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STATE OF THE FDIC: DEPOSIT INSURANCE, CONSUMER PROTECTION, AND FINANCIAL STABILITY

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

EXAMINING THE STATE OF THE FDIC

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STATE OF THE FDIC: DEPOSIT INSURANCE, CONSUMER PROTECTION, AND FINANCIAL STABILITY

THURSDAY, JUNE 30, 2011

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 2:22 p.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. Good afternoon. I would like to call this hearing to order.

Today we welcome back Sheila Bair, Chairman of the FDIC, to the Committee for the last time in her current position.

Chairman Bair's time at the FDIC has been historic. Our Nation experienced a financial crisis of a magnitude not seen since the Great Depression, and Chairman Bair played a critical part in helping us navigate out of the crisis.

Chairman Bair, you succeeded in maintaining public confidence in bank deposits, overseeing the resolution of over 300 failed banks with over $600 billion in assets, monitoring banks' liquidity needs, developing programs to stabilize the banking sector, and unfreezing credit markets. I applaud you for your astute management of these tasks.

Also, not only were you and your staff instrumental in the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, you have skillfully guided the FDIC as it assumes new, significant responsibilities. The FDIC is now a voting member of the Financial Stability Oversight Council, is in charge of the resolution of large, systemically important financial institutions, and insures each bank account of Americans up to $250,000.

During your tenure the American people were fortunate to have a strong consumer advocate leading the way at the FDIC. You sounded the alarm about the threat of foreclosures and the need for loan modifications before the crisis hit, targeted high-risk mortgage products before other regulators, and led the way to find innovative solutions to include the unbanked and underbanked in the traditional banking system. And to give more emphasis to consumer protection, you pushed for the creation of the Division of Depositor and Consumer Protection within the FDIC.

Last, you have worked hard to preserve the community banking system in rural communities like those in my home State of South Dakota. You have been a champion of the community banking system, and I appreciate your hard work.

I thank you for being here today, and I look forward to hearing your insights on the opportunities and challenges faced by the FDIC during your time as Chairman. I also welcome any parting words of advice you have for us as we continue to implement Dodd-Frank and build on our Nation's economic recovery.

I now turn to Ranking Member Shelby for his statement.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Today, as you said, we will examine the State of the Federal Deposit Insurance Corporation. This I believe is an appropriate time for this hearing as it comes at the end of Chairman Sheila Bair's 5-year term.

Chairman Bair's time in office has been marked by the financial crisis and by profound changes in banking law, especially those enacted by the Dodd-Frank legislation. As history will record, Chairman Bair was an active participant in both events. She played a key role in first devising and then later implementing the Federal Government's response to the financial crisis. During the formulation of Dodd-Frank, she also exerted a strong influence over the final legislation, especially, as you pointed out, the resolution regime provisions.

Given Chairman Bair's active tenure at the FDIC, I believe this is a unique opportunity to evaluate the successes and failures of the Federal Deposit Insurance Corporation. Only by learning from the past can we ensure that the FDIC remains a world-class regulator. One area, Mr. Chairman, that I would like to explore today is the FDIC's record regarding the Deposit Insurance Fund. Overseeing the fund should always be one of the FDIC's core missions.

Since 2007, 373 insured depository institutions have failed. The estimated cost of these failures to the Deposit Insurance Fund, to my understanding, is almost $84 billion. And as a result, the balance of the Deposit Insurance Fund has declined dramatically. At its lowest point, the Deposit Insurance Fund had a negative balance of $20.9 billion.

The high cost of resolving failed banks raises serious questions about whether the FDIC needs to reconsider how it deals with troubled banks. After the savings and loan crisis, Congress sought to improve the FDIC's resolution of banks by enacting the Prompt and Corrective Action regime. We call it PCA. The aim of PCA was to ensure that the FDIC closed troubled banks before they inflicted losses on the Deposit Insurance Fund.

A recent report by the GAO, however, showed that there are real problems with PCA. The GAO found that, since 2007, every bank that underwent prompt and corrective action because of capital deficiencies and failed inflicted a loss to the Deposit Insurance Fund. The GAO also found that while the regulators identified problematic conditions among banks well before the failure, the FDIC did not always promptly close banks, allowing bank losses to grow.

Most concerning, the GAO found that the average cost of resolving a bank was more than 30 percent of its assets.

I believe it is clear that prompt and correct action has not worked as it was intended. The cost of resolving banks is far too high and undermines the health of both the Deposit Insurance Fund and our banking system. Accordingly, I would like to hear today how PCA can be improved.

Another issue I would like to hear about today is capital. I believe that strong capital requirements are essential. Recently, the Basel Committee on Banking Supervision reached agreement on the new Basel III capital requirements. In 2006, right before this Committee in this same room, Chairman Bair raised serious concerns—and she was right—about the Basel II Capital Accords, arguing that they would dangerously reduce capital at our largest banks.

Thanks to her efforts, the implementation of Basel II was delayed and subject to important safeguards. Given her strong views on Basel II, I am very interested to hear her assessment of Basel III and how we can ensure that capital requirements are not watered down as memories of the crisis fade.

Finally, Mr. Chairman, I hope to hear how Chairman Bair believes we can ensure the viability of small banks. The FDIC has long been the regulator of small banks. Unfortunately, we have witnessed a significant decline in the number of small banks as the banking industry has consolidated. In 1984, there were 15,000 banking and thrift organizations. Today there is less than half that number.

I fear that one of the consequences of the Dodd-Frank Act is that it will accelerate the decline of small banks by imposing new regulatory burdens on them. Big banks will always be better positioned to deal with regulatory costs. Unlike small banks, they have the size and the resources needed to pay for and comply with new regulations.

Hence, bureaucracies like the new Consumer Financial Protection Bureau generally skew the competitive landscape in favor of big banks. The ultimate impact of the Dodd-Frank Act may well be to make the big banks bigger while wiping out the small banks in the coming tidal wave of regulatory compliance.

I look forward, Mr. Chairman, to hearing from Chairman Bair what steps we can do to ensure that our regulatory landscape allows small banks to survive and, more importantly, to thrive.

Thank you, Mr. Chairman.

Chairman JOHNSON. Are there any other Members who wish to speak?

[No response.]

Chairman JOHNSON. Since Chairman Bair has been before the Banking Committee 14 times since her confirmation, we will move right to her testimony. Your full written statement will be included in the hearing record.

Chairman Bair, please begin your testimony.

STATEMENT OF SHEILA C. BAIR, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. BAIR. Thank you, Chairman Johnson, Ranking Member Shelby, and Members of the Committee. Thank you for the opportunity to deliver my last testimony as FDIC Chairman on the state of the Federal Deposit Insurance Corporation. My 5 years as Chairman have been among the most eventful for U.S. financial policy since the 1930s. I sincerely appreciate the opportunity given to me by this Committee in 2006 when you supported my nomination.

The Members of this Committee and your colleagues in the Senate have always taken the time to listen to my concerns, and I hope you feel that I have done the same. Your advice and counsel were invaluable to me both during the crisis and the legislative reform process that followed.

When I started my term in June 2006, the strong reported financial condition of the banking industry was masking underlying weaknesses associated with an overheated housing market, lax lending standards, and excess leverage throughout the financial system. The strong financial condition soon gave way to record levels of problem loans and large quarterly losses. In all, some 373 FDIC-insured institutions have failed since 2006, imposing total estimated losses of $84 billion on the Deposit Insurance Fund.

Since early last year, we have seen earnings stage a modest recovery while problem loans have declined, although they still remain at elevated levels. The problem institutions are leveling off, and we expect fewer failures this year than last.

As in the last banking crisis, these failures caused the DIF balance to become negative starting in late 2009. The FDIC responded by raising assessment rates, imposing a one-time special assessment, and requiring the industry to prepay 3 years of estimated assessments. These actions both enabled the agency to avoid borrowing from taxpayers while minimizing the impact on the industry's capacity to lend. We expect the DIF balance to once again be positive when we report the June 30th results, and we are on track to restore the fund to its statutory minimums by 2020, as required by law.

We remain keenly focused on the financial health of the banking sector as well as the industry's consumer obligations. My written statement highlights the FDIC's ongoing focus on consumer protection and economic inclusion. When the CFPB starts operations next month, it will be able to work with the new FDIC Division of Depositor and Consumer Protection to ensure the consistent application of simpler and more effective consumer rules and to minimize regulatory burden on community banks.

We also remain intensely focused on financial stability. As I have testified several times over the past year, the Dodd-Frank Act, if properly implemented, will not only reduce the likelihood and severity of future crises, but will enable regulators to handle large company failures without resorting to bailouts or damaging the financial system.

Our highest implementation priorities relate to the new resolution framework for systemically important financial institutions, or SIFIs, and the strengthening of capital and liquidity requirements for banks and bank holding companies. Bank failures expose their

owners and debt holders to losses, which is how capitalism is supposed to work. Failed companies should give way to successful companies, and the remaining assets and liabilities should be restructured and returned to the private sector.

Bailouts are inherently unfair. They violate the 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 the centerpiece of the Dodd-Frank Act. Titles I and II of the Dodd-Frank Act authorize the creation of just such a resolution framework that can make the SIFIs resolvable in a future crisis. These provisions are designed to restore the market discipline to the megabanks, end their ability to take risks at the expense of the public, and eliminate the competitive advantage they enjoy over smaller institutions. We are making timely progress toward implementation of these provisions, as described in my written statement.

Moreover, as we learned in the crisis, the single most important element of a strong and stable banking system is its capital base. In the years leading up to the crisis, capital requirements were watered down through rules that permitted the 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 nonbank financial companies, that weakened the ability of the industry to absorb losses during the crisis and that has led to a dramatic deleveraging of banking assets in its wake. This is also why we have been such strong supporters of the Basel III process and other measures to enhance capital, including the Collins amendment and the SIFI capital surcharge.

Last week, the group of Governors and heads of supervision of the Basel Committee on which I serve agreed to important changes in the capital rules that will strengthen the resilience of the world's largest systemically important banking firms. The agreement provided for capital requirements ranging from 1 percent above the Basel III minimums to 2.5 percent, depending on the degree of systemic risk posed by each firm.

Importantly, the new requirements must be met with common equity. The FDIC strongly supported this requirement since equity capital is the only instrument which proved to have loss-absorbing capacity during the crisis. As financial reform moves forward, there is understandable concern about the slow pace of the economic recovery. However, the challenges facing our economy are not the result of financial reform. Instead, they reflect the enormous and long-lasting impact the financial crisis has had on U.S. economic activity. This suggests regulatory priorities for both the short and long term. Immediate focus should be placed on addressing operational deficiencies at large mortgage servicing companies to contain litigation risk and reduce the foreclosure backlog that is holding back the recovery of U.S. housing markets. Emphasis should be placed on streamlined modification protocols, write-offs of second liens where appropriate, and foreclosure alternatives such as short sales and cash for keys programs.

Longer term, the banking industry needs to return to the business of lending that supports the real economy. A strong and stable financial system is vital to the economic and fiscal health of the U.S. and our competitiveness in the global economy. Stronger and more uniform capital requirements and a resolution framework that subjects every institution, no matter its size, to the discipline of the marketplace are necessary steps to level the competitive playing field and help return the focus of our banking system to making good loans that serve the needs of households and businesses of all sizes in every part of our Nation.

Through its approval of last year's Dodd-Frank Act, the Committee took an important step forward in making our financial system stronger and more stable over the long term. Amid the controversies that accompany its implementation, I urge the Committee to maintain this long-term perspective and see essential reforms through to their completion.

Thank you very much, and I would be happy to take your questions now.

Chairman JOHNSON. Thank you for your testimony.

We will now begin the questioning of our witness. Will the clerk please put 5 minutes on the clock for each Member for their questions?

As we approach the 1-year anniversary of Dodd-Frank, efforts are underway to repeal parts of the act or the act in its entirety. What do you think of these repeal efforts? Should we go back to the system of regulation that existed before the financial crisis?

Ms. BAIR. I think we are much better off having the Dodd-Frank Act than not having the Dodd-Frank Act. It is not a perfect law. There are things that we would have liked to have seen done differently. But I think overall it does give regulators the tools needed to make the essential reforms of practices that we know fed the crisis and led to its severity. So, no, I would hope that the regulators be given the tools and the latitude to implement it, obviously subject to robust oversight. We are not perfect either, and the Congress has a very important role to watch what we are doing and make sure we are doing it the most effectively and efficiently as possible. But I do think we are better off having the Dodd-Frank Act, and I would not encourage its repeal.

Chairman JOHNSON. Without a director in place, the CFPB will not be able to exercise its examination and enforcement powers over nonbank financial institutions. Do you agree that this authority is essential to level the playing field between small community banks and their nonbank competitors and that it is important to move quickly on a director?

Ms. BAIR. Yes, I do think the ability to examine and enforce consumer laws against the nonbank sector is a very important part of the authorities of the new Consumer Bureau. This is a big problem. In the years leading up to the crisis, a lot of community banks in particular lost market share, especially with mortgage originations, because we had a lot of lightly regulated—if there was any regulation—independent mortgage originators selling into securitization vehicles. This did not serve community banks, and it did not do anything for borrowers either because many of these loans were so poorly underwritten and were clearly unaffordable.

So I think this is very important, and it is good to get it going now before that sector perhaps tries to start making a comeback. We can have good lending standards, but if there is no enforcement mechanism for both banks and nonbanks, we are going to have the kind of regulatory arbitrage that fed the crisis to begin with. Community banks have lost so much market share, especially in consumer lending and mortgages, and they have been relegated mostly to commercial real estate lending. Most of them are now specialty commercial real estate lenders. We would like to see them have the ability to better diversify their balance sheet, and I think trying to help get them back into the consumer space would be good for them and good for consumers, too.

Chairman JOHNSON. How would you respond to critics who say that Dodd-Frank does not end too big to fail? How would Dodd-Frank better protect the taxpayers from future bailouts of banks?

Ms. BAIR. So I think we pushed very hard with this, and we worked with the Senate on a bipartisan basis, and the law clearly says you cannot do a bailout of a poorly managed institution. It is just not allowed. The regulators do not have the discretion to do that. We wanted that. We wanted to take regulatory discretion out of the decision making.

So there is bankruptcy and there is a Title II process, but they are both harsh. They both impose losses on shareholders and unsecured creditors, which is where the losses should be. They are subject to claw-back provisions and other, we think, important measures to maintain market discipline over these firms. So I do not see how, going forward, a bailout could occur unless it was authorized by Congress, and I do not think Congress has any more appetite than we at the FDIC have to see bailouts in the future.

So we tried to lock that down. I think it is locked down in the statute. The tools are there to have alternatives to bailouts that are orderly and do not pose broader harm to the economy, and they can and should be used.

Chairman JOHNSON. There is concern that the biggest banks have only gotten bigger since the crisis and that these institutions are still too big to fail. Are you concerned about this? And has Dodd-Frank made financial institutions bigger?

Ms. BAIR. So I do not think any institution is too big to fail. I think that some need to simplify their legal structures and rationalize their legal structures with their business lines to make it easier to resolve them if they get into trouble in a future downturn.

But the tools are there to resolve them now. It would be more difficult, more expensive, and more inefficient without appropriate resolution plans, and that is why we think implementing Title I with the Fed—which requires these large institutions to file acceptable, credible plans with us that show how they can be broken up and resolved in a bankruptcy framework—is extremely important.

But, no, no bank is too big to fail, and there is a process now that can be used for them. If they get into trouble, we can deal with it in a way that does not provide broader disruptions to the economy.

Chairman JOHNSON. The Basel III agreement proposes that large banks finance their asset purchases with more equity.

Ms. BAIR. Right.

Chairman JOHNSON. The idea is to make banks more resilient to large losses and prevent another crisis. But there is some debate about the effects of this change. Banks argue that equity is more costly than that, and that new requirements will raise the cost of doing business and harm economic growth. Others think that new equity requirements are too low to guard against financial instability and say that fears of increased costs are exaggerated.

As an advocate of commonsense capital requirements, what is your view of this debate? Will the new capital requirements effectively increase the stability of the financial system? And how would you evaluate the tradeoffs between increased equity funding of banks and financial stability?

Ms. BAIR. Well, I think it is a very good tradeoff. I think the higher capital requirements are more than justified. I think most of the independent academic research as well as the research done by the Bank for International Settlements staff in supporting the Basel III process and the SIFI surcharge show that you have ample justification for going higher than the 7 plus the 2.5 for the SIFI surcharge that was ultimately agreed upon.

There is some incremental impact on lending costs, but it is modest, and the tradeoff of having more financial stability and, more importantly, when the next downward swing in the business cycle comes, making sure there is an additional capital buffer to absorb the losses so you do not have to have this massive deleveraging that occurred as a result of the financial crisis. That is really what led to this Great Recession. That is what we are trying to avoid. So the long-term benefit of doing this is tremendous, and any short-term costs in terms of an incremental increase in lending cost is quite modest. Also, I might add that the Basel Committee is providing several years to implement this. Our research shows that while most banks are at the 7-percent baseline Basel III requirement already, the larger ones can meet the higher SIFI surcharge in a couple of years, most of them through retained earnings. We do not anticipate that any will have to issue new common equity to meet these requirements.

So the burden is not tremendous on the large institutions. The long-term benefits for a more resilient system are substantial, and the short-term costs on lending are incremental at best.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman Bair, last week you claimed in a speech that the Dodd-Frank Act will end too big to fail. Other people believe that the Dodd-Frank Act has enshrined the doctrine that we have not done about too big to fail, maybe mitigated it.

Ms. BAIR. Right.

Senator SHELBY. Since the passage, however, S&P, Standard & Poor, has said that it will confer higher credit ratings on the largest banks because it continues to assume that there is still the potential for the Government to provide "extraordinary Government support" to these banks.

Do the S&P credit ratings for large banks show that our markets still believe that too big to fail is alive and well? How do you counter that?

Ms. BAIR. I have said that we have the tools to end too big to fail, and clearly in the statute—and we pushed for this with the support of a number of the Committee Members, which I appreciate—it said there would not be any regulatory discretion to do a bailout. It is simply prohibited. And when we tell the rating agencies that this is fair warning, they say, "Well, we think Congress is going to do that," and that would really surprise me.

So we all agree we should not have bailouts. We all agree we do not want that. I do not know why the market does not seem to be convinced of this, but I think that is part of our job, and the Fed's job, through the implementation of resolution plans and the FDIC's implementation of orderly liquidation authority. Next week we are going to be finalizing some more rules on building that infrastructure, a robust process for requiring resolution plans. I think we can.

S&P has not made a final decision. Both Moody's and S&P have this bump-up that they give the large banks on review, and so I think there is a chance over time that we can convince them and the market that this is not appropriate. And at the end of the day, we really need the market to understand that there will be no more bailouts, because if they want to invest in these big banks, they need to understand their dollars are at risk, and they need to do their homework and make sure that their investment is done prudently in an institution that is well managed and transparent to them.

Senator SHELBY. Wouldn't it be good policy in a free market economy to basically let the world know and the banks know and businesses know that if they fail they are going to be closed up?

Ms. BAIR. Yes. And I say that a lot.

Senator SHELBY. You agree with that, don't you?

Ms. BAIR. I do. I absolutely agree with that. And I think it is important for the Government, for the Treasury, and for the Federal Reserve—and I think they have—for them to continue to say the same thing. I think that is very important, yes.

Senator SHELBY. Chairman Bair, the GAO's—I mentioned this in my opening statement—recent report on prompt, corrective action found that PCA did not prevent widespread losses to the Deposit Insurance Fund, which is a key goal of PCA and which we all were hoping for.

Why has PCA not worked as it was intended? And what recommendations can you offer to improve PCA to ensure that it actually protects the Deposit Insurance Fund?

I know you have thought about this.

Ms. BAIR. We have thought about this a lot. I think, on the positive side, PCA has worked in the sense that it has taken a lot of regulatory discretion and judgment out of the decision to close a bank. It is always unfortunate when a bank has to be closed. Our process is harsh. The shareholders and unsecured creditors take losses frequently. Uninsured depositors take losses, as well. It is sometimes difficult for the primary regulator, the chartering entity of the institution, to acknowledge the weakness of the institution and repeal the charter.

The FDIC does not close the bank. The chartering authority is the one that revokes the charter and appoints us as receiver at

that point. Though it is a collaborative process in terms of the timing. Prompt Corrective Action has taken a lot of discretion out, which has been positive.

On the negative side, these failures have still been expensive and I think there are several reasons for that. One reason is, by definition, that this is a distressed sale when a bank closes, and so even though it may still be solvent on its books, the price you are going to get in a distressed sale is going to be at some discount. We have tried to counter that phenomenon by providing loss share credit support to acquiring institutions to provide them some comfort. Loss share agreements cover part of the acquirers losses over a period of time, given the fact that they are going to be putting some discount on their valuation of the distressed assets.

When you have a broad crisis like this, the whole idea of PCA is to start providing more intensive supervisory pressure on banks to raise more capital. But in a crisis, there is not a lot of capital to be had, and so that has been another problem, to get them recapitalized.

Finally, I think—this is something we are working on at the FDIC—to make the regulatory process more forward-looking. If a bank is not looking down the road to see what kinds of losses it may have in the future on these loans, it will be under-reserved and that will overstate its capital position, which, again, will compromise the efficacy of PCA.

So I think, for my successor, there is a lot of good work to be done here, but it is important and we do think PCA is successful in the sense that it has taken a lot of the discretion out of this, which has been helpful to us. A lot of people want to resist closing institutions, but they need to be closed at some point and if they are not closed in a timely way, the losses will be higher.

Senator SHELBY. I have one quick question. Chairman Bair, on May 1, 2009, the FDIC was appointed receiver of Silverton Bank——

Ms. BAIR. Right.

Senator SHELBY. ——headquartered in Atlanta, Georgia. As part of its business, Silverton, as you well know, arranged and managed participation loans. These participation loans allowed a lot of the small banks, especially in the Southeast, to jointly engage in commercial lending.

During the resolution of Silverton, the FDIC initiated foreclosures on several properties that were subject to participation loans. Complicated, I know. As a result, many small banks had to write down their loans and incur big losses, which occurred.

Ms. BAIR. Yes.

Senator SHELBY. When the FDIC—my question, I guess, is this. When FDIC resolves banks, to what extent does the Division of Resolutions and Receiverships work with the Supervision Division of FDIC to ensure that the resolution of a bank will not impose needless losses on other banks? In other words, you get it going and it never stops——

Ms. BAIR. That is right.

Senator SHELBY. ——especially probably dealing with participation.

Ms. BAIR. Right. So Silverton made a lot of bad loans. I will hasten to say we were not the primary regulator, but we had some bad banks, too, so all primary regulators had failures they would like to have not seen. But Silverton made a lot of bad loans and a lot of other banks participated in some of those bad loans and there is not much we can do about that.

I will say I have heard these concerns before. We went out of our way to give the banks that own the participations a chance to buy them back. Their bidding was significantly——

Senator SHELBY. Did they always have a chance to buy them back?

Ms. BAIR. Yes, they did——

Senator SHELBY. OK.

Ms. BAIR. ——and several, actually, and we did——

Senator SHELBY. But in all instances, they had a chance to buy the loans back?

Ms. BAIR. They did.

Senator SHELBY. OK.

Ms. BAIR. They did, and their prices were significantly lower than others and the winning bidder.

Senator SHELBY. OK.

Ms. BAIR. We have a statutory obligation to maximize recoveries——

Senator SHELBY. Sure.

Ms. BAIR. ——to follow least-cost resolution and that was the process we followed here, and I know it has been difficult for some of the banks that own these participations, but we really made every effort we could to let them bid and they just did not come in high enough. We have to go with the highest bidder. Those are our rules.

Senator SHELBY. Thank you.

Ms. BAIR. You are welcome.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Reed.

Senator REED. Thank you very much, Mr. Chairman, and let me commend you, Chairman Bair, for your extraordinary service——

Ms. BAIR. Thank you.

Senator REED. ——in very, very, very difficult times.

Senator Shelby and I, I think, both have shared concern about capital over many, many years, and it is nice and refreshing to hear you talk about very high capital levels using as the measure common stock——

Ms. BAIR. Yes.

Senator REED. ——or what I think was referred as tangible capital——

Ms. BAIR. Tangible, yes——

Senator REED. ——and the stress test——

Ms. BAIR. Right.

Senator REED. ——and that is also related to the issue of leverage, because with capital low, the leverage is high and also liquidity.

Just a couple of quick questions. One, as I understand it, Basel III applies to the big banks, but there is a host of other smaller institutions that have the same, I hope, requirements.

Ms. BAIR. Right.

Senator REED. Second, I understand under Dodd-Frank that there is a floor established for capital. It cannot go below that.

Ms. BAIR. That is right.

Senator REED. It raises the question, do you believe, not just FDIC but in other supervised entities, big as well as small banks, there will be adequate capital measures? Will some agencies take lower capital? Will some agencies adopt the minimum under the Dodd-Frank?

Ms. BAIR. Well, I think at the Federal level, certainly for all insured banks and their holding companies, we work very closely together, and so far have always been consistent in the rules that we have promulgated.

I think you are right. Basel III really was designed more to address the capital needs of larger, internationally active banks, though certainly there are issues regarding banks of all sizes and their capital adequacy. The quality of capital definitions in Basel III—cleaning up what we count as capital—will apply to all banks of all sizes.

In terms of the level of capital, whether you need the 7 percent or, for the smaller banks, leave it at the same place it is now, that decision really has not been made yet. I would say, though, overwhelmingly community banks have much higher capital levels already. They are almost all well over the 7 percent. One of the reasons is because they are small enough to fail, so the market demands a higher capital level from them. So however that issue is resolved, I do not think it would have a big impact on community banks. But you are right. The capital levels for the entire system need to be evaluated and strengthened.

Senator REED. And just to rule out a possibility, hopefully, you do not anticipate kind of regulatory competition to sign up banks based upon——

Ms. BAIR. No——

Senator REED. ——capital levels or interpretations of capital?

Ms. BAIR. No, certainly not domestically, or even internationally. These are international agreements and we compromised a bit resulting in lower numbers, but it was important to get all of the European countries involved. There are still some issues with regard to how European banks risk weight their assets and there is some work now that is being done to try to address this. There is too much discretion, frankly, with the individual banks under the Basel II Advanced Approaches which they implemented in Europe. We delayed it in the United States with support from Senator Shelby and others, and we appreciate that very much. So I think that is a real issue. But domestically, there should be no arbitrage, and even internationally, I think we have got a good chance of avoiding it.

Senator REED. In your testimony, you talk about the foreclosure backlog——

Ms. BAIR. Right.

Senator REED. ——is really inhibiting not only the banking industry, but overall economic growth. Right now, it seems the last remaining major opportunity to get this right is the deliberations between Federal regulators and the State Attorneys General. Could

you outline what you believe should be in that settlement, so that not only we sort of clean up the servicers, but we actually have a foundation for expansion of housing growth and economic growth.

Ms. BAIR. Right. So I think the market needs to clear, and one of the many problems with these servicer deficiencies is that the courts are slowing down on foreclosures. They are not sure—rightfully so—and they are skeptical about whether the documentation is there—whether all the requirements have been fulfilled. There is also litigation risk going backwards in terms of wrongful foreclosure claims and there are issues with investors where the servicers have obligations to those investors to appropriately service loans.

So we have suggested that there needs to be a look-back review to identify the wrongful foreclosures if they exist, and provide appropriate remediation of that. Going forward, frankly, we would like to see the modification process simplified. We have always been strong advocates of——

Senator REED. Including modification of principal, where it is appropriate?

Ms. BAIR. I think where it maximizes value, sure. And I think for distressed loans, and even where the loan cannot be restructured, or the borrower is in too big of a house, facilitating a short sale which involves a principal write-down is good for the homeowner to help them move on with their life and it can save the bank a lot of money, too, and the investors a lot of money by not having to go through the foreclosure, and it certainly helps those who want to buy the house. So I think, yes, in this context, it should be used.

But we do need to streamline and simplify the process. I do worry that it is going to get more bogged down because of all this litigation risk and uncertainty about whether all the rules have been followed. The regulators really need to be very aggressive in getting this cleaned up, and make sure the servicers clean it up. The servicers need to obviously hire more staff, have single points of contact, and better quality control. I think those things are in place and I hope everybody will work together for the same end.

Senator REED. Can I mention a question for the record, Mr. Chairman?

Chairman JOHNSON. Yes.

Senator REED. That is, and this is changing subjects very quickly and I will be very, very—obviously, with the Greek action today, there is some relief in Europe.

Ms. BAIR. Right.

Senator REED. But there are some larger economies that are potentially on the tipping point which could cause even more serious disruptions. Is this now the time for additional stress tests of our banks and major European banks to determine the exposure if a larger Euro economy or other economy defaulted?

Ms. BAIR. Well, I think the stress tests are going on in Europe right now. I believe the European banking authority plans to release its results in mid- to late-July. In the U.S., the Fed has been engaged with the larger bank holding companies and providing some additional stress scenarios based on certain sovereign debts potentially defaulting. And so I think that work is ongoing.

Our direct exposure is not great to those sovereigns, but obviously the direct exposure to the European banking system is significant. So I think stress testing really has to be an ongoing process. These are still difficult times. The system is not as stable as it should be, and so that work is going on now and will continue.

Senator REED. Thank you. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and thanks for having the hearing.

I had other things going today, but I wanted to make sure that I came here to pay my respects to someone who I believe has been a very, very strong leader——

Ms. BAIR. Thank you.

Senator CORKER. ——and strong advocate for what she believes to be correct. I sometimes wish she had not been quite as strong of an advocate when we disagreed, but——

[Laughter.]

Senator CORKER. ——you certainly have been that, and I know you leave here with certainly a very good legacy, a legacy of having gone through 5 years of tremendous turmoil. Again, I thank you for the access. We have talked multiple times on weekends and other times. I very much appreciate that. And again, sometimes you surprised me with your response, because I did not think that is what it would be, and it was very different, maybe, than what I was thinking, but it was always frank and I appreciate that, and I think all of us, especially in this atmosphere, like dealing with people who are direct and frank and are really telling us what they are thinking.

With that, I know you were a strong advocate for the Consumer Protection Agency. Do you feel comfortable, and you have a board, I know, at the FDIC——

Ms. BAIR. Right.

Senator CORKER. The consumer agency has no board. Is that something you are comfortable with?

Ms. BAIR. Well, yes. I think boards have worked well. I think it is the same with a committee. It is nice to be a dictator, but, you know, you have to go round up your votes and that can be challenging sometimes. That is a healthy process. You get input. You get different perspectives. It can frequently lead to a better quality product, and so I have enjoyed working with my board and I like the board's structure.

I think you can justify either structure. I think also with the Comptroller of the Currency, as well—would that be better to be a board? If you are looking at these structures——

Senator CORKER. Of course, you can always choose to be State-regulated on the OCC and move away from that.

Ms. BAIR. Yes, that is true.

Senator CORKER. The Consumer Protection Agency, you cannot. You would probably advocate that an organization like that have a board of some kind, would you not?

Ms. BAIR. Well, I think we did—during the Congressional consideration of the Dodd-Frank Act. We had suggested it be a board with a couple of bank regulators on that board. But that said, we are quite content to work with them as a single-headed agency.

That person, once confirmed, will be on our board and I think that will help perhaps at least expose them to differing views on safety and soundness and other things, which would probably be healthy, yes.

Senator CORKER. Are you surprised with the amount—you know, when Dodd-Frank was coming through, you were not one of the ones advocating for this, I do not think, but a lot of people were talking about, well, we have got to have this for clarity. We have to have this for clarity. Are you a little surprised at the tremendous lack of clarity, especially during this time of economic turmoil——

Ms. BAIR. Right.

Senator CORKER. ——that Dodd-Frank has created since it was put in place, since——

Ms. BAIR. Well——

Senator CORKER. And basically, what has happened is we in the Senate have been sort of put in place as supplicants to regulators hoping good things are going to happen. It has been a little surprising, has it not, just the banks not knowing, the financial entities not really knowing what is going to happen——

Ms. BAIR. Right.

Senator CORKER. ——and that has placed some caution there, has it not?

Ms. BAIR. Look, I think there are a lot of rules. I think a lot of this relates to the proprietary trading restrictions and the derivatives restrictions, and I think there is an argument for phasing those provisions in over time. Also, there are interrelationships between those initiatives. For instance, some of the changes in bank capital requirements that are being made, not so much about increasing capital levels, but about how we are asking banks to risk weight their assets. So regarding coordination, I think FSOC is a good place for that to happen. And it is a very large law and it has a number of rulemakings in it.

On the other hand, I would say that I think better coordination is always good. I think Congressional oversight is always good. I think writing rules that are short and clear whenever you can is good. It is a lot harder to write a short, clear rule than it is a 500-page very complex rule, and so I try to emphasize that at the FDIC. And I think coordination through FSOC, especially in terms of how these rules interrelate, and the costs, I think that would be a good role for the FSOC to perform——

Senator CORKER. So I am going to take that as a nonanswer and——

Ms. BAIR. OK. It is.

[Laughter.]

Senator CORKER. Thank you. A good job. You know, the FSOC, I guess, is looking supposedly at macroprudential issues——

Ms. BAIR. Right.

Senator CORKER. ——and yet each of the members is sort of more oriented toward the micro side. Are you all really looking at things like U.S. Treasury defaults or Spain or Italy or some entity like that going down and the effect? Are you all beginning to look at those things and the effect it would have on our system?

Ms. BAIR. Yes, there have been a number of discussions about possible systemic risk, and the FSOC is required to file an annual

report. It will be filed after I leave. But I think it will provide an overview of some of those discussions and some of the things that the FSOC is considering as potential systemic risk. So, yes. The short answer is, yes, that those discussions are taking place.

Senator CORKER. And this is my final question. I know you are obviously a very strong advocate for the resolution mechanism——

Ms. BAIR. Right.

Senator CORKER. ——that generally ended up being in place, and yet what Senator Shelby said is true. I mean, we are hearing—I am hearing from people who are actually buying some of these assets and they are just going, "Corker, it is just unbelievable. I mean, they are selling these things for nothing." I mean, the taxpayer is getting totally drilled on this. I know you mentioned you wanted to take the judgment out, and there is some goodness in that, too——

Ms. BAIR. Right.

Senator CORKER. ——but, you know, you and I talked a little bit about resolution and you talked about the incredible cost of a bankruptcy resolution and that was one of the reasons you wanted to see—and for other reasons. But are you still convinced that in light of the GAO report and things that you know yourself that are taking place throughout our country, where basically bad judgments are being made—it is a massive organization—are you still convinced that that route is lesser expensive to the system than bankruptcy?

Ms. BAIR. Oh, it is absolutely much less expensive than bankruptcy. I think our loss rates on larger institutions are much lower because of the capital structure of larger institutions. At the largest failure, WaMu, there were no costs to the Deposit Insurance Fund. That is because, typically, large institutions have large cushions of unsecured debt which is available for loss absorption in our process as well as the bankruptcy process.

A couple things we can do that bankruptcy cannot do that minimizes losses is, one, advance planning—be in an institution early, and have the institution start letting investors come in and do due diligence on an open institution basis so we are in a better position to sell it back into the private sector very quickly. We do not want it lingering in Government control or a bankruptcy process for a couple of years. So the advance planning is important. Second, we can provide temporary liquidity to keep it operational, to maintain the franchise as a going concern as it is sold.

So it is absolutely much cheaper. I have no doubt in my mind that it would be much cheaper than a bankruptcy process, but it also imposes the same amount of market discipline. But because we are regulators, we can be in there early, advance plan, and provide liquidity support to keep it operational.

Senator CORKER. Mr. Chairman, thank you for your courtesy in letting me go a few minutes over. I am sure we are going to see you around——

Ms. BAIR. Right.

Senator CORKER. ——in public service in some other way and we thank you for what you have provided over the last 5 years.

Ms. BAIR. Thank you, Senator.

Senator CORKER. Thank you very much.

Chairman JOHNSON. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman.

Let me start. I wanted to rush over here and extend, as my good friend, the Senator from Tennessee did, a real thanks. When I came on this Committee 2 years ago when we were in the midst of the crisis, you spent countless hours with me and my staff and your team did. Senator Corker and I, I always like to continue to point out that while there were a number of challenges around perhaps Dodd-Frank, Title I and Title II, I think, with the support of the Chairman and Ranking Member, got 95 votes.

Ms. BAIR. It did.

Senator WARNER. Not a perfect solution set by any means, but a lot of that, you had a lot of effective guidance on.

I do want to follow up on one comment that Senator Corker made, and let me be very clear on this. I do not want to have this question viewed on the solution set side——

Ms. BAIR. Sure.

Senator WARNER. ——because, obviously, that is the debate of the day. But I would like nothing more than for you to tell me that, as you have many times, that I may not be on the right path. But we talked a little bit about Greece and Portugal and their debts and what kind of contingency plans.

Ms. BAIR. Right.

Senator WARNER. How soon do we need to be starting to think the same in this country, when I think there is still an assumption from the financial community, the business community, that this is just one more political squabble and we will solve it at the eleventh hour, and sometimes a disconnect from our side, the political side, that do not understand at what point do people have to start covering?

Ms. BAIR. Yes, sir.

Senator WARNER. At what point do the shorts start to say, hey, this may be a great trade? And what kind of contingencies—and what kind of tools do we have left to put in place? As draconian as the challenges were when you and others, I think history will say, stepped up the right way, we do not have a TARP. We do not have stimulus. We do not have monetary policy in a major way left. I do not think this goes until August 2. I would love to have your reassurance to say, "Senator, do not worry. We are going to get through this one just fine." But in mid-July, if the shorts start going and people start covering——

Ms. BAIR. Right.

Senator WARNER. ——what are the contingencies that we have been thinking about for our country's financial system?

Ms. BAIR. Well, I think it is really a very dangerous game, and I think it is very important for people to understand that it is not just U.S. financial stability, it is world financial stability that rests on the financial integrity of the United States Government and our willingness to stand behind our obligations.

I am passionate about deficit reduction. Last year I wrote a very strong op-ed on this and strongly supported the Bowles-Simpson Commission and the work that you and others have been doing as essential. Because long term, if we do not have a credible deficit reduction plan, that could lead to a loss of investor confidence. But,

in the short term, to play around with even talking about a default, even a so-called technical default on U.S. debt, I think, is highly problematic.

You know, we still have time to do this, but will we? That is really the question. I gave a speech last week on short-termism and what seems to be an increasing inability culturally, whether it is business, Government, whatever, to look beyond the immediate fix, and there is no immediate fix here. This is going to be a lot of hard work, a lot of hard decisions need to be made. It is going to take time to get these deficits down. It is going to have to be some combination of entitlement reform and revenue increases and it just seems like all those things are so obvious and that the political process does not seem to be able to produce the tough decisions that really need to be made and then execute on them.

So we still have time, but if we keep kicking the can down the road, we will not, and we will start seeing the types of volatility that you are seeing with other countries that are viewed by the market as weak.

Senator WARNER. I guess what I—and I totally concur with what you have just said, but I guess, and I do not—on your last time testifying before the Committee, I guess I would ask two things. The notion that we can go up to the precipice——

Ms. BAIR. I do not think——

Senator WARNER. ——the notion that sometime, the second week, third week of July, the markets are going to have to start taking action, even some of the technical, just covering——

Ms. BAIR. Right.

Senator WARNER. ——is going to have to take place, I mean, am I wrong on that?

Ms. BAIR. No. I am sorry. No, you are not wrong. That is a very dangerous game with ramifications. Even if we go to the precipice, the market gets scared. The debt limits get raised. But what you have done, you have increased interest costs. You have increased Treasury's borrowing costs. And you have created a bigger deficit problem. So why even go there? Why even flirt with it? I just do not understand that. It is very harmful and will make the budget deficit worse.

Senator WARNER. Well, again, what I think—I scratch my head with Members of Congress who say they do not see any problem with this, and there seems to be no disagreement that every point that we raise on interest rates over a 10 year, over the baseline, is $1.3 trillion additional deficit reduction. So the notion of the $4.5 trillion plan that a bipartisan group have been talking about, that could be wiped away with a three-point interest rate. You know, I had a number of our community banks yesterday talk about still the challenge with the regulators and the mixed messages they are getting. But what would a 200 or 300 basis point interest rate increase——

Ms. BAIR. It would be——

Senator WARNER. ——do right now, not just to the deficit, but to business lending?

Ms. BAIR. It would be very damaging to our economy as sluggish as it is. We have been after the banks for a long time to be mindful of interest rate risk and to be able to withstand the stress of a 300

basis point jump. So I think they could—it would not be easy, and I certainly would like to avoid it, but it would certainly stress them more when they are not in the best condition now. Also, it is going to increase borrowing costs for households and businesses, and they are already tepid about borrowing and they are not sure about the economy. That is going to potentially tilt our economic trajectory downward again. It is so avoidable and there are so many really profound, very devastating ramifications to it. I just do not understand why we are even talking about getting to that point. I really do not.

Senator WARNER. And, Mr. Chairman, could I ask one more question, and then I would love to wait. If there is a second round, I have got questions on resolution. But again, I just want to pick up on one of your last points, which is even not getting to the precipice, somewhere——

Ms. BAIR. In between——

Senator WARNER. ——in between——

Ms. BAIR. It would be very bad.

Senator WARNER. ——between, you know, the week after the fourth and August 2, will not institutions, will not markets start building in a risk premium, and if we get close, that risk premium will not disappear even if we have some eleventh hour political solution?

Ms. BAIR. That is absolutely correct. That is absolutely correct. It will not. It is——

Senator WARNER. Fifty basis points? A hundred basis points? A hundred-and-fifty basis points?

Ms. BAIR. I would not want to put a number on it, but it would be there and it would probably be there for many years and exacerbate the problem we are trying to deal with and still have not solved.

Senator WARNER. It is just, again, remarkable to me, for all of the great work through the crisis that you did and what the Chairman and the Ranking Member, even when folks did not always agree with you, you have always been extraordinarily straightforward and, I think, a great representative of public service. We are going to miss your steady hand, and I sure as heck hope that we do not have one of these "all hands on deck" crises in the next 45 days. I think we are approaching the most predictable financial crisis in our lifetimes. I have this—and I have gotten a little obsessed about this, but this notion of, as a country, we are Thelma and Louise in that car with the foot on the accelerator heading toward a cliff.

Ms. BAIR. Yes.

Senator WARNER. Thank you, Mr. Chairman, and I look forward to another round of questions.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you.

Chairman Bair, Basel II—III again—I hope we have seen the last of Basel II.

Ms. BAIR. Yes, me, too.

Senator SHELBY. As I understand the agreement of Basel III Capital Accords, the agreement and the thrust is to increase the

amount of capital that large global banks must hold. What banks will that apply to in the United States?

Ms. BAIR. The Dodd-Frank Act requires higher prudential standards for bank holding companies $50 billion and above.

Senator SHELBY. $50 billion or bigger.

Ms. BAIR. Right. But I would also hasten to add this is the Fed's decision. They consult with us, but I believe they have publicly stated that for the smaller bank holding companies, any additional requirements will probably not be significant. So they will definitely——

Senator SHELBY. You mean smaller than $50 billion——

Ms. BAIR. No, I mean even for those that are above $50 billion. I think the SIFI surcharge is really for the very, very largest institutions so that——

Senator SHELBY. Now, $50 billion is a pretty good size institution.

Ms. BAIR. It is.

Senator SHELBY. Now, how many banks——

Ms. BAIR. Not what it used to be.

Senator SHELBY. ——in the United States, roughly, do we have that would go up to $50 billion?

Ms. BAIR. That are under or over $50 billion?

Senator SHELBY. Are 50, right around—50 or up.

Ms. BAIR. 50 or up, I think it is around——

Senator SHELBY. Roughly.

Ms. BAIR. I think it is around 70.

Senator SHELBY. 70 banks——

Ms. BAIR. I can get the number for you, yes.

Senator SHELBY. And what do we have, three banks that are $1 trillion banks?

Ms. BAIR. We have four.

Senator SHELBY. Four banks. That would be Bank of America.

Ms. BAIR. Right.

Senator SHELBY. Wells.

Ms. BAIR. Right.

Senator SHELBY. Citicorp.

Ms. BAIR. Citi and B of A.

Senator SHELBY. And what is the other one?

Ms. BAIR. Citi and B of A. JPMorgan Chase, Citi——

Senator SHELBY. JPMorgan Chase.

Ms. BAIR. ——B of A, and Wells, yes.

Senator SHELBY. OK. Now, what will this do—how will this Basel III change the banking landscape as we know it?

Ms. BAIR. Well, I think——

Senator SHELBY. Or what do you think it will do?

Ms. BAIR. I think it will make the system more resilient by providing a greater cushion of capital to absorb losses.

Senator SHELBY. For the bigger banks.

Ms. BAIR. For the very largest banks, it will provide an extra layer of protection. It will reduce the risk that they could fail because they will have more loss-absorbing capacity. Another benefit of more capital; for some who worry about funding differentials between large banks and smaller banks, is that it will make it a little more expensive for them to fund themselves. So that is a good

thing, I think, in terms of narrowing the spread between their funding costs and the smaller institutions funding costs.

It will make small and even midsized institutions a little more competitive because they will only have to hold 7 percent capita.

Senator SHELBY. And what will the capital requirements of the banks say $50 billion, Basel III banks, what will their capital requirements be as opposed to, say, a $25 billion bank?

Ms. BAIR. So I think——

Senator SHELBY. Or a $1 billion or $500 billion.

Ms. BAIR. For $500 billion, so I think——

Senator SHELBY. $500 million, I mean.

Ms. BAIR. I am hesitating only because this is really a——

Senator SHELBY. Roughly.

Ms. BAIR. This is the Fed's—this will be done through bank holding company capital, which the Fed——

Senator SHELBY. And that is regulated by the Federal Reserve.

Ms. BAIR. Which is regulated by the Fed. So I do believe they expect to tier gradual increases starting with institutions with $50 billion in assets. There will probably not be much of an increase at the $50 billion level. And, again, with the 2.5 percent, going up——

Senator SHELBY. Today, as we are sitting here today, what is the required capital, tier one capital?

Ms. BAIR. Tier one capital, right.

Senator SHELBY. Of, say, your banks.

Ms. BAIR. Well, it is 8 percent and 10 percent to be well capitalized on a risk-weighted basis——

Senator SHELBY. Well capitalized would be 10 percent.

Ms. BAIR. For tier one and tier two, that is——

Senator SHELBY. Tier one.

Ms. BAIR. And tier two. Tier one is 8.

Senator SHELBY. OK. Now, what will Basel III require them to do? To go above that, right?

Ms. BAIR. Only half of that has to be tangible common equity. Actually for adequate capital——

Senator SHELBY. So it is how you define the capital, is that what you are——

Ms. BAIR. Right. So it is far too complicated——

Senator SHELBY. Let us slow down just a bit.

Ms. BAIR. Sure.

Senator SHELBY. Now, explain to the Committee and to the American people, because they will be watching you here, what you mean by capital——

Ms. BAIR. Yes.

Senator SHELBY. ——how it is broken down by——

Ms. BAIR. So that is a very——

Senator SHELBY. Just go step by step.

Ms. BAIR. Yes. That is a very good question because we are talking about tangible common equity, so we are not talking about hybrid debt products like trust——

Senator SHELBY. Are you talking about liquidity, too?

Ms. BAIR. We are talking about just capital. Just capital.

Senator SHELBY. This is just capital.

Ms. BAIR. This is tangible common equity. The type of thing that people think of as common equity. There were other things that regulators in the past let count toward capital——

Senator SHELBY. And how do you define—as a regulator, how do you define common equity?

Ms. BAIR. So it is basically determined by what you cannot count toward tangible common equity. It needs to be common, it cannot be preferred. It needs to be tangible, it cannot be goodwill. They can count a little bit of mortgage servicing, but just a little bit. We allowed a little bit of that in the compromise. You cannot allow——

Senator SHELBY. Is it real capital you are talking about?

Ms. BAIR. Real capital, yes.

Senator SHELBY. You are trying to get——

Ms. BAIR. Real capital.

Senator SHELBY. ——real capital, not——

Ms. BAIR. Real common——

Senator SHELBY. ——something that is called capital.

Ms. BAIR. That is right. That is exactly right. And so the requirement for tangible common equity, just to be adequately capitalized, is only 3 percent. Now, U.S. banks are much higher than that, but the international minimum is 3 and Basel III takes it up to 7. So it is quite a jump, and that is a good thing. That is a very good thing.

Senator SHELBY. Well, what happened, just to reach back a couple of years——

Ms. BAIR. Right.

Senator SHELBY. ——for the record, what happened to our banks when they got in trouble? Was it a lack of capital? Or was it a lack of liquidity? Was it both?

Ms. BAIR. They were related. There was insufficient capital. I think insured banks were in a better——

Senator SHELBY. And why was it insufficient capital? Was it because the regulators were not doing their job?

Ms. BAIR. I think regulators do have some share of the blame. I absolutely do.

Senator SHELBY. The regulators have some culpability here.

Ms. BAIR. They do. On capital standards they absolutely do.

Senator SHELBY. OK.

Ms. BAIR. Yes, that is absolutely true. We let things like hybrid debt count as tier one capital, which we should not have done. Fortunately, we did not——

Senator SHELBY. In other words, what you were calling capital really was——

Ms. BAIR. It was not really capital. It was not——

Senator SHELBY. And what were they counting as capital then that you will not let them count as capital now?

Ms. BAIR. The biggest piece of this which was addressed in the Collins amendment is something called trust preferred securities, which basically counted as tier one capital for bank holding companies, but never counted for banks. And so even though it is called an equity instrument, it basically gives the shareholder a right to perpetual cumulative dividends. So if a bank gets into trouble, for common equity, they can eliminate the dividend, right? They can conserve capital by eliminating the dividend. With trust preferred

securities, you can suspend payment of your dividend, but it still accumulates, and at some point you have to pay it.

So this is debt. It is not equity.

Senator SHELBY. Sure.

Ms. BAIR. And they liked it because they could deduct the interest on it as debt under the Tax Code, and the regulators let them count it as capital. And when the crisis hit, the markets said——

Senator SHELBY. But it sure did not make them any stronger, did it?

Ms. BAIR. No. The markets said it is debt, it is not equity, and it was debt and it is debt.

You know, Senator, if you would indulge me for a minute, the Tax Code drives so much of this. The Tax Code makes it so much cheaper to finance with debt than equity by making the interest payments deductible for debt, with double taxation of dividends——

Senator SHELBY. Of dividends, I agree with you.

Ms. BAIR. So if we could equalize the treatment of debt and equity, I think a lot of this industry pressure to count debt as capital would go away.

Senator SHELBY. Last question. As a regulator—and you are a regulator, the FDIC.

Ms. BAIR. Yes, we are. Yes.

Senator SHELBY. As a regulator, shouldn't regulators, whether it is FDIC, the Federal Reserve, or the Comptroller, or whatever, shouldn't they know the condition of a financial institution and say, look, you are not paying dividends, you are not—a dividend, you are not even strong enough to maybe exist.

Ms. BAIR. Yes. Yes.

Senator SHELBY. Are you doing more and more of that now?

Ms. BAIR. We are, and we need to. And there was a couple hundred billion dollars of dividends that got paid out of banks and bank holding companies leading up to the crisis that should never, in my view, have happened. And I think that is another lesson learned from this crisis. And, again, typically it is the bank holding company that pays the dividend, but we have more and more been consulted by the Fed on this, and have urged caution, clearly now, especially with all the problems with the housing market and litigation risk related to the servicing issues. People need to be very cautious about dividends, even now as the banking system continues to heal.

Senator SHELBY. Thank you.

Chairman JOHNSON. Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair. And welcome.

Ms. BAIR. Thank you.

Senator MERKLEY. And congratulations on the soon-to-be completed tenure that you have had and the vigorous efforts you have made to provide sound regulation.

I also want to note that long before your term as FDIC Chairman, you were a voice calling out the abuses and systemic risk of subprime lending, and had many followed up on that much earlier, not only would we be better off in terms of our financial house, but

millions of American families would be in better shape. So I thank you for that.

I apologize that I missed the earlier questioning, but I just wanted to essentially see if you had points that, as we work to implement the division between investment banking and commercial lending, and you see the regulatory conversation proceeding, whether there are key points that this Committee should be paying a lot of attention to in order to really rebuild a secure financial foundation.

Ms. BAIR. So I think you are right, the Volcker rule in Dodd-Frank will help. The big investment banks are now bank holding companies, so they are in the safety net. Many of them are growing their insured banks, which is fine. But I do think that means that we should be particularly cautious about making sure that insured deposits are not used for proprietary speculative activity, and so we have been—directly or indirectly, very strong advocates for the best implementation of the Volcker rule.

And I think that more generally there needs—particularly in derivatives markets—there needs to be greater transparency. Obviously moving them to centralized trading and clearing facilities where they are sufficiently commoditized will let that happen. But just even short of that, we need to have more transparency and better reporting mechanisms from these large institutions so that they can immediately tell regulators on a net basis and a gross basis what their exposures are. I think we are not quite there yet, but we need to have that for entities that have large positions, both regulated entities as well as nonregulated entities. There needs to be some greater capacity to identify who has the large exposures and whether they are financially capable of making good on them if their positions went against them.

So I think there is a lot of work that is left to be done, and I hope—the SEC and CFTC, who have the primary responsibility for this, will have the resources they need to carry through, because, again, with the specter of a credit default event in Europe, we have been looking at this again, especially at the CDS market, and whether we can get a good handle on where the exposures are and who ultimately may be having to pay if there is a significant default event. And, frankly, the data could be a lot better than it is.

Senator MERKLEY. Could you comment a little bit on the issue regarding margin requirements for end users and where that discussion is going in the regulatory process and where it should go?

Ms. BAIR. So thank you. Thank you for asking that question. I think there has been some misperception about what the bank regulators have proposed. Right now a bank or a bank holding company needs to set credit exposure limits for any credit exposures taken. So if it is lending, it needs to identify the creditworthiness of that entity that is borrowing and set some type of credit exposure limit and either not exceed that or require additional collateral or margin to protect its risk exposure. And so it is the same concept because the derivatives exposure creates a credit exposure for a bank or bank holding company, just as a loan might.

So this is really a safety and soundness issue. My view is that this is the expectation for banks already. It is nothing new. It is just being formalized in this rule. Frankly, in retrospect, maybe we

should not have put it in the derivatives rule; we should have just continued to enforce it as a safety and soundness matter.

But I do think you need to distinguish banks and bank holding companies which have long been subject to safety and soundness regulation, and you are going to have safety and soundness principles apply to those entities in a more robust way than you might for a futures commission merchant or someone completely outside of the Federal support system for banking.

Senator MERKLEY. There has been a discussion of the fact that there may be a very large number of places that take up the trading of derivatives, and in my own mind I keep picturing that within a couple years there will be natural forces that would create excessive consolidation primarily that if you are selling you want to be exposed to the maximum number of buyers, and if you are buying you want a maximum number of sellers.

There has also been this question of separation between the trading function and the clearing function and whether those can be handled in a simultaneous fashion so you do not end up with lose ends hanging out that stymie the market. Your thoughts on those pieces?

Ms. BAIR. Well, I think they can be done, and that is certainly the traditional model for exchange-traded derivatives and securities, especially on futures exchanges. They are highly correlated. So, I mean, you cannot trade unless you centrally clear through the exchange facilities. So I think that model has worked pretty well, and I do not see why it could not—as these instruments became more commoditized why you could not follow that similar model.

I only hesitate because this is a little bit out of the FDIC's portfolio, and I know you have engaged with the SEC and the CFTC on these issues, too. But I do think for standardized instruments that it is the best. Sure, exchanges and clearinghouses concentrate risk, but you also know where it is. You can better regulate it. You can make sure the margining is robust and the systems are robust. The securities and futures clearinghouses have really never presented any major issues throughout the history of financial crises, and that is true of the recent one as well. So I think that is a positive sign to try to move as much as you can to that type of framework.

Senator MERKLEY. Thank you very much.

Chairman JOHNSON. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. Thank you for letting me have a second round, and I will promise to be brief, although I guess when any of us, when we say that, that is a little bit of an oxymoron.

I want to—I think Senator Shelby's line of questioning about the SIFIs and how we are going to work through this and the questions around Basel III in terms of the capital I think were great questions, questions about liquidity. But also the issue around resolution. I think if we think back to that problem in the crisis when there was not any resolution plan or road map, and one of the things that I know we have worked together on was trying to ensure that these large institutions had that resolution plan, at least on the shelf, constantly updated. And I want to—again, looking at—staff shared with me the list of the folks that you have put to-

gether in terms of an advisory board. I want to commend you on the quality of the folks there.

How do you think the banks are coming on their resolution plans? How soon do we need to get them? You know, when is this going to become a reality? And I would just love your assessment of where we stand on the——

Ms. BAIR. Well, my hope—it is a joint rulemaking, and my last board meeting is next Wednesday, so I hope very much that we can get a final rule out on living wills and have the first set for the very largest institutions come in perhaps early next year.

I think it is going to be an iterative process. I think the first round of resolution plans are probably going to need a lot of work. But this has been a priority for the international community as well. The Financial Stability Board has had a recovery and resolution project going on for quite some time. We have been working closely with the Bank of England on this, with our largest institutions, as well as most of the major European institutions, too. So through this international work, a lot of this has been done already.

So I think even though the first round of plans will not be perfect, that will at least start the discussion and the process. And as I said before, I do think some of these institutions will need to make structural changes. They are too complex. They have too many legal entities. Their business lines can cross-cut thousands of legal entities, which would make a resolution not impossible, but very difficult and unnecessarily expensive.

John Reed, one of our advisory committee members, made a comment at a recent committee meeting, which I thought was great, which was that corporate boards need to engage in this because this can really help them. If they are interested in understanding and learning what is going on inside these very large, complex organizations, simplifying the legal structures and aligning them with the business lines will also improve information management systems and their ability to get information, provide accountability and monitor what is going on inside of these large financial institutions.

Senator WARNER. And you do think—and I will just take one last——

Ms. BAIR. Sure.

Senator WARNER. One last question, and it will be two. But, you know, that coordination, since a lot of the problems were cross-border——

Ms. BAIR. Yes.

Senator WARNER. ——you feel it is moving forward and——

Ms. BAIR. Yes, it is. A lot of work has been done already, and I know cross-border resolutions will be difficult, but they will not be impossible, and pending an international resolution framework, we have bilateral agreements in progress or signed already with most of the major developed jurisdictions.

Senator WARNER. My last formal question to you as a Banking Committee Member, you know, we ought to go back to the issue that we have spent an enormous amount of time talking about, and that is, you know, how do we get that lending going to small business again. And I just—I thought we had kind of turned the corner.

I have to tell you, as somebody with a lot of—my colleague Senator Merkley, we worked hard on that small business lending facility that—I know it is not your bailiwick and you are not going to comment, but the fact that a lot of those dollars still have not gone out, you know, and I think 500 or 600 institutions have applied and there are still not any dollars distributed, you know, what—are there other tools—we had the help line in place in terms of whether the regulators were telling the banks—we still do hear this on a regular basis. The regulators are reclassifying all these loans as nonperforming even though they are still meeting payments. You know, are there any tools left in our quiver on this?

Ms. BAIR. So we have sent information for over 400 institutions that qualify for the Treasury's criteria. They are pending at Treasury right now. We got another spate of applications when they got their criteria out for the subchapter S corporations. I have asked that this be done by July 15th, and I think it will. We have asked our staff to prioritize it.

I have also been pushing the staff about what more we can do, and I found actually an interagency policy statement that we issued subsequent to the last financial crisis in 1993, and I want to remind the Committee and remind the banks about this. Perhaps we will release this later. We do have a policy that would allow banks to set aside small business loans as long as they do not exceed 20 percent of capital, where examiners will not scrutinize underwriting. They will look at the performance of the loans. And this was designed for that time and it could be designed again to give banks making small business loans more flexibility to make these loans in a way that will not lead to adverse outcomes for their supervisory rating. It is only for the CAMELS 1 and 2 banks, but this is still in effect. We are going to remind our banks about it and see if this——

Senator WARNER. Perhaps you could share that with us because that would——

Ms. BAIR. Yes. As we have discussed before, Senator, part of the problem is the lack of collateral, and there is not a lot we can do about that.

Senator WARNER. Thank you, Mr. Chairman. Thank you for giving me a second round, and thank you for calling this hearing. And, again, Chairman Bair, we—I know at least for this Senator—really respect your service and hope we get a chance to work again in the future.

Ms. BAIR. Thank you.

Senator WARNER. Thank you, Mr. Chairman.

Chairman JOHNSON. Sheila, I would like to thank you again for all the work you have done to serve the people of the United States. I wish you well in all your future endeavors.

Ms. BAIR. Thank you.

Chairman JOHNSON. Thanks again to my colleagues and our panelist for being here today. This hearing is adjourned.

[Whereupon, at 3:39 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SHEILA C. BAIR

CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

JUNE 30, 2011

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify today on the state of the Federal Deposit Insurance Corporation. The past 5 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 are still being felt and will likely persist in some measure for years.

Despite the challenges, I am pleased to report significant progress in the recovery of FDIC-insured institutions and the Deposit Insurance Fund (DIF), as well as in implementing regulatory reform measures as authorized under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act). Following through on these reforms will be crucially important to the type of long-term financial stability that will be necessary to support economic growth in the years ahead.

In my testimony today, I would like to summarize the progress that the FDIC has made in ensuring the safety and soundness of our banking system, protecting depositors, resolving failed institutions, and rebuilding the financial health of the DIF. I will highlight, in particular, efforts we are making to enhance consumer protection in the wake of a crisis where risky retail lending practices played a leading role. I will briefly summarize our progress in implementing the resolutions framework for systemically important financial institutions (SIFIs) that was authorized under the Dodd-Frank Act, and conclude with some additional thoughts on the importance of financial regulatory reform to the Nation's long-term economic health.

Condition of the Industry and the Deposit Insurance Fund

Since my term began in June 2006, the landscape of the banking industry has undergone dramatic change. When I arrived, the industry was in the midst of its sixth consecutive year of record earnings. The ratio of noncurrent loans to total loans was a record-low 0.70 percent.[1] There were only 50 problem banks, and we were in the midst of a record period of 952 days without a bank failure. However, as we soon learned, the apparently strong performance of those years in fact reflected an overheated housing market, which was fueled by lax lending standards and excess leverage throughout the financial system.

The industry quickly shifted from a period of apparently strong performance to record credit losses and some of the worst earnings quarters in U.S. banking history. The deterioration began with the onset of recession in late 2007. The trend worsened after the peak of the financial crisis, and the industry reported a record loss of $37 billion in the fourth quarter of 2008. By early 2010, the ratio of noncurrent loans to total loans had risen nearly eight-fold to 5.5 percent. The FDIC went from a long stretch of no failures to resolving 373 institutions since the start of 2007, including the largest bank failure in U.S. history. In addition, the Federal Government and U.S. banking regulators had to provide assistance to our largest financial organizations to prevent their failure from causing an even more severe economic disaster.

After showing signs of a turnaround in 2010, performance of FDIC-insured institutions continued to strengthen in the first quarter of 2011. Earnings have recovered to levels that remain lower than their prerecession highs, and asset quality indicators have also improved somewhat. 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, an increase of 67 percent from first quarter 2010 and the industry's highest reported quarterly income in nearly 3 years. Industry earnings have registered year-over-year gains for seven consecutive quarters. More than half of institutions reported improved earnings in the first quarter from a year ago, and fewer institutions were unprofitable.

The main driver of earnings improvement continues 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. 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

[1] Noncurrent loans are those that are on nonaccrual status or are 90 or more days past due.

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 loan-loss 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 more than 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 reflect, in part, reduced loan balances. Loan balances have declined in ten of the past eleven quarters, and the 1.7 percent decline in the first quarter was the fifth 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" remains high, at 888.[2] However, 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 to be lower than last year's.

In all, the failure of some 373 FDIC-insured institutions since 2006 has imposed total estimated losses of $84 billion on the DIF. As in the last 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, to increase the FDIC's liquidity, the FDIC required that the industry prepay almost $46 billion in assessments in December 2009, representing over 3 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 U.S. Treasury. The measures also reaffirmed the long-standing 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. We expect the DIF balance to once again be positive when we report the June 30 results. Over the longer term, 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 each group's share of industry assets.

The FDIC has used its new authority in setting reserve ratio targets and paying dividends to adopt policies that should maintain a positive DIF balance even during possible future banking crises 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 as required by the Dodd-Frank Act.

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[2] "Problem banks" are those assigned a CAMELS composite rating of 4 or 5.

Consumer Protection and Economic Inclusion

I would also like to address the various efforts underway at the FDIC that are focused on consumer protection. It is important to recall that a fundamental cause of the financial crisis from which the country is still emerging was a failure of consumer protection in the mortgage market. While the FDIC was at the forefront of efforts before the crisis to identify and try to address the implications of both subprime and nontraditional mortgage lending, the regulatory guidance on these loan products—which only applied to insured banks—came too late to prevent mortgage lending weaknesses from undermining the foundations of our housing and financial systems. Many other weaknesses—including inadequate capital resulting in too much leverage, lack of transparency in the derivatives markets, and poor coordination among regulators—magnified and expanded the problems created in the mortgage markets. If the rules now in place had been in existence in 2004, the crisis would have been less severe, if not averted.

The new Consumer Financial Protection Bureau (CFPB) can play an important role in making consumer protections both simpler and more effective. Already, CFPB proposals for simplifying mortgage disclosures currently made under the Truth in Lending Act (TILA) and the Real Estate Settlement Procedures Act (RESPA) have been well received by industry and consumer groups alike. More broadly, the CFPB also can fill an important void by ensuring that nonbank consumer financial companies are subject to the same rules and a similar regime of supervision and enforcement as are insured depository institutions. Many of the unsustainable mortgages made during the boom years were originated by nonbank mortgage companies. These firms simply were not subject to the kind of regular examination that FDIC-insured institutions must undergo. Leveling this playing field is extremely important to prevent regulatory arbitrage.

As you know, the law mandates that banks with assets of less than $10 billion continue to be examined for consumer protection compliance by their primary Federal regulators. In our case, this means that the FDIC will continue to examine about 4,500 State-chartered, nonmember banks for compliance with consumer laws and regulations. To ensure that consumer protection continues to receive appropriate focus, the FDIC established a Division of Depositor and Consumer Protection (DCP) that will be able to work with the new CFPB to ensure consistent application of consumer rules.

Moreover, the Dodd-Frank Act requires the CFPB to consult with the FDIC and other prudential regulators in the development of its regulations. This is a role we take very seriously. Along with our Division of Risk Management Supervision, DCP will ensure that we are institutionally prepared to engage in this consultation. An important part of the consultation process will involve making sure the CFPB understands the inter-relationship between consumer protection and safety and soundness, and also takes into account the potential impacts of its regulations on small, community banks. Simpler, clearer consumer protection rules will not only help consumers better understand their legal rights, but also help community banks engage in a broader array of consumer lending without burdensome legal compliance costs. The FDIC has many years of experience in supervising community banks for compliance with consumer laws and is highly supportive of the CFPB's goal of simplifying consumer rules, which should reduce regulatory burden on community banks. In addition, the Director of the CFPB will be a member of the FDIC's Board of Directors. This will further ensure the coordination of prudential regulation and consumer protection.

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. The Committee's objective is to explore ways to lower the number of households without access to mainstream financial services by identifying appropriate incentives or removing obstacles to the provision of financial products that meet the needs of these households, with an emphasis on safety and affordability for consumers and economic feasibility for banks. These consumer protection initiatives are integral to the FDIC's mission to promote public confidence, access to the banking system, and the benefits of deposit insurance. Economic inclusion is about promoting widespread access to safe, secure, and affordable banking services so that everyone has the opportunity to save, build assets, and achieve financial security.

Implementing Reforms To Promote Financial Stability

As I have testified several times over the past year, the Dodd-Frank Act, if properly implemented, will not only reduce the likelihood and severity 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. The FDIC is also engaged in implementing the other important Dodd-Frank Act reforms where we have been given authority to do so. The following is a brief summary of our implementation activities and how we see them influencing the future course of the banking sector.

SIFI Resolution Framework. The problem of financial companies that are Too Big to Fail has been around for decades. But the bailouts of troubled SIFIs that occurred in the crisis removed all doubt that this was a central problem facing our financial system.

The bailouts were made necessary by the absence of an effective resolution process for bank holding companies and their nonbank affiliates. Without those powers, the failure of an FDIC-insured subsidiary would likely have resulted in the costly and disorderly bankruptcy of the holding company and a significant widening of the financial crisis. This was not a risk policy makers were willing to take at the time.

The crisis of 2008 showed the overwhelming pressure that develops to provide Government bailouts when information is sketchy, when fear is the prevailing market sentiment, and when there is no clear sense of how bad things might get before the system begins to stabilize. But bailouts have consequences. They undermine market discipline. They inhibit the 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 373 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. That is why bailouts are inherently unfair. They violate the fundamental principles of limited Government on which our free-enterprise system is founded. They undermine trust in governmental functions that most people would agree are necessary and appropriate.

This is why the FDIC was so determined to press for a more robust and more effective SIFI resolution framework as the centerpiece of the Dodd-Frank Act. We were early advocates for a SIFI receivership authority that operates like the one we have applied thousands of times in the past to resolve failed banks. 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.

Titles I and II of the Dodd-Frank Act authorize the creation of just such a resolution framework that can make the SIFIs resolvable in a future crisis. These provisions are designed to restore the discipline of the marketplace to the megabanks, to end their ability to take risks at the expense of the public, and to eliminate the competitive advantage they enjoy over smaller institutions. In January, the Financial Stability Oversight Council (FSOC), of which the FDIC is a voting member, issued a Notice of Proposed Rulemaking describing the processes and procedures that will inform the FSOC's designation of nonbank financial companies under the Dodd-Frank Act. In April, the Federal Reserve Board (FRB) and the FDIC issued a request for comment of a proposed rule that implements the Dodd-Frank Act requirements regarding SIFI resolution plans and credit exposure reports. The FDIC Board has also approved a Notice of Proposed Rulemaking and an Interim Final Rule intended to provide clarity and certainty about how key components of the Orderly Liquidation Authority will be implemented. These measures will ensure that the liquidation process under Title II reflects the Dodd-Frank Act's mandate of transparency in the liquidation of covered financial companies.

Despite the timely progress that has been made in implementing these authorities, there remains skepticism as to whether the SIFIs can actually be made resolvable in a crisis. I believe the skeptics underestimate the benefits of having so much more information about these institutions in advance, as well as the authority to require, if necessary, organizational changes that better align business lines and legal entities well before a crisis occurs. I have also tried very hard to dispel the misconception that the Orderly Liquidation Authority is a bailout mechanism or, alternatively, a fire sale that will destroy the value of receivership assets. It is neither. The Orderly Liquidation Authority strictly prohibits bailouts. 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. It will result in a faster resolution of claims against a failed institu-

tion, smaller losses for creditors, reduced impact on the wider financial system, and an end to the cycle of bailouts.

Strengthening Capital Requirements. The other 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.

After the last banking crisis, in the early 1990s, Congress passed a number of important banking reforms that included stronger capital requirements. However, 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 nonbank financial companies—that weakened the ability of the industry to absorb losses during the crisis and that has led to a dramatic deleveraging of banking assets in its wake.

As the crisis has shown, overreliance on leverage is a short-term strategy with a big downside 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 Basel 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 the Dodd-Frank Act and the SIFI capital surcharge.

Last weekend, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision (BCBS), agreed to some important changes in the capital rules that will strengthen the resilience of the largest global systemically important banking firms—known as G–SIBs—and will create strong incentives for them to reduce their systemic importance over time. The assessment methodology for G–SIBs is based on an indicator-based approach, and comprises five broad categories: size, interconnectedness, lack of substitutability, global (cross-jurisdictional) activity and complexity. The agreement provided for capital requirements ranging from 1 percent above the Basel 3 minimums to 2.5 percent, depending upon the degree of systemic risk posed by each firm.

Importantly, the agreement requires that the enhanced capital requirements be fully satisfied with common equity. The FDIC strongly supported this decision to require common equity since it is the only instrument which proved to have loss absorbing capacity during the crisis. Alternatives such as contingent capital and so-called "bail-in" debt are worthy of further study, but remain untested in crisis situations. Our experience and judgment strongly suggest that these instruments still represent debt. The only proven buffer against the kind of widespread financial distress our system experienced in the crisis is tangible equity capital.

Some banking industry representatives are claiming that higher capital requirements will raise the cost of credit and could derail the economic expansion. However, we believe the costs of higher capital are overstated, and the benefits understated. Recent research that shows higher capital requirements, in the range that we are talking about, will have a very modest effect on the cost of credit.[3] Higher capital requirements will create a large net improvement in long-term economic growth by lessening the frequency and severity of financial crises that have historically proved devastating to economic growth. Over the long-term, these efforts to strengthen the capital base of the industry will benefit all parties concerned—including banks—by making our system more stable and less procyclical.

The fact is that the capital requirements U.S. banks now face are mostly the same as those that were in existence before the crisis. The reason banks are not lending more is a combination of risk aversion on their part and reduced borrower demand. Most banks have plenty of capacity to lend. Large banks have been raising capital since the crisis started, and most either already meet the new Basel III standards, or are well positioned to do so solely through retained earnings. Banks that need more time will benefit from the extended phase-in periods designed to ensure seamless transition to the new standards, including any SIFI surcharge.

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[3] *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*; 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*

Proprietary Trading and the Volcker Rule. The traditional function of banks has been to transform shorter maturity or more liquid liabilities into longer-term, less liquid loans. The economic value of this function, combined with its inherent susceptibility to depositor runs, has long been the justification for Government structures such as deposit insurance, the discount window, and Federal bank regulation that are designed to preserve stability in banking.

It is harder to explain why the Government should subsidize a trading operation with deposit insurance and other support. This question became particularly pointed in the wake of the crisis. Losses in banks' trading books were extremely large in the early part of the crisis. These losses seriously weakened institutions and contributed to a loss of confidence by counterparties, driving the crisis in its early stages.

The Volcker rule bans proprietary trading by banking organizations, and prevents them from simply moving proprietary trading operations into off-balance sheet vehicles by imposing meaningful limitations on bank investments in hedge funds and private equity funds. The statutory definition of prohibited proprietary trading is subject to important exceptions. In addition to risk-mitigating hedging, the most important of these exceptions involve market-making and securities underwriting. Notwithstanding the various permissible activity exceptions in the Volcker rule, in no event may the regulators permit activities that create material conflicts of interest, expose institutions to high-risk trading strategies, or threaten financial stability. The regulators have considerable discretion in how to interpret and implement the Volcker rule. The agencies' staffs have been working intently at crafting a proposed rule to implement this important mandate in an appropriate manner.

I view the Volcker rule as a conceptually well-founded limitation of the Federal Government's safety-net support of trading operations by banking organizations, and I do not believe it presents concerns for the competitiveness of the U.S. economy. Any restrictions on activities under the rule will affect where risky trades are housed. Unlike credit intermediation, where the Federal safety net plays an important role in assuring a stable funding base through deposit insurance and access to the discount window, there is no public policy rationale for Government support of proprietary trading.

OTC Derivatives Reform. At the June 2010 G-20 Summit in Toronto, the leaders reaffirmed a global commitment to trade all standardized OTC derivatives contracts on exchanges and clear through central counterparties (CCPs) by year-end 2012 at the latest. Further, the leaders agreed to pursue policy measures with respect to haircut-setting and margining practices for securities financing and OTC derivatives transactions to enhance financial market resilience. Through the Dodd-Frank Act derivatives legislation, the U.S. is taking a leadership role in proposing concrete and actionable measures to accomplish these international commitments.

Making good on these commitments is important to avoiding another derivatives-related crisis. During the decades leading up to the crisis, the perceived wisdom in the regulatory community was that OTC derivatives reduced risk in the financial system. The use of these essentially unregulated financial products grew exponentially precrisis but, at least in the case of credit default swaps (CDS), these products proved to hide and concentrate risks rather than mitigate them. Though CDS instruments did not cause the crisis, they helped to disguise the risks building in mortgage securitizations and greatly magnified the losses once securitized mortgages began to default.

The Dodd-Frank Act has given the SEC and the CFTC important roles in addressing the lessons that the financial crisis taught us about CDS. For the CDS instruments they regulate, each Commission will require standardized CDS instruments to be traded on an exchange and cleared through a clearinghouse. They also are charged with setting margin and capital requirements for customized CDS instruments that cannot be cleared though a clearinghouse. When Section 716 of the Dodd-Frank Act, the Lincoln amendment, becomes effective, dealer activity in uncleared CDS instruments is expected to migrate from banks to nonbank dealers that will be subject to the Commission's rules.

While the SEC and the CFTC have been given important responsibilities, they have not been given the resources needed to discharge them. Earlier this month, both Commissions announced that they would not meet the 1-year deadlines for many of the regulations needed to address CDS and other risks in the system. They are now projecting completing such rules by December of this year.

The Greek sovereign debt crisis has renewed scrutiny over the CDS market and who will bear the risk in the event of a default. While there has been some improvement in information available to regulators, risks in this market are highly interrelated, and it is difficult to know with certainty the capacity of counterparties to make good on their obligations in the event of a major credit event and where the ultimate exposure may reside. It is essential that the SEC and CFTC be able to

move forward with needed reforms in this market. I strongly encourage you to ensure that the SEC and the CFTC have the resources needed to do their jobs.

The Importance of the Dodd-Frank Reforms to the Economic Recovery

As the reform process continues, there is understandable concern about the slow pace of the economic recovery. The U.S. economy has been growing continuously for 2 years now. However, adjusted for inflation, consumer spending and non- real estate business investment remain near the levels that had been reached just prior to the recession, almost 3½ years ago. By almost any measure, the real estate sector remains depressed. Meanwhile, the U.S. economy has regained just over 20 percent of the 8.75 million payroll jobs lost as a result of the recession. In fact, there are over 1 million fewer U.S. private sector payroll jobs today than there were in December 1999, more than 11 years ago.

While the economic situation merits the utmost concern of policy makers, it is important that this concern not be misplaced. The challenges facing our economy are not the result of financial reform. Instead, they are largely the result of the enormous and long-lasting impact the financial crisis has had on U.S. economic activity. The pattern of excessive leverage and subsequent financial collapse is not unique to the recent U.S. financial crisis but has been repeated many times, in many places.

A Greater Focus on Real Estate Is Needed. One factor that greatly complicates the recovery from the crisis is that it is rooted in the real estate sector. According to CoreLogic, approximately 10.9 million residential mortgage loans—or more than one out of every five outstanding—are currently underwater, meaning that the borrower owes more than the property is worth.[4] Underwater borrowers are at high risk of default in the event of financial distress because they lack the ability to satisfy the loan through the sale of the property. Underwater borrowers are also frequently unable to move in order to find work when it is available elsewhere.

The fact that so many residential and commercial properties are currently underwater goes a long way to explaining the continuing weakness of the small business sector, which is so important to the creation of new jobs. Almost half of the liabilities of nonfarm noncorporate businesses are secured by real estate, both residential and commercial. The large and persistent declines in real estate values in many areas of the country have hurt both the demand for small business products on the part of their Main Street customers as well as the ability of small businesses to borrow against the real estate collateral they own.

Although the real estate market downturn is now entering its sixth year, signs of recovery remain elusive. Approximately 2.25 million mortgages remain mired in a foreclosure process that has been slowed by inefficiencies on the part of mortgage servicers, by deficiencies in the their handling of the legal paperwork, and by a frustrating inability to move quickly enough to modify troubled loans while there is still a chance to keep them out of foreclosure.

In April 2011, the Federal banking agencies ordered 14 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 and our economy. In addition, our combined regulatory and enforcement efforts should focus on helping to clear the market through streamlined modification protocols, write-offs of second liens where appropriate, and, for borrowers who cannot qualify for a loan modification, alternatives to the costly and time consuming foreclosure process such as "cash-for-keys" programs and short sales.

Returning Banking to the Business of Lending. Over the longer term, the highest regulatory priority should be placed on returning the banking industry to a primary focus on safe and sound lending that supports real economic activity.

A strong and stable financial system is vital to the economic and fiscal health of the U.S. and our competitiveness in the global economy. A well-functioning financial system supports economic growth by channeling savings into productive investment,

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[4] *See,* "New CoreLogic Data Shows Slight Decrease In Negative Equity", July 7, 2011. *http://www.corelogic.com/uploadedFiles/Pages/About_Us/ResearchTrends/CoreLogic_Q1_2011_Negative_Equity.pdf*

allows consumers, businesses, and market participants to engage in financial transactions with confidence, and is a source of credit to the broader economy even in times of stress. The crisis exposed the vulnerabilities of an unevenly regulated and highly leveraged U.S. financial system that proved to be anything but strong and stable. The excessive leverage in the financial system entering the crisis forced a massive deleveraging after the credit losses associated with the crisis began to be realized in earnest.

Since the beginning of the recession in December 2007, FDIC-insured institutions have set aside some $644 billion in loan loss provisions. During this period, 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, resulting from insufficient capital at the outset of the crisis, has been accompanied by the virtual disappearance of some important forms of nonbank credit intermediation. For example, while annual issuance of private mortgage-backed securities exceeded $1 trillion in both 2005 and 2006, it averaged just $62 billion per year in 2009 and 2010—almost 95 percent below peak levels.

Stronger capitalization and stronger financial practices will be necessary to restore confidence in our banking system, the lending capacity of the banking industry, and the vitality of important nonbank credit channels like private mortgage-backed securitization. One of the strengths of our financial system is the presence of almost 7,000 community banks with assets less than $1 billion and over 500 midsized banks with assets of between $1 billion and $10 billion. These institutions are, on average, much better capitalized than the largest institutions, and they earn profits primarily by lending to the local small businesses and households that represent the core strength of our economy.

But the competitive position of small and midsized institutions has been steadily eroded over time by the Government subsidy attached to the Too Big to Fail status of the Nation's largest banks. In the first quarter of this year, the cost of funding earning assets was only about half as high for banks with more that $100 billion in assets as it was for community banks with assets under $1 billion. Stronger and more uniform capital requirements, and a resolution framework that subjects every institution—no matter its size—to the discipline of the marketplace, are necessary steps to level the competitive playing field and help return the focus of our banking system to making good loans that serve the needs of households and businesses of all sizes in every part of the Nation.

Similarly, new rules recently proposed by the FSOC to require issuers of asset-backed securities to retain at least 5 percent of the credit risk, as mandated by the Dodd-Frank Act, are necessary to restore investor confidence in private securitization markets where issuance has virtually disappeared since the crisis began. Requiring that securitization deals have at least some equity behind them is necessary to give issuers a long-term interest in the performance of the underlying loans and to align their incentives with investors. Unless the interests of investors are protected in this way, we may not see a meaningful recovery in the private issuance of asset-backed securities, thereby forcing the vast majority of mortgage lending to take place either on bank balance sheets or through Government-sponsored programs.

The small extra cost associated with requiring that 5 percent of the mortgage pool be funded with equity instead of debt is trivial compared to the costs that have already been incurred due to the millions of defaults and foreclosures we have experienced in the crisis and the ensuing collapse of private securitization. Here again, the lesson is clear. Rules that align incentives and that enhance the transparency and stability of our financial markets and institutions are necessary to restore the capacity of the financial sector to support the real economy.

Conclusion

Through its approval of the reform package embodied in last year's Dodd-Frank Act, the Committee took an important step forward in making our financial system stronger and more stable over the long term. Amid the controversies that accompany implementation of the Act, I urge the Committee to maintain this long-term perspective and see essential reforms through to completion.

The implementation process has many facets, and a vigorous debate of the details is to be welcomed. But the central lessons of the crisis remain clear. The animal spirits that lead private financial institutions to new innovations and new efficiencies need clear regulatory rules within which to operate. These rules must check the inherent tendency of these markets to pursue excessive leverage that renders our financial system unstable. Every financial company, no matter how large, complex, and interconnected, also must be constrained by the discipline of the marketplace and face the credible threat of failure.

The regulators charged with carrying out the implementation of these reforms will need your full support and encouragement if they are to be successful in their work. The work they have ahead of them is considerable, and without proper funding and, where needed, the confirmation of qualified leadership, the result could be needless uncertainty about the regulatory environment and failure to instill confidence in our financial markets and institutions.

Thank you. I will be glad to take your questions.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM SHIELA C. BAIR

Q.1. Chairman Bair, on March 2, 2011, the *American Banker,* published an article that detailed allegations that the FDIC improperly used its administrative powers when it conducted an unscheduled examination in retaliation for the bank's refusal to comply with an FDIC enforcement order. During your testimony before the Committee you noted that regulators are "not perfect either, and Congress has a very important role to watch what we are doing and make sure that we are doing it the most effectively and efficiently as possible." While it is the role of Congress to oversee regulators to ensure that the law is followed, the FDIC has been reluctant to share information with the Committee regarding the allegations discussed in the *American Banker* article. Do you agree that the FDIC's use of its authority is an appropriate line of Congressional inquiry? If so, do you believe that the FDIC should cooperate fully with such an inquiry? Were you aware of the decision to initiate the enforcement action detailed in the *American Banker* article and if so, did you authorize the enforcement action? If you did not authorize the enforcement action, who did and were you aware of that person's decision? What information within the possession of the FDIC that is related to this matter do you deem to be "confidential supervisory information"? Please be specific, explain your reasoning and provide legal support for your conclusion.

A.1. In recognition of Congress's very important oversight role over Federal agencies, the FDIC has a long history of fully cooperating with the Committee on requests for information and consultations with its staff.

As FDIC senior staff previously discussed in a telephone conference call with senior Senate Banking Committee minority staff in March of this year, the documents and other information requested by the staff are confidential supervisory and law enforcement information concerning an individual depository institution, which institution is currently the subject of a pending administrative enforcement action under section 8 of the Federal Deposit Insurance Act (12 USC §1818). We should note that section 8 provides institutions that are subject to administrative enforcement actions with significant due process protections, including rights to challenge and appeal the actions of regulators before an administrative law judge and subsequently in Federal courts of appeal.

As we discussed on the conference call, there are a number of Federal laws that protect against the disclosure of confidential supervisory information and information related to law enforcement proceedings, including administrative enforcement actions. The Freedom of Information Act (FOIA), for example, exempts from disclosure exam-related information, including but not limited to examination reports, and records contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of the FDIC or any agency responsible for the regulation or supervision of financial institutions. 5 USC §552(b)(8). The FOIA also exempts from disclosure information and records compiled for law enforcement purposes, including records the production of which could reasonably be expected to interfere with enforcement proceedings. 5 USC §552(b)(7). Similarly, beyond the

foregoing, Congress has criminalized the unauthorized disclosure of examinations, investigations, records, or information by an officer or employee of the United States or any agency. *See,* 18 USC §§641; 1905; 1906.

Of course, Congress has reserved to itself the right to obtain information otherwise exempted from disclosure under the FOIA. 5 USC §552(d); cf. 18 USC §1906. Under long-standing case law and agency practice, however, only the Chairman of a Congressional Committee (or Subcommittee) having jurisdiction over agencies, through duly authorized direction, has the authority to direct the production of confidential information. *See, Exxon Corp. v. Federal Trade Commission,* 589 F.2d 582, 592-94 (D.C. Cir. 1978).

Long-standing governmental policy, as reflected in these laws enacted by Congress, is intended to foster full cooperation and open and frank communications between bank regulators and the banks under their supervision without concern that these supervisory communications would be made public. They also are designed to ensure appropriate confidentiality in law enforcement matters. In addition, these laws reflect Congressional intent to protect confidential and proprietary information unique to individual banks so that they are not competitively disadvantaged by disclosures regarding their financial and business operations.

Q.2. Chairman Bair, you recently noted that money market funds "were an accident waiting to happen, and it did happen" during the 2008 crisis. Money market funds are again a subject of concern because of their heavy exposure to European banks that hold a lot of Greek debt. If a large money market fund failed, would the FDIC have the expertise and resources to resolve it under the new resolution regime in Dodd-Frank? If so, would investors rather than taxpayers bear all of these losses?

A.2. The Dodd-Frank Act gives the FDIC the authority to resolve any nonbank financial company that is in default or in danger of default if a systemic risk determination is made under the Act. Among other things, the Secretary of Treasury (in consultation with the President and based on the recommendation of the Federal Reserve Board (FRB) and the FDIC) must determine that the company is in default or in danger of default, its failure would have serious adverse effects on U.S. financial stability, no viable private sector alternative exists, and action under the Dodd-Frank Act's orderly liquidation authority would avoid or mitigate the systemic consequences. In essence, the company cannot be dealt with under the existing Bankruptcy Code.

Thus, if a large money market fund were found to be systemically important, in default or in danger of default, and not resolvable under the Bankruptcy Code, the Secretary of the Treasury could appoint the FDIC as receiver.

To date, only bank holding companies with assets of $50 billion or more are designated as systemically important financial institutions (SIFTs) by statute. The Dodd-Frank Act also charges the Financial Stability Oversight Council (FSOC) with identifying other SIFTs. As required by the Dodd-Frank Act, SIFTs will be required to draft credible resolution plans, which will be submitted after the FRB and the FDIC issue a joint final rule. Once the resolution

plans are submitted, the FDIC will review them with the FRB. These so-called living wills will provide valuable advance information that will assist in implementing an orderly resolution of the financial company. If a large money market fund were to be designated as a SIFT, that fund would have to draft a credible resolution plan, which we would review jointly with the FRB.

If the FDIC were appointed receiver of a money market fund or any other systemically significant failing financial company, we would resolve it with no cost to taxpayers, as required by the Dodd-Frank Act.

Q.3. Chairman Bair, earlier this year the FDIC published a study entitled "The Orderly Liquidation of Lehman Brothers Holdings, Inc., Under the Dodd-Frank Act". This study asserted that had the Dodd-Frank Act been law in 2008, market chaos would have been avoided and losses would have been smaller and provides specifics on how the FDIC intends to use its additional authority. The study relies on certain assumptions in its analysis of how the FDIC would have resolved the collapse of Lehman. In particular, the FDIC assumes that would have been able to find a buyer through "a competitive bidding process and likely would have incorporated either loss-sharing to encourage higher bids or a form of good firm–bad firm structure in which some troubled assets would be left in the receivership for later disposition." How would the analysis change if the FDIC were unable to find a buyer for Lehman?

A.3. In the event the FDIC would have been unable to find a purchaser for Lehman Brothers Holdings Inc (LBHI) at the time of its failure, the Dodd-Frank Act authorizes the FDIC, as receiver of a covered financial company, to establish a bridge financial company to which the assets and liabilities of LBHI would have been transferred. Through a bridge company the FDIC would be able to continue key operations, services, and transactions that would maximize the value of LBHI's assets and operations in order to avoid a disorderly collapse in the marketplace.

Certain assets and liabilities of LBHI would be retained in the receivership, while other assets and liabilities, as well as the viable operations of LBHI would be transferred to the bridge financial company. The FDIC also would transfer certain qualified financial contracts to the bridge financial company. The bridge financial company would operate until the FDIC stabilized the systemic functions of LBHI, conducted marketing for its assets, received any necessary regulatory approvals from foreign regulators for its sale or disposition, and found one or more appropriate buyers.

As noted in the FDIC's paper on LBHI, a bridge financial company is a newly established, federally chartered entity that is owned by the FDIC and includes those assets, liabilities, and operations of the covered financial company as necessary to achieve the maximum value from the sale of the firm. Shareholders, debt holders, and other creditors whose claims were not transferred to the bridge financial company would remain in the receivership and receive payments on their claims based on the priority of payments set forth in section 210(b) of the Dodd-Frank Act. The covered financial company's board of directors and most senior management responsible for its failure would be replaced. The company's em-

ployees and FDIC contractors would continue to operate the bridge company under the strategic direction of the FDIC. The FDIC may operate a bridge financial company for 2 years with up to three additional 1-year extensions, although it would be the goal of the FDIC to sell the company as quickly as possible.

Q.4. Chairman Bair, until we receive additional data it will be difficult to determine the impact that Basel III will have on capital levels. Will a quantitative and qualitative analysis of the impact of Basel III on the largest banks be performed prior to the finalization of the rule? Would you agree to provide such an analysis to this Committee in advance of any final rulemaking information?

A.4. The capital impact of the Basel III agreement (Basel III) is critical to quantify before finalizing and implementing Basel III. During the formulation of Basel III, the Basel Committee on Banking Supervision (BCBS) conducted a robust quantitative analysis similar to those analyses performed as part of previous Basel agreements. This quantitative impact study included thirteen large U.S. banking organizations; 263 banks from 23 BCBS member jurisdictions participated in the impact analysis (see the results released on December 16, 2010, at *http://bis.org/publ/bcbsl 86.pdf*). This analysis enabled the BCBS to reach its final conclusions and recommendations and calibrate the capital levels of Basel III. In addition, the Federal Reserve released the results of its Comprehensive Capital Analysis and Review in March 2011. This analysis included an evaluation of the capital plans for addressing the expected impact of Basel III, as well as a forward-looking evaluation of capital planning and stress-scenario analysis at the 19 largest U.S. bank holding companies. The scope of application of the Basel III standards in the U.S. and the costs and benefits of additional information collection regarding such standards outside of the normal notice and comment rulemaking process are still being considered.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR HAGAN FROM SHIELA C. BAIR

Q.1. *REITs*—In the joint rulemaking proposed by the banking regulators related to credit risk retention for asset backed securities, the regulators specified certain criteria for qualifying loans that will be eligible for reduced risk retention. The definition of "commercial real estate loans" includes loans secured by real property that meet other requirements. Land and development loans, unsecured loans to developers, and loans to a real estate investment trust (REIT) were specifically carved out. REITs typically employ low leverage and are often publicly traded REITs. Additionally, these entities primarily invest in real estate to adhere with tax requirements. Could you explain why regulators excluded loans to REITs from its definition of "qualifying commercial real estate loans"?

A.1. Although the associated risk is tied to commercial real estate (CRE), a loan to a REIT typically does not present the same type of risk as a loan secured by a particular CRE property. REITs can engage in a single purpose or a variety of CRE-related activities,

such as renting, buying, operating, making CRE loans to others, and selling income-producing real estate. As a result, a REIT's primary source of repayment is through rental income, management fees, interest income, gain on sales, or a combination of these sources. By law, REITs are required to distribute 90 percent of the taxable income to their investors every year. This requirement creates a statutory restraint on the amount of operating income that can be retained as reserves and capital for a REIT to meet its payments in the event there is a reduction in its income stream. Further, investors may impose additional limitations on REITs to protect their pass-through tax positions. Given these restrictions and the unique risks associated with REITs, the regulatory agencies excluded loans to REITs from the definition of a qualifying CRE loan. The regulatory agencies encourage anyone with an interest in this aspect of the Credit Risk Retention proposal to submit a written comment.

Q.2. The Dodd-Frank Act amended the method by which the FDIC calculates deposit insurance assessments. Could you explain how these changes have affected how you calculate assessments—that is, are the assessments still risk based, and if so, is that risk the risk of a loss to the deposit insurance fund or the risk of loss to the system as a whole? Do the assessments now apply to all institutions holding financial assets or only to those that offer insured deposits?

A.2. The Dodd-Frank Act did not amend the statutory requirement that the FDIC establish a risk-based assessment system for insured depository institutions. A risk-based assessment system continues to be defined by statute as a system for calculating a depository institution's assessment based on the probability that the Deposit Insurance Fund (DIF) will incur a loss with respect to the institution, the likely amount of any loss, and the revenue needs of the DIF. Only insured depository institutions are required to pay these assessments.

As it has since the inception of the risk-based assessment system in 1993, the FDIC determines an institution's risk-based assessment by multiplying a risk-based assessment rate by an assessment base. The Dodd-Frank Act did not change this basic methodology. It did, however, provide a statutory definition for the assessment base—average consolidated total assets minus average tangible equity (with possible modifications for the assessment bases of bankers' banks and custodial banks). Historically, the assessment base was defined as domestic deposits (with some adjustments).

Q.3. I'd like to hear your thoughts on the agreement that the Basel Committee on Bank Supervision recently reached with respect to capital requirements for global systemically important financial institutions.

I know you addressed some of this in your testimony, but I am interested in your assessment of the Basel Committee's proposal and in particular, its proposals on contingent capital and risk weighted assets.

I noted that the Basel Committee excluded contingent capital and instead required that the surcharge be met with Tier One

Common Equity. The Committee agreed to review Contingent capital, and expressed support for its use for certain other purposes. What are your views on contingent capital as a tool for meeting the G–SIFI surcharge? It seems to me there are a lot of unresolved technical questions around contingent capital. And, it is my understanding that these instruments have tax benefits in foreign jurisdictions, that don't exist here in the United States.

A.3. The FDIC supports the BCBS's position that common equity is the most effective form of loss-absorbing capital, and its proposal that the G–SIFI surcharge be composed entirely of tier 1 common equity. Contingent capital is an interesting concept that poses a number of potential issues. These include the potential liquidity consequences to an institution experiencing a conversion, potential downstream effects of a conversion on holders of the instrument being converted, and whether policy makers would attempt to intervene to prevent a conversion. Generally speaking, the experience with hybrid capital instruments has been unsatisfactory in terms of their ability to absorb losses, and we do not wish to set up a repeat of this experience with a new class of innovative capital instruments.

Q.4. One question that, to my understanding, was not addressed in the proposal is around Risk Weighted Assets. I have heard concerns from U.S. institutions, economists and regulators that the way Risk Weighted Assets are calculated and enforced may be different across jurisdictions. Is this the case?

A.4. Risk-weighted asset calculations may differ across jurisdictions for a variety of reasons. With the "Advanced Approaches" of Basel II, banks are essentially setting their risk-based capital requirements using their own estimates of risk. This creates the likelihood of differences in risk-weighted assets for the same or similar exposures. Similar comments apply to the calculation of risk-weights for assets in trading accounts, since capital for the trading book is largely driven by banks' internal models, the results of which can vary widely. The Federal banking agencies have implemented Section 171 of the Dodd-Frank Act by placing a risk-based capital floor under the Advanced Approaches, preventing large U.S. banks from reducing their capital requirements below the levels a smaller bank would face for the same aggregate exposures.

Q.5. It would seem to me that if we are driving towards international standards on capital, it would be important to drive towards standards on how risk weighted assets are calculated. Wouldn't you agree?

A.5. The Basel Committee has initiated a review of how assets are risk-weighted across jurisdictions. All other things equal, greater consistency in risk-weighted assets is desirable, and the Basel Committee's review may be a useful step towards greater consistency. In our view, however, the capital requirements produced by the Advanced Approaches are often too low and too subjective for comfort, and that is why we have supported the Section 171 capital floor as a way of achieving risk-weight consistency among U.S. institutions, consistent with safety-and-soundness objectives.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM SHIELA C. BAIR

Q.1. At the Senate Banking Committee hearing with the FSOC in May, I expressed concern that the proposed rule on the designation of nonbank financial institutions (as SIFIs) essentially restated the statute and did not have enough specificity. You seemed to agree that we needed more clarity.

Can you tell me what progress has been made on developing this additional clarity?

Will it be a proposed rule with a 60-day comment period or guidance? If FSOC plans to issue guidance rather than a proposed rule, please explain why?

A.1. Over the past several weeks, we have been working with the other FSOC members to provide more clarity in the designation process for nonbank SIFTs. In response to the comments on the SIFT designation Notice of Proposed Rulemaking (NPR) that was issued in January 2011, the FSOC plans to issue a guidance document with a request for public comment, through which it will provide additional specificity with respect to the metrics and standards, both quantitative and qualitative, that the FSOC expects to use to designate a SIFI. The guidance also may be accompanied by a second NPR. Regardless of the form of the issuance, we expect the proposal will be published for comment for 60 days.

Q.2. The FDIC and Federal Reserve have put out a proposed rule on resolution plans or so-called "living wills" for systemically important financial institutions. My understanding is that if the Fed and FDIC determine that a plan is "not credible," the consequences are significant—increased capital and liquidity requirements, leverage limits, activities limits and forced sales, and even structural changes to a firm. The proposed rule does not define or go into any specifics on what is a "credible plan"? Given the consequences of a plan being deemed "not credible," shouldn't there be more specificity regarding what constitutes "credible"? What is your time frame on finalizing the rules?

A.2. We anticipate that the final rule for systemically important bank holding companies and nonbank financial companies will provide detailed requirements for a resolution plan, also known as a "living will." We will continue to work with the Federal Reserve Board (FRB) to evaluate and address comments received on the proposed rule, to ensure that the requirements for resolution plans in the final rule are as clear as possible. In addition, the FRB and the FDIC anticipate providing additional guidance to the Covered Companies, once final rules are in place.

We expect that we will finalize this rule by late summer.

Q.3. Several provisions of Dodd-Frank carve-out or treat smaller banks differently from larger banks. Will the various exemptions—from CFPB examination and interchange fee regulation, to name a couple—effectively protect smaller institutions? Can we have a tiered regulatory approach?

A.3. We agree that the majority of the provisions of the Dodd-Frank Act should have no direct impact on community banks. The legislation's regulatory cost will fall, as it should, directly on the

large institutions that create systemic risk. The Act will help level the competitive playing field between banking institutions and nonbanks, which will help preserve the essential diversity of our financial system and prevent any institution from taking undue risks at the public's expense.

The FDIC believes that a balanced, even-handed supervisory approach for all institutions will ensure safety and soundness, adequate consumer protection, and avoid unnecessary regulatory burden. Clearly, large systemically important financial institutions require continuous on-site supervision to inform our regulatory process of systemic and idiosyncratic risks to the Deposit Insurance Fund (DIF), the financial markets, and the domestic/international economy as a whole. Conversely, community banks can be supervised effectively through an appropriate set of regulatory requirements with periodic on-site examinations and off-site surveillance.

Although our approach to examining the condition of large and small institutions differs, the underlying goals of prudential supervision remain the same. All institutions are bound by a similar set of laws and regulations that promote safe-and-sound operation and consumer protection. Large institutions, because of their systemic importance and regional/national footprint, are subject to more complex requirements for capital, the delivery of consumer financial products, corporate governance, and financial transparency. Community bank requirements are similar, but are more in line with their size and complexity of operations. This is consistent with the idea that supervision should be tailored to the complexity of each institution's business activities and the potential risk to financial stability and the DIF.

Q.4. In the prudential regulators? recently proposed derivatives margin rule, the FDIC and other regulators proposed requiring commercial end users to post margin if the value of their trades exceeds a prescribed limit. Congress made it clear that it did not intend for margin requirements to apply to end users. Why is the intent of the law being disregarded?

A.4. The FDIC understands and appreciates the intent of Congress with regard to margin requirements for commercial end users. The proposed rule does not explicitly require commercial end users to post margin for noncleared derivatives exposures. Rather, the proposed rule is consistent with current safe-and-sound banking practices, which require banking organizations to have counterparty exposure limits. As such, commercial end users are not required to post margin against derivatives exposures provided the entities remain below exposure limits. Finally, the proposed rule would not establish minimum supervisory exposure limits.

Q.5. It has been brought to my attention that examiners are penalizing loan modifications by permanently placing loans on nonaccrual status even if the borrower has consistently demonstrated a pattern of making principal and interest payments on the modified loan. This classification makes the banks' capital position appear weak even though they are adequately capitalized. The result is their lending ability is hampered. Can you tell me what steps the FDIC has taken to address this problem?

A.5. The FDIC recognizes the challenges some borrowers face in making payments in this difficult economy and real estate market. The FDIC has joined several interagency efforts that encourage banks to originate and restructure loans to creditworthy borrowers and clarify outstanding guidance. For example, the Federal banking agencies issued the *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* on November 12, 2008, which encouraged banks to prudently make loans available in their markets. The agencies also issued the *Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers* on February 12, 2010, to encourage prudent small business lending and emphasize that examiners will apply a balanced approach in evaluating loans. This guidance was issued subsequent to the October 30, 2009, *Policy Statement on Prudent Commercial Real Estate Workouts* (CRE Workouts Guidance) that encourages banks to restructure loans for commercial real estate mortgage customers experiencing difficulties making payments. The CRE Workouts Guidance reinforces long-standing supervisory principles in a manner that recognizes that pragmatic actions by lenders and small business borrowers are necessary to weather this difficult economic period.

By statute, the accounting principles applicable to the regulatory reports that banks file must be uniform and consistent with, or no less stringent than, generally accepted accounting principles (GAAP). When FDIC examiners identify departures from GAAP during examinations, they recommend appropriate corrective action. Accounting for loan modifications that represent concessions granted to borrowers experiencing financial difficulties, generally known as troubled debt restructurings, is governed by GAAP, which deems such loans to be impaired. Usually, a loan that undergoes a troubled debt restructuring already will have been identified as impaired because bank management will have determined before the modification that collection of all amounts due according to the original contractual terms is not probable.

The banking agencies' reporting instructions for the Consolidated Reports of Condition and Income include long-standing guidance that specifies the circumstances in which a nonaccrual loan can be restored to accrual status. With respect to a troubled debt restructuring of a nonaccrual loan, when a well-documented credit evaluation of the borrower's financial condition provides reasonable assurance of repayment and performance according to the loan's modified terms, the loan need not be maintained in nonaccrual status. In response to your specific concern, we are not aware of a practice where examiners require banks to "permanently" place modified loans in nonaccrual status even though principal and interest payments are being made in accordance with the revised contractual terms. Because such a practice conflicts with our reporting instructions, we would invite bankers to provide examples of loans modified in troubled debt restructurings where permanent nonaccrual treatment has been directed, which would enable us to review and act on these cases.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

LETTER SUBMITTED BY WAYNE A. ABERNATHY, EXECUTIVE VICE PRESIDENT, FINANCIAL INSTITUTIONS POLICY AND REGULATORY AFFAIRS, AMERICAN BANKERS ASSOCIATION

Building Success. Together.

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June 30, 2011

The Honorable Tim Johnson
Chairman
Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Johnson and Ranking Member Shelby:

Thank you for your commitment to a strong and prospering community banking system. Oversight of the operations of the Federal banking agencies is important to ensure that they keep in mind their duty to be advocates for a healthy community banking system.

In that regard, I would like to share with you a letter from a community banker who raises an issue that has been raised with us by many bankers. The issue deals with FDIC failed bank resolution practices and how they can affect surviving banks, especially community banks.

I would ask that you include this letter and the questions that it raises as part of the record of the "State of the FDIC: Deposit Insurance, Consumer Protection, and Financial Stability" hearing on June 30, 2011.

Thank you for leadership.

Respectfully,

Wayne A. Abernathy
Executive Vice President
Financial Institutions Policy
and Regulatory Affairs
American Bankers Association

LETTER SUBMITTED BY WILLIAM B. GRANT, CHAIRMAN OF THE BOARD, PRESIDENT, AND CHIEF EXECUTIVE OFFICER, FIRST UNITED BANK & TRUST

June 29, 2011

The Honorable Tim Johnson
Chairman
Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Johnson and Ranking Member Shelby,

I applaud the efforts of the Senate Banking Committee to convene this hearing, and respectfully request that this letter be made a part of the official record of the proceedings.

By way of background, I am the Chief Executive Officer of a community bank located in the heart of Appalachia. In an effort to diversify our loan portfolio to achieve appropriate safety and soundness, our bank acquired a number of loan participations through the Silverton Financial Group. Silverton was a bankers' bank, meaning that its customers were community banks. As part of their services, they would procure commercial loans, and then sell pieces of those loans to their member banks. Silverton would perform all the servicing requirements for these loan participations, and as bankers, clearly understood their fiduciary responsibility to the banks.

Unfortunately, Silverton, like many banks, was not able to weather the effects of the Great Recession. As such, they were taken over by the FDIC, which moved forward with the liquidation of Silverton's assets.

We believe that a wise and appropriate policy would have been for the FDIC, as a prudential regulator, to give first bidding opportunity among the field of potential bidders to those entities that best understood banking, and the responsibilities of loan servicing especially to banks partnering with Silverton in loan participations and other activities. In fact, the FDIC assured us that, with the sale, that the "alignment of interest with community banks would not be sacrificed, but likely to be enhanced".

Such was not the case. Instead the winning bidder was an entity known as Square Mile. In fact, the FDIC entered into a joint venture with Square Mile. Square Mile is not a bank. Square Mile is not in the bank servicing business. They are a joint venture firm focused on maximizing their rate of return – regardless of any consequences for the community bank participants. Firms such as these lead America

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into the Great Recession. Their subsequent actions – and inactions – clearly reflect a disregard for the welfare of its community bank participants. A few points are illustrative of this behavior.

- The joint venture agreement with the FDIC calls for Square Mile to prepare business plans for each of the loans. This would be useful for participant banks to understand, and have conversations, on how each credit, and underlying business, would be approached and worked with on a case-by-case basis. To date, no plans have been made available to the banks.
- In several instances, borrowers have requested modifications for their loans. Square Mile has summarily denied these requests without any effort to engage the banks in discussions which could logically eliminate, or at least mitigate, potential losses. These modifications may have improved the value to participants, which includes the FDIC. This disregard to loan modification opportunities runs contrary to the administration's approach to improving the real estate market conditions.
- In a case involving our bank directly, we became aware of an offer made to buy a distressed property. The offer was made to Square Mile, and if consummated, would have paid us approximately $0.43 on the dollar. The offer was rejected out of hand, without discussions with us. It is clearly understood that there may have been contingencies or issues with the offer. The point is there was no attempt to reach out to us for discussions, as clearly required by their servicing agreement. Instead, when we pushed the issue with Square Mile, they offered to buy our share for $0.21 on the dollar – less than half of what was offered them.
- The most egregious example occurred earlier this spring. One of the participation loans, Impact Properties, was having some degree of difficulties. Square Mile had declined to entertain any modifications on the loan. The group of participating community banks came together with a solution to help this business. Part of the solution was that the Square Mile interest would be paid off at par. They would receive 100% of their share of the loan balance, even though they purchased their share at a discount. To the shock and dismay of the banks, they rejected this offer as inadequate. 100% payoff is inadequate? Then, they turned around and purchased, at a 40% discount, the shares of some of the struggling community banks that had to sell due to regulatory pressures, including the FDIC. This creates an interesting potential conflict where the regulator, who is also the partial owner of the loan pool, is pressuring its regulated institution to sell an asset at a discount to the regulator's benefit.

What makes the Impact Properties decision and subsequent conduct particularly shameful is that the FDIC stands to gain from the aggressive actions of Square Mile.

The essential problem, in my opinion, was entrusting the servicing of these loans to an entity whose interests are inconsistent with those of affected community banks. The rate of return sought by

Square Mile is far in excess of the interest rates on the loans. As such, they pursue a course of action aimed at default and foreclosure, and potential acquisition of the underlying collateral. As noted above, they also are willing to buy out participations at incredibly deep discounts – way below what they paid for their shares – from banks that are unable to stay in for the long term.

The solution is relatively simple and should be undertaken by the FDIC at the direction of this Committee. The FDIC, pursuant to its rights under Section 3.2 of its Agreement with Square Mile, should remove Square Mile as manager, i.e., servicer, of these loans. The administration and servicing of the loans should be vested with an entity familiar with banking, and in lock step with the FDIC in both observing safety and soundness principles and preserving the FDIC Fund.

It is possible that the FDIC may counter this proposal with an assertion that this venture with Square Mile maximized return to the Fund. The question to that should be: At what cost? It is entirely possible that the current course of action might result in the failure of some community banks. The loss of just one or two would probably cost the Fund more than it is reaping under its current arrangement with Square Mile. Furthermore, the failure to work with borrowers to find solutions in favor of foreclosure only exacerbates the real estate crisis which is impacting the banking system and the economy as a whole.

Members of the FDIC staff are well aware of the Square Mile's investment approach to servicing these assets, based upon my regular correspondence, and to my dismay continue to allow Square Mile and its principals to bid on purchasing and servicing new loan pools from the FDIC.

In closing, I would like to thank you for your support for community banking and your interest in making sure that the FDIC operates so as to promote the strength and viability of the community banking system.

Sincerely,

William B. Grant
Chairman of the Board,
President and
Chief Executive Officer

WBG/fm