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THE CHANGING ROLE OF THE FDIC

HEARING

BEFORE THE

SUBCOMMITTEE ON TARP, FINANCIAL SERVICES AND BAILOUTS OF PUBLIC AND PRIVATE PROGRAMS

OF THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

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THE CHANGING ROLE OF THE FDIC

WEDNESDAY, JUNE 22, 2011

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON TARP, FINANCIAL SERVICES AND
BAILOUTS OF PUBLIC AND PRIVATE PROGRAMS,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 1:34 p.m. in room 2157, Rayburn House Office Building, Hon. Patrick T. McHenry (chairman of the subcommittee) presiding.

Present: Representatives McHenry, Meehan, Gowdy, Ross, and Quigley.

Staff present: Will L. Boyington and Kate Dunbar, staff assistants; Katelyn E. Christ, research analyst; Pete Haller, senior counsel; Ryan M. Hambleton, professional staff member; Rebecca Watkins, press secretary; Kevin Corbin, minority staff assistant; and Justin Kim and Davida Walsh, minority counsels.

Mr. MCHENRY. The subcommittee will come to order.

Today's hearing on the TARP, Financial Services and Bailouts of Public and Private Programs Subcommittee is entitled, "The Changing Role of the FDIC."

We have before us today the 19th chairman of the Federal Deposit Insurance Corporation, Sheila Bair, who has served honorably during some of our Nation's toughest times. Chairman Bair, we realize this is your last hearing before Congress and you have had quite a career in your service to our Government and to our people, and I want to thank you for that. It has been through some of the most challenging times in our Nation's history.

You have also served on Capitol Hill and we appreciate your service there. We forgive you for serving on the Senate side, but certainly understanding Capitol Hill as you do, we thank you for your time.

It has been the tradition of this subcommittee to read the Oversight and Government Reform Committee's Mission Statement.

The Oversight Committee's Mission Statement begins, we exist to secure two fundamental principles. First, Americans have a right to know that the money Washington takes from them is well spent. Second, Americans deserve an efficient, effective government that works for them. Our duty on the Oversight and Government Reform Committee is to protect these rights. Our solemn responsibility is to hold government accountable to taxpayers because taxpayers have a right to know what they get from their government. We will work tirelessly in partnership with citizen watchdogs to de-

liver the facts to the American people and to bring genuine reform to the Federal bureaucracy.

This is the mission of the Oversight and Government Reform Committee.

I now recognize myself for 5 minutes for an opening statement.

As I said, we are pleased to welcome the chairman of the FDIC, Sheila Bair, for her last testimony before the U.S. House of Representatives. We certainly appreciate your role and your hard work. We wish you well in your future endeavors.

Today's discussion allows Members to better understand the role of the FDIC during the financial crisis, the new regulatory authorities issued by Dodd-Frank and the health of FDIC-insured banks.

Since 2007, the FDIC has been called upon to resolve 370 failed banks and thrifts. These efforts have cost the FDIC an estimated $83 billion and depleted the balance of the Deposit Insurance Fund pushing it into the red ink to the tune of $1 billion. Chairman Bair has taken steps to replenish the fund and I think the American people should know that this does not cost the taxpayers a dime and, in fact, this is self-funded by the banking industry.

Due to the FDIC's role as a safety and soundness regulator for most of the world's largest financial institutions, the Dodd-Frank Act positions the Corporation as a key player in preventing a future financial crisis. Dodd-Frank requires or authorizes the FDIC to implement 44 new regulations and grants the regulator various enforcement authorities, many that stem directly from Dodd-Frank's hope to end Too Big to Fail.

Among these regulations are risk retention rules that will dramatically impact the secondary mortgage market and other areas of securitization as well as increase capital standards set out under Dodd-Frank and being negotiated under Basel III.

Although these measures had some bipartisan support in theory, concerns have been raised during implementation. New risk retention rules could reduce the amount of lending to an already crippled housing market, while extreme capital standards may jeopardize the global competitiveness of U.S. financial institutions.

Just yesterday, Acting Comptroller of the Currency, John Walsh, stated that additional capital requirements for large firms should be "modest," noting that "capital levels are now extraordinarily high by historical standards." He specifically cautioned that "higher capital fosters a safer banking system, but if carried too far, the economy suffers when banking activity is not sufficient to support the desired levels of real economic activity." I think we all share those concerns and finding that balance, as part of today's hearing is to understand your thought process on that.

Each member of this subcommittee hears from constituents and businesses that are struggling to access capital. Thus, before instituting a regulation, it is imperative that regulators consider the flexibility that our small and community banks need to serve our communities. I look forward to Chairman Bair's explanation as to how the FDIC and other regulators will work to avoid one size fits all regulations that would deteriorate job growth and our economy.

Additionally, while some insist that the FDIC's new regulatory authority under Dodd-Frank will put an end to the bailout culture and Too Big to Fail, it appears the opposite is true. The Special In-

spector General for the troubled Asset Relief Program has reported to Congress that even after Dodd-Frank, "the largest institutions continue to enjoy access to cheaper credit based upon the existence of the implicit government guarantee against failure."

Ironically, Dodd-Frank has actually made big banks even bigger. Five of the largest financial institutions in this country are 20 percent larger than they were before the crisis.

This is not directed at the FDIC, but rather, many of these things are design failures in the legislation we passed and I will have some questions about that and how you see that implementation, and perhaps some legislative relief on some things you don't think are quite appropriate going forward.

Even Secretary Geithner noted the possibility of future bailouts, when months ago he stated that the Federal Government might have to do "exceptional things again." I know you have been questioned about that before, but the moral hazard of such explicit and implicit guarantees cannot be overstated.

These concerns, along with others that Chairman Bair and I have spoken about, are of critical importance to the economic future and well being of the United States and its citizens. Getting that balance right is a struggle. In terms of capital requirements, we would like to hear your thoughts on that.

[The prepared statement of Hon. Patrick T. McHenry follows:]

Rep. Patrick McHenry, Chairman
Subcommittee on TARP, Financial Services and Bailouts of Public and Private Program

Opening Statement
"The Changing Role of the FDIC"
June 22nd, 2011

We are pleased to welcome FDIC Chairman Sheila Bair for her last testimony before the House of Representatives as her term expires early next month. I'd like to start by thanking Chairman Bair for her service to the American people.

Today's discussion allows members to better understand the role of the FDIC during the financial crisis, the new regulatory authorities issued by Dodd-Frank, and the health of FDIC-insured banks.

Since 2007, the FDIC has been called upon to resolve 370 failed banks and thrifts. These efforts have cost the FDIC an estimated $83 billion and depleted the balance of the Deposit Insurance Fund, pushing it into the red to the tune of a billion dollars. But Chairman Bair has taken steps to put the fund back into the black in the near term.

Due to the FDIC's role as a safety and soundness regulator for most of the world's largest financial institutions, the Dodd-Frank Act positions the corporation as a key player in preventing a future financial crisis. Dodd-Frank requires or authorizes the FDIC to implement 44 new regulations and grants the regulator various enforcement authorities, many that stem directly from Dodd-Frank's hope to end "Too Big to Fail."

Among these regulations are risk retention rules that will dramatically impact the secondary mortgage market and other areas of securitization, as well as increased capital standards set out under Dodd-Frank and being negotiated under Basel III. Although these measures had some bipartisan support in theory, concerns have been raised during implementation. New risk retention rules could reduce the amount of lending to an already crippled housing market, while extreme capital standards may jeopardize the global competitiveness of U.S. financial institutions.

Just yesterday, Acting Comptroller of the Currency, John Walsh, stated that additional capital requirements for large firms should be "modest," noting that "capital levels are now extraordinarily high by historical standards." He specifically cautioned that "higher capital fosters a safer banking system, but if carried too far, the economy suffers when banking activity is not sufficient to support desired levels of real economic activity."

Each Member of this Subcommittee hears from constituents and businesses that are struggling to access capital. Thus, before instituting a regulation, it is imperative that regulators consider the flexibility that our small and community banks need to serve our communities. I look forward to Chairman Bair's explanation as to how the FDIC, and other regulators, will work to avoid one-size-fits-all regulations that would deteriorate job growth and our economy.

Additionally, while some insist that the FDIC's new regulatory authority under Dodd-Frank will put an end to the bailout culture and "Too Big To Fail," it appears the opposite is true. The Special Inspector General for the Troubled Asset Relief Program has reported to Congress that even after Dodd-Frank, "the largest institutions continue to enjoy access to cheaper credit based on the existence of the implicit government guarantee against failure." Ironically, Dodd-Frank has actually made Big Banks even bigger: five of the largest financial institutions in the country are 20 percent larger than they were before the crisis.

Even Secretary Geithner noted the possibility of future bailouts when, months ago, he stated that the federal government might have to do "exceptional things again." The moral hazard of such explicit and implicit guarantees cannot be overstated.

These concerns, along with others that Chairman Bair and I have spoken about, are of critical importance to the economic future and well being of the United States its citizens.

Thank you again Chairman Bair for your service. I look forward to your testimony today and wish you well in your future endeavors.

Mr. MCHENRY. With that, I recognize the ranking member, Mr. Quigley of Illinois, for 5 minutes.

Mr. QUIGLEY. Thank you, Mr. Chairman. Thank you for holding this committee meeting.

Chairman Bair, thank you for attending and for your years of service.

Obviously, the FDIC played a central role in navigating the 2008 financial crisis, specifically overseeing two of the largest bank failures in U.S. history, Washington Mutual and IndyMac Bank. In addition, in the aftermath of the crisis, Chairman Bair has actively engaged in implementing the necessary reforms to prevent another financial crisis.

As the chairman's tenure comes to a close, I believe her insight and perspective will be invaluable to the subcommittee's oversight of the events that comprised the financial crisis as well as the implementation of Dodd-Frank and other reforms aimed at bringing greater transparency and stability to our financial markets.

While there were multiple causes of the financial crisis, it is widely acknowledged that regulatory failure through gaps in oversight, insufficient tools and weakening of bank regulations was a significant factor. Therefore, Dodd-Frank addresses these failures by creating the Financial Stability Oversight Council to ensure coordination among multiple banking regulators.

It also extends the FDIC's resolution authority for failing depository institutions to large non-bank financial firms and requires strong capital standards for the largest financial institutions. These and other provisions have significantly altered the authority and responsibility of the Federal banking regulators including the FDIC.

I was heartened by the chairman's past statements that through the orderly liquidation authority and capital requirement provisions, the regulators have the tools to end Too Big to Fail. Still, I am concerned by the fact that in 2009, Bank of America, Chase, Citi Group and Wells Fargo controlled 56 percent of domestic banking assets up from 35 percent in 2000, while the top 10 U.S. banks controlled 75 percent of domestic deposits, up from 54 percent. I hope today's hearing will provide an update on the implementation of these Too Big to Fail provisions.

There are also a number of FDIC-related provisions under Dodd-Frank that are critical not only to ensuring financial stability, but also to leveling the playing field between the largest financial institutions which have only expanded since the crisis, and the community banks and credit unions.

These provisions relate to capital standards, as well as the manner in which the FDIC is assessed and I look forward to hearing from Chairman Bair regarding the status and implementation of these reforms.

Last, Chairman Bair has been praised as guiding the FDIC to "greater prominence through her fierce advocacy, not just for community banks, but also for consumers." In this regard, I commend you for your tireless efforts to hold accountable our Nation's mortgage-servicing industry. This is an industry that continues to engage in alleged systemic abuses and misconduct against homeowners across the country.

In your own words, "the mortgage-servicing and documentation problems are yet another example of the implications of lax underwriting standards and misaligned incentives in the mortgage process." Despite numerous investigations and regulatory actions taken by Federal and State regulators and law enforcement officials against the mortgage servicers, more allegations of misconduct have surfaced.

Therefore, I look forward to hearing from the chairman regarding further steps that can be taken by both regulators and policymakers to hold the servicers accountable and protect our constituents and communities from wrongful foreclosures.

Again, I thank you. I thank the chairman for appearing before us today and your service to our country.

Thank you.

Mr. MCHENRY. I thank the ranking member.

With that, Chairman Bair, it is the tradition of the Oversight and Government Reform Committee and policy of the committee that all witnesses be sworn. So if you please rise and raise your right hand.

[Witness sworn.]

Mr. MCHENRY. Let the record reflect that the witness answered in the affirmative.

Again, thank you, Chairman Bair. You have served under Republican and Democratic Presidents, you have had a distinguished career in government service and we wish you the best going forward.

With that, we recognize you for 5 minutes for an opening statement. You know the drill with the lights and we look forward to hearing your testimony.

STATEMENT OF SHEILA BAIR, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. BAIR. Thank you very much, Chairman McHenry, Ranking Member Quigley and members of the subcommittee. Thank you for the opportunity to testify today on the Changing Role of the FDIC.

My testimony today is focused on two very important lessons learned from the crisis. First, in order to restore discipline in the marketplace, large, complex banks and other financial companies must, without exception, be allowed to fail if they become non-viable.

The problem of financial companies that are perceived by the market as too big to fail unfortunately has been about for decades, but the bailouts of several badly managed, systemically important financial institutions during the crisis removed all doubt about their implicit government backing.

These bailouts were made necessary by the absence of FDIC style resolution powers for non-bank financial institutions as well as for bank holding companies and their non-bank affiliates. The massive disruptions caused by the Lehman failure made clear that the bankruptcy process was ill suited to the orderly resolution of large financial entities. Forcing bank holding companies into a bankruptcy process was not a risk the government was willing to take.

The bailouts have consequences. They undermine market discipline. They inhibit restructuring of troubled financial companies and the recognition of losses. They keep substandard management in place and preserve a suboptimal allocation of economic resources.

In contrast, smaller banks are fully exposed to the discipline of the marketplace. Some 370 FDIC-insured institutions have failed since I became FDIC chairman. This is how capitalism is supposed to work. Failed companies give way to successful companies and the remaining assets and liabilities are restructured and returned to the private sector.

Bailouts are inherently unfair. They violate the fundamental principles of limited government on which our free enterprise system is founded. That is why the FDIC was so determined to press for a more robust and effective SIFI resolution framework as a centerpiece of the financial reform legislation.

We were early advocates for a SIFI receivership authority that operates like the one we have applied thousands of times to insured banks in the past. We pushed for liquidation plans by the SIFIs that would prove they could be broken apart and sold in an orderly manner and for greater oversight and higher capital in relation to the risk these companies pose to financial stability.

While all of these proposals were ultimately enacted in Dodd-Frank, there does remain skepticism as to whether the SIFIs can actually be made resolvable in a crisis. For the very largest institutions, it will be difficult, but we have many important tools which if used correctly can end Too Big to Fail.

Under Dodd-Frank, we will have more information about these institutions on an ongoing basis, stronger prudential requirements, living wills prepared in advance, as well as the authority to require, if necessary, organizational changes that rationalize business lines and legal entities to assure that they can be broken up and sold back to the private sector in an orderly way.

I hope this is an area where the industry will work collaboratively with the government. The expectation of bailouts creates funding advantages for weak, large banks, creating competitive disadvantages not only for smaller institutions, but also for the better managed larger institutions. Most importantly, the reputation of the entire industry is damaged when poorly managed institutions are bailed out by taxpayers and escape responsibility for their own actions. Because of the bailouts, popular resentment and cynicism toward the banking sector remains very high.

The second lesson of the crisis involves the dangers of excessive debt and leverage. The single most important element of a strong and stable banking system is its capital base. Capital is what allows and institution to absorb losses while maintaining the confidence of its counter parties and its capacity to lend.

After the last banking crisis in the early 1990's, Congress passed a number of important banking reforms that included stronger capital requirements. The capital requirements were watered down over the years through rules that permitted use of capital with debt-like qualities that encouraged banks to move assets off the balance sheet and that set regulatory capital thresholds based on internal risk models.

The result was an increase in financial system leverage, particularly at bank holding companies and on-bank financial companies that weakened the ability of the industry to absorb losses during the crisis and that has led to a dramatic de-leveraging of banking assets in its wake.

The problems of excess leverage extend far beyond banking. Our tax system rewards the use of debt financing over equity for businesses and households alike, making them more vulnerable to financial distress. Governments too have relied on debt to postpone the cost of paying for services that the constituencies are reluctant to do without.

As the crisis has shown, over reliance on leverage is a short term strategy with a big down side over the longer term. That is why the FDIC has been so committed to following through on the capital reforms that are taking place through the Basal III International Capital Accord. That is also why we have been such strong supporters of other measures to enhance capital including the Collins Amendment to Dodd-Frank, the elimination of trust preferred securities and the SIFI capital surcharge.

Since 1933, public confidence and financial stability have been the core missions of the FDIC. We understand the economic cost of financial crises. One of the most important lessons I have drawn from my experience has been the need for regulators to have the political courage to stand firm against weak practices and excessive risk taking in the good times.

My main regret is that we did not have better information and better resolution tools in place at the height of the crisis to prevent the bailouts of a number of our Nation's largest financial companies. Yes, the bailouts were necessary under the limitations we faced, but they have slowed the recovery, they have undermined support for government in all forms, tainted the reputation of well run banks and tilted the competitive balance toward weak, mega banks.

Our support for a more robust SIFI resolution regime and stronger capital standards in the wake of the crisis speaks to our determination that this experience never be repeated.

Thank you and I would be happy to take your questions.

[The prepared statement of Ms. Bair follows:]

Chairman McHenry, Ranking Member Quigley, and members of the Subcommittee, thank you for the opportunity to testify today on the changing role of the FDIC. The past five years, marking my tenure as FDIC Chairman, have been among the most eventful for U.S. financial policy since the 1930s. During this time, our nation has suffered its most serious financial crisis and economic downturn since the Great Depression, the aftereffects of which will be felt for years to come.

In my testimony today, I would like to focus on two very important lessons learned from the crisis. First, in order to restore discipline in the marketplace, large, complex banks and other financial companies must – without exception – be allowed to fail if they become nonviable. My testimony will review the responses taken to the financial difficulties of systemically-important financial institutions (SIFIs) in the crisis, and how the absence of effective resolution tools led directly to government bailouts. While these bailouts were necessary under the circumstances we faced at the time, they brought about serious adverse consequences for our financial system.

The second lesson involves the dangers of excessive debt and leverage. Rising financial leverage in the years leading up to the crisis was encouraged not only by misaligned incentives that promoted risk-taking within financial institutions, but also by a regulatory process that was overly permissive toward leverage and a tax code that has created a long-time preference for debt over equity as a means to finance economic activity. It is important that Congress and the regulators understand and act on these lessons learned if we are to avoid a costly recurrence of the recent financial crisis in the not-too-distant future.

The Problem of "Too Big to Fail"

The problem of financial institutions that are Too Big to Fail has been with us for decades. But the bailouts of several large banks and nonbank financial companies during and after the financial crisis of 2008 removed all doubt that Too Big to Fail was a central problem facing our financial system.

The crisis of 2008 centered on 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 and capital requirements that apply to federally-insured depository institutions in the U.S. In addition, the shadow banking system also fell largely outside of the FDIC's authority to resolve failed insured financial institutions through receivership.

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. The size and complexity of these institutions, and the inadequacy of the bankruptcy process as a means to avoid systemic disruption after their failure, rendered these companies Too Big to Fail.

In the heat of the crisis, policymakers frequently resorted to bailouts instead of letting these firms collapse into bankruptcy. The fear was that the losses generated in a failure would cascade through the financial system, freezing financial markets and stopping the economy in its tracks. The worst fears of policymakers were realized when Lehman Brothers – a large, complex nonbank financial company – filed for bankruptcy on September 15, 2008.

The long-term outcome for Lehman creditors clearly demonstrates the shortcomings of bankruptcy as a means to resolve failed financial companies. The firm managing the Lehman bankruptcy reports that more than $75 billion in value was destroyed by the bankruptcy process itself, including tens of billions of dollars from the inability to roll over valuable derivatives contracts. More than two-and-a-half years after Lehman's failure, the process has cost over $1.2 billion in legal and other professional fees, and many creditors still don't know what their claims will be worth.

Anticipating the complications of this 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, prompting emergency intervention on the part of governments around the world to forestall an even worse economic catastrophe.

Limits on the FDIC's Ability to Respond to the Crisis

The U.S. government provided financial assistance to the financial sector during the financial crisis on a massive scale and in a variety of forms. The Federal Reserve expanded lending through the discount window, and introduced several special programs to provide liquidity to a variety of important financial markets and institutions. Under the Emergency Economic Stabilization Act (EESA) of 2008, Congress authorized the Treasury to purchase or insure up to $700 billion in troubled assets, of which some $300 billion was used to provide equity investments in large banking organizations. At the height of the crisis, the Federal Reserve Board, the U.S. Treasury Department, and the

FDIC – in consultation with the President – invoked the so-called "systemic risk" authorities, which allowed us to provide emergency assistance to individual institutions on three occasions and to temporarily extend the FDIC guarantee to liabilities beyond insured deposits in order to stabilize the funding base of banks and their holding companies. In all, the announced capacity of Federal Reserve, FDIC and Treasury programs to support the financial sector during the crisis exceeded $14 trillion.[1]

The absence of FDIC resolution powers for bank holding companies and their nonbank affiliates during the crisis posed insurmountable hurdles to our ability to respond to the financial difficulties of these large banking organizations through our traditional receivership process. While each of these bank holding companies had FDIC-insured depository institutions as subsidiaries, the FDIC's receivership powers extended only to the insured institutions themselves. Had the FDIC been appointed receiver for these bank subsidiaries, the result surely would have been to trigger the failure of the holding company as well – which would have fallen under the jurisdiction of a Lehman-like commercial bankruptcy, and not an FDIC-managed receivership. Since the non-bank affiliates were not insured depository institutions, the FDIC had very little advance information about their structure, activities, and counterparty exposures, making it difficult to know what effect the failure of the holding company might have on other financial institutions and the financial markets. Under those limitations, if any of those institutions had been allowed to fail, the result could well have been a significant widening of the financial crisis. This was not a risk we were willing to take at the time.

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[1] See: "A Year in Bank Supervision: 2008 and a Few of Its Lessons," *FDIC Supervisory Insights*, Vol. 6, Issue 1, Summer 2009, p.4. http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum09/si_sum09.pdf.

Lessons from the Bailouts

The crisis of 2008 illustrated the overwhelming pressure that develops to provide government bailouts when information is sketchy, fear is the prevailing market sentiment, and there is no clear sense of how bad conditions might get before the system begins to stabilize. The FDIC responded to the problems of large banking organizations in the crisis the only way it could under the circumstances. With the limited information and resolution powers we had at the time, allowing SIFIs to fail would have been irresponsible.

But bailouts of this sort have a number of serious adverse consequences for the financial industry and our economy. They inhibit the restructuring of troubled financial companies and the recognition of losses that are necessary for a prompt recovery from the crisis. Unless large financial institutions and other companies are allowed to fail, our economy cannot correct the mistakes in strategy or risk management that led to the problem, and scarce economic resources will continue to be misallocated. Some 370 FDIC-insured institutions have failed during my tenure as FDIC Chairman. In every case, insured depositors have been completely protected, but uninsured depositors, unsecured creditors and equity holders have been exposed to losses and management has been replaced.

This is how capitalism is supposed to work, as failed companies give way to more successful companies, their liabilities are restructured, and their assets are eventually returned to their highest and best use under new management in the private sector. But our previous inability to resolve SIFIs in a crisis made them exempt from the normal

discipline of the marketplace that applies to smaller banks and practically every other private company.

Bailouts are inherently unfair to the vast majority of institutions that are not Too Big to Fail. They violate the fundamental principles of limited government on which our free-enterprise system is founded. This has the perverse effect of undermining trust in governmental functions that most would agree are necessary and appropriate. This situation can only be regarded as a new and dangerous form of state capitalism, where the market assumes large, complex, and powerful financial companies are in line to receive generous government subsidies in times of financial distress. Unless reversed, this policy can be expected to result in 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.

The dilemmas we faced in responding to the crisis only increased our determination to press for a more robust and more effective SIFI resolution framework as the centerpiece of the financial reform legislation. We were early advocates for a resolution model based on the receivership authority the FDIC has used to resolve thousands of institutions over the years. We proposed that SIFIs be required to develop their own liquidation plans that would demonstrate that they could be broken apart and sold in an orderly manner. We also proposed that they be made subject to greater oversight, higher capital and liquidity requirements, and other prudential safeguards, and that many of their off-balance-sheet assets and conduits be counted and capitalized on the balance sheet. All of these proposals were ultimately enacted in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).

How the Dodd-Frank Reforms Will End Too Big to Fail

The new SIFI resolution framework will designate large bank holding companies and certain systemically-important non-bank financial companies as SIFIs, and subject these companies to several new regulatory requirements. 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 supervisory oversight by the Federal Reserve and higher capital requirements. They will be required to maintain resolution plans that show how they could be wound down in an orderly manner – without a bailout – in a crisis. Based on these resolution plans, they could be required to restructure their operations, or even divest, if necessary to demonstrate that they are resolvable. The information available to the FDIC in planning to resolve a failed SIFI also will be enhanced by our new backup powers that apply to SIFIs that are deemed to be "not generally in sound condition." 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.

The reforms create an Orderly Liquidation Authority (OLA) that gives the FDIC receivership-like powers over bank holding companies and non-bank SIFIs if they cannot be resolved in an orderly manner through bankruptcy. While some have called the OLA a bailout mechanism and others a fire sale, in fact it is neither. The OLA strictly prohibits bailouts. It is better suited than bankruptcy to resolve claims against failed financial institutions in a prompt and orderly manner. It is a transparent process that operates under fixed rules that prohibit bailouts or favoritism in administering the priority of claims.

Despite these advantages, there remains skepticism that the SIFIs can be resolved at all, given their size, interconnectedness, and international scope of operations. However, I believe that the adherents of this view vastly underestimate the benefits of advance resolution planning that will be afforded by the SIFI resolution plans, as well as the steady progress that is being made around the world to strengthen and harmonize resolution regimes and coordinate resolution activities across national boundaries.

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 Brothers.[2] The resolution plans will give regulators much more advance information about the structure, activities, and counterparty exposures of the SIFIs, including quarterly Credit Exposure Reports that provide detail on counterparty exposures of the subject institution and how its failure could affect other financial companies. 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.

It cannot be emphasized enough that the ultimate effectiveness of the SIFI resolution framework will depend on the willingness of the FDIC and the Federal Reserve Board to use this authority and insist, if necessary, on organizational changes that better align business lines and legal entities well before a crisis occurs. Preventing bailouts in any future financial crisis will require that SIFI organizational structures be rationalized and simplified well before the onset of systemic financial distress.

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[2] "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.

Benefits of Reform to the Economy and the Banking Industry

There are a number of compelling reasons for well-run banks and thrift institutions to support the SIFI resolution framework under Dodd-Frank. First, as we have seen in the case of the recent crisis, well-run institutions have much to lose from the marked deterioration in credit performance, collateral values and loan demand that is typically associated with periods of severe financial instability. The Dodd-Frank reforms are needed to promote long-term financial stability and prevent this type of large-scale economic damage. But it is also important to recognize that the repeated bailouts provided to banks with serious deficiencies in strategy and risk management have had a significant adverse impact on the reputation and competitive position of the well-run companies that make up the vast majority of FDIC-insured institutions.

In an April 2010 Pew Research poll, just 22 percent of respondents rated banks and other financial institutions as having "a positive effect on the way things are going in this country."[3] In a July 2010 poll by the Pew Center and the National Journal, some 74 percent of respondents felt that government economic policies since 2008 had helped large banks and financial institutions "a great deal" or "a fair amount."[4] Only 27 percent felt these policies had helped the middle class and only 23 percent felt they had helped small business. A Rasmussen poll published earlier this year shows that fully 50 percent of Americans believe the federal government is more concerned with making Wall Street

[3] "Distrust, Discontent, Anger and Partisan Rancor: The People and Their Government," Pew Research Center for the People & the Press, April 18, 2010. http://pewresearch.org/pubs/1569/trust-in-government-distrust-discontent-anger-partisan-rancor.

[4] "Government Economic Policies Seen as Boon for Banks and Big Business, Not Middle Class or Poor," Pew Research Center for the People & the Press, July 19, 2010. http://pewresearch.org/pubs/1670/large-majorities-say-govt-stimulus-policies-mostly-helped-banks-financial-institutins-not-middle-class-or-poor.

firms profitable than with making sure the U.S. financial system works well for all Americans.[5]

The *de facto* policy of Too Big to Fail also has conferred a clear competitive advantage on the largest banks. In February, Moody's reported that its ratings on the senior unsecured debt of eight large U.S. banking organizations received an average "uplift" of 2.2 ratings notches because of the expectation of future government support.[6] Meanwhile, in the first quarter of this year, the average interest cost of funding earning assets for banks with more than $100 billion in assets was about half the average for community banks with less than $1 billion in assets. Indeed, I would also argue that well-managed large banks are disadvantaged. Too Big to Fail also narrows the funding advantage they would otherwise enjoy over weaker competitors. Fortunately, we already are making some progress in reducing big bank funding advantages. Moody's recently announced that it has placed a number of large banks on watch for downgrades based on Dodd-Frank's ban on bailouts and the FDIC's new resolution tools.[7]

In light of these considerations, it is reasonable to expect that well-run banks will come to support the Dodd-Frank reforms to the SIFI resolution framework as the foundation for a more stable financial system, and to correct reputational damage and competitive inequities that have resulted from the bailouts that took place in the crisis.

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[5] "50% Say Government Puts Wall Street Ahead of Main Street," Rasmussen Reports, January 18, 2011. http://www.rasmussenreports.com/public_content/business/general_business/january_2011/50_say_government_puts_wall_street_ahead_of_main_street.

[6] "Supported Bank Debt Ratings at Risk of Downgrade Due to New Approaches to Bank Resolution," Moody's Investor Service Special Comment, February 14, 2011.

[7] "Moody's Reviews Bank of America, Citi, Wells Fargo Supported Ratings for Downgrade," Moody's Investor Service Announcement, June 2, 2011.

The Importance of Limiting Financial Leverage

The second major lesson of the crisis involves the dangers of excessive debt and leverage. The single most important element of a strong and stable banking system is its capital base. Capital is what allows an institution to absorb losses while maintaining the confidence of its counterparties and its capacity to lend. 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.

At the end of the U.S. banking crisis of the 1980s and early 1990s, Congress embarked on important banking system reforms just as we are doing today, including a commitment to promote a well-capitalized banking system. This included a Prompt Corrective Action system with mandated objective restrictions on bank balance sheet leverage. Also, the U.S. joined with other countries in implementing Basel I, a risk-based capital system based on fixed risk-weights. However, by the mid-1990s, regulators began to implement several fundamental changes in capital requirements that allowed for greater leverage.

One important regulatory change that facilitated the growth of leverage was the 1996 decision to permit Trust Preferred Securities, a form of subordinated debt, to meet a portion of a Bank Holding Company's tier 1 capital requirements. Since these securities are debt obligations, they cannot absorb losses while the issuer operates as a going concern. The use of Trust Preferred Securities in holding company capital allowed those organizations to operate with less loss absorbing capital than they had before. Our

experience with these instruments during the crisis is that they impeded recapitalizations and that institutions relying on them were generally weaker and more likely to be engaged in high-risk activities. Other notable changes in regulatory capital requirements included the 1998 introduction of the Market Risk Rule that substantially lowered capital requirements for trading assets, and the 2001 Recourse Rule that lowered capital requirements for well-rated securitization exposures.

In 2004, the Basel Committee on Banking Supervision published its Basel II capital standard that included the so-called Advanced Approaches, which allow banks to use internal estimates of risk to determine their capital requirements. As other countries moved with dispatch to implement the Advanced Approaches, we saw risk-based capital requirements for banks in those countries dropping to levels that were often much lower than the old Basel I requirements. By contrast, adoption of the Advanced Approaches by large U.S. banks has been subject to significant restrictions, largely at the insistence of the FDIC. Without these restrictions, the capital of U.S. banks entering the crisis would have been much lower, and the cost of the crisis to the federal government and the broader economy would have been much higher. In the wake of the crisis, analysts are increasingly coming to recognize that the risk-based capital calculations produced under the Advanced Approaches are suspect.[8]

This progressive easing of regulatory requirements in the years leading up to the crisis allowed large bank holding companies and investment banks to significantly increase their leverage, benefitting those institutions in the pre-crisis years but ultimately leaving the U.S. economy worse off. From 2000 through 2003, the aggregate tangible equity to assets ratio of the ten largest U.S. bank holding companies ranged between 5.5

[8] "The Shrinking European Bank Sector," Barclay's Capital Equity Research, May 23, 2011.

percent and 6 percent. But this ratio subsequently dropped below 5 percent through 2004 and 2005, below 4 percent in 2006, and to less than 3 percent by year-end 2007. Large U.S. investment banks followed a similar path. By year-end 2007, the aggregate tangible equity to assets ratio of the top five investment banks was just 2.84 percent.

By contrast, at the end of 2007, the ten largest FDIC-insured depository institutions, which faced higher leverage requirements under Prompt Corrective Action and were not allowed to include certain subordinated debt instruments in core capital, had tangible equity capital equal to 6.46 percent of assets.

The excessive leverage in the financial system entering the crisis, along with the need to repair balance sheets after the crisis, has forced a massive deleveraging of bank balance sheets. Loans and leases held by FDIC-insured institutions have declined by nearly $750 billion from peak levels, while unused loan commitments have declined by $2.7 trillion. This deleveraging illustrates the severe danger of insufficient financial institution capital: it can deprive the broader economy of an important stabilizing source of credit during a downturn.

The economic and fiscal toll of financial crises on the real economy is invariably heavy. In the U.S., we lost almost nine million payroll jobs in the recession, suffered a one-third decline in house prices, and have seen over nine million foreclosures started in a four-year period. The decline in economic activity caused by the crisis has reduced both federal and state tax revenues, while plummeting home prices have affected property tax revenues. These fiscal costs of the financial crisis are of concern not just because of their bottom-line impact on government deficits, but because they reverberate

back to the real economy. State and local governments, for example, have reduced services and cut over 500,000 jobs since year-end 2008.

The ramifications of over-reliance on financial leverage extend far beyond the regulation of financial institutions. Our tax system rewards debt financing of business relative to equity financing, encouraging some corporations to lever themselves imprudently, while the tax deductibility of mortgage interest encourages households to take on debt. The fiscal machinery of many governments around the world has relied on debt issuance as a way to deliver services without the immediate cost of paying for those services. A country that relies on borrowing to pay its current bills will eventually find that its economic health and competiveness suffer.

Overreliance on leverage by financial institutions is a problem that clearly contributed to the financial crisis and its severity. Pre-crisis increases in leverage provided a kicker to financial institution growth and earnings, but the real economy bore much of the cost of the subsequent unraveling. As we consider regulatory change going forward, we should not repeat past mistakes by placing the interests of financial institution shareholders ahead of the protection of taxpayers, creditors, and the broader economy.

Ongoing Reforms to Place Responsible Limits on Financial Leverage

With Basel III and an important provision of the Dodd-Frank Act known as the Collins Amendment, we have an historic opportunity to put our banking and financial system on a firmer footing.

The Basel III International Capital Accord. Basel III both increases the numerical minimum capital ratios and strengthens the definitions of capital that can be used to meet the new minimums. First, it creates a new measure of regulatory capital, "tier 1 common equity," that is much closer to pure tangible common equity than the present tier 1 definition. Debt instruments such as Trust Preferred Securities will migrate over time out of tier 1 and into tier 2 capital status. Meeting minimum requirements for tier 1 common equity will provide a much more meaningful assurance of the bank's ability to absorb losses.

Basel III also requires capital for certain risks that the old rules did not adequately address. This includes capital for the risk of deterioration in the credit quality of over-the-counter (OTC) derivatives and additional capital to cover risks of trading assets. Most notably, Basel III includes an international leverage ratio that, while it is numerically lower than the U.S. ratio, includes capital for some off-balance sheet exposures. The leverage ratio is an important tool to ensure a base of capital exists to cover losses that the risk-based rules may have erroneously categorized as minimal.

When I called for an international leverage ratio in Merida, Mexico in 2006, the reaction from regulators and bankers alike was dismissive. That such a ratio is now part of an international agreement reflects the recognition of the importance that hard and fast constraints on leverage have for financial stability.

Basel III is scheduled to be phased-in over a 5-year period that begins in 2013. We believe that large U.S. banks are well positioned to meet the Basel III capital standards far ahead of the Basel timeline and mostly with retained earnings.

The Collins Amendment. Another important 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. Without the Collins amendment, our current rules set a course to allow the risk-based capital requirements of our largest banks to be governed by the assumptions of bank management regarding the riskiness of their own exposures. In my view, such an approach would eventually create the conditions for another leverage-driven banking collapse.

On June 14, the FDIC Board did its part to correct this situation by approving an interagency final rule to implement the risk-based capital floors on the Advanced Approaches that are required by the Collins Amendment. This rule is a significant event that will safeguard the capital adequacy of our largest banks in the future, when the lessons of the crisis may no longer be fresh in our minds, and the banks' internal models once again are enticing us to believe that risks and needed capital are minimal.

The SIFI Surcharge. In addition, the Basel Committee is developing capital standards for the most systemically important institutions – the so-called "SIFI surcharge" – that would augment the standards announced in December 2010. As the *Wall Street Journal* recently wrote, "The simple yet powerful idea is to require banks that

are playing with taxpayer money to hold more capital..."[9] The extra risk posed to financial stability by the SIFIs strongly suggests the need for an additional buffer to absorb losses and reduce the likelihood of a recurrence of the crisis situation of 2008. The higher capital requirements associated with the SIFI surcharge will appropriately raise the cost of becoming a systemically-important institution, potentially creating incentives for institutions to become smaller and less complex, and reducing disparities in funding costs between large and small institutions.

Most large U.S. banks are expected to be able to meet Basel III standards, including any SIFI surcharge that might apply to them, in the near term and mostly through earnings. Still, some banks might need to take advantage of the phase-in period that would be part of any SIFI surcharge. Like all U.S. rulemakings, any proposed changes to capital requirements would be based on a notice and comment process that will provide institutions additional opportunity to express their views about the impact of the changes. But given the timeframes involved and current capital levels for U.S. banks, we believe that concerns about higher capital requirements curtailing lending and economic activity are misplaced. A growing body of research shows that higher capital requirements will have a relatively modest effect on the cost of credit and on economic activity, and will help to prevent the misallocation of scarce capital to wasteful purposes, as occurred in the case in the housing bubble.[10]

"Bail-in" Debt. The consensus of U.S. regulators is that the higher capital standards should be met solely with common equity. But even as global regulators are

[9] "Tarullo's Capital Idea," Wall Street Journal, June 16, 2011.
[10] See, for example: 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.

approaching consensus on the need for higher capital requirements and a SIFI surcharge, some are calling for at least part of the additional capital to take the form of debt that is convertible to equity when the institution encounters financial distress. While theoretically plausible, the concept of "bail-in" debt suffers from a number of practical problems. Conversion to equity in a stressed situation could trigger a run on the institution, downstream losses to holders of the debt, and potentially feed a crisis. Unfortunately, the current proposals to count bail-in capital against the new Basel III capital requirements have all-too-many parallels with the ill-fated experiment with Trust Preferred Securities at U.S. bank holding companies in the years leading up to the crisis. During the crisis, those securities did not absorb losses on a going concern basis, and served as an impediment to recapitalizations. We are very pleased that Congress saw fit to eliminate the prospective use of Trust Preferred Securities as part of capital requirements for banks and bank holding companies under Dodd-Frank.

If bail-in capital were implemented, it is not hard to envision crisis scenarios in which it is quickly consumed in the death spiral of a severely troubled institution, leaving regulators in the position of having to resolve the institution anyway. We should learn from our mistakes and avoid such devices in the future. That is why I strongly believe that the higher capital requirements under Basel III should be met with the same tangible common equity that Basel III requires for the new minimum standard for common equity capital.

Conclusion

Since its creation in 1933, the mission of the FDIC has been to promote financial stability and public confidence in banking through bank supervision, deposit insurance, and the orderly resolution of failed banking institutions. It is an organization that understands the true economic costs of financial instability. That is why the FDIC consistently takes the long view on regulatory matters, and strives to uphold consistent standards for consumer protection and safe and sound banking that will serve the long-term public interest.

I am proud to have had the opportunity to serve as FDIC Chairman for the last five eventful years. One of the most important lessons I have drawn from my experience has been the need for regulators to have 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, and to allow higher concentrations of risk on the balance sheet and the movement of risky assets off the balance sheet, where they continue to pose a risk to stability.

In my experience over the past five years, I certainly regret that we did not have better information and better resolution tools in place at the height of the crisis to prevent the bailouts of a number of the nation's largest financial companies. The bailouts were made necessary by the lack of sufficient information and authorities, but also have had the effect of slowing the recovery, tipping the competitive balance in favor of large, complex institutions, tainting the reputation of all banks, and undermining public support for government functions that most would agree are necessary and appropriate. The

FDIC's insistent support for a more robust SIFI resolution regime in the wake of the crisis speaks to our determination that this experience never be repeated.

Thank you for the opportunity to testify. I would be glad to take your questions.

Mr. MCHENRY. Thank you for your testimony.

I now recognize myself for 5 minutes.

As I said in my opening statement, the Acting Comptroller of the Currency, John Walsh, stated in an interview the other day that additional capital requirements for large firms should be "modest," noting that capital levels are now extraordinarily high by historical standards and higher capital fosters a safer banking system, but if carried too far, the economy suffers when banking activity is not sufficient to support desired levels of economic activity."

Chairman Bair, we noted that you and the Acting Comptroller of the Currency have had disagreements on capital levels. Is there a capital level requirement that is too high?

Ms. BAIR. I think there certainly could be, but I don't think the numbers we are talking about really come anywhere close to that. We are working through the Basal Committee process. I think it is very important to have international agreement on the appropriate standards and the Basal Committee has done a lot of analytical work on this, looking at the cost of the crisis, the amount of losses on financial institution balance sheets and how much additional capital would have been needed to absorb those losses to avoid this massive de-leveraging that we experienced.

It has also tried to weigh those costs against incremental increases in lending from higher capital standards. So I think the numbers have very much tried to strike the right balance.

The 7 percent Basal III standard, which I don't think Acting Comptroller Walsh has a disagreement with, has been agreed to but as part of that agreement, there was broad based consensus on the Basal Committee, including with Mr. Walsh, that we would be looking at higher loss absorption capacity for the very largest institutions. That is the process now.

I have been on record as thinking at 300 basis points, a 10 percent standard would be about right. That is actually moderate when you look at most of the studies that have been independently done by academics or the government. These studies generally support much high capital levels based on the type of analytics I described.

The Wall Street Journal, in a recent editorial endorsing much higher capital standards, actually threw out 15 percent. I thought it was interesting. The benchmark they were using was what the market demands of a smaller finance company which clearly has no government support whatsoever and the market demands a 15 percent capital requirement. I think the 10 percent actually is moderate by all analytics we have looked at.

I would also add though that this is going to go out for comment. Whatever the number the Basal Committee agrees to will go out for comment. It will explain the analytics behind the number and people will have a chance to provide public comment.

Mr. MCHENRY. How are your metrics different from the OCC's?

Ms. BAIR. I don't know. Apparently OCC has done some independent analysis. I just haven't seen it and would welcome looking at it. I think perhaps he is looking at historical number but historically I think there is probably a prudent case that this financial system has not had sufficient capital which is why we continue to have these cycles, a very severe one recently.

Also, if you are looking at risk weighted assets, unfortunately, there is a lot of subjectivity in capital levels based on how a bank is risk weighting its assets. I don't know what the analytical underpinning is for his views. I would be happy to take a look at them but I haven't seen them.

Mr. MCHENRY. I am not asking about the health of European banks, but in terms of international competitiveness, isn't it important that we are harmonized globally with these capital requirement levels so we are not disadvantaged?

Ms. BAIR. I think it is important we have international agreement. I think strong capital is a competitive strength and I think European banks are having some trouble now because the way they risk weight their assets does not have the confidence of the market. I think also the problems they are having with Greece and other distressed countries with their sovereign debt and the inability to restructure that is related to the high levels of leverage in their banking system and the inability of some of their banks to withstand the writedowns on that debt if there was a debt restructuring.

I worry about capital levels in Europe and I worry about the impact that could have coming back to the United States. I think international agreement is important to get those capital levels up in Europe.

Mr. MCHENRY. Finally, in terms of the Dodd-Frank law as it is proposed by Congress, are there items that we should address as you are walking out the door, items we should address to fix, to correct, to improve, to change Dodd-Frank? It is intended to be an open ended question.

Ms. BAIR. It is not a perfect law. Certainly there were things that we would like to have seen differently and we can share those views with you. I think it is a law we can work with. I think on the Title II authority, we feel we do have the tools that we need. I do believe that net-net, it is a good law. We are better having it, than not having it, at least the parts of it where the FDIC has a mandate that we can work with, the authorities given to us.

Mr. MCHENRY. You didn't take the bait?

Ms. BAIR. I didn't take the bait. Sorry.

Mr. MCHENRY. Perhaps in another month, we can have a conversation and you can tell me your thoughts.

With that, I recognize the ranking member, Mr. Quigley.

Mr. QUIGLEY. Thank you.

Coming from Illinois, small banks, community banks, you touched a little bit on competitive disadvantages. What else can we do?

Ms. BAIR. I think the good news is that the banking sector is healing and it is really all about the economy and getting the economy on a stronger footing so borrowers will want to start borrowing more money again. Even smaller banks, we are seeing many instances where they are raising capital. A lot of them that had been on our rejected failure list are actually coming off because they have raised capital. I think there are some positive improvements in the community banking sector.

It has been tough for them, but if you look at the number of community banks that got in trouble as a percentage of assets as well

as numbers, it is much, much smaller than the kind of distress we saw with the large institutions. Most of them actually managed through this very well. They managed their commercial real estate concentrations pretty well and in our supervisory process, we are trying to take lessons learned from the success with community banks and fine tuning our own supervisory process.

I do think regulatory burden is an issue. Chairman McHenry mentioned this as well. I have endorsed some type of two tier regulatory approach. I do think that regulatory requirements that may be driven by problems we have seen with larger banks, if you apply them across the board to small banks even if they have not much to do with the business model of small banks, can make it very expensive for small banks. They don't have the huge compliance departments that large banks have. I think a two tiered regulatory approach is important.

I think simplification of consumer rules and consumer disclosures would help consumers. It would also help community banks. A lot of community banks have gotten out of consumer lending just because the rules are so complex and complicated. They don't have the compliance capability to deal with it.

Mr. QUIGLEY. That is a specific point we hear quite a bit about the regulatory process. The terms they are using—harsh regulatory examinations, depressing impacts these practices have on their ability to lend and support the fragile economic recovery—some very specific stuff. The senior regulators in D.C. keep saying they are properly instructing their field examiners but bankers are saying the field examiners are not following the rules.

We hear there are inconsistencies in their decisions. The people higher up are saying their plans are not being implemented locally. The examiners are telling the bankers their decisions are being changed above but then there is a time lag in how these decisions get back to the banks which creates inconsistencies and a real problem moving forward.

Ms. BAIR. I do hear this a lot. I can tell you the measures we have taken. I am kind of beside myself to try to figure out what else to do. We have told our examiners directly that loans shouldn't be criticized because collateral has fallen. If you have a credit worthy borrower that can make the loan, if the collateral has gone down, it is still a good loan.

We have not required new appraisals unless more credit is being extended. Then obviously you do want to get an appraisal. I have said this specifically, we have said it in writing. We have disseminated this information to banks so they know what the rules are. If they feel examiners are doing it inconsistently, they can tell that to the examiner.

We have told our examiners they need to be independent of the banks. They have a job independent of the bank, but they do need to listen to bank management and hear their side of it and discuss directly with them their concerns.

We have done all this and set up special hotline numbers for bankers who feel the policies are not being applied. We have an ombudsman program that will keep it confidential if they don't want their names used. We have frankly worked hard on this. We are not perfect. We have a lot of examiners and more banks than

anybody, so perhaps the challenge of getting all this communication out to examiners is more pronounced because of the sheer numbers.

On the other hand, when we have received complaints and have drilled down into it, sometimes examiners are being blamed for bringing the bad news. Bank management is not always realistic about the extent of their troubles. Sometimes I find the complaints are not actually coming from the community banks but from borrowers who were not able to get a loan. Especially in the construction industry, there are a lot of folks who are not creditworthy anymore.

We do try to drill down and get to the truth of the matter and we have found instances where mistakes were made and we try to correct that. In some other cases, it may just be a bad situation, examiners being blamed when they really have followed the appropriate policies.

Mr. QUIGLEY. Mr. Chairman, rather than go into a whole new area, I will yield.

Mr. MCHENRY. I thank the ranking member.

At this point, I will recognize Mr. Gowdy of South Carolina for 5 minutes.

Mr. GOWDY. Thank you, Mr. Chairman.

Thank you for your service to our country.

I will yield the remainder of my time to Chairman McHenry.

Mr. MCHENRY. I thank the gentleman. That is quite kind and gracious.

You mentioned the ombudsman program you have, the hotline. I will be very honest with you. We were going to have a second panel and we reached out to different associations here in town, invited bankers and no one wanted to appear on a second panel.

Ms. BAIR. How should I take that?

Mr. MCHENRY. That is really the question and it is not personal, first of all, but it is either that the complaints, they don't want to air publicly. Why is that? Are they so fearful of their regulator or are they fearful of what the public thinks of them complaining or is it one of those things, they will grumble but really don't want to get into the specifics? It may just be Washington politics. Who knows? I thought that was a little odd.

Wrestling with that concept, because I am concerned about regulatory overreach as we have discussed privately, but there is a balance. We look at our banks in our community, and Mr. Quigley mentioned this as well, we don't know the health of their balance sheet, we don't know if they have overexposure in raw land, for instance, so they are telling their customers it is the regulator that won't let me do it, when in reality it is an imbalance in their balance sheet or they have a capital problem, a challenge.

Do you have any comments about that?

Ms. BAIR. I do. I have been dealing with this a lot. We want a high quality, second to none examination process. Our examiners feel that way, our leadership feels that way, so it is important for that process to be one where there is an issue that procedure has not been followed appropriately, those can be brought to our attention in a way that we encourage, don't penalize, so we can look into it.

It has frustrated me because I get a lot of generalized complaints but when I say tell me what it is so I can fix it, let us look into it and I will fix it if it is there, and I don't get any specifics, so I don't know if maybe people just want to grumble and it may be a little bit of both. All I can say is that it is my policy, it will be Vice Chairman Gruenberg's policy, it is the policy of our leadership in our Risk Management Division to encourage, accommodate and look into every single complaint and not the other way around.

That doesn't mean we will always agree. We do look into them and we find the examiner was doing things appropriately and there have been instances where we found something else and we have taken appropriate action, but I don't know what else I can do. If people don't want to come forward, there is not much I can help with.

Mr. MCHENRY. Thank you for commenting on that because it is one of those things that we all deal with. We want to fix problems where we can fix them.

Ms. BAIR. Right.

Mr. MCHENRY. There is another question that kind of goes hand in hand with this. You saw the news last week or the week before with Jamie Dimon's question of Chairman Bernanke, sort of the cumulative effect of these regulations and the impact they will have on the cost and availability of credit.

Has there been a holistic review by the regulators or at the FSAC level about the cost of these regulations because certainly we agree, and I think it is economic fact that they do have an impact—additional capital does cost, but there is a tipping point for safety and soundness by which you have to be there and over the long term, it could be a net positive. Can you comment on that?

Ms. BAIR. I don't think there has been at the FSAC level. I think certainly with regard to capital, there has been a lot of cost benefit analysis and also for the rules that we do. Our IG just looked at this at the request of Congress, I believe, and we follow all the requirements of cost benefit analysis. We have a lot of economists, we encourage that type of economic analysis of our rules.

We have also started looking into community bank impact and actually for any rule or guidance we put out, we have a separate line that says what the community bank impact will be. Yes, on an individual agency basis, I think it is occurring. It might be very worthwhile for the FSAC on an interagency basis to look at this.

I do think there are interrelationships especially with what we are doing with the derivatives new rules and some of the restrictions on proprietary trading, what kind of impact that will be and how they interrelate to capital I think would be a helpful interagency analysis. Just in terms of raising capital, I am actually very confident that there has been very good analysis and the numbers we are talking about now are more than justified.

Mr. MCHENRY. Thank you.

With that, I recognize Mr. Meehan of Pennsylvania for 5 minutes.

Mr. MEEHAN. Thank you, Mr. Chairman.

Thank you, Chairman Bair, for your service to our country during what was certainly a very challenging time for our Nation. I

am sure you are looking for an opportunity to enjoy the life thereafter, but again, thank you for your service.

There are so many aspects of the impact of what we have tried to do in response to the many problems that occurred, but I see it through the eyes of many of the people in my district who are facing issues locally. I was intrigued by your comment that many of the smaller banks are the ones that are competing now at a disadvantage because of the rules that have been focused on the large banks.

I hear a lot in my community, particularly in the housing sector—homebuilders, realtors, bankers—and there seems to be a game in which they are all sort of pointing to the other one and saying, they are the ones responsible for not allowing us to get going. Everything that I have studied certainly indicates that a robust housing market is a key to getting out of an economic slump.

Obviously with such an amount of under water mortgages, we are not going to see robust, but I also see small community bankers with responsible institutions who have weathered this area very well and builders with very good reputations who have proven their capacity to analyze the market. Right now, some are actually saying this is a great time to take risks, if you understand your market.

Yet, what I am understanding from talking and meeting with my homebuilders is that many of them are concerned about hard caps for construction lending, development lending. What I really need to understand is whether or not this 100 percent hard cap is really that? Is it advisory or are we creating the kind of hardline standard that locks in the inability for local bankers and local builders to do what they have been doing for generations, which is to make sound judgments about each other?

Ms. BAIR. I think construction development lending is very high risk lending and if you look at the figures we have had for the smaller institutions, they have been almost heavily driven by losses in construction development lending and high concentrations of those. Yes, it is a benchmark, it is not a cap, but the general rule is 100 percent, they shouldn't go over 100 percent of capital and if they do go over 100 percent of capital, you need to have special risk management processes in place and board level involvement in managing those risks.

There is a lot of scrutiny in C&D lending; it is not a hard cap, but I would say there is a lot of scrutiny of it and well justified given the number of banks we have seen that have failed because of heavy concentrations in that area. Again, it depends on the local market. Obviously in some areas they are heavily over billed already, so probably the last thing you need to do is start a new housing tract. That is based on local conditions. Our examiner are asked to look at the local conditions.

Mr. MEEHAN. They are taking into factor not only local conditions, but the history of both the builder and the institution. Obviously, they don't analyze the builder, but the builder is living through the analysis by the bankers. I am hoping that is an issue that can continue to be analyzed on the local level and that the regulators will take into consideration that impact.

The other issue, which we are getting a lot from the realtors, and I know you have made comments on the QRM and some of them have included even you are not quite sure, if I am correct, if we ought not let incentives deal with it rather than this hard and fast rule. Can you give me your instincts on that, where we should be going with it?

Ms. BAIR. I guess I am a market oriented person, so if we can let economic incentives drive lending standards instead of regulators micromanaging it and saying this is what your lending standards should be, yes, I prefer that approach. I think it is very difficult. I think the distributing process got completely out of control—it was a huge driver of the crisis. It needs to be reformed.

My sense is that meaningful risk retention, skin and the game, will be the best way that we can discipline underwriting standards going forward. I would like to bring the securitization market back, I think it is a healthy part. I would like to have banks have diversification in their funding of their lending activity, but it needs to be brought back in the right way.

Already we are getting into debates. I think the staff put together what they felt objectively based on a lot of analytical work or the "gold standard," which was the directive of the legislation. The QRM was mean to be an exception, not a rule. Now we have into arguments about are we setting the standards too high, is this going to disadvantage people.

Yes, my preference would be that everybody has to keep some skin in the game, to discipline it that way as opposed to regulators trying to micromanage what those lending standards should be. I think I can say that freely because I won't be part of the decision-making, as you know. That would be my preference.

That, plus I also agree, I think Chairman McHenry spoke of this, we need loan level disclosure in these securitizations. Investors buying these mortgage-backed securities need to see the loans inside the securitizations before they make an investment decision. That would also be a very good check on underwriting standards.

Mr. MEEHAN. Your perspective is very important to us as we look at these policies. Thank you again for your service.

Mr. Chairman, I yield back.

Mr. MCHENRY. I thank you, Mr. Meehan.

We have votes on the floor now and I just have two or three more questions to ask and we will be able to adjourn.

Yesterday I read about a meeting you had yesterday, somehow a meeting of all the bank minds.

Ms. BAIR. Sort of an advisory committee.

Mr. MCHENRY. Yet discussions about orderly liquidation was a significant order of the day. I read there was no agreement really on the proper way to approach this. Was there consensus? Can you comment on that?

Ms. BAIR. I don't think we were looking at consensus. It was the first meeting of an Advisory Committee on Systemic Resolutions. We have a lot of senior prominent people involved, representing a lot of different segments of the industry as well academia. I think they challenged us, raised good questions and I think it helped clarify our thinking. That, frankly, is what we wanted to get out

of it. We did not want someone to come in and nod their heads at us.

I thought it was very valuable. I think the message I took away was it is going to tough, but it is doable. There is no on and off switch on this. I can't just turn off Too Big to Fail and say it is gone now after being around for decades. It is going to take a lot of hard work on our part, on the banks part, on the Federal Reserve Board's part.

We do have the tools now to tackle it in a meaningful way. At least one rating agency has signaled a possible downgrade of some of these large institutions, removing the bump up they have gotten in the past from implied government support. I view that as a positive sign. I think we do have the tools to end it and over time, will end it.

Mr. MCHENRY. In terms of the orderly liquidation authority, some have knocked it saying it basically prioritizes systemic risk over property rights. How do you reconcile that?

Ms. BAIR. I don't understand that.

Mr. MCHENRY. Is that unfounded?

Ms. BAIR. I think it is. Our priority of claims is pretty much what you have in bankruptcy. The thing that we can do that you can't do in bankruptcy is we can preplan, we can be in these institutions with the Fed on an ongoing basis, collecting information. We can preplan with their living will. We can work with international regulators in advance of failure to navigate whatever their requirements might be for facilitating an international resolution and we have done that with smaller banks a lot already.

Bankruptcy courts really can't do that. The other thing they can't do is they can't provide temporary liquidity support which I think is where was some of the "bailout" criticism comes from, but with the financial institution, if you need to preserve the franchise value, you do need to provide some ongoing liquidity support just to keep the place operational as it is broken up and sold off.

Those are the things that are different, what we can do better in bankruptcy and we can require continued performance in derivatives which was a huge problem during Lehman and one I hope Congress will look at in the bankruptcy process as well.

In terms of how creditors are treated, it is very, very similar to bankruptcy. Actually, I think creditors will come out better in our process because we do have the ability to maintain the franchise, it just doesn't fall apart when the filing occurs, as you saw with the Lehman process. I think in that sense it will help creditors but the claims priority is the same.

In implementing OLA, we have tried to follow the bankruptcy code as much as possible, as we do with bank receiverships.

Mr. MCHENRY. Your view is it is going to be a rules-based unwind?

Ms. BAIR. It will be rules-based, it will be transparent. There will be lots of reports to Congress and it will be faster too, and less laden with attorneys' fees and other types of administrative expenses.

Mr. MCHENRY. But not situationally? It is going to be a rules-based unwind that will be public?

Ms. BAIR. Yes.

Mr. MCHENRY. You will set the standard?

Ms. BAIR. Yes, and it will be competitive too, as we do with banks now. There is an advanced marketing process, we try to get in as many bidders as possible. That is one of the key parts of the living will process, to make sure that the business lines are a line with legal entity so they can be broken up into marketable segments and sold in a very prompt manner.

Our process is to get back into the private sector as quickly as possible. We don't like setting up bridges and running them indefinitely. Having that preplanning is important. Some may need to do some organizational changes to simplify their legal entities with their business line so they can be broken up and sold off if they get into trouble. That is good from a risk management perspective as well.

Mr. MCHENRY. Will you speak to my small business owners, because they are talking to their banker and they have had a relationship, they may have good cash-flow, they may be profitable and the banker is saying, the regulator won't let us lend. Having met with you, and we had this meeting 6 months ago, I said, respond to this. Talk to the small business person who is trying to keep things going and their banker is telling them it is the regulator, the regulator is saying each bank is different. Who is speaking the truth here?

Ms. BAIR. We have really strongly encouraged banks to make prudent small business loans. We want them to make small business loans—especially the small banks have a big presence in this area. We want them to make those loans.

I think sometimes the regulators are blamed and maybe the bank is just feeling the small business may be a little too risky but maybe it is easier for the customer relationship to say the regulator is making them do it as opposed to saying they don't think it is a good credit risk. We have set up a hotline for small businesses who feel they have been unfairly denied credit. They can call us, we will look into it if it is our bank. We will refer it to another regulator if it is not our bank.

That has been helpful. It has been educational for us to see the kinds of complaints that are coming in. I think it has been helpful to the small businesses as well to understand what our rules say and do not say and what our examination processes allow banks to do and perhaps discourage them to do.

I think part of the problem here is that the economy is uncertain. It is making small business borrowers cautious, it is making banks cautious. Getting the economy on a sounder footing, I cannot overestimate that is really what is going to cure this. We can keep pushing banks and I think interim government programs to provide support for small business lending are good but at the end of the day, it has to be get the economy going again in a more robust way.

Mr. MCHENRY. What I am hearing from you today is you have some concern about the transparency of derivative transactions and the approach there?

Ms. BAIR. I think transparency for derivatives is extremely important. I would certainly put that at the top of my list of things. I think a lot of the abuses that occurred in the CDS market would

not have occurred if regulators and certainly the market in general had a better picture of who was taking what position, what size of exposure and what price. I think that is very important.

Derivatives are going to take a while. That market developed for a long time without any kind of regulatory overlay. As I have said before, I think doing that in some graduated way probably makes sense.

Also, in terms of the problems during the crisis, I think derivatives all gets bunched together. It was really the credit default swap market that was the big driver in the crisis, so perhaps paying particular attention to that segment would be a good thing.

Mr. MCHENRY. The second thing you mentioned is the cost benefit analysis and the cost of the totality of these financial regulations and rulemaking coming out of Dodd-Frank? That FSAC could move forward on it.

Ms. BAIR. Yes, I think looking at the interrelationships of the rules and their cumulative impact, I think that is good. We each have individually been looking at this, but I think that would be a good structure project for the FSOC. I think that makes a lot of sense.

Mr. MCHENRY. Thank you. Thank you for your testimony.

Because we have votes on the House floor, the Members have departed and I took the liberty to ask a few questions before I depart, but thank you for your service to the American people. You have chaired the FDIC at what would seem like a pretty reasonable time when you took your first term. We know you were very active in the financial crisis in trying to make sure cooler heads prevailed and to really preserve the insurance fund you are in charge of. We really appreciate that.

I don't think we will fully understand the impact you had or the role you played for many years, unless you are writing a book and we may know sooner.

Ms. BAIR. Very good. I hope I hold up. Thank you, Mr. Chairman. I am sorry we didn't have more of a chance to work together. I have enjoyed this opportunity and wish you all the best as well.

Mr. MCHENRY. Thank you. Thank you for your service.

Before this meeting is adjourned, Members will have 7 legislative days to submit questions for the record.

With that, the hearing is now adjourned.

[Whereupon, at 2:24 p.m., the subcommittee was adjourned.]

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