC Board of Directors has undertaken a number of organizational changes.

To focus on our expanded responsibilities to monitor and, potentially, resolve Systemically Important Financial Institutions (SIFIs), we established the Office of Complex Financial Institutions (OCFI). The OCFI will be responsible for the FDIC's role in the oversight of bank holding companies with more than $100 billion in assets and their corresponding insured depository institutions as well as for non-bank financial companies designated as systemically important by the Financial Stability Oversight Council (FSOC). The OCFI, in concert with the Federal Reserve Board, also will be responsible for reviewing resolution plans and credit exposure reports developed by the SIFIs. Also, the OCFI will be responsible for implementing and administering the

FDIC's SIFI resolution authority and for conducting special examinations on SIFIs under the FDIC's backup examination and enforcement authority.

In addition, we reorganized our existing supervisory operations to create separate divisions for safety and soundness supervision and consumer protection. The Division of Risk Management Supervision is responsible for the FDIC's supervision and enforcement of safety and soundness standards at FDIC supervised institutions. The Division of Depositor and Consumer Protection (DCP) manages the FDIC's many responsibilities for depositor and consumer protection, including effective coordination with CFPB. This reorganization reflects the importance of dedicated focus on both risk management and consumer protection supervision and will enable the FDIC to best carry out its mission in the regulatory and market environment following the passage of the Dodd-Frank Act.

DCP has responsibility for compliance examination and enforcement programs as well as the depositor protection and consumer and community affairs activities that support that program. Relative to the CFPB, DCP will have a clear delineation of authority to enforce consumer protection laws for institutions with $10 million or less in assets. DCP will work closely with the CFPB on the development of consumer protection regulations.

Finally, consistent with the requirements of Section 342 of the Dodd-Frank Act, the FDIC established a new Office of Minority and Women Inclusion (OMWI) in January. This new office assumed the responsibilities and employees of the FDIC's former Office of Diversity and Economic Opportunity, allowing for a smooth transition and no disruption in the FDIC's ongoing diversity and outreach efforts. The new organizational structure will also enable us to undertake some important new initiatives in this area. We are in the process of hiring an OMWI Deputy Director whose primary responsibility is overseeing enhanced contractor outreach and minority and women inclusion efforts, developing standards for assessing diversity policies and practices of regulated entities and establishing criteria for dealing with contractors who fail to meet standards for inclusion and diversity in their workforces. In addition, an OMWI Steering Committee has been created to promote coordination and awareness of OMWI responsibilities across the FDIC and ensure that they are managed in the most effective manner.

Current Condition of the Financial Services Industry

FDIC-insured institutions recorded six consecutive years of record earnings starting in 2001, culminating in net income of $145.2 billion in 2006. However, this short-term profitability was masking an underlying weakness in credit quality that would emerge starting in 2007 as real estate markets weakened and the U.S. economy moved toward recession. By 2008, annual industry earnings had fallen to just $4.5 billion, and in 2009, the industry recorded a net loss of $9.8 billion – the largest in its history. Quarterly provisions for loan losses taken by FDIC-insured institutions since the end of 2007 now total just under $645 billion, equal to over 8 percent of the book value of loans outstanding at the beginning of the period.

During 2010, the industry began reporting progressively lower levels of loss provisions, which led to a stabilization of industry earnings. FDIC-insured institutions recorded annual net income of $86.2 billion in 2010, still well below all-time highs but the highest level since before the recession started. New data show that industry financial performance strengthened further in the first quarter of 2011. Earnings rose and asset quality indicators improved compared to the last quarter and year-ago levels. However, problem assets remain at high levels, and revenue has been relatively flat for several quarters.

Banks and thrifts reported aggregate net income of $29 billion in the first quarter, which was 67 percent more than in first quarter 2010 and was the highest quarterly income in nearly three years. Industry earnings have registered year-over-year gains for seven consecutive quarters. More than half of institutions reported improved earnings in the quarter from a year ago, and fewer institutions were unprofitable.

The main driver of earnings improvement continued to be reduced provisions for loan losses. First quarter 2011 provisions for losses totaled $20.6 billion, which were about 60 percent below a year ago. This was the sixth consecutive quarter that provisions declined from year-ago levels. Reduced provisions for losses reflect general improvement in asset quality indicators. The volume of noncurrent loans declined for the fourth consecutive quarter, and net charge-offs declined for the fifth consecutive quarter. All major loan types had declines in volumes of noncurrent loans and net charge-offs.

However, the ratio of noncurrent loans to total loans of 4.71 percent remains above levels seen in the crisis of the late 1980s and early 1990s.

The positive contribution from reduced provisions outweighed the negative effect of lower revenue at many institutions. Net operating revenue – net interest income plus total noninterest income – was $5.6 billion lower than a year ago. This was only the second time in the 27 years for which data are available that the industry has reported a year-over-year decline in quarterly net operating revenue. Both net interest income and total noninterest income reflected aggregate declines. More than half of all institutions reported year-over-year increases in net operating revenue, but eight of the ten largest institutions reported declines.

The relatively flat revenues of recent quarters, in part, reflect reduced loan balances. Loan balances have declined in ten of the past eleven quarters, and the 1.9 percent decline in the first quarter was the second largest percentage decline in the history of the data. Balances fell in most major loan categories. Recent surveys suggest that banks have been starting to ease lending standards, but standards remain significantly tighter than before the crisis. Surveys also indicate that borrower demand remains sluggish. Growth of well-underwritten loans will be essential not only for banks to build revenues but also to provide a stronger foundation for economic recovery.

The number of "problem banks" leveled off in the quarter at 888, with total assets of $397 billion. The rate of growth in the number of problem banks has slowed considerably since the end of 2009. As we have repeatedly stated, we believe that the number of failures peaked in 2010, and we expect both the number and total assets of this year's failures in 2011 to be lower than last year's.

Near-Term Regulatory Priorities

As I have testified several times over the past year, the Dodd-Frank Act, if properly implemented, will not only reduce the likelihood of future crises, but will provide effective tools to address large company failures when they do occur without resorting to taxpayer-supported bailouts or damaging the financial system.

Our highest near-term regulatory priorities are two-fold: 1) implementing the various regulatory mandates that make up the new resolution framework for SIFIs, and 2) strengthening and harmonizing capital and liquidity requirements for banks and bank holding companies under the Basel III protocol and Section 171 of the Dodd Frank Act, the Collins Amendment.

SIFI Resolutions Framework

The new SIFI resolution framework has three basic elements. First, the new FSOC, chaired by the Treasury Secretary and made up of the other financial regulatory agencies, is responsible for designating SIFIs based on criteria that are now being established by regulation. Once designated, the SIFIs will be subject to heightened supervision by the Federal Reserve Board and required to maintain detailed resolution plans that demonstrate they are resolvable under bankruptcy—not bailout—if they should run into severe financial distress. Finally, the law provides for a third alternative to bankruptcy or bailout—an Orderly Liquidation Authority, or OLA, that gives the FDIC many of the same powers over SIFIs that we have long used to manage failed-bank receiverships.

I would like to clarify some misconceptions about these authorities and highlight some priorities I see for their effective implementation.

SIFI Designation

It is important at the outset to clarify that being designated as a SIFI will in no way confer a competitive advantage by anointing an institution as Too Big to Fail. SIFIs will be subject to heightened supervision and higher capital requirements. They will also be required to maintain resolution plans and could be required to restructure their operations if they cannot demonstrate that they are resolvable. In light of these significant regulatory requirements, the FDIC has detected absolutely no interest on the part of any financial institution in being named a SIFI. Indeed, many institutions are vigorously lobbying against such a designation.

We believe that the ability of an institution to be resolved in a bankruptcy process without systemic impact should be a key consideration in designating a firm as a SIFI. Further, we believe that the concept of resolvability is consistent with several of the statutory factors that the FSOC is required to consider in designating a firm as systemic, those being size, interconnectedness, lack of substitutes and leverage. If an institution can reliably be deemed resolvable in bankruptcy by the regulators, and operates within the confines of the leverage requirements established by bank regulators, then it should not be designated as a SIFI.

What concerns us, however, is the lack of information we might have about potential SIFIs that may impede our ability to make an accurate determination of resolvability before the fact. This potential blind spot in the designation process raises the specter of a "deathbed designation" of a SIFI, whereby the FDIC would be required to resolve the firm under a Title II resolution without the benefit of a resolution plan or the ability to conduct advance planning, both of which are critical to an orderly resolution. This situation, which would put the resolution authority in the worst possible position, should be avoided at all costs. Thus, we need to be able to collect detailed information on a limited number of potential SIFIs as part of the designation process. We should provide the industry with some clarity about which firms will be expected to provide the FSOC with this additional information, using simple and transparent metrics such as firm size, similar to the approach used for bank holding companies under the Dodd-Frank Act. This should reduce some of the mystery surrounding the process and should eliminate any market concern about which firms the FSOC has under its review. In addition, no one should jump to the conclusion that by asking for additional information, the FSOC has preordained a firm to be "systemic." It is likely that, after we gather additional information and learn more about these firms, relatively few of them will be viewed as systemic, especially if the firms can demonstrate their resolvability in bankruptcy at this stage of the process.

The FSOC issued an Advanced Notice of Proposed Rulemaking (ANPR) last October and a Notice of Proposed Rulemaking (NPR) on January 26, 2011 describing the processes and procedures that will inform the FSOC's designation of nonbank financial companies under the Dodd-Frank Act. We recognize the concerns raised by several commenters to the FSOC's ANPR and NPR about the lack of detail and clarity surrounding the designation process. This lack of specificity and certainty in the designation process is itself a burden on the industry and an impediment to prompt and effective implementation of the designation process. That is why it is important that the FSOC move forward and develop some hard metrics to guide the SIFI designation process. The sooner we develop and publish these metrics, the sooner this needless uncertainty can be resolved. The FSOC is in the process of developing further clarification of the metrics for comment that will provide more specificity as to the measures and approaches we are considering using for designating non-bank firms.

SIFI Resolution Plans

A major – and somewhat underestimated – improvement in the SIFI resolution process is the requirement in the Dodd-Frank Act for firms designated as SIFIs to maintain satisfactory resolution plans that demonstrate their resolvability in a crisis.

When a large, complex financial institution gets into trouble, time is the enemy. The larger, more complex, and more interconnected a financial company is, the longer it takes to assemble a full and accurate picture of its operations and develop a resolution strategy. By requiring detailed resolution plans in advance, and authorizing an on-site

FDIC team to conduct pre-resolution planning, the SIFI resolution framework regains the informational advantage that was lacking in the crisis of 2008.

The FDIC recently released a paper detailing how the filing of resolution plans, the ability to conduct advance planning, and other elements of the framework could have dramatically changed the outcome if they had been available in the case of Lehman.[12] Under the new SIFI resolution framework, the FDIC should have a continuous presence at all designated SIFIs, working with the firms and reviewing their resolution plans as part of their normal course of business. Thus, our presence should in no way be seen as a signal of distress. Instead, it is much more likely to provide a stabilizing influence that encourages management to more fully consider the downside consequences of its actions, to the benefit of the institution and the stability of the system as a whole.

The law also authorizes the FDIC and the Federal Reserve Board to require, if necessary, changes in the structure or activities of these institutions to ensure that they meet the standard of being resolvable in a crisis. In my opinion, the ultimate effectiveness of the SIFI resolution framework will depend in large part on the willingness of the FDIC and the Federal Reserve Board to actively use this authority to require organizational changes necessary to the ability to resolve SIFIs.

As currently structured, many large banks and nonbank SIFIs maintain thousands of subsidiaries and manage their activities within business lines that cross many different

[12] "The Orderly Liquidation of Lehman Brothers Holdings under the Dodd-Frank Act," *FDIC Quarterly*, Vol. 5, No. 2, 2011. http://www.fdic.gov/regulations/reform/lehman.html

organizational structures and regulatory jurisdictions. This can make it very difficult to implement an orderly resolution of one part of the company without triggering a costly collapse of the entire company. To solve this problem, the FDIC and the Federal Reserve Board must be willing to insist on organizational changes that better align business lines and legal entities well before a crisis occurs. Unless these structures are rationalized and simplified in advance, there is a real danger that their complexity could make a SIFI resolution far more costly and more difficult than it needs to be.

Such changes are also likely to have collateral benefits for the firm's management in the short run. A simplified organizational structure will put management in a better position to understand and monitor risks and the inter-relationships among business lines, addressing what many see as a major challenge that contributed to the crisis. That is why—well before the test of another major crisis—we must define high informational standards for resolution plans and be willing to insist on organizational changes where necessary in order to ensure that SIFIs meet the standard of resolvability.

The Orderly Liquidation Authority (OLA)

There also appear to be a number of popular misconceptions as to the nature of the Orderly Liquidation Authority. Some have called it a bailout mechanism, while others see it as a fire sale that will destroy the value of receivership assets. Neither is true. The OLA strictly prohibits bailouts. While it is positioned as a backup plan in cases where bankruptcy would threaten to result in wider financial disorder, the OLA is actually a better-suited framework for resolving claims against failed financial institutions. It is a transparent process that operates under fixed rules that prohibit any bailout of shareholders and creditors or any other type of political considerations, which can be a legitimate concern in the case of an ad-hoc emergency rescue program. Not only would the OLA work faster and preserve value better than bankruptcy, but the regulatory authorities who will administer the OLA are in a far better position to coordinate with foreign regulators in the failure of an institution with significant international operations.

The FDIC has made considerable progress in forging bilateral agreements with other countries that will facilitate orderly cross-border resolutions. In addition, we currently co-chair the Cross Border Resolutions Group of the Basel Committee. It is worth noting that not a single other advanced country plans to rely on bankruptcy to resolve large, international financial companies. Most are implementing special resolution regimes similar to the OLA. Under the OLA, we can buy time, if necessary, and preserve franchise value by running an institution as a bridge bank, and then eventually sell it in parts or as a whole. It is a powerful tool that greatly enhances our ability to provide continuity and minimize losses in financial institution failures while imposing any losses on shareholders and unsecured creditors.

Under the OLA, the FDIC can conduct advance planning, temporarily operate and fund an institution under government control to preserve its value as a going concern, and quickly pay partial recoveries to creditors through advance dividends, as we have long done in failed-bank receiverships. The result will be a faster resolution of claims against a failed institution, smaller losses for creditors, reduced impact on the wider financial system, and an end to the cycle of bailouts.

The history of the recent crisis is replete with examples of missed opportunities to sell or recapitalize troubled institutions before they failed. But with bailout now off the table, management will have a greater incentive to bring in an acquirer or new investors before failure, and shareholders and creditors will have more incentive to go along with such a plan in order to salvage the value of their claims. These new incentives to be more proactive in dealing with problem SIFIs will reduce their incidence of outright failure and also lessen the risk of systemic effects arising from such failures.

In summary, the measures authorized under the Dodd-Frank Act to create a new, more effective SIFI resolution authority will go far toward reducing leverage and risk-taking in our financial system by subjecting every financial institution, no matter its size or degree of interconnectedness, to the discipline of the marketplace. Prompt and effective implementation of these measures will be essential to constraining the tendency toward excess leverage in our financial system and our economy, and in creating incentives for safe and sound practices that will promote financial stability in the future.

In light of the ongoing concern about the burden arising from regulatory reform, I think it is worth mentioning that none of these measures to promote the resolvability of SIFIs will have any impact at all on small and midsized financial institutions except to reduce the competitive disadvantage they have long encountered with regard to large, complex institutions. There are clear limits to what can be accomplished by prescriptive regulation. That is why promoting the ability of market forces to constrain risk taking will be essential if we are to achieve a more stable financial system in the years ahead.

Strengthening Capital Standards

At the height of the crisis, the large intermediaries that make up the core of our financial system had too little capital to maintain market confidence in their solvency. The crisis also showed how leverage can be masked through off-balance-sheet positions, implicit guarantees, securitization structures, and derivatives positions. While bank capital requirements are critically important to financial stability, the problem of excessive leverage in the financial system extends well beyond bank balance sheets to a wide range of nonbank financial companies and special-purpose vehicles.

Last year witnessed two landmarks in the history of bank capital regulation: the international Basel III agreement and Section 171—the Collins Amendment—of the Dodd Frank Act. Basel III strengthens the definition and increases the amount of bank capital so that banks will be able to withstand downturns and continue to lend. Basel III also requires capital for risks that the old rules did not adequately address and establishes an international leverage ratio. The Collins Amendment ensures large banks will be required to hold at least as much capital in proportionate terms as would a smaller bank with similar exposures.

Implementing these significant improvements in capital regulation is, in my view, one of the most important near term regulatory priorities. I hope that a Final Rule implementing aspects of the Collins Amendment will be agreed upon before my term as Chairman comes to an end. Agency staffs are also drafting an NPR that will seek comment on the implementation of Basel III in the U.S., with publication targeted for later this year.

Why are these proposed changes in capital regulation so important? A first and obvious point is that banking and financial crises have devastating effects on economic growth and job creation. Maintaining strong capital levels consistent with a safe-and-sound banking system both promotes long-term economic growth and makes bank lending less procyclical.

Skeptics argue that requiring banks to hold greater amounts of higher-cost equity capital will raise the cost of credit and impair economic performance.[13] But recent studies that also account for the social cost of debt financing relative to equity show that higher capital requirements will have a relatively modest effect on the cost of credit and economic activity, while making the financial system more resilient to shocks.[14]

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[13] See: "Interim Report on the Cumulative Impact on the Global Economy of Proposed Changes in the Banking Regulatory Framework," Institute of International Finance, June 2010. http://www.iif.com/press/press+151.php

[14] See: Admati, Anat, Peter M. DeMarzo, Martin R. Hellwig and Paul Pfleiderer. "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive." Stanford Graduate School of Business Research Paper No. 2065, March 2011. http://www.gsb.stanford.edu/news/research/Admati.etal.html

Hanson, Samuel, Anil Kashyap and Jeremy Stein. "A Macroprudential Approach to Financial Regulation." Working paper (draft), July 2010. http://www.economics.harvard.edu/faculty/stein/files/JEP-macroprudential-July22-2010.pdf

Our financial system was so vulnerable heading into the crisis because of shortcomings in capital regulation. Regulatory definitions of what counted as capital were too permissive, the level of high-quality capital was too low, our rules missed important risks, and a dangerous precedent—growing reliance by the regulators on banks' own risk estimates—was gaining momentum.

For over twenty years, there was international agreement that Tier 1 capital should be at least four percent of risk-weighted assets. Since four percent Tier 1 capital needed to consist "predominantly" of common equity and if "predominantly" means "at least half" (and it was in some countries), a bank could theoretically have as little as two percent common equity. The rest of the Tier 1 requirement could be met with hybrid debt or other non-loss absorbing capital. For example, common equity could include substantial amounts of deferred tax assets that are not available to absorb loss when a bank is unprofitable, mortgage servicing rights and other intangible assets whose values may be highly sensitive to assumptions, minority interests in consolidated subsidiaries that are not available to absorb loss outside the subsidiary, and equity investments in financial firms—interlinked exposures that increase contagion risk in the system. All of these deficiencies of the capital definition were exposed during the crisis.

While the definition of Tier 1 capital itself represents something of a mixed bag, the minimum Tier 1 capital ratio – four percent of risk weighted assets – is also subject to

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Marcheggiano, Gilberto, David Miles and Jing Yang. "Optimal Bank Capital." London: Bank of England. External Monetary Policy Committee Unit Discussion Paper No. 31, April 2011. http://www.bankofengland.co.uk/publications/externalmpcpapers/extmpcpaper0031revised.pdf miscalculation that could leave the institution holding too little capital. Here again, the crisis demonstrated significant shortcomings with our rules. Complex and illiquid securitization exposures and OTC derivatives exposures in trading books required little capital. Some off-balance sheet vehicles (such as some Structured Investment Vehicles or SIVs) avoided capital requirements altogether. In addition, 2004 Basel II's advanced approaches abandoned fixed capital requirements by loan category and allowed banks to calculate their risk-based capital requirements based on their own estimates of risk.

The FDIC's analysis showed the advanced approaches would significantly reduce capital requirements. The U.S. Quantitative Impact Study conducted in 2004-2005 validated our concerns: the 26 large organizations participating estimated that their Tier 1 capital requirements would drop by a median 31 percent compared to the agencies' general risk-based capital rules. For residential mortgages, widely agreed at the time to pose little risk, banks' own models produced median capital drops of almost 73 percent. The agencies' analysis also showed that different banks were estimating widely different capital requirements for loans with similar risk characteristics, an illustration of the underlying subjectivity of the advanced approaches.

Other countries acted with dispatch to implement the advanced approaches, without benefit of any objective constraint on bank leverage. Throughout the crisis and its aftermath, capital requirements in most European countries are lower under the advanced approaches than they were under Basel I, and often much lower.

I am proud of the FDIC's insistence that in the U.S. banks remain subject to the leverage requirements established by our statutory Prompt Corrective Action regulations, and that the transition to the advanced approaches would be gradual and subject to significant safeguards. Many large banks criticized us for taking that stand. But imagine if we had implemented the advanced approaches promptly in 2004, with all capital floors phased out in two years as originally scheduled by the Basel Committee. Large U.S. banking organizations almost certainly would have entered the crisis with far less capital to absorb losses, which would have caused even more failures and more retrenchment in credit availability.

In a speech before the International Conference of Bank Supervisors in Merida, Mexico in 2006, when I called for an international leverage ratio, the idea was summarily dismissed. By December, 2010, however, the Basel Committee finalized an international leverage ratio standard that is in some ways more stringent than our U.S. standard.

This policy shift reflects, of course, the lessons of the crisis about the dangers of excessive leverage. The development of the international leverage ratio, and the rest of the stronger capital standards of Basel III, also reflects the efforts of the men and women of the FDIC and our fellow banking regulators who worked tirelessly to negotiate these agreements.

The second landmark in capital regulation is Section 171 of the Dodd Frank Act—the Collins Amendment. In my view, this is the single most important provision of the Act for strengthening the capital of the U.S. banking system and leveling the competitive playing field between large and small U.S. banks. Section 171 essentially says that risk-based and leverage capital requirements for large banks, bank holding companies and nonbanks supervised by the Federal Reserve Board may not be lower than the capital requirements that apply to thousands of community banks nationwide.

More is on the agenda. The Basel Committee is developing capital standards for the most systemically important institutions that would augment the standards announced in December, 2010. These standards must be met with the same tangible common equity that Basel III requires for the new minimum standard for common equity capital. Allowing convertible debt to meet these standards suffers from a number of potential problems. Conversion in a stressed situation could trigger a run on the institution, downstream losses to holders of the debt, and potentially feed a crisis. Reliance on innovative regulatory capital is something that has been tried with Trust Preferred Securities. During the crisis, those securities did not absorb losses on a going concern basis and served as an impediment to recapitalizations. Regulators should avoid such devices in the future, and instead rely on tangible common equity.

Minimizing Regulatory Burden

The FDIC recognizes that while the changes required by the Dodd-Frank Act are necessary to establish clear rules that will ensure a stable financial system, these changes must be implemented in a targeted manner to avoid unnecessary regulatory burden. We are working on a number of fronts to achieve that necessary balance.

The FDIC is particularly interested in finding ways to eliminate unnecessary regulatory burden on community banks, whose balance sheets are much less complicated than those of the larger banks. At the January 20 meeting of the FDIC's Advisory Committee on Community Banking, we engaged the members – nearly all bankers – in a full and frank discussion of other ways to ease the regulatory burden on small institutions. We discussed ways of analyzing the impact of new regulations on community banks, how questionnaires and reports can be streamlined through automation, how to keep bank reporting requirements focused on the items most essential to risk management, and ways that bankers can communicate their concerns in this area to FDIC officials.

Above all, it is important to emphasize to small and mid-sized financial institutions that the Dodd-Frank Act reforms are not intended to impede their ability to compete in the marketplace. On the contrary, we expect that these reforms will do much to restore competitive balance to the marketplace by restoring market discipline and appropriate regulatory oversight to systemically important financial companies, many of which received direct government assistance in the recent crisis.

Addressing Future Economic Challenges

The task of restoring the normal functioning of our financial markets and institutions remains incomplete. The implementation of reforms under the Dodd-Frank Act will go a long way toward restoring long-term confidence and stability to our financial system. We also face a number of broader economic policy challenges, both in the near term and over the longer term. This section outlines two areas where policymakers urgently need to focus their attention if we are to secure the recovery and reduce the likelihood of future economic instability.

Securing the Recovery in U.S. Housing Markets

High risk mortgage lending and shortcomings in consumer protections for mortgage borrowers were among the most important underlying causes of the housing bubble and the financial crisis that resulted. Not only did the proliferation of high-risk subprime and nontraditional mortgage products help to push home prices up during the boom, but excessive reliance on foreclosure as a remedy to default has helped to push home prices down since the peak of the market over four years ago. While the U.S. economy is in its eighth quarter of expansion, mortgage markets remain deeply mired in credit distress and private securitization markets remain largely frozen. Serious weaknesses identified with mortgage servicing and foreclosure documentation have introduced further uncertainty into this already fragile market. The FDIC has emphasized the need for specific changes to address the most glaring deficiencies in servicing practices, including a single point of contact for distressed borrowers, appropriate write-downs of second liens, and servicer compensation structures that are aligned with effective loss mitigation.

The FDIC is especially concerned about a number of related problems with servicing and foreclosure documentation. "Robo-signing" is the use of highly-automated processes by some large servicers to generate affidavits in the foreclosure process without the affiant having thoroughly reviewed facts contained in the affidavit or having the affiant's signature witnessed in accordance with state laws. The other problem involves some servicers' inability to establish their legal standing to foreclose, since under current industry practices, they may not be in possession of the necessary documentation required under State law. These are not really separate issues; they are simply the most visible of a host of related, unresolved problems in the mortgage servicing industry.

As you know, even though the FDIC is not the primary federal regulator for the largest loan servicers, our examiners participated with other regulators in horizontal reviews of these servicers, as well as two companies that facilitate the loan securitization process. In these reviews, federal regulators cited "pervasive" misconduct in foreclosures and significant weaknesses in mortgage servicing processes.

Unfortunately, the horizontal review only looked at processing issues. Since the focus was so narrow, we do not yet really know the full extent of the problem. The Consent Order, discussed further below, requires these servicers to retain independent, third parties to review residential mortgage foreclosure actions and report the results of those reviews back to the regulators. However, we have heard concerns regarding the thoroughness and transparency of these reviews, and we continue to press for a comprehensive approach to this "look back."

These servicing problems continue to present significant operational risks to mortgage servicers. Servicers have already encountered challenges to their legal standing to foreclose on individual mortgages. More broadly, investors in securitizations have raised concerns about whether loan documentation for transferred mortgages fully conforms to applicable laws and the pooling and servicing agreements governing the securitizations. If investor challenges to documentation prove meritorious, they could result in "putbacks" of large volumes of defaulted mortgages to originating institutions.

There have been some settlements regarding loan buyback claims with the GSEs and some institutions have reserved for some of this exposure; however, a significant amount of this exposure has yet to be quantified. The extent of the loss cannot be determined until there is a comprehensive review of the loan files and documentation of the process dealing with problem loans. We also believe that the FSOC needs to consider the full range of potential exposure and the related impact on the industry and the real economy.

In April 2011, the Federal banking agencies ordered fourteen large mortgage servicers to overhaul their mortgage-servicing processes and controls, and to compensate borrowers harmed financially by wrongdoing or negligence. The enforcement orders were only a first step in setting out a framework for these large institutions to remedy deficiencies and to identify homeowners harmed as a result of servicer errors. The enforcement orders do not preclude additional supervisory actions or the imposition of civil money penalties. Also, a collaborative settlement effort continues between the State Attorneys General and federal regulators led by the U.S. Department of Justice. It is critically important that lenders fix these problems soon to contain litigation risk and remedy the foreclosure backlog, which has become the single largest impediment to the recovery of U.S. housing markets.

Controlling the Growth in U.S. Federal Debt

The banking industry today is very focused on credit risk. Over the last three years, FDIC-insured institutions have set aside over $640 billion in loan loss provisions and, in the process, written off more than half a trillion dollars in bad loans. This is by far the most severe credit event in our modern history. But even as institutions are focused on cleaning up balance sheets and building capital, the FDIC is encouraging them to remain focused on what could be the next major threat to financial stability – interest rate risk at depository institutions. Since the liability side of the bank balance sheet is typically shorter in duration than the asset side, banks tend to be adversely affected by rising interest rates. During a prolonged period of very low short-term interest rates and a steep yield curve, institutions may be tempted to make money by essentially borrowing short and lending long. However, structuring the bank portfolio in this way risks increasing the institution's vulnerability to losses in the event of rising interest rates.

The FDIC is actively addressing the need for heightened measures to manage interest rate risk at this critical stage of the interest rate cycle. In January 2010 we issued a Financial Institution Letter (FIL) clarifying our expectations that FDIC-supervised institutions will manage interest rate risk using policies and procedures commensurate with their complexity, business model, risk profile, and scope of operations.[15] That same month, the FDIC hosted a Symposium on Interest Rate Risk Management that brought together leading practitioners in the field to discuss the challenges facing the industry in this area.[16]

Effective management of interest rate risk assumes a heightened importance in light of the recent high rates of growth in U.S. government debt -- the yield on which represents the benchmark for determining private interest rates all along the yield curve. Total U.S. federal debt has doubled in the past seven years to over $14 trillion, or more than $100,000 for every American household. This growth in federal borrowing is the result of both the temporary effects of the recession on federal revenues and outlays and a long-term structural deficit related to federal entitlement programs

The U.S. has long enjoyed a unique status among sovereign issuers by virtue of its economic strength, its political stability, and the size and liquidity of its capital markets. Accordingly, international investors have long viewed U.S. Treasury securities as a haven, particularly during times of financial market uncertainty. However, as the amount of publicly-held U.S. debt continues to rise, and as a rising portion of that debt comes to be held by the foreign sector (about half as of September 2010), there is a risk that investor sentiment could at some point turn away from dollar assets in general and U.S. Treasury obligations in particular.

[15] See http://www.fdic.gov/news/news/financial/2010/fil10002.html
[16] See: http://www.fdic.gov/news/conferences/symposium_irr_meeting.html

With more than 70 percent of U.S. Treasury obligations held by private investors scheduled to mature in the next five years, an erosion of investor confidence would likely lead to sharp increases in government and private borrowing costs. As recent events in Greece and Ireland have shown, such a reversal in investor sentiment could occur suddenly and with little warning. If investors were to similarly lose confidence in U.S. public debt, the result could be higher and more volatile long-term interest rates, capital losses for holders of Treasury instruments, and higher funding costs for depository institutions. Household and business borrowers of all types would pay more for credit, resulting in a slowdown in the rate of economic growth if not outright recession.

Over the past year, the U.S. fiscal outlook has assumed a much larger importance in policy discussions and the political process. Members of Congress, the Administration, and the Presidential Commission on Fiscal Responsibility and Reform have all offered proposals for addressing the long-term fiscal situation, but political consensus on a solution appears elusive at this time. It is likely that the capital markets themselves will continue to apply increasing pressure until a credible solution is reached. Already, the cost for bond investors and others to purchase insurance against a default by the U.S. government has risen from just 2 basis points in January 2007 to a current level of 42 basis points.

Financial stability critically depends on public and investor confidence. Developing policies that will clearly demonstrate the sustainability of the U.S. fiscal situation will be of utmost importance in ensuring a smooth transition from today's historically low interest rates to the higher levels of interest rates that are inevitable in coming years. Government policies to slow the growth in U.S. government debt will be essential to lessening the impact of this shock and reducing the likelihood that it will result in a costly new round of financial instability. In short, there is no greater threat to our future economic security and financial stability than an inability to control the size of U.S. government debt.

But as strongly as I feel about this issue, I feel just as strongly that a technical default on U.S. government obligations would prove to be calamitous. Investor confidence in U.S. Treasury obligations is absolutely vital to domestic and global financial stability and cannot be taken for granted. In the end, that confidence is based solely on the belief that policymakers will do whatever is necessary to make good on the nation's financial obligations. Any signal to the contrary risks permanently destroying the inviolable trust that investors the world over have placed in this nation for more than two centuries. I urge Congress to reaffirm this trust by committing to a responsible increase in the debt ceiling.

Conclusion

Chairman Capito and members of the Committee, I have provided today a fairly comprehensive account of the causes of the crisis, the FDIC's response to the crisis, the implementation of regulatory reform, and some important economic challenges that still lie ahead. As I conclude, I would like to share with you one of the most important lessons I have drawn from my experience as FDIC Chairman. It is that the most important attribute of effective regulation is the political courage to stand firm against weak practices and excessive risk taking in the good times. It is during a period of prosperity that the seeds of crisis are sown. It is then that overwhelming pressure is placed on regulators to relax capital standards, to permit riskier loan products, to allow higher concentrations of risk on the balance sheet and permit the movement of risky assets off the balance sheet, where they continue to pose a risk to stability.

The history of the crisis shows many examples when regulators acted too late, or with too little conviction, when they failed to use authorities they already had or failed to ask for the authorities they needed to fulfill their mission. As the crisis developed, too many in the regulatory community were too slow to acknowledge the danger, and were too slow to act in addressing it. The fact is, regulators are never going to be popular or glamorous figures, whether they act in a timely manner to forestall a crisis or if they fail to act and allow it to take place. The best they can hope to achieve is the knowledge that they exercised the statutory authority entrusted to them in good faith and to its fullest effect in the interest of financial stability, without regard to the political consequences.

While I share the sense that the worst is past for this economic cycle, the outcome of the next financial crisis is already being determined by decisions regulators are making today in the Dodd-Frank Act implementation process. The Dodd-Frank Act provides the tools to restore market discipline and put an end to the cycle of government bailouts under Too Big to Fail. These tools will be effective—and the large, systemically-important institutions will be resolvable—in the next crisis only if regulators show the courage today to fully exercise their authorities under the law.

For example, no financial firm wants to be designated as a SIFI, and there is even a great deal of resistance to the collection of information during the SIFI designation process. But we must have this information so that we can be assured that we will not be faced with the need to invoke the orderly resolution authority in a crisis without the benefit of advance planning and a well-considered resolution plan. Similarly, the success of the SIFI resolution framework will critically depend on the willingness of the FDIC and the Federal Reserve Board to actively use their authority to require organizational changes at SIFIs that better align business lines and legal entities well before a crisis occurs. Unless structures are rationalized and simplified in advance, there is a real danger that their complexity could make a SIFI resolution far more costly and more difficult than it needs to be.

These authorities are being shaped now in the interagency rule-making process. If properly implemented, these measures can make our financial system significantly more stable by restoring market discipline to systemically-important institutions. If we lack the political courage to insist on these measures now, when market conditions are relatively calm, we will have no hope of preventing bailouts in the next crisis.

I have also emphasized in this testimony that strong capital standards are of fundamental importance in maintaining a safe-and-sound banking system that supports economic growth. Capital standards play a central role in preserving financial stability. Well-defined and objective capital requirements do not depend for their operation on the ability of supervisors to foresee risks that are not yet evident. Supervisory processes will always lag innovation and risk-taking to some extent, and restrictions on activities can be difficult to define and enforce. Hard and fast objective capital standards, on the other hand, are easier for supervisors to enforce, and provide an additional cushion of loss absorbency when mistakes are made, as will inevitably be the case.

We have already experienced a great deal of political resistance to higher capital requirements from industry representatives claiming that they will stifle growth and derail the expansion. These claims ignore the enormous economic costs of having too little capital coming into this crisis, as well as new research showing that the high social cost of debt financing argues for a more conservative approach to financing financial and economic activity in the years ahead.

Thank you, and I would be glad to take your questions.

Response to questions from the Honorable Luetkemeyer
by Sheila C. Bair, Chairman,
Federal Deposit Insurance Corporation

Q1: Can the FDIC please provide any information that supports Chairman Bair's statement that the Small Dollar Loan Pilot Program was broadly profitable?

Answer 1: The dominant business model that emerged from the pilot was the long-term, relationship building model. Pilot banks with existing programs were the most likely to report that overall relationships with small dollar loan customers are profitable. These banks indicate that costs related to originating and servicing a small dollar loan are similar to other loans. However, given the small size of these loans, the interest income and fees generated are often not sufficient to achieve short-term profitability. Nevertheless, some banks with existing programs were able to generate long-term profitability through volume and by using the small dollar loan products to cross-sell additional products.

In addition, a few banks achieved short-term profitability. These banks are located primarily in census tracts with high concentrations of low- and moderate-income households, immigrant households, or both, and have identified a need for small-dollar loan products among these consumers. In general, these banks are well positioned to generate higher transaction volumes and tend to impose interest rates and fees at the higher end of the range, although they remain within the recommended 36 percent APR limit. Case studies conducted during the pilot and published in the *FDIC Quarterly* highlight examples of both long-term and short-term profitability.[1]

Q2: Are there plans to follow up with additional pilots or studies of SDLs?

Answer 2: The FDIC is not currently conducting additional formal pilots or studies of small-dollar loans. However, we continue to work with the banking industry, consumer and community groups, nonprofit organizations, other government agencies, and others to research and pursue strategies that could prove useful in expanding the supply of small-dollar loans. These strategies include:

- Highlighting the facts about the pilot and other successful small-dollar loan models.
- Encouraging broad-based partnerships among banks, nonprofit, and community groups to work together in designing and delivering small-dollar loans.
- Studying the feasibility of safe and innovative emerging small-dollar loan technologies and business models.
- Considering ways that regulators can encourage banks to offer safe and affordable small-dollar products.

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[1] See "The FDIC's Small-Dollar Loan Pilot Program: A Case Study After One Year," FDIC Quarterly, 2009 Vol. 3, no. 2 at http://www.fdic.gov/bank/analytical/quarterly/2009_vol3_2/smalldollar.html

Q3: Dodd-Frank Act § 1073(c) requires the federal banking agencies to make guidelines "regarding the offering of ... no-cost or low-cost basic consumer accounts." How does the FDIC plan to implement this requirement?

Answer 3: The FDIC is very concerned about the availability of no- or low-cost basic consumer accounts. In 2007, we formed an Advisory Committee on Economic Inclusion to bring more focus to this and related consumer issues. The FDIC has created templates for banks offering no- and low-cost transaction and savings accounts and small dollar loans. The FDIC will implement section 1073(c) of the Dodd-Frank Act by building on what we have learned from the no- and low-cost pilot activities.

Q4: Dodd-Frank Act § 1205 authorizes Treasury to establish "demonstration programs ... to provide low-cost, small loans to consumers that will provide alternatives to more costly small dollar loans." Is the FDIC cooperating with Treasury on these demonstration programs? Are there any lessons from the Small Dollar Loan Pilot Program that might inform Treasury's development of demonstration programs?

Answer 4: Following the completion of the FDIC Small-Dollar Loan Pilot, the FDIC published an *FDIC Quarterly* article highlighting the results of the pilot and the lessons learned.[2] In addition, the best practices and elements of success that emerged from the pilot are reflected in the Safe, Affordable, and Feasible Small-Dollar Loan Template.[3] FDIC staff members have met with Treasury staff to discuss and share the lessons from the pilot and maintain open and cooperative relationships with their counterparts at Treasury.

Q5: Is there an appropriate role for non-bank partners in offering SDLs with banks?

Answer 5: Pilot bankers and other successful small-dollar lending programs have reported that partnerships with consumer or community groups were crucial to the success of their programs. Appropriate roles for community-based partners include providing client referrals, providing financial education and counseling, and sharing in program costs. In some cases, partnerships may be one-on-one relationships, while other models rely on broad-based coalitions and strategies, which include the provision of small-dollar loans as part of larger efforts to increase access to the financial mainstream.

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[2] See "A Template for Success: The FDIC's Small-Dollar Loan Pilot Program," FDIC Quarterly 2010, Vol. 4, No. 2 at http://www.fdic.gov/bank/analytical/quarterly/2010_vol4_2/FDIC_Quarterly_Vol4No2_SmallDollar.pdf

[3] http://www.fdic.gov/smalldollarloans/

Q6: Should Treasury include non-banks in its demonstration programs?

Answer 6: Treasury has the sole authority to design and implement its demonstration programs. The FDIC supports encouraging partnerships with community and consumer groups and nonprofit organizations, where banks and credit unions are the credit providers.

6A: Will the FDIC permit banks to partner with non-banks to offer SDLs?

Answer 6A: The FDIC encourages broad-based partnerships among banks, nonprofit, and community groups to work together in designing and delivering small-dollar loans. In particular, the FDIC's Alliance for Economic Inclusion (AEI), a national initiative to establish coalitions of financial institutions, local policymakers, community-based and consumer organizations, and other partners to increase access to the financial mainstream, focuses, in part, on expanding access to small-dollar loans and other basic retail financial services.

6B: Is there any FDIC policy against permitting these types of partnerships?

Answer 6B: FDIC-supervised institutions frequently have relationships with third parties, which allow the institutions to provide a wide variety of services and engage in numerous activities. The FDIC has issued guidance advising its institutions to appropriately oversee and manage the risks associated with those third-party relationships. That guidance provides that an institution's board of directors and senior management are ultimately responsible for managing activities conducted through third-party relationships, and identifying and controlling the risks arising from such relationships, to the same extent as if the activity were handled within the institution.

Q7: The NCUA's Short-Term Small Loan Program allows credit unions to extend loans of $200 to $1000 at a 28% interest rate, and with an application fee of $20 and a term of 30 to 180 days, resulting in annual rates of greater than 100%. *See* http://www.ncua.gov/Resources/RegulatoryAlerts/Files/2010/10-RA-13.pdf. Press reports indicate that many credit unions are operating within the NCUA's general rate cap of 18%, but are charging higher application fees, resulting in annual rates of more than 300%. Credit unions, some of which are cooperating with non-depository partners, report that an up-front fee is necessary to make these loans profitable.

7A: How does this square with the FDIC's experience in the Small Dollar Loan Pilot Program?

Answer 7A: All banks in the FDIC Small-Dollar Loan Pilot charged interest rates and fees that resulted in annual percentage rates (APRs) of 36 percent or less. About half of the banks charged an origination fee.

7B: Would the FDIC permit banks to charge a larger up-front fee?

Answer 7B: The FDIC does not impose a cap on origination or application fees for small-dollar loans. Banks have discretion to set their own fees pursuant to applicable federal and state laws. In 2007, the FDIC issued final guidelines to state nonmember banks regarding affordable small-dollar loan products, and indicated we would provide Community Reinvestment Act credit for small dollar loans that were consistent with the parameters set forth in the guidelines. These guidelines state that an origination fee that bears a direct relationship to origination costs may be assessed. The guidelines do not further specify guidance on up-front fees, but do encourage lenders to offer small-dollar credit with APRs no greater than 36 percent, as permitted by state law.

7C: Would the FDIC consider a program such as the NCUA's that permits an application fee that is more than a nominal amount?

Answer 7C: As mentioned, the FDIC did not impose a set level of fees for the small dollar loan pilot program. Banks set their own fee levels that also would be subject to appropriate federal and state laws. The pilot banks' experiences demonstrate that banks can offer successful programs with fees that adhere to the FDIC Small-Dollar Loan Guidelines. Only about half of the pilot banks charged an origination fee and, when this fee was added to the interest rate, all banks remained within the targeted 36 percent APR.

Statement by Jeff Betsill

My name is Jeff Betsill, and I have been in the residential construction industry for thirty five years. My father, Alex, was a carpenter and I grew up working alongside him, learning the trade from a very early age. From my father, I learned the value of hard work and commitment to any task undertaken. I learned to always include quality and do the right thing even if it costs you monetarily. My love for taking a vacant lot and coordinating materials and labor to produce a great home has always driven me to stay in homebuilding.

I would appreciate you granting me a moment to focus on the word "home". A home, at the most heartfelt definition, is a place where American's raise families, share joys and share hurt. As a young builder, I would converse with home buyers that the purchase of a home was the best investment they would likely ever make. Owning a home is a start to sharing in each other's lives. Of course, at the time, I believed the value of a home would always either maintain or increase in value. In the thirty two years preceding the experience we are all now a part of, I had never seen the value of a home decrease. I obviously did not understand the factors controlling my world.

I sit before you today to discuss my experience throughout the downturn with a particular construction lender for my business. Unfortunately, and I hate to admit this, but early in my years of owning my own company, I was not nearly as schooled in lending practices as I am today. I always believed that working hard, while considering the quality of the home and experience I was producing, would pay beneficial net results for all individuals involved. I would be misleading this Committee if I led it to believe I was an individual that completely understood what lenders (both construction and home loan) could and could not do.

I will share with you my experience with a lender to my organization and the effect their actions had not only on my own company, but my employees and the general population. The particular situation I am referring to began in a subdivision of close proximity to where we sit today. This subdivision was named as one of the top thirty best selling subdivisions in the Metro Atlanta Market. We began construction using funds lent from this lender in late 2004. Three builders made the builder group in this subdivision, and each builder, I would say, averaged approximately twenty-five homes per year through late 2007. The margins we were able to get in this location were strong and we were building primarily on a pre-sale basis. It was truly our greatest source of income.

In mid 2008, we had requests in for a couple of speculative loans and a couple of pre-sale construction loans with this lender. To approve the loan requests, the lender asked for routine information. In the prior years, approval was pretty much a guarantee in less than two to three weeks, especially at this subdivision. Well, approximately three weeks went by and we followed up for an update as to the loan requests. They requested additional, less typical, information. We provided the requested information and another month or so went by without approval. We then received a phone call from a loan officer we had known for many years, working for the bank. In the conversation with him, he advised my company that our company's loan portfolio was moved to the special assets division. Of course, I was completely shocked given the rate of sales and margins being achieved and questioned as to why. The loan officer went on to state that the bank was looking at ALL collateral in place prior to the beginning of the downturn as a "toxic asset". Of course, this was the reason behind the loan portfolio being moved to the special assets division of the bank. With the move of the loan portfolio to special assets, we were told that nothing would change, just additional scrutiny for each request.

Additional scrutiny occurred, and we provided more and more information. A few more weeks went by and we then were requested, by the lender, to travel to a location approximately an hour and a half from our office for a meeting. At that meeting, the banks loan officers advised me they were proceeding with foreclosure on all lots we had with them. They did the same with the other builder remaining in the subdivision. At the time, we were current and making interest payments. It was approximately six months from the initial loan request to when the meeting occurred. During the foreclosure process, we had continued interest in building pre-sale homes and practically begged the lender to allow us a workout strategy, even giving them an option for our company working through all lots in eighteen months. Many additional options were provided to the lender in an effort to avoid foreclosure, at one point we received a response that the lender was not considering any options and they were proceeding to final foreclosure.

Of course, the impact on my company as the result of such a decision has been close to impossible to overcome. The subdivision was our income producer during a difficult time. The actions by the lender stigmatized my company and myself as a result of the foreclosure proceedings and have made it nearly impossible to obtain financing on any scale for continued operations. I have tried to work through my lot inventory with my additional lenders in a build out program, and have been fairly unsuccessful in that regard. With the decision of the lender to foreclose, we lost the two contracts to build pre-sale homes at the subdivision. We were also forced, as a result of the loss of income, to lay off many employees.

We have witnessed similar situations occur time after time involving many builders in our area, and have read stories nationwide which contain similar components to ours. These lenders have taken away all opportunities for producing income from thousands of builders, and in turn, loaded the home market with thousands upon thousands of bank owned homes. As we are now well aware of, the banks then unload the homes at significantly depressed prices, driving down existing home values.

In closing, I would like to thank the Committee for allowing me the opportunity to share my experience today. I have done so in hopes that the citizens of this great nation can gain an understanding that they are not alone in their frustrations with banks and lenders. I feel, as many small business and homeowners owners do, that decades of hard work and dedication were erased by a few inconceivable decisions by a single lender.

May 25, 2011

The Honorable Lynn A. Westmoreland
Member of Congress
3rd District of Georgia
1213 Longworth Building
Washington, DC 20515

Dear Congressman Westmoreland:

We are writing today to update you as requested during our meeting in February. As you may recall, we discussed the repercussions we have experienced due to bank failures. We are a small business which has performed site work, excavation and utilities in the construction industry throughout the state of Georgia for the past 34 years.

Our debacle began in the fall of 2007 with 150 employees, and by early 2008 we found our company with a $6M cash problem (30% yearly revenue) in work performed, but not collected. We now have an employment of 70 as of this date. The $6M uncollected by us, various owners and job sites, with the same problem, "failed banks". As a result the contractor is on the hook for payment of material, labor and equipment, supplied on these projects. Then comes the FDIC or successor banks' inability to fund projects and we see the projects foreclosed, wiping out liens, and any hope of recouping any funds. We are actively seeking to recover approximately $4M through our legal system. One of our legal cases represents a failed bank (Integrity Bank) which was taken over by FDIC. This case is scheduled to be tried in Georgia 11th Appellate Court on May 27, 2011. This case is a clear example of the failed bank (Integrity Bank) not following the mandatory rules and regulations set forth by the FDIC. While another case our company forced the developer into involuntary bankruptcy to protect our lien ($2.1M) from foreclosure efforts, which has allowed the developer time for the project to gain momentum. The project has successfully obtained a sale to Sam's Club and a major theatre group, while recently obtaining Kohl's contract due to close early June, 2011. With each closing, the debt is reduced on the outstanding A & D loan, jobs are created and we get closer to collecting our outstanding receivable. We have since learned our attorney failed to perfect our lien and we have met with the principles and E & O council of the firm, and received a 100% guarantee from the council of the firm

While diligently trying to collect funds for work performed on sites with failed funding, it has placed a heavy burden on our company and its survival. We have reduced salaries, cut jobs, benefits and entered into forbearance agreements in order to work out our debts.

RICHARD R. HARP EXCAVATION, INC.
240 Industrial Way, P.O. Box 1195, Fayetteville, Georgia 30214
Phone (770) 460-7747 Fax (770) 460-9571

We have successfully been able to work our agreements with our suppliers, however the bank is a different story. Our original bank of 15 years failed approximately two (2) years ago and is under a receivership bank.

We currently have four (4) loans which consist of one (1) line of credit and one (1) short term, both collateralized by heavy equipment and two (2) installment notes collateralized by buildings which house our company operations. Our line of credit matured in August, 2010 and the receivership bank has not been willing to renew. We continued to make our payments within a 30-day time period and the bank accepted our payments.

In the fall of 2010, it was announced the receivership bank is on the FDIC "watch list" and must raise capital and lower debt. We received our Notice of Demand on all loans December 6, 2010, while the receivership bank accepted our payments on December 30, 2010, and swept our checking accounts in January hence obtaining four (4) months advanced payments. In March we received court documents for repossession. With the guarantee the FDIC has given the receivership bank, it has taken away all incentives or desires for the receivership bank to renew bank loans to existing customers.

We were trying to negotiate a renewal of **100%** principal (not 10 cents on the dollar) balance which would entail a balloon payment at the end of term. By doing so, it would allow us the settlement of pending court cases, one of which represents 100% guarantee of $2.8M plus attorney fees in excess of $500K.

We have paid tremendous amounts to attorneys in the past three (3) years and have gone against their recommendations of closing our business because of our tremendous loss. I will admit it would have been much easier to have walked away. However, the foundation and support given to me by my family and our sense of **pride** has given me the determination to keep fighting the battle in order to pay our debts and keep our dedicated employees working.

Thank your for your time.

Sincerely,

Richard R. Harp
President

May 26, 2011

Dear Congressman Westmoreland,

I am enclosing a really good summation of the role the FDIC has had in the failure of community banks that was prepared by Hugh Morton.

Also, I am enclosing a letter from David Coxon, our former CEO at Southern Community Bank that demonstrates some of the problems the regulations have caused for local bankers.

I am not going to repeat all of this information, but I do want to give you some "bullet" points on the role of the FDIC.

1. The main culprit is the regulation requiring "fair market accounting" that was implemented in 2007. This regulation requires banks to write down their loans based on appraisals of property secured by their loans and to require their appraisals on a much more frequent basis. Overall they created a tremendous downward trend in real estate values of those properties financed with bank loans. That in turn had an adverse impact on all real estate values in general.
2. This fair market accounting regulation also required banks to increase their loan loss reserve account by the amount of devaluation of the real estate appraisal value of the properties financed by their loans. This increase to their loan loss reserve reflected directly on the bank's bottom line of their financial statements and reduced capital by that same amount of deficiency. This eroded bank capital incredibly.

   Even though these were "paper" losses they showed up as real losses on the bank financial statements. Never before in banking, to my knowledge, has such accounting been used In the past there were downturns in the economy and real estate values, but they were only slight declines in the real estate values and the impact on the bank's bottom line was manageable by giving the bank time to restore their real estate assets back to financial soundness.

   This also allowed the borrower time to work through these downturns and also restore their real estate values and contribute to the economic recovery that followed these downturns.

3. The loss share agreement between the FDIC and the acquiring bank of the assets of a failed bank I believe contributed greatly to the demise of many local businesses because of the requirements in the loss share agreement and the incentive to recover up to 90% of loan losses and also recover other expenses, therefore receiving financial gain for the elimination of loans that could have been managed with the borrower and restored to a healthy state. Instead, these agreements often destroy local businesses because they lose their assets and their credit and in turn impact the local economy very negatively.

There should never be a financial incentive of up front cash to financial institutions to acquire another bank and financial gain for elimination of loans.

4. These actions and other regulatory actions have contributed greatly to our staggering unemployment problem by destroying thousands of these small and medium size businesses that employ the majority of the workers in America.

   Not only does it destroy many of these businesses, but the surviving small and medium size businesses struggle because they cannot obtain the capital they need to maintain and expand their businesses and create new jobs.

I hope these "bullet" points will help with the other two documents I am enclosing.

Thanks for standing up for small and medium businesses in America.

Regards,

Tom Reese

Chapter 13

Bank Regulators Make It Worse

While bank regulatory agencies and their field examination teams obviously had no direct role in causing the subject financial crisis, certain of the policies and actions they employed in attempting to manage ailing banks contributed greatly to the magnitude of losses sustained by the banking industry, adding ultimately to the length and severity of the overall recession. Bank regulators were definitely a component of The Perfect Storm.

By regulators, I am referring to the state banking commissions, the Office of The Comptroller of The Currency, which is the administrative agency controlling national banks, and the Federal Depository Insurance Corporation (FDIC), which has ultimate authority over all federally insured banking institutions. My discontent has not been so much with the people working for these supervisory agencies. They have been given a Herculean task to perform. My complaints center more on the structure and the guidelines they have been given to work under.

The observations and conclusions stated herein regarding the role the various regulatory agencies played in the resolution of the economic crisis of 2007-2010 are drawn not only from my experiences in banking and corporate finance, but also the time during this period I served on the board of a troubled community bank, which ultimately failed. I witnessed first hand the actions and attitudes of regulators during this period and the unfortunate consequences of many of their decisions. I observed them closing banking institutions that would otherwise likely have survived, or at least would have had a less costly resolution, if a more accommodating alternate course of action had been taken. I watched as one peer described it, "banks being closed by appraisals and journal entries", or as another community banker put it, "We are being required to write down theoretical losses using real capital."

Regulators Focus On Loan Concentrations

When bank examination teams began detecting rising default levels on residential real estate loans among member banks in 2006-2007, their first reaction was to focus on the concentrations each institution had in undeveloped residential land loans, residential subdivision development loans and new home construction loans. The same examiners who were applauding the bank's profitability in previous examinations were now castigating them for the very same concentrations that had created the profits. These were the same loan concentrations that examiners had scrutinized and found acceptable in previous examinations when the loans were performing.

As mortgage conditions continued to deteriorate, the regulators began issuing agreements called Memorandums of Understanding (MOUs) to banks having even moderate levels of loan problems or any excessive concentrations of loans in residential acquisition, development and construction loans. These agreements were effectively forced on the boards of targeted banks and gave the regulators control over many areas of the banks' activities, particularly their lending programs.

If a bank's condition later worsened, regulators would typically impose a much more serious agreement called a Consent Order, which effectively gave the regulators substantial control over the bank's operations. Consent Orders, which were previously called Cease and

Desist Orders, usually established goals and deadlines for an institution to achieve. One of the principal goals was to increase the institution's capital. Failure to achieve the goals mandated in a Consent Order almost always resulted in a seizure of the bank by the FDIC.

The consequence of these agreements was that many banks, especially community banks, were precluded from making any additional loans secured by residential real estate other than permanent mortgages. At the same time that some banks were being given TARP funds by the federal government, designed in part to stimulate lending, regulators were attempting to prohibit banks from lending. While the Obama Administration was chastising banks for decreasing their lending volume, the banking regulators were quietly going from bank to bank effectively shutting down much of the bank's short-term residential lending programs.

Is Temporary Capital Deficiency A Basis For Bank Closing?

Between 2007 and February 2001, 336 banks in the U.S. have been closed by the FDIC. In my home state of Georgia alone, 55 banks were closed by the regulators from mid 2008 through the end of January 2011, making it the epicenter for bank failures. If current trends and regulatory interpretations continue, it is my prediction the majority of community banks in Georgia will eventually be closed.

Only a few of the Georgia bank closings were actual bank failures. The majority were closed because their tier one capital levels, determined principally by appraisals of collateral properties securing real estate loans, dropped below the mandatory minimum level of two percent. The regulators believe, though, that what they were doing in closing these banks was mandated by Congress. They are technically correct.

It has been said that generals are always fighting the last war. The same could be said of the regulators. The last war was the S&L calamity of the 1980s. The regulators are now trying to prevent some of the mistakes that were believed at the time to have contributed to the severity of the S&L disaster. This is the reason banking regulations now require a prompt closing once a bank's capital ratio falls below the minimum required level, a ration established by regulations implementing the FDIC improvement act of 1991.

Banks do not fail, though, because their capital levels, as determinod by questionable appraisals, fall below a preconceived number. Banks deal in liquidity. They take in deposits and lend out a percentage of them. A bank's fractional reserve business structure does not enable it to return everyone's deposits at one time should they demand them, even if the bank had an extremely high capital level. A bank with, say, a very high 20 percent capital level can fail as quickly as one with a two percent level if it is unable to meet the deposit withdrawal demands of its depositors. A bank could never liquidate its assets quick enough to pay all its depositors should it need to do so. The closing mandate included in the 1991 act was bad legislation

Most of the thousands of banks that failed in the 1930s did so because of "runs" on their deposits – not because of deficient capital ratios. The point is that a bank can operate with no capital so long as it has enough liquid assets to meet its demands for deposit withdrawals.

<u>**Regulatory Restrictions Increase Number Of Bank Failures**</u>

Aside from the restrictions on lending, there are four practices I observed regulators engaging in that have unnecessarily increased the number of bank failures:

(1) Fair Value Accounting – The very strict application of fair value accounting, also know as mark-to-market valuation, which was implemented by the FDIC in 2007 (FAS157), for valuing problem loan assets has been responsible for most of the closings of banks during this business cycle and is the principal reason for the weakened condition of many community banks that are still struggling to survive. The strict application of mark-to-market accounting has been especially oncrous because it has given little opportunity or time for banks to work through their loan problems.

Fair value accounting in its strictest manner of implementation requires that banks routinely reappraise the value of property securing their troubled loans. If there exists a deficiency between the loan balance and the reappraisal, the bank is required to establish an accounting reserve to cover the indicated losses that might arise from a potential future sale of the property securing the loan. This reserve is then charged against the bank's capital and cannot be removed until the loan is paid off or the property is foreclosed and sold. Such potential "appraisal losses" requiring the establishment of loss reserves on a large enough number of problem loans could conceivably force the closure of a bank without the bank ever incurring an actual loss through the sale of foreclosure properties. Even if a subsequent reappraisal were to show an increase in value for the collateral property, the reserve cannot easily be recovered until the loan is paid in full or the property is foreclosed and disposed of in an amount at least equal to the loan amount.

In this strict mark-to-market regulatory environment, there has been little incentive for banks to work with troubled borrowers. Since the banks have already been forced to take the accounting charge to their capital and regulators are pushing them to dispose of problem assets, they might as well foreclose and attempt to sell the collateral property.

This has especially been the case with many larger regional banks that received TARP money. They were much quicker to foreclose and dump properties on the market at reduced prices, thereby further reducing the value of real estate collateral securing loans held by other community banks. The community banks without TARP funds have been, as expected, less aggressive in discounting property to get a quick sale.

The dumping of properties by banks attempting to meet demands of regulators has exacerbated the seemingly unending downward spiral in real estate values which has brought even lower values on subsequent reappraisals of the real estate securing troubled loans, requiring banks to set aside even larger reserves for possible future losses. This, unfortunately, has depleted bank capital levels even further. Should the bank's tier one capital level drop below two percent, the FDIC is required to begin a process to either close the bank and dissolve it or preferably to find another healthy bank to take over the bank's deposits and certain of its assets as might be negotiated between the purchasing bank and the FDIC.

With the downward spiral of real estate prices in the past couple of years, community banks in particular have grown to dread visits by the field examination staffs of the regulatory agencies. With each examination comes calls for new reappraisals of collateral property securing real estate loans. Even though the number of problem loans at a bank might not have changed since the bank's last exam, declining real estate values can give lower reappraisal valuations of collateral property, triggering calls from regulators for additional charges to capital. With each successive exam, banks have watched their capital levels being eroded away – the ultimate fear being that the capital level will drop so low that one Friday afternoon regulators will show up and take control of the bank.

Typically, in the current banking environment, a bank is subject to being seized, although it is not mandated, by the FDIC if its core capital level – referred to by regulators as tier one capital – drops below four percent. It hasn't always been this way. The entire eight and one half years I was CEO of an S&L in the 1980s, we never had a capital level over two percent and we survived the worst of the S&L crisis.

Sitting on the board of a troubled community bank in this period, I witnessed first hand the depletion of a significant portion of the bank's hard earned capital through accounting entries based upon questionable appraisals and unnecessary "write downs". The bank was forced to expense losses in most cases, even though there had been no actual losses from the disposition of foreclosed property. The collateral property was often still owned by the borrower and, in many cases, interest was being paid, though sometimes in arrears. In other cases, fully performing loans were "written down", to use banking lingo, just because of the type or real estate securing the loan.

In one glittering example, a Georgia bank had a large residential subdivision development loan secured by developed lots. The loan was performing with interest paid up to date, but due to the substantial devaluation of building lots in the area, the value of the collateral was less than the loan balance. One of the guarantors on the loan was a principal in an unrelated non-real estate business and had a seven figure income and at least an eight figure net worth. The guarantor was cooperating by keeping interest and tax payments current, but the examiners bullied a $9,000,000 charge to capital anyway, giving almost no regard to the strong personal guarantee. Based on the results of the examination and the forced $9 million write-down of the development loan, the bank failed its minimum capital level and was promptly closed.

In another case, a bank had already written down a residential development loan based upon a reappraisal that assumed a five year selling period. The examiners agreed with the lot sales price of the building lots derived in the appraisal, but decided that the five year sell-out period used in the appraisal to discount the value of the lots for "cost of carry" was too optimistic and required new recalculations of value using a seven year sales period. The bank had to take a further write-down of $2,000,000 to its capital base for the arbitrary change in the estimated sales period. The examiner apparently thought he had more expertise in the issue than the appraiser, but, candidly, it would appear to be bordering on an abuse of authority.

Loan Losses Need To Be Accrued – Bankers are asking that some way be found for spreading these mark-to-market accounting losses on loans secured by real estate over a period of five or ten years, permitting some banks to survive that would otherwise fail. Permitting a write-down over a period of several years would help stabilize many banks. It would enhance their lending capabilities, providing needed funds for business and household loans in local communities. Secondarily, renewed lending would provide a source of earnings for troubled banks to help shore up their capital levels. Even more importantly, it would make troubled banks more attractive to private equity investors, thereby enhancing the banks' ability to raise equity funds to supplement their depleted capital – the critical element needed to keep regulators from closing many banks.

Over-aggressive Loss Reserves - Banks were required to establish loss reserves for loans that were partially, or in some cases, fully performing. I will describe two of the most ludicrous cases I encountered:

- Through most of my career, we enjoyed the privilege of borrowing money at prime rate from the banks we utilized in our real estate operations. However, when short-term interest rates dropped rapidly in 2008 and prime rate settled at a historically low level of 3.25 percent, many of our bankers opted to set interest rate floors in the 5.00-6.00 range. Like most real estate developers in this era, we were at their mercy to renew the loans. We had no choice but to accept the higher interest rates. We certainly couldn't repay the loans in full.

  Later as savings deposit rates continued to roll downward to lower levels and the earnings improved at most of our banks, I approached them requesting that they lower our borrowing rate back to the prime rate level at which we had originally contracted. Even though some of them were quite willing to lower rates to assist us in carrying our debt load, they found that to do so would constitute a "troubled debt restructuring" which would itself require the establishment of more reserves for potential future losses. Even if all interest payments were up to date, the bank executives weren't willing to honor my request because of the added capital impairment it would entail for their bank.

- As equally nonsensical, banking regulators began pressing banks in early 2011 to establish reserves for loans which were not being repaid or serviced according to the original plan of repayment. In other words, if a residential subdivision developer, regardless of his financial strength, was unable to sell developed building lots in a slow market to pay interest on the development loan, but was able to service the debt from other sources, regulators started declaring the loans as problem loans and began requiring that banks set up loss reserves for possible future losses even though interest payments on the loans were paid up to date.

My company has carried several subdivision development loans for over three years from sources of cash other than the sale of lots. As a result of this change of regulatory policy, several of my bank lenders were recently required to expense loss reserves even though the likelihood of a loss had not been established. It just added another case of additional capital impairment for the banks -- an impairment that could be the last straw, so to speak, to cause a bank's capital rating to drop below the minimum two percent level.

(2) Brokered Deposit Restrictions

A bank's capital level, as I have described, is obviously an important concern for bank regulators, but it pales in comparison to the question of a bank's level of liquidity. The inability of a bank to meet its ongoing deposit withdrawals is a far more serious issue that can cause the immediate closure of a bank. Before the days of federal insurance of deposits, runs on banks were common in periods of financial turmoil, resulting typically in bank failures. Most of the bank failures that occurred in the early 1930s were in fact due to liquidity issues. There were many banks during the depression of the 1930s with negative net worth positions that were actually allowed to remain open because they had strong cash positions enabling them to comfortably handle deposit outflows from a nervous public.

Accordingly, as important as its liquidity position is to a bank's continued viability, it is somewhat nonsensical that regulators should, as I have witnessed, take steps to actually create liquidity deficiencies for troubled banks. Why, one could ask, would the FDIC act, as they have in this period, to put banks in a liquidity-deficit position that necessitates their closing? The issue revolves around a law that was passed in 1983 permitting banks and S&Ls to hold insured deposits of lending institutions based in other geographical locations. Prior to 1983, insured institutions could not accept deposits outside of a 100 mile radius. As part of the deregulation package to assist thrift institutions with their negative interest spread problems, banks and S&Ls were permitted to solicit deposits from any part of the nation.

To help facilitate such out-of-market deposit accumulation, specialized brokerage firms sprang up to match depository institutions having a surplus of deposits with active institutions having a need for deposits. A banker located in a strong growth area could call one of these deposit brokers and raise considerable sums of insured deposits typically in denominations of $100,000. Over the next two decades, brokered deposits became an important source of funds for growing institutions, particularly in sun belt states with active real estate markets.

However, under current FDIC rules, when a bank's capital drops below the threshold of a "well-capitalized" bank – typically eight percent – regulators no longer allow the bank to hold brokered deposits. As their brokered deposits mature, under-capitalized banks are not allowed to renew the brokered deposit contracts, regardless of the impact the loss of funds might have on their liquidity ratios. A community bank, for example, with $40 million in brokered deposits must return these deposits to their respective institutions as the certificates of deposit mature. The community bank must replace these funds from other sources or be subject to seizure by the regulators should their liquidity position drop below ratios prescribed by the FDIC.

The reasonable solution for the community bank would be to raise deposit rates in their local market to attract enough local deposits to replace the brokered funds as they mature. One would think this should satisfy the regulators. But, incredulously, the FDIC has added a significant obstacle, making it more difficult for under-capitalized banks to compete for local deposits. The FDIC has adopted a deposit interest rate rule which says, in essence, that any bank subject to restrictions on brokered deposits is not permitted to pay more that 75 basis points (3/4 of one percent) above an established national average rate for deposits with a similar maturity. Otherwise, the local deposits are treated as brokered deposits.

A bank can request a waiver from the national rate cap *if* the bank can show that it is in a high rate market. The difficulties in showing this rate differential have in practice rendered this option fairly ineffective.

I am particularly puzzled by the FDIC's aversion to the renewal at maturity of brokered deposits that a bank might already have on deposit. It would seem that permitting a bank to renew deposits would actually enhance the bank's safety and soundness and increase its chances for survival, rather than failure. Many in the industry refer to brokered deposits as "hot money", which suggest they are perhaps more vulnerable to volatile withdrawal outflows; however, renewing deposits for the longer terms of 3 or 5 years that are now readily available in the brokered market can actually work to stabilize an institution's deposit base. Moreover, since interest rates on brokered deposits have typically been lower than rates on local deposits in the Georgia market, the practice of forcing a bank in our market to divest themselves of all brokered deposits and replace them with local deposits would actually increase the institution's cost of funds, thereby decreasing its earnings and, ultimately, its viability. Such would not appear to be in the interest of the bank or the FDIC, hence my puzzlement.

Even more puzzling, a network has evolved on the internet in recent years that allows banks to effectively eliminate brokers in out-of-market deposit solicitations. If a bank wants to spend the necessary time contacting individual banks, it can raise the same amount of supposed "hot money" deposits without the use of brokers. The FDIC has, however, placed no restrictions on such deposits except that they conform to interest rate restrictions imposed on the bank. What is really the difference between these internet deposits and brokered deposits? The interest rates are typically no lower on internet deposits than brokered deposits. Actually, in early 2010, rates on internet deposits were higher than those attained through brokers.

Why then create all the additional problems for troubled banks by forcing them to rid themselves of their brokered deposits? When I posed this question to a regulator, I was told in essence that failed banks with large volumes of brokered deposits are not as attractive to potential purchasers in the resolution process as are banks with more core deposits. They believe it would cost them more to resolve a failed bank with brokered deposits than one without. It would appear then that the FDIC's policy restrictions prohibiting the renewal of brokered deposits are designed more to prepare a bank for failure rather than enhance its chances of survival.

(3) FDIC Actions Have Contributed To The Decline In Real Estate Values

We have witnessed dramatic devaluation in real estate during the past three years in many markets in the nation. It all started initially with servicers of defaulted permanent residential mortgages selling their foreclosed real estate collateral at discounted prices to move them more quickly. This was followed by commercial banks selling their residential builder foreclosures at below market prices – often, as I have noted, at the urging of bank regulators. The absolute worst disposition of foreclosed real estate at "fire sale" prices has, however, been conducted by the FDIC. The dramatic decline in residential real estate values has indeed been a vicious downward spiral sinking many banks in its wake and, ironically, the FDIC has been one of the biggest offenders.

Instead of ramping up their property resolution teams and selling collateral property in a slower and more orderly manner, the FDIC, like the servicers for Fannie Mae and Freddie Mac, has dumped properties on the market, in some cases, for less than thirty percent of the loan balance. Such sales at extremely low prices have not only been a drain on the FDIC's reserves necessitating huge levies on all surviving institutions, but they have contributed to an overall reduction in real estate prices in the local markets, thereby further depressing the value of real estate collateral securing the loans of other troubled institutions (and homeowners). Subsequent lower appraisals on their problem real estate loans have required the expensing of additional reserves which in many cases has pushed an institution's capital level below the minimum two percent ratio needed to avoid seizure by the FDIC.

Not only have they dumped foreclosed real estate mortgage collateral, but the FDIC has also dumped performing loans for a fraction of their face value to other banks and, in some really wild cases, to the borrowers themselves. That is correct. The FDIC resolution teams have been offering borrowers with performing loans substantial discounts to refinance their loans elsewhere. Our community bank has been approached by several individuals with loan requests for refinancing to purchase their own loans from the FDIC at 30 to 40 percent discounts.

Most performing loans of failed institutions have, however, been funneled to other banks through a program called DEAD-X. Under the DEAD-X program, banks with excess cash can bid on pools of performing and non-performing loans held by the FDIC usually being sold at substantial discounts. Since the DEAD-X market is limited only to banks, I am aware of two cases where wealthy investors have made arrangements with small banks to purchase loans from DEAD-X through them. In other cases, groups of wealthy individuals have purchased small community banks as a platform to purchase loans from DEAD-X.

The irresponsible dumping of both real estate properties and loans by the FDIC has been a major factor in causing declining property values which, in turn, has been a major factor in causing more bank failure which, in turn, has necessitated the dumping of even more foreclosed real estate collateral by the FDIC; and the downward value spiral continues.

This pattern is well illustrated by the previously described case of one of our homes in Ellenwood, Georgia in the southeastern section of the Atlanta metro area. While the purchaser was willing to pay $191,000 for the house and we were willing to sell it for $191,000, the appraiser said it was only worth $172,000. Although we had closed sales of similar homes in a sister subdivision 2.5 miles away that would have supported appraisal values in the $190,000-$200,000 range, the appraiser chose to use sales data on a larger house in a subdivision 1.5

miles away that had been sold by the FDIC for $125,000. The severely discounted FDIC sale was detrimental to all homeowners in the area.

(4) TARP Funds Are Restricted

The losses incurred by the FDIC since 2007 in the process of resolving failed financial institutions have been staggering. As of January 2010, the FDIC had already incurred losses in excess of $36 billion and is estimating it's losses from 2010 through 2014 to exceed $52 billion, making this the biggest loss total in the history of the FDIC – by some estimates, ten times worse than the S&L crisis of the 1980s.

The FDIC defends its expensive game plan for resolving failed banks by pointing to it's inadequate man power and shortage of other resources needed to hold and manage loans and properties of the banks they have seized. If this is the case and if in fact the FDIC is not good at managing loans and properties, wouldn't it have been better for them to attempt to keep troubled banks open when possible and give them time to resolve their own loan problems and manage their own foreclosed properties instead of being so eager to seize troubled banks as soon as their tier one capital levels drop below two percent of assets. Where is the wisdom of creating another huge loss for the insurance fund and further diminishing real estate values in the local market when some degree of forbearance might have prevented it altogether?

Unless it posed a grave threat to the bank insurance fund, wouldn't it have been better to let the bankers who were far more knowledgeable of their borrowers, their properties and their markets and who were far more motivated to minimize their losses, to continue to manage their loans and resolve their problems? Wouldn't it have been far less costly than letting a group of disinterested strangers come in and dump loans and properties or alternately paying dearly for another bank to assume the bank's assets? Wouldn't it have been better to give them more time to resolve their own problems?

This is exactly, though, what the federal government did for a few banks that it deemed to be too big to fail and several other banks that didn't really need the support. Congress passed the Emergency Economic Stabilization Act of 2008 in October 2008, which set up the Troubled Asset Relief Program (TARP). This program initially appropriated $250 billion with the intent that the funds be used to buy up questionable mortgage-backed securities. But after its passage Treasury officials changed plans and devised a strategy to utilize the appropriated funds to prop up the liquidity position and capital levels of selected banks by purchasing preferred stock in the institutions.

Frankly, I thought this was a brilliant idea -- a loan to the banks that increased their capital. Not only was it good for the banks, but since the government was lending its funds at 5 percent or better and paying only 2-3 percent for the funds, it was an excellent profitable arbitrage for the Treasury. Most importantly, it gave the participating banks much more time to work through their problems.

But why not offer this assistance to other troubled institutions? The banks that received TARP funds were the troubled mega-banks that could have created huge problems for the economy should they have failed. They also gave funds to a handful of smaller regional banks that, ironically, were able to prove they didn't really need the funds. Many community banks with modest problems that needed the funds to meet higher capital levels were denied TARP funds because they were viewed as being a higher risk. This logic reminds me of a few country bankers I have known who would make you a loan only if you could convince them you didn't really need it. The reality is, if you were a big bank with problems, you were given TARP funds. If you were a small bank with problems, you were denied TARP funds unless you could prove to them you didn't really need it.

FDIC Seizures Prove To Be Expensive

FDIC press releases indicate that the recent bank seizures in Georgia have had projected losses from 17.1 to 32.7 percent of their assets. The median loss of these twelve banks was 23.7 percent of assets. Consider the case of a struggling community bank with $100 million in assets that has remaining unimpaired tier one capital slightly below two percent, making it subject to closure. To put the bank back to a level of eight percent tier one capital, which the FDIC considers as adequately capitalized, would require an injection of the $6 million in TARP funds. Would it not be better to support the bank with a temporary "loan" in the form of preferred stock than to subject the FDIC fund to a potential loss as large as $32 million?

I'm not suggesting that we let such troubled institutions continue to make risky loans, but just let them survive to manage their business and resolve their problem loans. If the institution succeeds and repays its TARP funds, then there is no loss to anyone. But the day the FDIC closes a bank there is a guaranteed loss for the insurance fund – in many cases, a tremendous loss. And, as we have observed, there will be further devaluations of real estate in the institution's local market as the bank seizure is resolved.

Given the FDIC's deposit insurance protection against "runs" on their deposits, I believe most banks could overcome their problems in time and could restore their capital deficiencies. In these cases, what is the compelling reason to hastily close a bank, the resolution of which devalues properties, damages communities and destroys the shareholders financially? Where is the justice in closing banks at the low point in the cycle, based solely upon appraisals when the forbearance of a year or two might bring better economic conditions and improved appraisal valuations? It is wrong, both economically and morally.

In Georgia before a lender can file a lawsuit on a borrower or a guarantor for a loss it believes it will incur from a foreclosure on real estate securing its debt, the lender must first get the anticipated loss confirmed by a judge in the county where the property is located. The lender's appraiser makes a case for his estimate of value and the borrower has his chosen appraiser to make a case for his own contradictory estimate of value which will be predictably higher than the lender's estimate of value. If the judge rules in favor of the borrower, the lender's claim is usually invalidated and the lender cannot proceed with a suit for loss under the terms of the promissory note.

I have a friend, an appraiser with a PHD, who has directed the focus of his practice in the first couple of years to defending builders and developers in such confirmation hearings. Through the end of 2010 he had prevailed in 100 percent of his cases, successfully convincing the judges in each instance that the comparable sales data used in the lender's appraisals was not acceptable market data. He has been successful in showing that the comparable sales used in the lender's appraisal in most cases were not bonafide market value sales, but were sales made by banks under duress from pressure placed on them by the FDIC to dispose of foreclosed assets.

In cases where a lender's appraiser claims that his chosen comparables are the only ones readily available, my friend has been able, using national averages of differences between normal sales and lender sales, to show that the sales data of the comparable properties should have been adjusted upwards 25-30 percent.

I am mentioning this scenario because it is extremely rare that an appraiser makes such an adjustment. The tragedy is that appraisals like the ones he has been able to discredit are being used to close banks throughout the nation. Had many of the appraisals used to mark loans of troubled banks to market been adjusted upwards by 25-30 as was probably appropriate, a significant number of failed banks would have survived and the horrendous cost to the FDIC fund and this loss of value to stockholders could have been avoided.

<u>The FDIC Has Two Courses of Action</u>

The FDIC has two general courses of action in resolving a seized institution. The preferable course is to structure a deal with a healthy bank to assume the deposits and purchase as many of the assets of the failed institutions' as can be efficiently negotiated. The other course, when a deal can not be negotiated with another bank, is to dissolve the bank and sell off the assets as best as possible.

The deals negotiated with other healthy banks to acquire seized banks are consequently quite generous to the acquiring banks. I asked officials at one bank that had purchased another bank from the FDIC how they were now prospering with the minimal loan volume in the current banking environment. In their choice of words, they said they didn't have to make loans to be profitable – they were "making a killing" off the FDIC deal.