Remarks by
FDIC Chairman Sheila C. Bair
to the
Independent Community
Bankers Association,
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Thank you, Cynthia, for that very kind introduction.

Let me add another little known fact about my resume.

Just after college, I worked for about eight months as a bank teller at a small savings and loan in Lawrence, Kansas. I had graduated from college early, in December, and needed to make some money before I started law school in the fall. So I went to work at an S&L. Actually, the pay was lousy, but the work was fun.

That was a different time. A time of passbook savings and 30-year fixed-rate mortgages. A time when people would proudly present their monthly mortgage payments in person at the teller window. A time when parents would come in with their kids on Saturday mornings to deposit a portion of their weekly allowances. A time when "saving" and "thrift" were considered overriding virtues. When kids competed over who had the most passbook stamps.

Those times will never come back completely. But couldn't this country use just a little bit more of that local, personal touch when it comes to financial services?

Would we have all these problems with abusive, unaffordable mortgages if people still got their home loans from the same folks they went to church with or who umpired their kids' Little League games?

When you are a community banker, you learn a lot about people and what's going on in their lives. And you have a long-term commitment to your town.

That's why community bankers -- all of you here today -- make such a difference. You know your customers and your market better than anyone. Your interests are their interests. You have your finger on their pulse.

Community bankers didn't cause our current problems. Very few of you were involved in the subprime mortgage mess.

But as America's Main Street bankers, you can be a major part of the solution. Long term, I believe the problems we're having now will lead to new opportunities for community banks and thrifts to regain a bigger share of the mortgage market. Short

term, however, weakness in the housing sector and turmoil in the financial markets are making for very challenging times for us all.

Industry conditions

It's no surprise to anyone that the second half of 2007 was a very tough period for the banking industry. And to be honest, let me say up front, that the worst may not be over.

Fourth quarter results were heavily influenced by a number of well-publicized write-downs by large banks.

- Industry earnings were down 27 percent for the year as a whole, and were the lowest we've seen since 2002.

- A substantial part of the sharp decline in fourth quarter earnings was concentrated in a handful of institutions.

- Many community banks also were seeing their troubled loans increase and their earnings diminish, but to a lesser degree than the large banks.

Fortunately, the industry as a whole is coming off a golden period of record profits and remarkable liquidity. And because of this financial strength, the overwhelming majority of banks and thrifts remain well-capitalized (99 percent) and profitable (88 percent).

Asset quality remains key. Write-offs and loss provisions will likely remain elevated for the near future, given current trends.

We'll also need to keep a close eye on loan portfolios other than housing, including commercial real estate and consumer credit.

A note of caution – CRE concentrations

As most of you know, CRE concentrations -- and especially construction and development lending (C&D) -- rose rapidly during recent years. They are now higher than they were in the early 1990s.

This trend was fueled by strong liquidity in global credit markets and rapid home price appreciation that led to sharp increases in residential construction in the early years of this decade.

Community banks were a natural fit for this kind of "high-touch" lending, especially as consumer loans and mortgages were commoditized by Wall Street. But now that the housing boom is clearly over, we're seeing more consequences as we move through this credit cycle.

While the market is vastly different than it was during the 1980's -- and bank risk-management practices and capital cushions are far superior -- there are signs of concern.

- As of year-end, the industry's median ratios of C&D and CRE loans to total capital were 42 percent and 199 percent, respectively.

- Concentration ratios for mid-sized institutions ($1 billion to $10 billion) are notably higher, with median concentration ratios of C&D and CRE of 103 percent, and 355 percent of total capital, respectively.

In releasing fourth quarter results, a number of institutions reported greater problems in their 1-4 family construction lending portfolios.

Problem markets such as California, Florida, and Michigan have been especially hard-hit.

CRE guidance

As you know, in December 2006, the FDIC and the other federal agencies issued guidance for understanding and managing CRE risks.

We got a lot of attention on the original CRE proposal.

We worked to iron out a practical, workable piece of guidance that the industry could buy into, and would send a message that regulators were concerned about growing CRE concentrations.

At present, we are concerned about institutions with large concentrations in construction and development lending.

Given the weakness in housing markets around the country, we are keeping a close eye on trends in the C&D sector and out-sized concentrations held by banks.

As a deposit insurer, we look very carefully at significant asset concentrations.

While CRE and C&D lending can be a profitable business line -- as with any asset exposure -- significant concentrations can lead to problems when markets sour.

So, if you stayed true to good underwriting and loan administration standards, picked your risks prudently, and managed CRE concentrations, you should be OK, despite the current slowdown.

However, if you competed fiercely for deals, turned a blind eye to the loose terms that were available in the market, or took on significant undiversified concentrations, you may well get hurt if we have a sustained slowdown in real estate.

We can all agree that there are certain parts of the U.S. that are overbuilt. And some financial institutions have significant C&D exposures in those areas.

Words of wisdom

Let me make a few simple suggestions to help you navigate through this CRE cycle:

- Manage Your Portfolio Closely – Stick to prudent, time-tested lending policies; understand your asset concentrations; and manage concentrations according to an acceptable level of risk tolerance.

- Keep Your Data Fresh – This sounds basic. But you really need to know your market conditions and assess your borrowers' financial positions so that you can spot deteriorating trends early.

- Evaluate Your Loan Workout Infrastructure – Consider the staff and the skill sets you currently have to see if they can effectively manage an increase in workouts.

While I hope that the CRE market has a soft-landing -- especially construction and development lending -- we want our insured institutions to be ready and fully prepared to work through a sustained downturn, and to hold down losses.

So a word to the wise: keep a sharp eye on your CRE and C&D portfolios.

Fast-tracking loan mods

While C&D concerns may be an emerging priority in 2008, the subprime mortgage mess remains the more immediate concern. I think everyone understands the depth of the subprime problem, and its ripple effects.

What we need now are systematic approaches to modify unaffordable mortgages given the enormous size and scope of the problem. We need long-term, sustainable solutions to preserving homeownership, not quick short-term fixes that won't solve current problems.

Speed is crucial, especially for subprime mortgages. Some 1.7 million of them will reset in the next two years, most by the end of this year.

Other nontraditional loans in the Alt-A market will begin readjusting in earnest next year.

While most of you did not originate subprime and nontraditional mortgages, you are now helping us to dig out of this mess. You're committing hundreds of millions of dollars to help consumers refinance into loans they can afford. By keeping credit available in your local market, community banks are supporting consumers and businesses to maintain economic vitality both locally, and across the nation.

Going forward, one thing is abundantly clear: Lenders in the home mortgage market need to get back to the basics -- to restore common sense, time-tested lending standards.

Moreover, we need to make sure that all actors in the home loan market are playing by the same rules, and treating consumers fairly.

In the months ahead, I hope we'll see a strong national standard emerge for mortgage lending. Such a standard will set the groundwork for ending this sorry chapter in the history of mortgage finance.

A silver lining?

Despite all the current turmoil, there may be a silver lining down the road. We could see a renaissance in Main Street banking.

Traditional banks and thrifts are increasing their mortgage lending. They are bringing back old customers and winning over new ones.

Responsible lending can increase access to credit for borrowers from all walks of life, who before had no or very limited access.

The economic and social benefits of home ownership are well known. Homeownership is a primary vehicle to build savings for the future. It is the gateway to the middle-class American Dream.

Before ending, I'd like to comment on a couple other things that the FDIC is working on.

Small-dollar lending

As you know, last year we launched a small-dollar loan pilot program. This is our answer to payday lenders, who have been growing rapidly.

And thanks to the support of ICBA, we had many community banks apply, more than we could accept. We selected a diverse group of over 30 banks for the program. They have 550 branches in 27 states and total assets ranging from $20 million to $10 billion.

And the program is capturing attention. USA Today wrote about it a week ago as part of a major story on states cracking down on payday lenders.

Over the next two years, we'll be determining best practices and business models that can help more bankers offer affordable, responsible and profitable small-dollar loans. This type of affordable lending can be good for both consumers, and for banks.

Capital reform -- standardized approach

Let me also update you on the new risk-based capital standards under Basel II.

Last December, the U.S. agencies finalized the rules that will allow the largest banks to use their internal models for calculating their risk-based capital requirements. As you know, I've been a skeptic of model-based capital regulation.

The last study we did showed capital requirements declining significantly in many categories. Declines were particularly dramatic in capital held against residential mortgages.

For those reasons, I insisted that the final rule require a comprehensive study on the effectiveness of the Basel II rules. This study would have to give the rules a clean bill of health before caps on risk-based capital reductions could be removed.

In addition, we retained the leverage ratio for all banks as a tried-and-true measure of solvency and settled on a very slow, four-year transitional process.

For several years now, community banks have been asking for a more risk-sensitive capital rule that doesn't hurt their ability to compete with big banks. To address this concern, regulators are now in the process of finalizing a proposed rule aimed at offering smaller banks a more risk-sensitive capital framework.

This proposed rule will offer a version of the Standardized Approach that is currently in use in Europe. Unlike the advanced approaches, it includes capital floors for each asset category.

As part of this rulemaking, we will be asking whether all banks should have the option of using the standardized framework. We will also ask key questions about the use of external ratings to set capital for complex structured finance instruments, as well as raise issues about the adequacy of capital held against off-balance sheet exposures.

This is a priority for us. We need to modernize our risk-based capital framework for all banks, but in a way that preserves strong capital, which I believe is a competitive strength, not a weakness.

Bank Secrecy Act

There are also a few initiatives the FDIC is working on regarding compliance with the Bank Secrecy Act (BSA).

We're in the process of putting out a reminder to the industry on the importance of having an effective independent testing process. It is our hope that with high-quality independent testing, our examiners can spend less time transaction testing in lower risk areas. The goal is to help ease regulatory burden and better allocate resources, while providing for adequate BSA compliance.

We're also working with FinCen and other regulators on ways to assist banks in serving their money service business customers. This includes developing a better definition of MSBs and better differentiation between higher and lower risk money service businesses.

I want to emphasize that the FDIC remains committed to reducing unnecessary burden on bankers for bank secrecy compliance, and all areas of the supervisory process.

Industrial loan companies

Finally, let me say a word about industrial loan companies.

As you know, the moratorium is over. And the FDIC is again considering ILC applications. Many of the more controversial applications have been withdrawn. But the fundamental issue remains: How much mixing of banking and commerce does Congress want to permit under the law?

I continue to urge Congress to give us clarity on this very significant question by adopting an ILC bill that gives the FDIC Board clear guidance we can use in considering applications. And I hope we get an answer soon.

Conclusion

As we work to solve our problems, and to learn from them, let us work for a common cause.

Let us return to traditional values that protect borrowers, protect responsible lenders, protect neighborhoods, and ultimately protect the country with the promise of a secure and stable economic future.

I truly believe that this is the path to a renaissance in American banking. And I believe community bankers can lead the way.

Thank you for inviting me today. I look forward to working with all of you as we move forward. I'd be happy to take a few questions.

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