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OPINION

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Please, Listen to the Lady!

The short essay below was first published online by ***The New York Times*** *earlier today, as part of its Dealbook blog, edited by Andrew Ross Sorkin. Please do not hesitate to offer comment at the Times' link below.*[1]

Sheila C. Bair, the Federal Deposit Insurance Corporation's chairwoman, has had a tough time keeping her opinions to herself during this financial crisis, often in private and, not infrequently, in public.

As head of an agency that is funded by the very banks it insures and regulates, one might think that she would be vulnerable to co-opting by her constituent banks. Instead, as unpopular as some of her positions are within the banking establishment, Ms. Bair has been a stern mother to her unruly brood, as she proved again this week by taking issue with elements of the Financial Stability Improvement Act negotiated between the Treasury Department and the House Financial Services Committee.

Ms. Bair's primary issue in connection with the act is the need to have banks absorb the cost of a future financial meltdown by pre-funding the act's proposed financial company resolution fund. Her wisdom on this matter is pretty hard to take issue with: Chasing banks after a crisis, in order to avoid extraordinary calls on the F.D.I.C.'s depository trust fund, places the government in the untenable position of having to tap the banks when their resources are most depleted.

The agency's trust fund is currently nearly depleted and the F.D.I.C. will surely be faced with the equally unattractive prospects of having to tap the Treasury or hit the banks for more premium payments while they are still experiencing increasing loan losses.

The F.D.I.C. chairwoman, by advocating for funding the proposed resolution fund during fat times, in order to avoid exhausting the depository trust fund during lean or crisis periods, is echoing the sound thinking of many, including Paul A. Volcker, the Federal Reserve's former chairman, who insist that dynamic regulation in bank capital requirements and other prudential regulatory metrics needs to be incorporated in any reform package.

Dynamic regulation — requiring higher capital, loan provisioning, depository trust fund premiums/resolution fund contributions and the like when the economy is booming, and loosening regulatory requirements somewhat when things are slack — is the only practical way of avoiding future boom and bust crises.

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[1] http://dealbook.blogs.nytimes.com/2009/10/30/another-view-please-listen-to-bair/

But the above is just the tip of the iceberg of disagreement between the F.D.I.C. and the rest of the Obama administration and Congress. From her public statements and the tone of her actions, it is clear that Ms. Bair remains extremely concerned that continuing to leave trillions of dollars of deteriorating loan assets in the banking system will only serve to sustain the status quo of (a) banks being unable to fulfill their capital formation mission (lending), and (b) an unrelenting, though carefully-paced, stream of bank failures for a protracted period of time.

Back when all branches of government were worried more about the financial system's viability, rather than its profitability, Ms. Bair creatively morphed the F.D.I.C.'s seized bank asset disposition programs into what became the Public Private Investment Program's legacy loan program to encourage banks to divest themselves of troubled loan assets (as opposed to securities) at reasonable prices. During the P-Pip's short life, as circumstances would have it, private sector investors began to follow the government into the equity of banks and ignited a bank stock rally that quickly spread to the broader market.

This outcome, of course, delighted those in the Treasury, the White House and Congress who were thrilled at the prospect of life-giving equity flowing into the financial sector from someone other than taxpayers. But it also put tremendous pressure on Ms. Bair to put the legacy loan program on ice and refrain from rocking the boat amid all the talk of green shots and glimmers.

Obtaining price discovery on the market value of bank loans (which, unlike securities, need not be marked to market by banks) would have been counterproductive, of course, at a time when banks were only beginning to succeed in raising capital. Ms. Bair either understood that or was persuaded to appreciate the situation.

But she has not completely relented. The F.D.I.C. has kept alive the legacy loan program in connection with the boatload of distressed assets its division of resolutions and receiverships continues to inherit. And I would not be at all surprised if Ms. Bair believes that in the long run there more aggressive action will be required to resolve distressed bank loans, with the government providing the financial incentives and regulatory pressure to be able to do so.

Sheila Bair is no omniscient goddess of bank regulation or macroeconomics — and she can be quite controversial. In the case of her criticism of placing the Fed as the more-equal-among-equals in a proposed council of regulators, and the Treasury secretary as its chairman, she does seem somewhat to be protecting her turf and political at times. (That's hard to avoid when Treasury Secretary Timothy F. Geithner tried to have her fired when the Obama administration entered office.)

But Ms. Bair and the F.D.I.C. continue to prove that they have the best interests of the country and the banking system at heart and that in the long run, failing to take a good dose of the medicine she prescribes to fix the banking system will be to the detriment of its health.

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