Remarks by
FDIC Chairman Sheila C. Bair
to the
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Indira Gandhi said three decades ago that: "The great need in the world today is to so define national interest that it makes for greater harmony, greater equality and justice, and greater stability in the world."

That is a timeless and eloquent statement. To me, it speaks to our mission as financial leaders and regulators. Our immediate job is to promote public confidence in our banking and financial systems, which makes for greater stability and greater opportunity in our national economies. But as the global economy becomes ever more closely integrated, economic instability and uncertainty in one region of the world can have consequences in other regions.

So it is not only in our respective national interests to strengthen financial practices and expand access to mainstream financial services. It is in our collective interest to promote financial stability and economic opportunity. A major focus of my trip this week is to look at how India is making reforms to improve financial access for its people, and to compare notes with what we're doing in the United States.

I would like to focus my remarks today on four main areas. First, I would like to summarize the structure of the U.S. banking system and the development of our capital markets. While the U.S. experience may not represent a model for every nation, it may offer some perspective from which to consider the unique situation of India.

Second, I would like to speak frankly about some of the missteps that led to the recent financial crisis, and the actions that are being taken now to correct these problems. Third, I would like to briefly summarize the state of the recovery in the U.S. economy and banking system. And, finally, I would like to speak to the important issues – shared by both of our nations – of expanding access to mainstream banking services and promoting financial education.

The U.S. Banking and Capital Market Structure

For almost 150 years, U.S. banking has been governed by a "dual" banking system, combining generally smaller institutions chartered by the individual states and the typically larger institutions with federal charters. The FDIC insures the deposits of banks and thrifts under both state and federal charters, and also supervises some 5,000 state-chartered banks. In addition, the FDIC has resolution authority for all FDIC-insured depository institutions that fail. Maintaining this dual system of charters under federal deposit insurance requires a great deal of policy and regulatory coordination.

Many have suggested that there must be a simpler way to go about this. But this dual system encourages new banks to open where there is demand for their services. It also supports small community-oriented banks that specialize in lending to agriculture, small businesses, retail consumers and other vital sectors that are not always served well by large institutions or the capital markets. Small banks, with assets of less than 1 billion dollars, hold just 11 percent of U.S. banking industry assets, but are responsible for 38 percent of the banking industry's small business lending. And small businesses, those with fewer than 500 employees, are responsible for the creation of about two-thirds of net new jobs in our economy. In short, small state-chartered institutions are essential sources of credit and other services to the most dynamic, entrepreneurial portion of the U.S. economy.

Deposit insurance is a critical element to the ability of small depository institutions to compete with their larger counterparts. The FDIC guarantee assures smaller institutions of access to stable, low-cost deposit funding no matter the fluctuations of the economy or the financial markets. The FDIC insures over 600 million deposit accounts in almost 8,000 banks and thrift institutions. During our 76-year history, over 3,000 insured institutions have failed, but no insured depositor has ever lost a penny of insured deposits -- and none ever will.

We are proud to share our tradition of protecting depositors with India's Deposit Insurance and Credit Guarantee Corporation (DICGC). As a matter of fact, India's deposit insurance system is the second-oldest in the world, with a 48-year history.

As important as banks are to the U.S. economy, we have become increasingly reliant over time on funding provided to businesses and households through the global capital markets. By one estimate, market-based sources of funding surpassed depository institutions as holders of U.S. credit market debt in the late 1990s.

A private corporate bond market has long been an important source of credit to large U.S. companies. In recent decades, this market has become more accessible by smaller and newer companies. By contrast, the federal government has been more directly involved in making capital market funding available to homebuyers and farmers. Government agencies or government sponsored enterprises have been created to organize secondary markets in mortgages and farm loans and to provide various types of credit guarantees in order to encourage the origination and securitization of these loans.

The high degree of federal involvement in housing and rural finance reflects: The importance of the capital markets as a source of financing; the difficulties that homeowners and farmers would have in trying to obtain capital market financing on their own; and the importance of home ownership and agriculture to our economy and our communities.

In some cases, such as with residential and commercial mortgage-backed securities, practices developed under government-sponsored initiatives have been imitated by the private market, resulting in new private securitization activity that has further expanded access to credit. However, as I'm sure you are aware, the market practices that were followed during the rapid expansion of private mortgage securitization during the last decade were not safe and sound.

Instead, these practices supported the spread of high risk mortgage loans that were not in the long-term interest of mortgage borrowers and that contributed directly to the crisis in U.S. mortgage markets and global financial markets. The risks created by these loans were buried in complex mortgage-related instruments and credit derivatives that ended up on the books of banks, bank holding companies, and non-bank institutions.

These complex and opaque financial positions became the fundamental source of uncertainty in financial markets once the nature of the mortgage crisis became apparent in 2007 and 2008.

Regulatory Reform and Bank Capital Requirements

This brings me to the second section of my talk. While financial innovation in banking and capital markets has been highly successful in making credit available to U.S. business and household borrowers, the recent crisis has highlighted some critical shortcomings in our market and regulatory practices.

These shortcomings must be addressed in order to restore the vitality of our financial sector and prevent a recurrence of this episode in the future. To address these issues, the U.S. Congress is considering financial regulatory reform legislation that is expected to reach President Obama's desk by July 4th.

When all is said and done, these reforms will bring significant changes to the financial industry. To my mind, the most important reform will be to create the authority to resolve large, complex financial institutions that get into trouble, without a taxpayer bailout.

This authority is essential to restoring the discipline of the marketplace on excessive risk taking at large banks and non-bank financial companies. Other key provisions would: Create a new, independent regulatory authority for consumer financial products that would ensure their safety no matter who offers them; provide for better supervision of large complex financial organizations and establish a Systemic Risk Council to detect and address emerging systemic threats to financial stability and the economy; and require many derivatives and over-the-counter financial products to trade on regulated platforms.

This legislation creates a framework to improve the resiliency of the U.S. financial system. It provides enhanced tools to address emerging risks to the stability of our system before they threaten to create a future crisis.

In my view, another critical component of a stronger international financial system is capital – in higher amounts and of better quality. During the years leading up to the financial crisis, the cushion of equity capital in the banking systems in a number of countries dwindled relative to the volume of financial activity and the risks that were being taken.

During this period, many banks increased their leverage by: Issuing "hybrid" capital instruments that qualify as regulatory capital but actually represent debt; putting illiquid assets in the trading book or in off-balance sheet structures to reduce capital requirements; or increasing portfolio risk in an opaque manner through the use of credit default swaps or riskier underwriting practices.

These efforts to increase profits by effectively raising leverage left many institutions unprepared for the onset of the crisis and vulnerable to liquidity runs that occurred when counterparties began to doubt their solvency. Going forward, we need to improve both the level and quality of bank capital.

Efforts are underway to do this, and their success is critically important. The Basel Committee on Banking Supervision published two important proposals in December 2009 dealing with ways to strengthen the capital and liquidity of banks. In the area of capital, the Committee proposed several key reforms: strengthening the quality of capital by setting minimum thresholds for core, loss-absorbing equity; establishing a capital buffer over the regulatory minimums that can be drawn down during times of stress; and increasing the capital requirements for the risks arising from derivatives; and establishing an international leverage ratio.

Much remains to be determined with regard to the details of these proposals. Many important decisions need to be made. It will take time to properly define the stronger standards we need to achieve, and a reasonable phase-in period for new requirements should certainly be part of the discussion.

The U.S. is firmly committed to this process. In the words of U.S. Treasury Secretary Geithner, meaningful reform requires "the enforcement of more conservative capital and leverage requirements on the activities, whether on- or off-balance- sheet, of all major financial institutions."

The Basel Committee's December proposals are an important step in this direction. India, of course, is now a member of the Basel Committee, and we look forward to working with you and our other counterparts on the Committee to reach consensus on these and other important decisions.

Recent Developments in the U.S. Economy and Banking Industry

Now let me turn briefly to summarize the progress we have made to date in overcoming the financial crisis and what ultimately became the most severe U.S. recession since the 1930s. After many months of recession and job losses, the U.S. economy is

beginning to recover. Though substantial uncertainties remain, we are seeing gradual progress in terms of economic activity, and even signs that payrolls are starting to expand and that bank loan performance is beginning to stabilize. But banks continue to set aside large provisions for loan losses, and bank failures continue at an elevated pace.

While some of the early bank failures in this crisis included large mortgage lenders that offered risky loan products, U.S. bank regulators are now dealing with problems among smaller community banks with high concentrations of construction and commercial real estate loans. Still, during the past year we have seen some welcome signs of stability in many housing markets. Inventories of vacant homes are beginning to shrink, existing home sales are up, and investors have been buying distressed properties even in troubled markets.

Home prices have been relatively stable in most parts of the country over the past year, following a historic, 33 percent average decline from mid-2006 through the early part of last year. Federal policy initiatives, including a homebuyer tax credit and purchases of mortgage-backed bonds by the Federal Reserve, have provided important support to the stabilization of housing markets. But now that many of these programs have expired, we face some additional uncertainty about the near-term direction of home prices.

Today, more than 11 million homeowners – or more than one in four of those with a mortgage – are underwater, owing more than their homes are worth. At the end of March, there were some 2.4 million U.S. mortgages in the process of foreclosure, and almost three and a half million more were at least 60 days past due.

The FDIC was an early advocate of finding ways to modify distressed mortgage loans to make their payments more affordable, to prevent foreclosures, and to allow borrowers to stay in their homes. We pioneered this approach at IndyMac Federal Bank, where the FDIC was appointed conservator in July 2008. Efforts to systematically modify at-risk mortgages continue to gain momentum. About 640,000 permanent modifications were put in place in the first four months of this year under private initiatives and under an incentive-based plan developed by the Treasury Department with assistance from the FDIC.

But we still have a long way to go until this crisis is behind us. That's why the FDIC continues to encourage investors who buy failed banks under loss-share agreements to be aggressive in preventing needless foreclosures.

Financial Inclusion and Education

I would like to conclude today with a few remarks on financial inclusion and financial education, issues that are of great personal interest to me. More than two billion adults worldwide do not have access to formal or even semi-formal financial services. In September 2009, the G-20 Leaders meeting at the Pittsburgh Summit committed to

improving access for poor people by encouraging safe and sound new modes of financial service delivery.

The U.S. is by no means immune from these challenges. According to a recent FDIC-sponsored survey by the U.S. Census Bureau, at least 25 percent of U.S. households -- close to 60 million adults -- are financially underserved. Instead, they frequently use high-cost alternative financial service providers to conduct transactions including paying bills, remitting money to family, and cashing their paychecks. The annual dollar volume of alternative financial service provider transactions is estimated at more than $320 billion.

It is reasonable to conclude that banks have a strong incentive for pursuing underserved customers, given the sheer size of the alternative financial services industry. However, according to our survey, less than 18 percent of banks identify expanding services to these consumers as a priority in their business strategies.

The important role played by the FDIC in protecting bank deposits gives us a keen institutional focus on consumer protection and access to financial services. In 2006, we strengthened this focus by creating an Advisory Committee on Economic Inclusion. The Committee provides the FDIC with advice and recommendations on expanding access to banking services for underserved populations. Its strategic plan is focused on savings, financial literacy, affordable credit, and other key consumer needs. The idea is to engage mainstream financial institutions in these important initiatives by supporting research, developing a supportive policy framework, and, where appropriate, launching pilot projects to market test new ideas.

Through our Advisory Committee, we have developed a number of programs to encourage banks to offer affordable small dollar loans, savings accounts, and checking accounts. And I must say that I cannot help but be impressed with the initiatives India is undertaking to extend the benefits of its formal, regulated financial system across a nation with some 600,000 villages. Your efforts make use of the latest information technologies, while recognizing their inherent limits. And you have been innovative in leveraging the limited geographic reach of banking institutions by facilitating their use of correspondents.

Beyond expanding access to mainstream financial services, both India and the U.S. recognize the importance of financial education. We firmly believe that financial education fosters financial stability for individuals, families, and entire communities. The more people know about credit and banking services, the more likely they are to increase savings, buy homes, and improve their standing of living.

One of the root causes of our mortgage crisis was an increase in the complexity of mortgage products and the widespread use of loans that consumers did not understand and that did not serve their long-term financial interests. We believe that both financial stability and consumer protection start with an educated consumer. That belief is the

basis of our efforts to improve financial education in the U.S. and working collaboratively with other countries.

This effort started with some years ago with Money Smart, our comprehensive financial education curriculum designed to help individuals outside the financial mainstream.

The Money Smart program, which has been translated into seven languages and has been taken by over 2.5 million people, helps consumers build financial knowledge, develop financial confidence, and use banking services effectively.

I am very pleased to announce to you today that we are working on a translation of the Money Smart curriculum to Hindi, an effort we expect to complete later this year. It is our hope that this effort will further strengthen the cooperation between our two countries as we strive to meet the challenge of expanding access to financial services in a manner that protects consumers and preserves financial stability.

Conclusion

Prime Minister Singh visited Washington last fall, and was honored with the first state dinner of President Obama's administration. The timing of this visit is in keeping with the long-standing and steadfast partnership between the United States and India.

I feel privileged to have been invited to visit India. I have been here for only a few days, yet I have seen the depth and warmth of this partnership. And I have also seen firsthand India's amazing progress and vast future potential. Amid the differences in geography and culture there is much we have in common, and there is much we can learn from one another.

My hope is that in our own sphere of banking that we can develop the "new pathways of international cooperation" that Prime Minister Singh called for when he visited the White House. I look forward to working with you to find those pathways that bring us closer and that continue to improve the quality of life of millions of people in both our countries. Thank you.

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