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Program

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Introductions

GLENN HUBBARD: Good afternoon everyone. Welcome. If I could just have your attention, it is my pleasure to welcome you to the 403rd meeting of the Economic Club of New York in our 102nd year. I'm Glenn Hubbard, the Chairman of the organization. The Economic Club of New York is the nation's leading non-partisan forum for discussions of business and economics. More than a 1000 guest speakers have been before the club over the past century, and their names are listed in your program. The speakers share a strong tradition of stature, of substance, of excellence. I also would like to recognize the members of our Centennial Society. Several dedicated club members sparked the formation of the society to insure the club's long term financial standing, and their names are in your program.

We are, of course, honored today to hear from our speaker, Sheila Bair, who is the Chairman of the FDIC. Sheila was sworn in as the 19th Chair of the Federal Deposit Insurance Corporation on June 26th, 2006. She was appointed Chairman for a five year term and is a member of the FDIC's Board of Directors through July of 2013. I had the privilege of working with Sheila in the Bush Administration and can speak first hand to her many talents that are known to you all. Before her appointment in the FDIC, she was Deans Professor of Financial Regulatory Policy for the Eisenberg School of Management at the University of Massachusetts Amherst. She also had served as Assistant Secretary of the Treasury for Financial Institutions. Since joining the FDIC, Sheila was named by Forbes Magazine in 2008 as the second most powerful woman in the world. She has been actively involved in helping resolve the financial crisis, and needless to say, we all look forward to her insights there and what she has to say. After her remarks, as is our custom, two designated club members will ask the questions. Chairman Bair, you have the floor.

HONORABLE SHEILA BAIR: Thank you Glenn. That was a very kind introduction. I am very honored to be here this afternoon. I'm told this is the first time in your distinguished 102 year history that you've invited an FDIC Chairman to speak. You get Presidents, Prime Ministers, Five Star Generals, lots of Fed Chairman and Treasury Secretaries and many Corporate CEOs, not to mention the U.S. Senate Majority Leader, my former boss, Bob Dole. That's a lot of gravitas and intellectual capital to follow. So I'm feeling it, dare I say it, that this is my own personal stress chest.

I hope that the ideas I discuss with you today will have value in the ongoing debate over how we restore our financial sector to vitality and return it as the engine of growth for the real economy. During a recent visit to the University of Massachusetts where I used to teach I was asked by a former student who knows my market base proclivities to explain the extraordinary government intervention of the past several months. Well how do you explain what the government is doing? As a lifelong Republican and market advocate, it's not easy. The government is going into places where we don't want to be. We're doing things we'd rather not be doing, but had little choice not to undertake them, and they have worked so far.

We have moved beyond the liquidity crisis of last year. Most major institutions managed to turn a profit in the first quarter, and one of the few that didn't was hurt by an improvement in its credit spreads, which damaged its balance sheet by increasing the theoretical cost of repurchasing its own debt. As I see it, we are now in the cleanup phase. We need to get in, do the repair work and get out. We must also look to how to improve our system for the future.

At the FDIC we have two Credos, which have pretty much driven our corporate culture over the past 75 years. One, no depositor should ever lose a penny of insured deposits and none ever has. And two, failed banks should be closed expeditiously. There should be a minimum of disruption, their financial assets quickly sold back into private hands, and the losses first absorbed by their shareholders and creditors to maintain market discipline. This FDIC resolution mechanism has worked in prior eras when the vast majority of financial activity occurred inside insured depository institutions. The reality is the bulk of the financial activity which has driven the current crisis falls outside of FDIC insured banks.

The past 25 years have seen vast changes in how credit is provided and the types of firms which provide financial intermediation. Unfortunately, our laws for dealing with financial crises have not kept pace with these changes. As a consequence we have very different laws to resolve the different parts of a financial firm. This makes a coordinated resolution of entire financial organizations which may or may not include an FDIC insured bank almost impossible.

As I will discuss later, the bankruptcy process simply does not work for large, systemically important financial institutions in a way that can preserve stability and avoid disruptions in the financial system. The lack of an effective resolution mechanism for large financial organizations is driving many of our policy choices, and it has contributed to unprecedented government intervention and to private companies. It has fed the too big to fail presumption, which has eroded market discipline for those who invest and lend to very large institutions, and this intervention in turn has given rise to public cynicism about the system and anger directed at the government and financial market participants.

We need a new resolution regime for these large institutions, which does a better job of imposing loss on investors and creditors instead of leaving it in the hands of government and the laps of the taxpayer. To be sure, creating such a resolution mechanism would be very bold, but recent history I believe has shown that it is a very necessary step. For 75 years the FDIC has quickly and effectively resolved failed banks. We are good at this. We have a lot of practice over the years. The 60 Minutes news program a couple of weeks ago told the story well I think, and maybe you saw it.

When an FDIC insured bank or thrift is in danger of failing, the FDIC has standard procedures that kick into gear. Typically where a bank is approaching insolvency, we invoke prompt corrective action. This involves formal notification to the bank of its undercapitalized status and the need for a corrective plan. We begin assembling an information package for bidders with the structure and terms of the transaction, and then we send FDIC staff to review the bank's books, contact perspective bidders and begin the process of auctioning the back to achieve the best return to the deposit insurance fund. Our staff work with the acquiring bank and make the handover as unintrusive and seamless as possible, arriving at the field bank after it closes the doors for the day, usually on a Friday night. The FDIC takes control of the bank and begins the closing process.

At the same time, the acquirer begins to prepare the bank to reopen. Overnight all insured deposits are transferred to the acquiring bank and are made available online or through ATMs. By Monday morning the bank reopens with a new name and under new control of the acquiring institution. The FDIC is hard at work dealing with the field bank's assets in accordance with our priority structure. This is the typical process, so sometimes banks have to be closed because of an inability to meet their funding obligations. These liquidity failures can be more sudden and require that we set up a bridge to give us time to market and sell the institution.

The biggest positive from our process is the very quick reallocation of resources from the weak to the strong. Make no doubt about it, this can be a painful process for shareholders, creditors and bank employees. But the differences between this process and the governments actions since last fall in dealing with the nation’s largest institutions are stark. Was it pretty? No. Given the benefit of hindsight, could things have been done differently? Perhaps. But most of us in this room I hope would agree that the government’s actions were necessary and successful for now in stabilizing a very volatile situation. But going forward, it is very clear in my mind that we need new tools and new methods to promptly and effectively deal with the cleanup.

We must not forget the lessons learned from the savings and loan debacle in the 1980s. Delay was very real and had very significant cost. The S&L crisis started in 1980 when interest rate controls on deposits were lifted at a time of historically high interest rates. With most S&Ls holding long term fixed rate mortgage portfolios, the higher interest rates for deposits generated huge losses, almost completely wiping out the industry’s tangible capital two years later. While some S&Ls were closed, the main response was in manipulating accounting rules, reducing capital requirements, lightening up supervision and basically hoping it all worked out. Seven years later, the thrift industry collapsed generating billions of dollars in losses in residential and commercial real estate.

The Resolution Trust Corporation was then created with taxpayers forced to pay $124 billion to shut down $750 S&Ls. Not a pretty site and not an easy case to explain to taxpayers. But it had one redeeming virtue. It removed a huge backlog of toxic assets to our nation's portfolio which allowed our economy to move back into the black. The FDIC's resolution powers are extremely effective when a smaller bank fails, but they fall short when it comes to a very large financial organization. Why? The main problem is that we don't have the ability to resolve bank holding companies. We can only resolve the insured depository institution within the holding company. When a failing bank is part of a large complex holding company, many of the essential services for the banks operations lie in other parts of the company outside of our reach.

The loss of essential services can make it difficult to run the bank. Because of the complex network of corporate relationships, holding companies often wield critical control over bank and non-bank subsidiaries as well as mutually dependent business activities. It's not unusual for many corporate services to operate in both the insured and non-insured affiliates without regard to legal separation. In some cases, the insured deposits were maybe so dependent on its holding company that it is difficult, if not impossible to operate without holding company cooperation. This can hamstring the FDIC and our ability to preserve the bank's franchise value and minimize losses to the deposit insurance fund, which is our number one mandate. Taking control of just the bank is not a practical solution. A basic change to give us the ability to resolve both banks and their holding companies would remove a key limitation and the tools we currently have to deal with non-viable large institutions.

The second reason we need a change in the game rules is the FDIC's resolution powers don't apply to financial firms that are not depository institutions. These firms, like bank holding companies, must be resolved through bankruptcy. This can be a messy business in the case of systemically important non-bank financial firms. Bankruptcy is designed to protect the interest of creditors, not to prevent a meltdown of the financial system when a systemically important financial firm gets into trouble. When a firm is placed into bankruptcy, and automatic stay is put on most creditor claims to allow management time to develop a reorganization plan. This can create liquidity problems for creditors who must wait to get their money. For financial firms, bankruptcy can trigger a rush to the door as counterparties to derivative contracts exercise their rights to immediately terminate the contracts, net out their exposures and sell any supporting collateral.

When these statutory rights were initially provided in the 1980s and expanded in 2005, they were designed to reduce the risk of market disruption. However, during periods of economic instability, this rush to the door can overwhelm the market's ability to complete settlements, depress prices for the underlying assets and further destabilize the markets. This can have a domino effect across financial markets as other firms are forced to adjust their balance sheets. Financial firms are highly interconnected. They are central to credit and liquidity, and tying up those intermediation functions during a court based process is untenable. We need a process that provides for continuity in functions as the government undertakes an orderly transfer or unwinding of the firm's positions. At the same time, special expertise is required to provide that continuity while also protecting market functionality and taxpayer exposure. This stands in contrast to the mandate of a bankruptcy court, which is to protect creditors.

Our goal should be to create a new resolution process that imposes losses on the appropriate parties without interrupting essential operations. Bankruptcy doesn't meet these objectives. For instance, the FDIC has special resolution authority to prevent immediate closeout netting and settlement of an insured depository institutions financial contracts. We have 24 hours after appointment as receiver to decide whether to transfer the contracts to another bank or to an FDIC operated bridge bank or to cancel the contracts. This remedial authority prevents instability and contagion, which is what you can get from bankruptcy. The lack of a resolution mechanism has required the government to improvise for each individual situation making it very difficult to address systemic problems in a coordinated manner.

On top of that, there is the matter of fairness. There needs to be a clearly laid out process in place. Governments should not be in the business of arbitrarily picking winners and losers, and smaller banks shouldn't be subject to one regime while larger institutions and non-banks are subject to another. Investors and creditors have lacked strong incentives to perform due diligence because of the perception that these institutions are so large and complex that the government would have to bail them out—and they were right. What's needed is a new way to unwind these big institutions. We need an effective resolution mechanism, not a get out of jail free card. Taxpayers should not be called on to foot the bill to support non-viable institutions because there is no orderly process for resolving them. This is unacceptable and simply reinforces the notion of too big to fail, a 25 year old idea that ought to be tossed into the desk bin.

When the public interest is at stake, the resolution process should support an orderly unwinding of the institution in a way that protects the broader economy and the taxpayer, not just private financial interests. To be sure a new resolution regime is not a panacea. We also need better and smarter regulation. Many of the institutions that got into trouble were already heavily regulated. We didn't do enough to constrain leverage, regulate derivatives, and most important, protect the consumer. We forgot that there is a difference between free markets and free for all markets.

But while considerable attention has been focused on regulatory shortcomings, not enough perhaps has been focused on the lack of market discipline fostered by too big to fail. To address this problem, we must have a realistic way to close and resolve non-viable systemic institutions. Here is how a resolution authority could help. Many have cited a good bank/bad bank model for resolving these institutions. Under the scenario, you take over the troubled firm, imposing losses on stockholders and unsecured creditors. Viable portions of the firm would be placed into the good bank using a structure similar to the FDIC's bridge bank. The non-viable or troubled portions of the firms would remain behind in a bad bank and would be unwound or sold over time. The cost of the bad bank would be partially paid for by losses imposed on stockholders and unsecured creditors. Any additional costs could be borne by assessments on other systemically risky firms.

This has the benefit of quickly recognizing losses in the firm and beginning the process of cleaning out the mess. The stockholders and managers of some big banks might not like this process. They might prefer a too big to fail subsidy or investment from the government. Some regulators might fear it because it would give an independent body the ability to close institutions for which they are responsible. It would be a brave new world, which in the short term could increase the cost of capital for large institutions. Investors and creditors will come to understand their own responsibility and the wisdom of conducting due diligence of the strengths and weaknesses of bank managers and balance sheets. In turn, investors and creditors will charge a premium for the newly recognized risk that these institutions could indeed fail. But that is as it should be. Everybody should have the freedom to fail in a market economy. Without that freedom, capitalism does not work. In the longer term, illegal mechanism to resolve systemically important firms would result in a more efficient alignment of capital with better managed institutions, and ultimately this would benefit those better managed institutions and make the financial system and the economy stronger and more resilient.

So who should pay for an anybody can fail doctrine? Well certainly not the taxpayer. As a taxpaying citizen I don't favor encouraging foolish behavior. Nor should those costs be borne by the deposit insurance fund, which should continue to be used only for the cost of protecting depositors when banks fail. A new resolution authority could include assessments on large firms to fund a reserve that would be tapped to absorb losses for a failure. I believe it's only fair that the industry that benefits should pay just as banks pay for deposit insurance now. The assessments could based on the differential and the cost of capital between smaller institutions, which clearly can fail, and thus have higher cost, and their larger competitors. More over we should not base this strictly on size, which not be perfectly aligned with risk. For example, a large mutual fund that invests in the S&P 500 is not systemic. Risk based surcharges should be imposed on high risk behavior. This might include certain types of derivatives trading, market making or proprietary trading or rapid growth. We now have such a risk based system for the insurance premiums we charge for deposit insurance and it's working very well.

Who is best able to get the job done? Well I don't think we need another government bureaucracy or program. This is cyclical work and we've had a lot of agencies already, perhaps too many. I'm not sure it makes much sense to create another one that would need to be staffed up and ready to go. But the FDIC is up to this task, and whether alone or in conjunction with other agencies, the FDIC I believe is central to the solution. Given our many years of experience resolving banks and closing them, we're well suited to run a new resolution program. Some have said we don't have experience in resolving large institutions. Well but no other agency has the skills and tools needed for resolving these institutions. And the knowledge and skills, frankly, used to resolve smaller institutions can be applied in large part to the bigger ones. In addition, we can and would reach out to the private sector for experienced bank management to help us unwind and resolve larger entities. Creating a standalone resolution authority or housing it in another agency could actually lead to instability down the road. Systemic events are infrequent. The last big failure, the Continental Illinois crisis happened nearly 25 years ago. With such long periods between crises, it is difficult to imagine the duties of the standalone resolution authority in the interim. When crisis does strike, the authority would likely be understaffed and unprepared because we all know too well how hard it is to see the brewing storm. This would make it less lightly that authorities would be able to act quickly creating the kind of public panic a new independent authority was supposed to prevent.

So let me conclude by saying again that we cannot effectively solve the problems caused by the too big to fail notion unless we overhaul how we regulate and supervise big institutions and how we resolve them when they implode. Closing down a big name company is never pleasant. It's a messy business, but a necessary one in a market economy. To move forward, we can't let ourselves be prisoners of outdated authorities trapped in a resolution regime, which predated the evolution of the shadow banking sector crafted in a prior era when insured banks overwhelmingly dominated financial services. The sooner we modernize our resolution structure, the sooner we can end too big to fail and clear the way for a stronger, brighter and more stable economic future. Thank you very much.

GLENN HUBBARD: Thank you very much Sheila. As is our customer, we will have questions from two distinguished club members. Bill Donaldson, Donaldson Enterprises. He's had a very distinguished career, not only in the private sector, but also as SEC Chairman, and has had that very tough job of being a business school Dean as well on his resume. Also, Paul Gigot, who is the Editorial Page Editor of the Wall Street Journal. Paul, the first question goes to you.

PAUL GIGOT: Thank you Glenn. Madam Chairman, thanks for being here. I want to follow-up on your expanded resolution authority discussion because you've proposed this power and power for the FDIC, but one of the objections that many people, certainly many people in this room that I hear from have, with the government actions of the last six or eight months, has been their arbitrary quality. If the government is going to be getting what strikes me as a rather vast new power, what checks and balances should be part of this new authority to reassure all of us that it isn't used arbitrarily or for political purposes.

SHEILA BAIR: Well I think that's absolutely essential, and I would draw from the current resolution authority we have for depositor institutions. It doesn't need to be the same, but I think the same segments are important. For instance, it spells out a very clear claims priority. Who needs to take losses before the government takes losses. It mandates least cost resolution so that the entity, the resulting entity has to pursue the less costly alternatives of resolution options so long as that is not disruptive to the larger system, but to deviate from least cost, there's an extraordinary procedure which requires a super majority. My board, the Federal Reserve, the Treasury Department, and the President actually being involved in that decision. I would also support a directive in the statute, if Congress were to create this authority, that the goal should be to expeditiously wind down the entity and return it to private sector. I think there has been some difference in the tenor of the debate about resolution authority as to whether you're basically creating a mechanism to prop up the entity or whether you're creating a mechanism to resolve it. So I think it's really we're talking about an entity to resolve the institution, and I think those types of directions by Congress would be helpful. I think we have had an arbitrary process right now because there isn't any system. We can do banks and then there's a bankruptcy option for the holding companies of the non-banks. And as we saw with Lehman Brothers, there's a lot of difficulty. So without a standardized resolution regime, the situation has been ad hoc, and I think has fed into perceptions that government now is being arbitrary. That's a good question.

BILL DONALDSON: Let me begin by commending Chairman Bair for her leadership for the FDIC. This has been a very difficult time, the FDIC has a tremendous history of famous closing events on Friday afternoon and opening them up on Monday morning with no apparent harm to those involved. However, we're in a period now where the latest estimate of the IMF, in it's global financial stability report, estimated in October of 2008 that there would be losses of $1.4 trillion. That estimate was changed in January of 2009 to $2.2 trillion, and in April of 2009, $2.7 trillion. The $750 billion of TARP funds is now down to a $100 billion. Currently, the environment's deteriorating, and yet to restore bank balance sheets to pre-crisis levels, tangible common equity to tangible assets of 4% will require $275 billion in capital injection. Once the stress test results are released on May 4th, and assuming the estimated losses projected by IMF are as I mentioned, what do you see under this condition of real stress as the next step given the reluctance of Congress to give more dollars? Partial nationalization, managed insolvency or something else?

SHEILA BAIR: Well I do, I think a resolution process to be included in the tools that we have, as indicated, I think is important. I also think, the IMF seems to be high in terms of others that have put out those estimates, so there's no question that we still have a lot of losses to work through. If we have to, absent new authorities that might be provided by Congress, I think the path we're on now, at least for insured depository institutions and bank holding companies, those that are being subjected to the stress test now, I don't want to front run any announcements, but I do believe the current resources of the treasury will be sufficient. And we've also instituted the legacy loan programs and the legacy securities program to provide a way on an open bank basis, to provide some relief and a way to work out troubled assets currently on the balance sheets of financial institutions, and we're relying trying to leverage private sector resources to do that in a way that's responsible and prudent and protects the taxpayer.

So I think though the losses are there and will have to be worked out over time. For loans at least, most of them are held for investment, so they don't have to be immediately marked, and one of the purposes of the stress test is to see what, over a two year more adverse scenario, what the losses might look like and make sure that the capital buffers are adequate now or in the very near term to get us through that. And then I think again, for the very troubled assets, it's important to recognize those losses early, clean it up, acknowledge it, and I think that will also give the industry the ability to recapitalize with private sector money, which is important because, again, we want the government to get out of this.

So I do think the tools, Bill, are there without additional TARP capital being made available, and we'll obviously keep a close look on the situation, but I think for now we have the resources we need, and we're having to get a little creative because we do need an updated system, for resolutions, in particular, but given the structure that we have, I think we can work through it with available resources.

PAUL GIGOT: Bank of America CEO, Ken Lewis has testified under oath that last December he wanted to drop his acquisition of Merrill Lynch under a material adverse condition clause because of big Merrill losses. Yet, Mr. Lewis says that the Treasury Secretary at the time told him that he could not do that, could not bow out of the merger, and moreover, that he should not tell his shareholders about Merrill losses before they voted on the merger. Was this fair to Bank of America shareholders, and do you think the Treasury's handling of the BofA/Merrill Lynch merger reduced or increased systemic financial risk?

SHEILA BAIR: I'm going to ask Glenn if we can give Paul another question because I can't answer that one. I'm afraid I just can't comment on that, I'm sorry. Would you like to ask another?

PAUL GIGOT: Not even on the shareholder fairness point?

SHEILA BAIR: You know, I never comment on open and operating institutions, and BofA clearly is an open and operating institution. If you could rephrase your question to be a journal policy question, then perhaps I could get into a discussion with you then.

PAUL GIGOT: Well I tried. Let me ask you, just to follow up on Bill's question about the dwindling TARP funds. There's a bill before Congress that talks about, that you are aware of, that would give your institution $500 billion more in borrowing authority from the Treasury to do a variety of things, mostly to protect deposits. But I wondered if you have the statutory authority to use that $500 billion to purchase troubled assets from individual banks that may be failing but not have failed, that you're not planning to resolve?

SHEILA BAIR: Well, just one point of clarification. The borrowing authority would be increased permanently to a $100 billion, and then there is a temporary increase to $500 billion in an emergency situation. Again, that would require our extended risk procedures, which are extraordinary, super majority of my board and the Federal Reserve board and the Treasury Secretary and the President all agreeing that we needed to tap into that. So I don't anticipate going above that $100 billion unless we were truly in an emergency situation, and I think the loan program is not that type of situation.

We've been seeking an increase in our borrowing authority since last year. It really is. It's all about protecting depositors, that's the reason this has been requested. It's not tied to the legacy loan program. We think that through our ability to control the amount of leverage that we would provide in the legacy loan program, charge a guarantee fee, get our own third party valuation of the credit quality of the assets, and also have price validation through private investors that our risks actually for the legacy loan program are going to be manageable.

If we did have losses on that, we would have to do an assessment. Also included in that provision is an ability to assess holding companies for programs that benefit holding companies, and that might also be an important tool they have. But no, the borrowing authority really is for depositors. It's not for the legacy loan program, and I think our normal borrowing authority, again, with the safeguards we can build into the legacy loan program to protect us, we project zero net cost, but if there was cost, again, it would be made up through an industry assessment.

BILL DONALDSON: Following the release of Treasury's complex, but I believe plausible plan to leverage government loans and private capital to purchase impaired assets, the PPIP, there was a rally in bank equities. However, the surge came to an abrupt halt following the release of Bank of America's first quarter results on April 20th. The $4.2 billion operating profits were seen as largely the product of exceptional non-recurring items with a little aggressive accounting. As a result, focus on loan loss provisions which jumped by $6.2 billion resulting in fear of further losses and a possibility that the Treasury might put their preference shares of banks into common equity which would improve the capital position, but definitely have a harmful diluted effect on common shareholders presented a dilemma. Large banks have little incentive to sell impaired assets because current market to market value underestimates the real worth, but rising delinquencies, credit card losses and so forth must make progressively higher loan loss provisions. PPIP provides loss protection and incentives to investors who want to purchase impaired assets, yet it gives banks few inducements to sell. How do you think that's going to evolve in the next few months?

SHEILA BAIR: Well a couple of things. I think this is another tool in the overall strategy to strengthen bank balance sheets. I think it can be an important part of an ability to recapitalize if the bank's balance sheet can be cleansed, even if that requires recognizing some loss to sell those assets. With a clean balance sheet, you're in a stronger position to go out and raise private non-government capital, and at the end of the day that's what we want. We want a government exit strategy.

I do think as well in terms of incentives for banks. I think, first of all, some of these assets have already been marked, if there's been an acquisition, for instance, some banks have already marked even the whole loan assets. So it's not necessary the case for those assets if they wanted to sell them, but they would take a loss, and even for those that are held to investment that have not been marked yet, I think, again, the advantage you have by having a clean balance sheet to raise private capital. As well as I think we will try to provide some equity piece of the consideration given to the selling bank. So, for instance, obviously a selling bank wouldn't have any role in the auction process or the pricing of the assets, but we would like to give them an opportunity as the consideration that they get for the assets, to take some part of that in an equity interest in the PPIF that acquires their assets. That way if the price is lower and there are significant returns on it, that they will be able to reclaim some of that.

We've actually had a number of conversations with banks, and I think that structure is something that they're comfortable with. Ironically, I think the biggest issue we're going to have is with TARP, and I think the people on the selling side as well as the buying side, there's a sense that there is uncertainty in a potentially changing landscape in terms of the rules that would apply and what would and would not apply or be considered TARP assistance. So I think that is really going to be crucial to get that clarified going forward. But I do think through the structure and providing some opportunity for an equity upside for the selling bank that we will be able to have good participation in the program. That's certainly our hope. Good question.

PAUL GIGOT: Well former Federal Reserve Chairman, Paul Volcker, recently said that I never thought I'd live to see the day when the financial system is so totally dependent on the behavior of the U.S. government, and we've got to fight to get away from that. What, in your view, are the two or three most important things that have to happen. Other than your resolution authority, which I assume is one thing, but in addition to that, that have to happen so we can get back to private banking in this country, a private financial system, and specifically, how do you envision the FDIC Bank Debt Guarantee Program, how long do you think that needs to stay in place or is that something that will stay permanent too?

SHEILA BAIR: No, it will not. Let me answer that part first. It is scheduled to expire now at the end of October. We significantly raised a surcharge, we significantly raised the cost of the…Debt Guarantee. So the surcharges we're going to put in the deposit insurance fund to ease some of the pressure there on all banks, large and small for keeping the deposit insurance funds strong. There has been a slowdown already in issuance, so I think there's some indication that making it more expensive works. And so, my firm intention is that we get out of it by the end of October. Frankly, it was something I never wanted to do. I've always been uncomfortable with it. But I think it has been a successful program. It has stabilized the debt markets and revived lender bank lending and the spreads have come down. So its purpose has been successful.

We need an exit strategy for this and every single other Federal program, which again is why my sense is resolution authority is really just another tool as part of, I think, as a broader strategy, to take a deep breath and recognize the losses now. Recognize them, recapitalize and get the government out. I think the longer we leave those assets, the troubled assets, the legacy assets on bank balance sheets, the more uncertainty investors will have and the more reluctance they will have to start investing in banks again. So I would say though long term I think banks are very well positioned. Marketshares come bank already, deposit funding is stable. It's been a very important source of funding for banks to support the economy. So I think long term banks are very well positioned, and which is another reason why let's identify these troubled assets, recognize the losses, get them cleaned up and really show investors that you have strong balance sheets, and because I think long term the banking sector is very well positioned.

BILL DONALDSON: The PPIP envisions six dollars of non-recourse lending to induce private sector purchases of high risk assets. In effect, the banking system itself is relieved of these toxic assets, but floated out, once again, with high leverage and does nothing about the toxic assets themselves. Does this not set the stage for the possibility of a kind of an arbitrage? Purchasers get highly leveraged upside for better assets purchased with the government getting very little for providing leverage, but assuming a need to offset bad loans. If they are really bad, then the big bets with slim equity result in the FDIC taking most of the risk. Is this not a dangerous bending of the FDIC modus operandi? It's long record of successful closing of struggling non-economic viable banks. Is the PPIP the best solution? And what other solutions are possible, have been considered and rejected?

SHEILA BAIR: Well I think of the available tools, PPIP, is an appropriate structure and a way that we can address troubled assets because they need to be addressed. And I would also say even though we think resolution authority is a good tool, clearly there are many viable institutions that still have some of these assets on their balance sheet. So we need a mechanism I think to cleanse those assets for all institutions, or most of them, and large ones as well as small ones, and we structure the program along those lines. The 6 to 1 leverage is the absolute maximum. We wanted to get out there with the maximum that we would want to provide. And even though that sounds like a like, it's actually, you know, typical bank balance sheets are leveraged 10, 12 to 1, and we insure those deposits on an unsecured basis. So in terms of the risks that we take as a deposit insurer is really not that eye popping.

You know, leverage, responsibly used, can be an important tool. I mean, for decades, we had a very good system in mortgage finance in this country that was based on a 20% payment down for a non-recourse loan, to buy a house, and with that 20% skin in the game, you saw that mortgage borrowers, for the most part, stuck with their mortgage and paid their mortgages, and we certainly didn't get in the kind of situation we're in now. So leveraging in and of itself is not a bad thing. If responsibly used we think it can be a good thing. The lack of the ability to get credit to buy assets now is weighing, we think, on asset prices and creating prices that are far lower than what their true value is. So providing some degree of financing with an FDIC guarantee for the PPIF, we think we can tease the liquidity premium out, but still come up with a good, fair price through third party private investor validation of the pricing.

So we do think there are a number of safeguards that are built in, we think responsibly used leverage is not a bad thing, it's a good think. It can help, back to your earlier question about how to better leverage, if you will, resources that the treasury has, the this is an appropriate mechanism and an appropriate role for the FDIC. So, again, I think it's having a broader arsenal of things, including resolution authority would be helpful, but given the current authorities, I think this is a structure that is creative. Granted, a little bit outside of the norm, but I think appropriate. You know, we have the risk. As the program is currently structured, we would only buy loans from banks, from banks we insure. So we have a lot of that risk already, and it's in our interest to provide a mechanism for dealing with it.

GLENN HUBBARD: Paul, last question.

PAUL GIGOT: You mentioned the TARP. There's been a debate about when and how banks should be allowed to leave the TARP. If a bank has the capital to be able to repay and is eager to do so, do you think that that decision to escape the TARP should be up to the discretion of the bank or should that be at the discretion of the Treasury or Federal Reserve?

SHEILA BAIR: Well I think it should be done in consultation with the appropriate supervisory authority, and I will tell you I think that bank holding companies and banks can sometimes have perhaps rosier views of the strength of their capital position than others might, and so I think the reason the TARP capital was put in there to begin with was to make sure that their balance sheets were, you know, not just keep them afloat, but to keep them in a strong enough position to lend because that's really what we need now. If we don't have banks lending, this economic situation is going to get a lot worst. So I do think it's appropriate for there to be a supervisory consultation process. So I would say that that should be a bilateral discussion between the bank, bank holding company and their regulator.

GLENN HUBBARD: Thank you.

SHEILA BAIR: Thank you.

GLENN HUBBARD: Thanks very much Chairman Bair, Bill Donaldson and Paul Gigot. Please enjoy your lunch.

(END)