Remarks by
FDIC Chairman Sheila Bair
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Good afternoon and thank you for inviting me to speak. It's been a tough 18 months since the financial crisis began. And despite some bumps in the road, government and industry together have taken extraordinary steps to prevent our financial system from collapsing. Let me start with a few comments about the current challenges we're facing, and the actions we've been taking.

As you know, the FDIC has worked closely with other federal agencies, with Congress, and the White House during this crisis – and will continue to do so. As always, our main job is protecting FDIC insured depositors, and preserving the stability of our banking system. Financial innovations come, and they go. But FDIC-insured institutions will always play an indispensable role in the economy. While many sources of bank funding have dried up, deposits have not. In fact they're growing. Insured deposits grew 11 percent last year. They remain a stable source of funding because depositors know that their money is safe.

All of the government measures that have been put in place in recent months are designed to ensure that credit flows on sound terms to both consumers and businesses. Well-managed banks that rely primarily on insured deposit funding should be able to weather this storm. And they will be a key source of lending to help the economy recover.

I see some glimmers of hope. I'm cautiously optimistic that the industry is getting on a better footing. We've moved beyond the liquidity crisis of last year. The FDIC's Temporary Liquidity Guarantee Program and other initiatives stabilized the situation. And we're now seeing positive signs of recovery in those markets as we wind down that program at the end of October. Most major institutions managed to turn a profit in the first quarter. As I see it, we are now in the clean up phase. We need to get in, do the repair work, and get out.

The bank stress test results released by the Federal Reserve last week were well received by the market and are serving as a catalyst for capital raising by our largest financial institutions. A well-capitalized banking system instills market confidence and assures future economic growth and development. In addition, bank funding remains stable because insured depositors continue to be fully protected by the full faith and credit guarantee of the Federal Deposit Insurance Corporation.

But to be honest, there's still more pain to go.

Housing remains under repair

Housing led us into this downturn, and housing will have to lead us out. The problems in housing involved self-reinforcing cycles that have harmed the economy and American consumers, many of whom are now struggling to keep their homes, pay their bills and look after their families

While home prices were rising, mortgage default rates remained low, mortgage lenders loosened underwriting standards, and mortgage fraud and predatory lending flourished. But since home prices peaked in early 2006, we're trying to staunch a self-reinforcing counter-cycle of falling prices, rising credit distress, impaired loan portfolios, and a pullback by lenders. U.S. home prices have fallen some 31 percent from their peak in early 2006. And futures price indexes suggest that home prices could fall further before bottoming out late this year or in early 2010.

It's going to be a slog. It'll require hard work on the part of industry and government. And it's likely to take another year or two for the market to recover.

At the FDIC, we've aimed our policy initiatives at preventing a destructive over-correction in housing that could further damage our economy and our financial institutions. While we've had to close nonviable institutions (and closings are expected to keep rising into next year), the FDIC and other regulators are working to improve the ability of other institutions to keep making loans to creditworthy borrowers.

Our Temporary Liquidity Guarantee Program is helping banks and thrifts fund themselves. The Treasury capital programs are helping bolster capital ratios so banks will be in a stronger position to meet the demand for credit.

Foreclosures and loan mods

We're also finally moving toward a policy of modifying troubled mortgages where the borrower has the ability and the willingness to keep making payments at a lower interest rate. The FDIC implemented such a loan modification program at IndyMac Federal Bank, in California, in one of the hardest hit markets in the country. We did some 13,000 modifications in our short time as conservator.

We've also worked with Treasury and the other housing agencies to design and implement a similar program where any servicer can earn financial incentives by undertaking a systematic plan to modify their past due loans. Not every loan will be modified. First, they will have to pass a net present value test to demonstrate that the modified loan is likely to be more valuable to the investor than what they can obtain in foreclosure. This program could eventually give more than 3 million at-risk borrowers a chance to keep their homes.

Loan modification not only helps lenders avoid the cost of foreclosure and helps borrowers keep their homes, it also helps limit growth in the inventory of excess vacant homes, which is estimated to be between 1 million and 1.5 million units. As long as foreclosures continue to exceed two million a year – as they did in 2008 – we're going to see continued downward pressure on U.S. home prices.

On the other hand, if we can get foreclosures down to historical norms through systematic loan restructurings and refinancings, I think that we'll be much closer to arresting this self-reinforcing downturn in our housing markets.

Already, we're seeing signs that housing markets are stabilizing in the wake of the shocks to the economy and the financial markets last fall.

Following a truly dismal fall and winter, recent reports indicate that foot traffic is up in some areas where the economic fundamentals have remained relatively stable. Discounted prices, low mortgage rates, and tax credits for first-time buyers have combined to make home-buying more attractive than it has been for some time. Your own pending home sales index rose 3.2 percent in March. And the home builders index has also bounced back a little from its recent lows.

We're not looking at boom times in housing anytime soon. There is still too much overhang in terms of credit distress and oversupply. But what we can look forward to -- and I think fairly soon -- is a more normal functioning of housing markets, with more stable prices and a gradual improvement in the credit situation. Compared to the wild swings of recent years, that kind of stability will be a very welcome development for all of us.

Lending practices need improving

Even once housing markets stabilize, we still have the long-run challenge of improving lending practices and financial structures to help avoid another housing bubble.

The first job will always be to protect the consumer from unsound and unscrupulous lending practices. The mortgage financing system that helped build our prosperity after World War II was based on simple, 30-year amortizing loans that everybody understood. We realize now that many of the innovations of recent years did not serve the long-run needs of consumers. In fact, they put borrowers in danger, along with mortgage investors and our entire financial system. We need to move back to greater simplicity in mortgage instruments.

We also need more transparency and better incentives all along the production line for mortgage loans, from the borrower to the investors who fund the loans. Banks and thrifts can lead the way by only making loans that meet sound underwriting principles … where income has been documented, the home's value has been fairly appraised, and a determination has been made that the borrower can repay the loan based on a reasonable debt-to-income ratio. Making loans that people can't afford to repay isn't good business for anybody.

We also need to jump-start the private mortgage securitization business, and get it on a sounder footing. At the height of the housing boom, in 2005 and 2006, more than one trillion dollars in private residential, mortgage-backed securities were issued a year. But by the second half of last year, that market had virtually shut down. Restarting this vital method of mortgage finance is going to require a great deal of discipline, care and restraint from everybody.

The mortgage industry must set strong standards for underwriting, disclosure and data transparency before investors will come back to private mortgage securities. The complex structures that obscured risk must be abandoned. We've got to get back to the basics of Finance 101. We need simpler, more standard deals that everybody can understand, and where performance can be readily analyzed. We need to make sure that incentives are aligned among all parties by making compensation contingent on the long-run performance of the underlying loans.

As you well know, there are many different types of financial and service providers involved in any real estate transaction. But the average homebuyer only has direct contact with two of these: the Realtor and the lender. That means Realtors and lenders play a special role. They are standard bearers for fair and acceptable business and credit practices.

The confidence of homebuyers and mortgage investors has been shaken to the core. And it can only be restored with the commitment of real estate professionals who insist on the highest possible standards for consumer protection … and for safe and sound business practices, in all parts of the industry.

We've seen the costs of lax lending practices, and they are very high indeed. Your customers are looking to the government, to their lenders, and to you to restore their faith and trust in the system. We will do our part to earn that trust. And we stand ready to work with you, so you can do your part. I know we can count on you. And that you'll continue to demonstrate the leadership that your customers expect.

Conclusion

These are truly extraordinary times for the American economy. We're dealing with one of the greatest economic challenges we've seen in many years. Getting through a recession triggered by a credit crisis and a severe downturn in housing puts us in uncharted waters. People want the quick fix. And if you're looking for the quick fix, you're not going to get it. It's going to take time. People need to keep their heads. People need to be patient.

By nature I'm an optimist. I know we're going to dig out of this. Our country has seen even tougher times than these. I certainly heard the stories about living through the

Great Depression from my parents when I was a kid growing up in a small rural town in eastern Kansas. So I know if we make bold decisions, if we stay fluid and flexible, and we keep our heads, I know we can turn this crisis around.

I know we can turn it into an opportunity to make things better, and clear the way for renewed prosperity in the months and years ahead.

Thank you very much.

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