Remarks by FDIC Chairman Sheila C. Bair to the Independent Community Bankers of America's 2010 National Convention and Techworld; Orlando, Florida March 19, 2010

This has been a season of challenges for the banking industry and our economy. It has also been a season in which many groups – including this one – have been trying to send a message to Washington about what will work and what will not work in terms of economic policy. I think you're getting through.

The message we're hearing in Washington is this: Community banks are essential to the economy, but many of them are experiencing acute credit distress; Community banks are doing more than their share under difficult circumstances to provide the credit that will be needed to create jobs in the recovery; Community banks are looking for a balanced approach to supervision and regulation as they themselves walk a fine line in their lending policies; and Community banks support regulatory reform that finally ends too big to fail and levels the playing field, but they rightfully oppose reforms that just heap more regulation on them.

Economists tell us that the worst of the recession is behind us, yet we know that credit performance is a lagging indicator. You are still seeing the effects of the recession in your past-due and nonaccrual loans. Our latest *Quarterly Banking Profile* showed that noncurrent loans at FDIC-insured institutions reached a record high of almost 5.4 percent at year end. The credit crisis, which began on Wall Street, is now mostly being felt on Main Street. Your customers are feeling the effects of diminished cash flows and lower collateral values. And you are seeing your nonperforming loans continue to rise.

Amid these ongoing events, some clear lessons stand out for all to see. First, the worst excesses that led to the credit crisis were not generated by community banks. To be sure, many community banks are highly dependent on commercial real estate and construction loans. And these concentrations did create a vulnerability to the credit crisis we have seen in mortgage and real estate markets during the past three years. Institutions that did not manage these risks are now experiencing high credit losses and, in many cases, lower supervisory ratings. But most of the risky subprime and nontraditional mortgages that fueled the housing bubble were not the work of community banks. They were the work of a highly complex, disjointed and depersonalized securitization process.

By contrast, community banking is a relationship business, where character and creditworthiness both count, and where you take care of your customers because they are more than just a number to you. Small businesses create two thirds or more of all net new jobs. And they overwhelmingly rely on credit provided by community banks. Overall bank lending is down. Total loans and leases held by FDIC-insured institutions fell by 7.5 percent in 2009 – the steepest decline since 1942. Several factors are responsible for this, including weak demand from household and business borrowers a

decline in the credit standing of many borrowers and tighter standards on the part of many banks.

But the one group of banks that has proven to be the steadiest source of credit is community banks. During the final quarter of 2009, loans and leases at the largest banks – those with over $100 billion in assets – fell by 2.8 percent, or about seven times as much in percentage terms as the decline at community banks. These largest banking organizations accounted for more than 90 percent of the total drop in bank lending for the quarter. The smallest banks – those with assets less than $100 million – actually increased their loans by more than half of one percent. While so many big banks keep pulling back, you are hanging in there, doing your best to support the credit needs of our struggling economy. That deserves recognition in Washington, and all of our thanks.

Supervisory Guidance

As you know, the FDIC supervises almost 5,000 banks – mostly community banks. So we have a keen appreciation for the role you play in the economy and the challenges you have faced as the recession hit Main Street full force. In the Fall of 2008, at the height of the financial crisis, the FDIC took a leading role as the federal banking agencies issued a joint statement to the industry on meeting the needs of creditworthy borrowers. The statement pointed out that in the wake of the crisis our economy would become even more dependent on bank credit, and that it would be in everyone's interest for banks to make prudent lending a priority.

In October, regulators again called attention to credit distress and credit availability with a new statement on commercial real estate (CRE) loan workouts. The CRE guidance encourages banks to continue making good loans to commercial real estate borrowers—most of which are small businesses. It also encourages banks to work with borrowers that are experiencing difficulties in their repayment capacity because of economic conditions. And it emphasizes that restructured loans will not be subject to adverse classification by examiners solely because the value of the underlying collateral has fallen.

Last month, the federal banking agencies and the Conference of State Bank Supervisors issued a joint statement on lending to creditworthy small-business borrowers. The statement recognizes the importance of small businesses and the fact that some are experiencing difficulty in getting credit. It clearly states that financial institutions that extend credit using prudent lending standards will not be subject to supervisory criticism.

I know that there are concerns about examiners being overzealous in adversely classifying loans and applying capital requirements. These are issues that we have discussed at length with our Community Bank Advisory Committee, which was created last year to conduct just this type of dialog. What I want you to understand is that we hear your concerns. We are trying very hard to achieve a balanced approach to supervision during these challenging times. There are no easy answers or quick fixes here, and we will need to work together to get through this as we've always done.

Reforming Too Big To Fail

As we emerge from the crisis, we must look ahead to the long-term viability of our banking system and the reforms that will be necessary to maintain a greater degree of financial stability. Job number one must be to level the playing field once and for all and to put an end to the doctrine of too big to fail. Too often in the past, and especially at the height of the financial crisis, we saw large, systemically important institutions exempted from the type of supervisory sanctions that community banks face every day.

Every Friday, you read about more small and mid-sized banks that have been subjected to the ultimate regulatory sanctions: Failure and receivership. We have just come through the greatest financial crisis since the 1930s, and for many of you it's not over yet. It is time to get serious about establishing a credible, pre-funded resolution authority for giant banks and non-bank financial institutions.

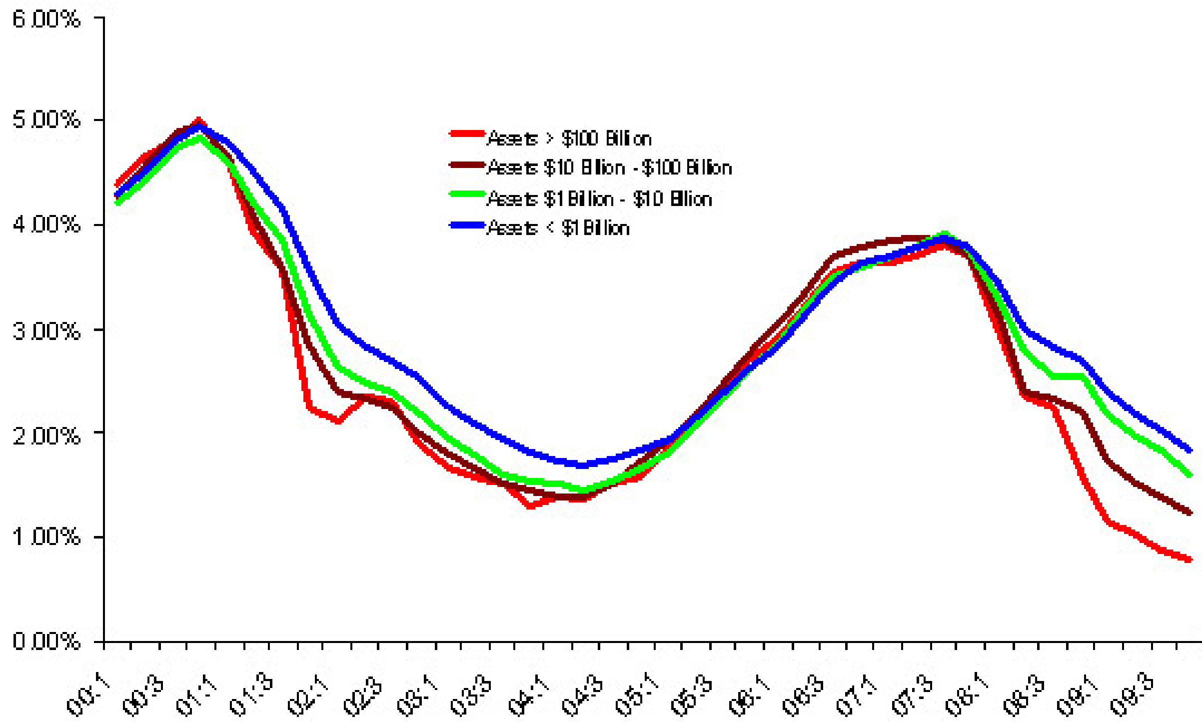
Both the House and Senate financial reform bills call for a resolution authority that specifically applies to these large, complex institutions. The bills would require them to pay assessments in advance so that the FDIC will have immediate funding to support an orderly wind down, without having to reflexively tap taxpayer support. This authority would not be part of the Deposit Insurance Fund, and the costs of resolving these institutions would not be paid for by community banks. Instead, we would finally have a mechanism under which large, complex institutions could be closed if necessary without wreaking havoc on the rest of the financial system. The ability to resolve these institutions would force them to internalize the full costs of the systemic risks they create. These institutions would finally be subject to the same kind of market discipline that guides your risk management efforts every day of the year.

Both the House bill and the Senate draft contain specific prohibitions on assistance to individual open institutions. This is essential to ban future bailouts. However, we do have serious concerns about other sections of the Senate draft which seem to allow the potential for backdoor bailouts through the Federal Reserve Board's 13(3) authority. We will work closely with the Senate to make sure there are no loopholes around the carefully crafted resolution procedures. If the Congress accomplishes anything this year, it should be to clearly and completely end too big to fail. Never again should taxpayers be asked to bailout a failing financial firm. It's time that the big players understand that they sink or swim on their own.

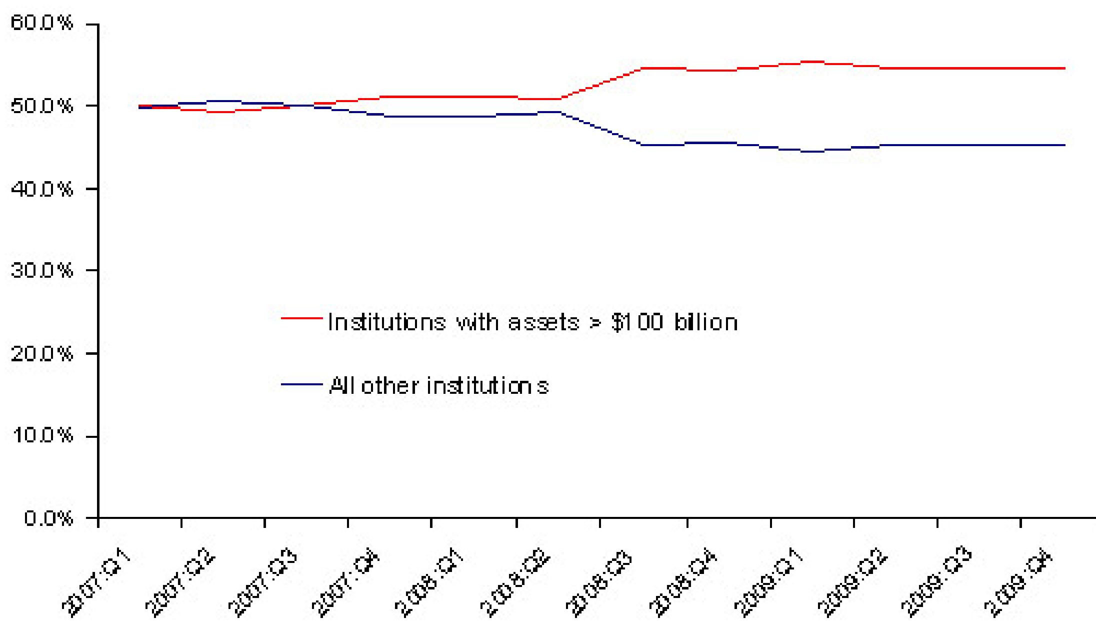
Restoring Competitive Balance

For too long we have seen large banks and non-banks alike receive implicit government support to the distinct disadvantage of community banks. You can see this disadvantage in your funding costs. The average cost of interest-bearing domestic deposits for the largest banks, those with more than $100 billion in total assets, was over 100 basis points less than average deposit costs at community banks in the fourth quarter.

Average Cost of Interest-Bearing Domestic Deposits, 2000 - 2009



Share of Total Noninterest-Bearing Deposits



Source: FDIC. Analysis excludes State Street and BNY-Mellon.

In the third quarter of 2008 - before the FDIC introduced its Transaction Account Guarantee Program (TAG) - some of the nation's largest banks experienced substantial increases in noninterest-bearing deposits, while smaller banks saw them decline. During the quarter, the 10 largest banks raised their share of total industry non-interest-bearing deposits from 51 percent to 55 percent, while the share for all other banks correspondingly fell. This shift has remained in place ever since. And it might have become even more pronounced, had it not been for the TAG program which arrested this trend.

These signs all point to a presumption in the marketplace that the largest banks are, indeed, too big to fail. They provide clear evidence that the regulatory structure as it stands today puts community banks at a sizeable competitive disadvantage. The goals of any regulatory reform legislation must be to: Restore market discipline to all segments of the financial industry; Ensure your ability to compete on a level playing field; And prevent the excessive government subsidized risk-taking that created this crisis.

Ongoing Review of TAG Program

Competitive concerns have also led to calls by small and mid-sized institutions for an extension of the TAG program, which is scheduled to expire on June 30 of this year. As you know, the TAG program was the most widely used element of the Temporary Liquidity Guarantee Program (TLGP), with more than 6,900 banks and thrifts opting to participate as of the end of 2009. It has been highly effective in offering an extra margin of protection to small businesses and other holders of payment-processing accounts at small and mid-sized institutions. Although the Debt Guarantee Program under the TLGP involved fewer insured institutions, they managed to issue more than $618 billion in guaranteed debt before the program expired last October.

That program, too, was highly successful in helping to normalize spreads in the interbank lending market and to ease liquidity problems among banks that rely on wholesale funding. While the larger funding crisis has subsided, we recognize that community banks are still dealing with liquidity pressures. For that reason, we are evaluating how the termination of the TAG program could affect community bank funding and liquidity needs. I have asked the FDIC staff for an analysis of the TAG program, its rationale and its results to date, so that the FDIC board may consider whether an extension is warranted. We will take the results of this analysis into consideration when evaluating our plans for the TAG program.

There is still a threat that the credit challenges facing community banks could lead to renewed liquidity problems if uninsured deposits once again flow to the largest banking organizations. This in turn could trigger liquidity failures, imposing additional costs on the deposit insurance fund. As part of our analysis, we'll consider whether an extension of the TAG program may be needed to maintain stability in the industry's funding base given the ongoing credit challenges brought on by the financial crisis, as well as protect us against unnecessary losses.

Clarifying Policy on Above-Rate Deposits

As some of you may know, last year we changed the rule for complying with the statutory interest-rate restrictions for banks that are less than well capitalized. The new regulation includes a streamlined safe-harbor for compliance using a national rate schedule that is published on the FDIC's website. The rule also builds in the flexibility to identify high-cost areas. As we make these judgments, one issue that can be material in some markets is the presence of multiple branches of large banks.

As I mentioned earlier, the largest banks enjoy lower average funding costs – and the differential appears to be rising. In our judgment, this trend is driven at least in part by the market perception that some of these banks are too big to fail. It was never our intent for this regulation to disadvantage smaller banks. That is why, as of today, we have amended the question and answer document on our website to clarify that the FDIC will, as appropriate, drop multiple branches of the same banks from the calculation of locally prevailing deposit rates. I would point out that this was an issue that was flagged for us by members of our Community Bank Advisory Committee, who have made many useful suggestions like this in the meetings we have held so far.

Consumer Protection: a Vital Competitive Issue

Let me now focus on consumer protection. I know that many of you are concerned about the prospects for a Consumer Financial Protection Agency, and the extra layer of regulation that it might impose on the industry. I understand your concern. Depository institutions are among the most heavily regulated industries in America today. You feel like you're an easy target when things go wrong anywhere in the financial sector. The irony is this: The regulatory reforms put in place in banking after the last crisis actually helped push risk-taking outside of traditional banking and into the shadow banking system. This created gaps between regulatory jurisdictions; weakened consumer protection; and led to the problems with subprime and nontraditional mortgages, and risky securitization structures. This is why the focus of improved consumer protection in the aftermath of this crisis should not be placed on you.

There is ample evidence that consumers did not understand the consequences of the subprime and nontraditional mortgages that were sold to them during the buildup of the housing bubble. Lightly regulated companies at the periphery of the banking industry exploited this information gap at your expense, making it tougher to do legitimate business in more suitable financial products. We all know that when standards are not uniform, and when consumers are not well informed, there will be a race to the bottom in credit practices. The losers in this race include both legitimate financial providers and the consumers that the system is supposed to be serving. That is why basic consumer protections are a fundamental piece of our regulatory infrastructure. The market cannot function efficiently without them. But it's time we leveled the playing field for all market players. We need strong rules that apply – and that are enforced – across the board for banks and nonbanks. And it is just as important to ensure that the burden of this regulation does not fall on the mainstream lenders who were not the cause of the problem.

We believe that compliance is an integral part of the safety and soundness of institutions. We also believe that examination and enforcement authority for community banks should remain with their prudential regulator. That's why we worked very hard to persuade the architects of the House bill to keep examination and enforcement authority for banks with under $10 billion in assets, with their primary federal regulator. The Senate bill takes the same approach. A consumer watchdog that levels the playing field – but does not increase the regulatory burden on you – can only help to improve your competitive position, and give you a chance to profitably make high-quality loans to your customers.

Conclusion

We have all learned a great many lessons from this crisis -- lessons about protecting consumers; about the need for a resolution authority for large, complex institutions; and about the essential role that community banks play in America's highly entrepreneurial economy. These issues are more closely connected than most people realize. Traditional community banking, where long-term relationships matter more than statistical models, remains the future of banking in America. You recognize the need to take care of your long-term customers by dealing fairly with them in the good times, and by extending credit to them in the hard times.

Our country is recognized around the world as the place where new technologies and dominant firms can be started in someone's garage. And it is community banks that finance the startups where dreams are launched and new jobs are created. But, for too long, your business model has been at a critical disadvantage to larger financial companies with implicit government backing and insufficient regulatory oversight. And now, even as problem loans reach record levels, you may be looking at regulatory reform as just another source of uncertainty for your institution.

I urge you to look at it another way. This crisis will pass in time. Your problem loans will eventually decline and your bottom line will recover. But barring another crisis of this magnitude, this opportunity to level the regulatory playing field may not come again in our lifetimes. The FDIC will continue to fight for a regulatory framework that preserves the stability of our financial system and puts smaller institutions on an equal footing. But we need your help. We need you to make credit available now in support of the economic recovery. And we need you to embrace sensible regulatory changes - changes that ensure community banks will remain the essential drivers of a diverse and vibrant American economy.

Last Updated 3/19/2010