FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

SHEILA C. BAIR
CHAIRMAN

June 17, 2010

Honorable Luis V. Gutierrez
Chairman
Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I am writing in response to your request for my views on your proposal for a pre-funded working capital reserve (ex ante fund) for the orderly liquidation of systemically important financial institutions. My public support for an ex ante fund is long held and well documented.

Foremost among the needed financial reforms is a new legal and regulatory framework to resolve the failure of a large interconnected financial firm similar to the regime long in place for insured banks and thrifts. Such a liquidation regime would provide the government with the tools to ensure the orderly winding down of these institutions, without disrupting the broader economy, while imposing the losses on shareholders, bondholders, and other creditors. It also would bring sorely lacking market discipline to our largest institutions. A key element for such a regime – as it is for banks – adequate working capital to be used by the receiver to provide temporary financing to maintain operations as the institution is broken up and sold off.

The House passed bill, as well as the bill approved by the Senate Banking Committee, would impose assessments on large, interconnected non-bank financial institutions to build a working capital fund "up front." The Senate passed bill would instead require the FDIC to borrow from a line of credit established by the Treasury Department and assess the industry "ex post" to repay the Treasury Department for any shortfall. Ex post assessments could, I believe, result in either pro-cyclical assessments during an economic crisis, or multi-year delays in repayment. In contrast, an ex ante fund would provide the FDIC with the ability to charge regular assessments in "good times," providing more predictability to covered financial companies and better capacity to manage their expenses. The ex ante fund also would give the FDIC the authority to impose risk-based assessments on all large, interconnected firms, requiring the riskiest firms to pay the most. To avoid double charging banks that already pay deposit insurance premiums, your proposal appropriately bases the assessments on assets held outside of insured depositories.

As I have previously stated, I believe an ex ante fund provides better protection for taxpayers than a system borrowing all funds from the Treasury Department when needed and then repaying the borrowings through after-the-fact industry assessments. Even though it is contemplated that the funds will be fully repaid by the industry, the immediate temporary use of government funds would undoubtedly be viewed by the public as a government bailout. With the ex ante fund, any temporary use of government assistance would occur only if and when the industry funding is depleted. Finally, your proposal provides further protection for taxpayers by requiring the FDIC to recoup any costs associated with the resolution through additional post-failure industry assessments.

I appreciate that some believe an ex ante assessment could be viewed as a "bailout fund" and thus it is preferable to establish a Treasury line of credit. To address those concerns, I would only ask that one analyze the strong record of the FDIC in protecting the Deposit Insurance Fund (DIF). For over 75 years, the FDIC has maintained the DIF scrupulously in conformance with its statutory mandate – to protect insured depositors. The FDIC would be equally as scrupulous in protecting the integrity of an ex ante resolution fund, consistent with the express terms of this legislation.

Your proposal also places the budgetary burden of the new systemic risk regulatory regime where it belongs – on the entire non-bank financial sector. Resolution of insured banks will continue to be funded through the DIF. Over the decades, insured banks have paid heavily into the DIF to maintain the integrity of industry funding of deposit insurance, and this has been particularly true during the recent crisis. At the same time, as the financial crisis hit, the shadow sector collapsed into the regulated banking sector, reaping substantial benefits from the stabilization measures that were instituted. The burden of nonbank resolution authority should fall on nonbanks, and the FDIC is vigorously opposed to any proposal that meets pay-go requirements on the back of the Deposit Insurance Fund. The new resolution authority – like many other parts of this bill – is necessitated by instability created by the explosive growth of the shadow sector, and the shadow sector should pay for its costs. Since the current financial crisis began in 2008 the commercial banking sector has already paid in more than $65 billion to stabilize the financial sector through assessments to recapitalize the DIF. Commercial banks are projected to pay almost another $80 billion under the current DIF recapitalization plan by 2016.

Thank you for considering my views.

Sincerely,

Sheila C. Bair