I was honored to deliver an address on the importance of sound bank regulation to a sound economy at the 49th Annual Conference on Bank Structure & Competition hosted by the Chicago Fed on May 10, 2013.]

SOUND BANK REGULATION CRUCIAL TO SOUND ECONOMY

By

WILLIAM M. ISAAC

Former Chairman

Federal Deposit Insurance Corporation

Senior Managing Director

FTI Consulting

Chairman

Fifth Third Bancorp

Before

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It' s a great honor and privilege for me to appear before this esteemed group of academics, regulators and financial industry practitioners. I' m particularly honored to be included as a speaker alongside Chairman Bernanke, Comptroller of the Currency Curry, and Acting Director of the Federal Housing Finance Agency DeMarco.

I began my career at Foley & Lardner law firm in Milwaukee and always looked forward to attending this Annual Bank Structure and Competition Conference hosted by the Chicago Fed to learn the latest thinking on bank competition and regulation. I confess that many of the presentations were over my head but I absorbed what I could.

I represented a fair number of Wisconsin banks and appeared regularly before the Fed on regulatory matters, including mergers and acquisitions. I was in awe of the Fed and particularly the Chicago Fed in those days.

I remember Elbert O. Fults who headed supervision for the Chicago Fed and Brenton Leavitt who headed supervision for the Board in Washington. Jack Ryan and Bill Taylor graduated from the Chicago Fed and went on to lead bank supervision for the Board, each ran the RTC for a time, and Bill Taylor became Chairman of the FDIC. They were good old fashioned regulators – fair, but tough as nails. They believed in capital – lots of capital – and wanted more of it as the economy got more heated.

This leads nicely into my topic today. I've been asked to address the recent financial crisis and to offer my views on whether we are on the right track or wrong track in our international approach toward bank regulation and supervision.

I've spent my entire career in the financial industry in various capacities. I began as a bank regulatory and acquisition expert at Foley & Lardner and then served as general counsel and corporate secretary for the largest bank in Kentucky. In 1978, at the tender age of 34, I was appointed by President Carter to the board of directors of the Federal Deposit Insurance Corporation. I was named Chairman of the FDIC in 1981 after President Reagan's election and remained in that position until the end of 1985, two years beyond my six-year term. I've been a consultant to financial institutions since leaving the FDIC and have served on several financial company boards, including my current service as non-executive Chairman of Fifth Third Bancorp, a leading regional bank.

Before proceeding, let me make clear that the views I express are my own and are not necessarily the views of any agency or firm with which I am or have been associated. For that matter, I'm not sure my family would agree with my views.

The period from 1978 to 1992 was exceptionally tumultuous for the U.S. economy and financial system. The 1970s was a period of low economic growth and high inflation – "stagflation" was the term coined to describe it.

Paul Volcker was appointed Chairman of the Federal Reserve by President Carter in 1979 with the mandate of getting inflation under control. Volcker, a courageous and principled man, did just that – but at great short-term cost. The prime rate soared to 21 ½%, creating havoc throughout the economy and financial system.

We suffered through a deep economic recession, and the unemployment rate climbed to 11%. A depression ensued in the agricultural sector along with a collapse in the energy sector and a serious recession in real estate.

The thrift industry was badly insolvent and the deposit insurance agency for the savings and loans was depleted and was merged into the FDIC with U.S. taxpayers absorbing $150 billion of losses.

Our largest banks were loaded with loans to lesser developed countries. The Federal Reserve, FDIC and Treasury developed a contingency plan to nationalize the major U.S. banks if the LDC countries renounced their debts.

Thousands of insured banks and thrifts failed during this period. Our seventh largest bank, Continental Illinois, right here in downtown Chicago, failed and was in effect nationalized by the FDIC and many regional banks went under, including nine of the ten largest banks in Texas.

Economic conditions in 2007-2008 were benign in comparison to 1980-1981. And the condition of the banking system was much better in the recent period than in the 1980s – only 400 or so banks and thrifts failed this time versus 3,000 in the earlier period.

Yet, we were able to get through the 1980s without creating panic in the financial markets and without perpetuating economic malaise. In fact, the economy began the longest peacetime expansion in U.S. history around 1983 even as we continued resolving thousands of bank and thrift failures. Today's economic recovery in the U.S., in contrast, is the weakest since the Great Depression.

How do we account for these differences in results between the two periods? Surely, fiscal and monetary policies and a dysfunctional political system have something to do with it. But without question regulatory policies also have a great deal to do with both the severity of the crisis in 2008-2009 and the tepid recovery.

I point specifically to the pro-cyclical accounting and regulatory policies we began to put in place about two decades ago. Sound bank regulation should always be counter-cyclical and lean against the prevailing winds.

The time to be tough on banks and to demand that they increase capital and reserves, tighten credit standards, and slow their growth is when the economy is booming, as it was in 2004-2007. When the economy is struggling, as it has been for the past five years, regulators should be encouraging relatively sound banks to increase their lending activities

rather than making incessant demands for more capital, piling on massive new regulatory burdens, and creating more uncertainty about the future.

Let me be even more specific about my concerns. Mark to market accounting was and is a highly destructive force in the financial world. Some refer to it as "fair value accounting" but I refuse to use that terminology because it is not "fair," it adds no "value," and it does not "account" for the actual results of operations. Mark to market accounting requires banks to mark their financial assets to current market prices even when the markets are barely functioning, as happened in 2008-2009. Mark to market accounting needlessly destroyed over $500 billion of capital in the U.S. financial system during 2008-2009 – eradicating some $4 trillion of lending capacity and creating chaos in the financial markets.

The U.S. employed mark to market accounting during the 1930s. President Roosevelt in 1938 asked Secretary of the Treasury Henry Morgenthau to meet with regulators to determine why banks were not increasing their lending and helping the U.S. recover from the Great Depression. They concluded that mark to market accounting was a serious impediment to bank lending and agreed to move to historical cost accounting.

That's where things stood until the Securities and Exchange Commission pushed the Financial Accounting Standards Board to revert to mark to market accounting in the early 1990s, a move opposed by the Federal Reserve, FDIC and Treasury. Secretary of the Treasury Nicholas Brady wrote to the FASB on March 24, 1992 opposing mark to market accounting, saying in part: "Market value accounting could even result in more intense and frequent credit crunches, since a temporary dip in asset prices could result in immediate reductions in bank capital and an inevitable retrenchment in bank lending capacity." He could not have been more prescient.

Despite the abysmal performance of mark to market accounting in the recent crisis, accountants and regulators refuse to sweep it aside and in fact are proposing to expand it to include loans, which would have a devastating impact. Let me be very clear: there's no place for mark to market accounting in banking apart from assets held in trading accounts. Loans and securities not held in trading accounts should be written down only if there is serious doubt about collection of the full amount of principal and interest. Fluctuations in value due solely to market movements should be disclosed in footnotes to the balance sheet and should not impact banks' capital accounts.

Another major area of concern for me is the Basel capital accords, which rely on exceedingly complex, backward looking models to measure risks and set capital

requirements for banks. Basel I (we are now on Basel III) was suggested when I was still Chairman of the FDIC. It sounds good in theory to set capital requirements in accordance with perceived risks, but I had and still have major concerns.

Models are necessarily backward looking. They can’t see around corners and can only predict the future based upon the past. This means that models are pro-cyclical and accentuate whatever has gone before. Boom times are extended beyond reason as are difficult times. That clearly happened in the 2004-2007 boom period and is happening today in the opposite direction. Moreover, how do models cope with unknowable factors such as the impact of unprecedented fiscal and monetary policies and the whimsical impact of mark to market accounting?

I was also concerned about the temptation models would create for the government to use them to allocate credit. My specific concern in the 1980s was that regulators would be under great pressure to underweight politically favored classes of loans such as residential real estate and sovereign loans. This, of course, happened to such a massive degree that these two classes of loans are at the core of today’s worldwide financial crisis.

Despite their utter failure in the recent crisis, models are being used to an even greater extent today. All banks of consequence are required to allocate capital and reserves and stress test their portfolios based on models. And we continue to have a political debate about how residential real estate and sovereign loans should be weighted.

Don’t get me wrong, I believe models can be useful tools to aid management and regulators. But they are no substitute for wisdom, experience, and sound judgment in operating and evaluating a bank.

Models must be accompanied by absolute standards for safe and sound banking and by hands-on supervision of banks. We need a minimum ratio of tangible equity capital to total assets in all banks, and I would set that number at somewhere around eight percent. And we need on-site examiners evaluating assets, governance processes including board oversight, management capabilities, and compliance with laws.

In his speech at the Asian Banker Summit in Jakarta on April 24 of this year, FDIC Vice Chairman Tom Hoenig suggested that the U.S. adopt a minimum ratio of tangible equity to total assets as the primary measure of capital adequacy and use risk-weighted capital as a secondary measure to insure that banks do not take excessive risks. I concur wholeheartedly.

Another serious concern of mine is that bank regulation is being made uniform throughout the world. I know this might strike you as a bit odd because it is conventional wisdom that world-wide uniformity in bank regulation is a good thing and will prevent competition in laxity.

While that notion has a certain amount of appeal, it breaks down when the rules of the road are uniformly bad and are set at the least common denominator. If regulators throughout the world are pursuing the same pro-cyclical policies and are employing models that underweight or overweight risks and fail to properly account for important macro-economic factors, how do we get out of the mess we’re in?

The most fundamental risk control element in banking is diversification. Europe can’t help the U.S. right now and the U.S. can’t help Europe because we are both in the same mess at the same time for the same reasons and we are employing the same remedies. I much prefer that the U.S. focus its energy on getting the U.S. policies right and a good place to start would be rejection of Basel III in its present form.

Banks provide loans and access to capital markets to allow businesses to grow and create jobs and consumers to save, borrow, and make payments. They are absolutely essential to economic growth. People enjoy cursing banks from time to time, but in truth we cannot prosper without them.

There have always been bank failures and always will be. The trick is to allow sufficient risk taking to promote economic growth but not so much that leads to widespread failures and financial panic.

It’s clear from the three major banking crises in the U.S. in the past 40 years (1974-1976, 1980-1992, and 2008-2009) that we have not achieved this balancing act. None of these crises occurred because of lack of regulatory authority but rather the failure of regulators to use their authority effectively to rein in excessive speculation by financial institutions. We responded to each crisis by piling on more burdensome regulation without addressing the actual causes of the crisis or the ineffective regulatory system that allowed it to happen. Ineffective regulation is worse than no regulation because it gives citizens a false sense of confidence that government is protecting them.

The recently enacted Dodd-Frank legislation is the worst of many bad examples. It’s some 2,500 pages long and will produce more than 20,000 pages of new regulations from the same regulators who presided over the last three major financial crises. Dodd-Frank does not address the major causes of the recent crisis or offer any new approaches to prevent the next one.

What regulatory authority did bank regulators not have to rein in the risks taken by financial institutions that precipitated the latest crisis? What regulatory authority did the SEC not have to rein in the excessive risks and grossly inadequate liquidity plans of investment banks? I can’t think of any.

It’s naïve and contrary to all historical experience to believe that Dodd-Frank and the Basel III capital accords, which significantly increase the cost of capital and regulation to banks and their customers, will solve the problems or will eliminate too big to fail banks.

So how do we fix this perennial problem? The solution is a combination of greater market discipline and more effective regulators, not mountains of senseless regulations.

There are three warning signs when an institution, large or small, is approaching the danger zone. We need regulators who have the political will and financial skill to take strong actions when they see these warning signs develop and before they become large enough to crash the system.

The first warning sign is concentration of risk. Most financial institutions fail because their risks are too concentrated by geography, industry and/or product line. A large bank should be able to diversify its risks more broadly than a small bank. Admittedly, if a large bank does not diversify its risks, it can cause considerably more damage than a small bank.

During the 1980’s, Texas banks were among the most profitable and highly capitalized in the country just before nearly all of them failed. They failed because there was no interstate banking at that time and they were concentrated in Texas commercial real estate and energy loans.

The second warning sign is inadequate liquidity. Bear Stearns and Lehman Brothers reported relatively high levels of capital, but they failed because of insufficient liquidity – the proverbial run on the bank. It’s stunning that those institutions were allowed to operate with balance sheets approaching a trillion dollars funded primarily by short-term wholesale liabilities. Inadequate liquidity has been a primary cause of financial failures, forever. Why can’t management and regulators get this right?

The third warning signal is significant exposure to capital markets on the either the asset or funding side. Capital markets have seized up in the past and will seize up in the future – and it usually can’t be anticipated. The Russian crisis of the 1990’s brought down Long Term Capital Management. Russia was less than one percent of the world’s economy yet resulted in a worldwide financial crisis and meltdown.

Any company that syndicates and sells a large percentage of its loans and other assets is at greater risk of failure than a company that originates and holds its assets. Capital markets can seize up at any time and severely disrupt the business of a company that relies on an originate-and-sell business model. Moreover, with little or no recurring income because originated and securitized assets are sold not held, you have to keep "feeding the beast" – originating and selling more and more regardless of the risk and markets. When this model also relies primarily on short-term wholesale funding sources, it's especially toxic – a clear sign to regulators to be vigilant.

Given the long history of financial crises, we should acknowledge that regulators are not capable of preventing them without turning banks into government-controlled public utilities that are inhibited from taking sufficient risks to support economic growth.

We need a system that assumes failures will occur but are handled in a way that does not devastate the economy or result in taxpayer bailouts. We must make clear that in all bank failures creditors, other than insured depositors, will face risk of loss so that neither the FDIC nor taxpayers will lose money.

Requiring large firms to increase their common equity capital to breathtaking levels – say above 9% of assets – is not the answer. That lowers return on equity to the point that banks will be unable to raise sufficient capital and will shrink their balance sheets, impeding economic growth. The very companies and individuals who most need bank loans will be denied access. This is happening in Europe and the U.S. today.

Because equity capital is permanent and cannot declare an "event of default" when it perceives the risks to be excessive, it's only marginally effective in imposing discipline on management. Moreover, equity holders have upside potential and are therefore more tolerant of risk than creditors.

If equity plus long-term senior and subordinated debt is set at a minimum of 20% of assets, and creditors other than insured depositors are placed at risk, it's highly unlikely that the FDIC, much less taxpayers, would ever incur losses. Moreover, this plan will impose discipline by the marketplace, making failures much less likely. A risky bank will have to pay higher interest (sending a clear negative signal to management, the board, investors and regulators) and ultimately might not be able to issue long-term debt, forcing it to curtail growth.

When a large bank fails, the FDIC will place it in a bridge bank that will operate under FDIC control with new management and directors. The bridge bank will continue to serve the needs of depositors and borrowers, while leaving the equity, long-term debt, and

perhaps a portion of the uninsured deposits behind in a receivership with no guarantee of recovery. The bridge bank will be re-privatized as soon as possible.

These measures – smarter regulation coupled with greater market discipline – will significantly reduce moral hazard, end too big to fail, and make taxpayer bailouts a thing of the past. Dodd-Frank and similar laws around the world need to be replaced with serious reform legislation that addresses the real issues.

Thank you again for inviting me to participate in this wonderful forum. I will be pleased to take any questions you might have.