REMARKS ON REGULATORY REFORM

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It is a pleasure to be with you today. As the room is filled with experts on financial services regulation, I thought the most appropriate response to your kind invitation would be to offer a few comments on the current debate over our financial system from outside the Beltway.

As you may be aware, I have had the opportunity during the last year or so to give testimony regarding financial regulatory reform on behalf of the Conference of State Bank Supervisors. This has been an exhilarating, exhausting and profoundly educational experience and, I hope, a helpful addition to a very important public policy debate. That said, I have come away from this experience concerned about one thing that has been lacking from the debate: a positive vision of what the outcome should be. If we "succeed," what will the financial world look like? How are we to measure success? I have heard a lot about what we <u>don't</u> want – what we want never to happen again – but precious little about what we <u>do</u> want. I have a few suggestions that I hope will contribute to a useful conversation on this topic.

My colleagues in CSBS and I are of the view that the United States needs and deserves a diverse, competitive and durable banking system that contributes to the economic recovery and provides the financial products, services and innovation necessary to promote the economic health of local communities and our nation over the long term. To be clear, our vision of diversity is a banking system that includes institutions of all sizes suited to meet a variety of consumer and business needs and that is capable of surviving and thriving throughout the business cycle.

I regret to say that it is our further view that we are nowhere near to achieving this vision. The United States banking industry is concentrated and under continued financial stress. Federal policies and actions have distorted the banking system. This has to be corrected to remove taxpayer exposure and to ensure that banks, regardless of size, are subject to market discipline.

While federal intervention has essentially guaranteed "too big to fail" institutions, the economic downturn has weakened a significant number of community and regional banks that, unfortunately for them, are not too big to fail. Further, financial institutions and the agencies that regulate them have lost some measure of public confidence and stand to lose more.

What can be done about this? I would suggest we address support for economic recovery first and the structure of the industry thereafter.

While there are significant and important differences among policy makers as to what to do about the current crisis, I don't believe that there is much disagreement about the need for action by federal and state governments to promote economic recovery and put our people back to work. Are the banking industry and its regulators aligned to promote recovery? Regrettably, the answer to that question is no. The industry is constrained by asset quality issues and a shortage of needed capital. Under a barrage of criticism for alleged laxity in the run-up to the crisis, regulators have substantially toughened their supervisory standards and attitudes toward the institutions they regulate. As a result of asset quality and capital issues and the related regulatory response, there has been a constriction of industry capacity to lend and a significant reduction of risk appetite generally. The downturn has reduced loan demand significantly as well; however, the industry's problems must be addressed so that credit constraint will not retard recovery when loan demand picks up.

I would respectfully make the following suggestions about what stakeholders in banking should and should not do to bring the industry back to health:

We should continue to address asset valuation issues squarely and should not delude ourselves that asset values (particularly real estate related asset values) will recover to prior levels if we just give them time. The insistence by bank supervisors that these assets be valued to reflect their current worth has been and is a needed corrective to the unwillingness by some of our banks to deal with problems early and effectively. Real estate loans are not like wine: age does not improve them.

Based on a realistic valuation of assets, the goal of supervision should be to heal distressed institutions rather than to constrain them further. The current supervisory practice of requiring distressed banks to address asset quality issues, raise capital, enhance risk management and strengthen their boards and governance is both necessary and appropriate. What's missing is a concomitant supervisory commitment to allowing these correctives time to work.

In many cases, the required capital raise is based not on the current needs of the institution but on projections of trends in the bank's operations. On these assumptions, the distressed bank is almost certainly not well capitalized and, accordingly, access to brokered and other non-core deposits is limited or eliminated. Deprived of liquidity and ordered to raise a lot of capital in a market where a little is hard to get, weak banks get weaker and less likely to heal. Supervisory policy with regard to distressed banks needs to be altered to give them a chance.

There are, of course, counterarguments to this point of view, the most prominent of which (at least in my hearing) are that (i) forbearance just prolongs the agony, weakens healthy institutions by allowing "zombie banks" to continue to operate, and makes the losses to the FDIC insurance fund greater than they need be; and (ii) there are too many banks in the United States, so that a winnowing process is both inevitable and necessary.

My summary responses to these counterarguments are: What evidence do you have that weakening distressed banks and accelerating failure strengthens the banking system or preserves the insurance fund? On what basis have you determined that we have too many banks and does your "evidence" include consultation with consumers, small businesses and governmental leaders (other than those in Basle)? Can you assert with a straight face that these same criteria were applied to Citigroup? Most importantly, how does our current course of supervision contribute to national economic recovery?

There needs to be a debate on these issues soon. Those who believe in continued stringency owe it to the industry and the country to come out with an explicit statement as to their vision for the future of the banking industry and how the current regulatory policy contributes to economic recovery.

The healing process that I am proposing will require significant capital infusions into our banks. Given this need, our supervisory policies should encourage new investment in our banks. I think it is fair to say that current policy does not further this important goal.

What are the sources from whence the needed capital can come? The first, and most obvious, source is a secondary offering to existing shareholders and the market. There have been some notable successes in this regard among global and large U.S. institutions, which is all to the good. The success rate for community and regional banks has been mixed, with some notable successes and a lot of non-starters. Capital raises through public secondary offerings have been cumbersome, expensive, dilutive of existing shareholders and often poorly subscribed. While it is necessary and proper for supervisors to require that local and secondary market offerings be attempted, it is in our interest and the interest of the banks we supervise to have other and additional sources available.

There was a time when many of us in the states hoped that the capital purchase program under TARP would be such a source. TARP could have been an important vehicle for supporting community and small regional banks. In fact, on several occasions CSBS has urged that TARP be made more accessible to such banks by predicating capital investments on the viability of banks after such investments rather than before. However, that program was set up to provide aid - it appears - to firms that generally didn't need it and carried terms that stigmatized many of the firms that took it.

Given the capital needs of community and regional banks, the Administration's proposal of a small business lending fund is very welcome. The terms of the proposal, as I understand it, would provide most of the institutions with the financial foundation to restructure their loan portfolios and to make new loans to creditworthy borrowers. In North Carolina, for example, the fund could provide up to $1.6 billion of new capital and support up to $19 billion of new lending. This may not seem like much to folks inside the Beltway, but it is huge in my world. While I understand that the proposal is controversial, I hope that it can be established and implemented. Properly implemented, the proposal can be a valuable tool to stabilize and restructure a large number of our banks and to support the recovery.

Private equity is a third potential source of needed capital. Private equity investors have shown an interest in investing in banks, sometimes only through the FDIC resolution process, but often in healthy banks, as a platform for participation in the resolution process or rolling up small banks or both. Regulatory applications by private equity firms to engage in this activity have been subjected, as a rule, to a cumbersome, slow and sometimes insulting process that can best be compared to death by a thousand cuts. This treatment is based, as best I can tell, on the view of private equity taken by some of my federal colleagues. This view is similar to Prime Minister Edward Heath's opinion of Mr. Tiny Rowland, to wit: private equity is the "unacceptable face of capitalism."

The treatment of private equity by federal regulatory agencies is in contrast to the achievement of financial holding company status by, among others, Goldman Sachs and Morgan Stanley - the acceptable faces of capitalism one supposes - with lightning speed and over a weekend, as I recall.

Half facetious historical references aside, private equity can be an important source of capital that can aid the repair and restructuring of the banking industry. Concerns about these investors should be addressed through enhanced guidance on what is acceptable and what is not and the process must be accelerated. If the recent past has taught us anything, it is that capital moves at lightning speed to places where it is welcome. Potential investment that is here today may be gone tomorrow.

This treatment of private equity also contrasts with the loss sharing transactions that have been done through the FDIC resolution process, which have generated significant capital for acquirers, both through the magic of purchase accounting and their generation of substantial accretion in value to acquirers virtually immediately. Given the current impasse over private equity, regulatory incentives are aligned for an increase in failures and continued losses to the deposit insurance fund. Stressed banks are told to raise enhanced levels of capital based on forward-looking supervisory approaches; sources of capital are inhibited or constrained by the regulatory process; resolution transactions are low risk and highly profitable, so potential acquirers determine it is in their interest to wait until the distressed bank fails; they do and the bank does fail. The loss-share winner gets a good deal and the rest of our banks pay the price through increased deposit insurance premiums.

I make these loss sharing remarks as a friend and colleague of the dedicated and hard working people at FDIC and, in particular, Chairman Bair. They are doing their best under very trying circumstances to shore up our banking system and wisely administer the insurance fund. In these activities, they are significantly constrained by the "prompt corrective action" provisions of FIDICIA which, as you all know, removed regulatory discretion in dealing with distressed banks. I have, on behalf of CSBS, testified in support of amendment of FIDICIA to return at least some discretion to supervisors. I still believe that would be good policy. Until that happy day, my colleagues in CSBS and I stand ready to work with federal supervisory agencies to exercise such discretion as remains to us in a way that slows the carnage and preserves the FDIC's assets.

I am not arguing that distressed banks should be propped up and allowed to continue a slow death that harms competitors and the market. I am arguing that a change in policy can reduce the number of failures and facilitate a restructuring of the industry based on private investment and enhanced market discipline. Capital is available to finance this process now. I am concerned that by delaying or preventing investment, we will lose a good opportunity to heal our banks.

A lot more can and should be said about what the structure of the banking industry should be and how it should be regulated. Time does not permit me to go into that topic today. The banking industry is being restructured right now; unfortunately, the restructuring is primarily being done through contraction and failure. This process is haphazard and destructive of capital, institutions and public trust. It wastes assets and seriously restricts the ability of the banking industry to contribute to economic recovery or the long-term health of our economy. I hope we – including everyone in this room – can set aside our differences over a number of policy issues – important though they may be- and focus together on healing the industry and preparing it for the future.

There will be plenty for all of us to do – with and against each other – after the crisis is over.

Thank you very much.