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FEDERAL DEPOSIT INSURANCE CORPORATION
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Let me begin by offering my sincere thanks for the opportunity to speak here today. It is always good to visit with bankers — to listen to your concerns — and tuck away your insights about our industry, about the FDIC, and how we can do our job better. One of my goals upon taking this job was to ensure the FDIC was communicating frequently and effectively with bankers and I believe that must include people in my position as well as the staff of the Corporation.

We've hosted just under forty delegations of state banking associations — including you all — for breakfast or lunch at the FDIC's offices in Washington. It has been very rewarding to get direct feedback — some would say a 'reality check' — from you during my first few months on the Board. And I appreciate very much hearing your concerns as you work to meet the financial needs of your communities, make a profit for your shareholders, and struggle to comply with the regulations sent from Washington.

It is also a special pleasure for me to be here because of my own background in the banking business. I spent more than twenty years in shoes similar to yours — originally in Illinois and then, for 20 years, in Florida — and I feel like I have great appreciation for the decisions you face every day. I've tried to bring this perspective to the Board of the FDIC — and conferences like this will help keep me focused on the issues and concerns that are important to you.

I'd like to talk a little today about some of the issues we're following at the FDIC and give you some sense of what we're seeing in the economy and the supervisory arena. And finally, I'd like to discuss a few of my own goals for the FDIC itself as we position the Corporation for the years ahead.

It is very likely most of you have been following — in some fashion — the discussion in Washington on the issue of Deposit Insurance Reform. And — if you're at all like your banking colleagues from around the country — you probably have several different opinions about the subject. But I would like to briefly outline our reasons for bringing this issue to the table and briefly discuss the recommendations we made to Congress earlier this year.

As the federal agency responsible for consumer confidence in a safe and sound banking industry, the FDIC, I think, has an obligation to provide deposit insurance in the most efficient and cost-effective manner. We must also ensure that our policies do not make things worse for the industry during hard economic times and we must ensure the system is administered fairly. Our goal in developing our recommendations was to give Congress a framework for adapting our current system to the changing financial landscape.

The current Deposit Insurance system, as most of you know, was modified in crisis and was designed to help the industry emerge from that crisis. At the time, funding was badly needed to recapitalize the deposit insurance funds following record bank and thrift failures. The Congress pegged our fund to a hard target of 1.25 percent of estimated insured deposits, and allowed the FDIC to charge the industry steep premiums until that level was reached. This system has worked, and worked well. You all remember this because you helped foot the bill. But we're in a different era now, and we at the FDIC believe it's time for a re-evaluation of the system.

In summary, we identified four broad areas we think were in need of reform. First, the BIF and the SAIF funds need to be merged. This seems to be one area where there is little controversy. Second, we think we should eliminate the 'hard target' of 1.25 percent and allow the fund to grow and recede with the economic cycle — to float within a range — we've suggested between 1.15 and 1.35, but the exact size of the range is subject to fine tuning. By eliminating the hard target, we remove the specter of a 23 basis point insurance premium on banks. To provide an element of stability to the structure of the fund, we've recommended a steady flow of premium revenue to the Fund — not for the purpose of building a Fund of unlimited size, but to support a fund which has a revenue stream and which is intended to be revenue neutral over the long haul. This is a structure which would provide rebates to you when the Fund reached whatever ceiling is established. These rebates would be based upon your past contributions to the Fund, and would provide no immediate or near-term rebates to the brokerage firms and other free riders who have received the benefits of Deposit Insurance in recent years, but have paid nothing into the Fund. Third, we recommend improving our system of risk-based pricing to ensure that banks pay premiums based more accurately on the risk they pose to the fund. Finally, we recommend indexing the coverage level — whatever that level may be — to inflation to ensure it does not erode over time.

We obviously believe these are sensible and reasonable recommendations. In developing them, we conducted rigorous internal analysis including modeling the performance of our fund under various reform scenarios. Further, we engaged in outreach to hundreds of individual bankers and trade groups, soliciting advice and input to ensure that what we proposed was feasible and would work. And since we released our recommendations, we've been working with the Congress to determine whether a consensus reform bill can be written and passed during this Congress.

Now, that doesn't mean there is currently any overarching consensus within the industry about how to proceed. Indeed, I doubt there's consensus in this room about how to proceed. But most of us seem to agree that the current system is in need of an update and I do sense some movement in Washington toward common ground on deposit insurance reform. I encourage you all to join the debate. Make your views heard both within your trade organizations and to your representatives in Congress. And help us design a deposit insurance structure which protects the interests of the banking public, preserves confidence in our banking system and retains the support of your industry. This is our goal as we continue our discussion and we welcome your input.

In addition to providing deposit insurance, another thing we do at the FDIC is pay very close attention to the current state of the economy, with an eye toward understanding the impact of larger trends on the safety and soundness of the banking industry. I'd like to review with you — our sense of where we stand and what we can expect from our economy and our industry down the road.

After 10-plus years of record expansion, we've abruptly slowed to about one percent GDP growth over the last two quarters. To some extent we're seeing a rapid and significant change in the perception or reality of economic fundamentals, and that raises a degree of concern for all of us involved in the financial services industry — whether we're bankers or regulators.

Let me cover the bad news first. There are trends underway that nobody wants to see continue. In the first quarter, net income for the S&P 500 was down 27 percent from a year ago. There have been more than 900,000 job cuts announced since December — more than triple the number during the same period last year. Nationwide, office vacancies increased at the fastest pace on record in the first quarter, then surpassed that record increase in the second quarter. The office vacancy rate in downtown Columbus, for example, has risen from 11 percent to 17 percent — just since the beginning of this year, with one million square feet of new space scheduled to be completed this year. Business bankruptcies and bond defaults are up sharply and consumer bankruptcies have spiked as well. The global economy is weak. We've all heard frequent announcements recently of more layoffs and cutbacks planned for business investment by many of the very firms which once led the New Economy revolution.

Manufacturing has been especially hard-hit. Capacity utilization in the manufacturing sector is at its lowest level since 1983. As you know, this has been difficult for Ohio and West Virginia since manufacturing plays such a prominent role in both of your states' economies. The steel, chemicals and glass industries — so prominent in West Virginia — have been hit by the recent slowdown and by longer-term structural factors such as foreign competition and industry consolidation. Ohio has seen widespread declines in manufacturing payrolls as well.

Ohio and West Virginia have seen a sharp increase in consumer bankruptcies in recent quarters. While the number of personal bankruptcy filings for the U.S. grew by 17 percent in the first quarter compared to a year ago….the growth rates for West Virginia and Ohio were 27 and 28 percent, respectively. To some extent this probably reflects an anticipation of more stringent bankruptcy laws, but the relatively higher dependence of your states' economies on traditional manufacturing industries has doubtless played a role as well.

The way we see it at the FDIC, the near term outlook nationwide is that loan quality may get a little worse before it gets better. How much worse depends on the depth and duration of the current slowdown.

So much for the bad news.

It's not all doom and gloom. While we must heed these trends and do our part to deal with these challenges, it is also important to remember that the U.S. economy and banking system are in a strong position to weather this slowdown. The nationwide unemployment rate, while rising, was still at a relatively low 4.4 percent in May 2001. The U.S. workforce, our technological expertise, and our financial wealth lend our economy a degree of resilience that is extraordinary. Consumers experienced a $2.2 trillion loss in the market value of their equity portfolios last year, along with another $1 trillion in losses in the first quarter of 2001. Yet they remain fairly upbeat, and consumer spending continues to support our economic growth.

- Insured institutions also continue to exhibit strength. At the end of 2000 there were only 45 institutions with equity ratios less than 6 percent of assets, compared to over 1200 such institutions ten years ago.
- Quarterly net income for the industry returned to near-record levels in the first quarter of 2001.
- Bank loan portfolios remain relatively unencumbered with non-performing assets.

- Again, at the end of 1991 there were 1,000 banks with non-current loans greater than six percent of total loans. At the end of 2000 there were only 100 such institutions.

In your states, the overwhelming majority of insured institutions continue to report solid financial condition. Returns-on-assets have drifted downward in line with weakening economic conditions. Insured-institution ROA was 0.89 percent in Ohio, down from 0.98 percent a year earlier. The ROA for West Virginia was 0.84 percent in March, down from 1.0 percent a year earlier. About six and a half percent of banks in each state are unprofitable, slightly less than the 6.9 percent figure for the nation as a whole.

These financial numbers are scorecards which reflect past events. As I've indicated, the outlook going forward looks somewhat testing. What is the appropriate response of banks and regulators to the current economic situation? I think, in part, you simply need to be aware of the trends taking place and do the analysis needed to develop lending strategies that you think can succeed under less-than-ideal economic conditions.

As regulators, we need to focus attention on the banks which are farthest out on the risk curve. This could be any bank whose capital, management or internal control systems are not adequate to the level of risk selected. Lending concentrations in banking have been on the increase since the mid-1990s, especially in the area of construction lending, commercial lending and commercial real estate lending. Banks with significant exposures in these areas need to consider the possibility that the economic environment going forward could be less forgiving than it was during the 1990s.

The 1990s ushered in what looks like a new era for consumer lending; an era of enhanced availability of consumer credit and higher levels of personal bankruptcy filings and consumer loan charge-offs. Changes in the structuring and delivery of consumer credit have altered the credit environment in a way that the industry can serve more customers, and earn more money. For some banks, this has meant operating with a business model that features high capital ratios, high volume lending, and high levels of earnings, in exchange for accepting a higher level of loan losses. This business model, and the accompanying democratization of credit, are reasons why consumer loan charge-offs have been higher during this expansion. Products like subprime auto loans and high loan-to-value mortgages have expanded the reach of lenders and the choices of borrowers, but remain untested in a recession.

As I mentioned briefly earlier, we've seen some deterioration in credit quality in recent months. At the end of the second quarter, 2001, 1.2 percent of all loans held by commercial banks were non-current. This is the highest level since the third quarter of 1995. The non-current rate for commercial and industrial loans was 1.82 percent, a seven year high. While loan quality is a concern, this trend must be put into perspective. In relative terms, the current statistics do not approach the experience of banks during the last economic downturn in the early 1990s. Moreover, strong earnings and capital provide a significant buffer for banks, allowing them to effectively weather the effects of this erosion in credit quality.

We have also noticed that many community banks are relying on non-traditional sources of funding to meet loan demand as the competition for core deposits has increased. These non-traditional sources include wire services for deposits and Federal Home Loan Bank advances. Since 1995, Home Loan Bank advances have increased from $33 billion to $172 billion and more than 2,000 additional banks have joined the system. There is no question that these advances play an important role in helping you meet your funding needs and manage your liquidity. Advances provide liquidity to smaller institutions which don't have access to the broader capital markets.

Typically, the FDIC looks at the use of Federal Home Loan Bank funding or other wholesale funding in the context of the bank's overall funding strategy and in terms of management's ability to understand and manage the risks associated with these sources. Our supervisory concerns have typically revolved around the impact of advances on your liquidity, your interest rate risk, and earnings and capital.

A final supervisory concern I want to mention is related to the ongoing difficulties in the agricultural sector. Farm banks remain vulnerable because their profitability is closely linked to the uncertain economics of farming and the ongoing reliance of farmers on government support payments. Without these payments, farmers would have far greater difficulty meeting loan payments, and it's worth noting that about half of net farm income last year came in the form of payments from the Treasury. We are not predicting serious near-term problems in the farm bank sector. The performance of these institutions remains steady, with loan quality and capital positions remaining fairly strong. As supervisors, however, we are watching these trends and the overall economic situation in farm country very closely.

The final topic I'd like to cover today concerns the FDIC as an organization and my goals for the corporation as a new Board member. Those of you in the banking industry today are the survivors. You capitalized the Bank Insurance Fund after the last crisis and you continue to pay the bills. I believe you have the right to hear where I come from with respect to how the organization sets its priorities and how I hope we manage our obligations going forward.

As you may know, our Board of Directors is in transition. Chairman Tanoue left the FDIC earlier this month after three years of service. Don Powell, a bank CEO from Amarillo, TX, has been confirmed as our new Chairman and I expect him to be sworn in sometime in August. I think he's going to be a great leader, for the FDIC and for the banking industry. James Gilleran of California has been nominated to head the Office of Thrift Supervision, and the current director, Ellen Seidman, has indicated she'll step down upon his confirmation. Once we've passed through this transition period, I believe the FDIC Board will enter a sustained period of stability. I hope we can use this opportunity to review our internal operations with an eye toward becoming an even more effective and relevant voice in the banking arena.

The FDIC has been given the responsibility of managing public confidence in our banking system. And we've been provided the resources by the banking industry to perform this function. We at the FDIC must always remember that responsible stewardship of these resources and maintaining public confidence are of paramount importance to the continued success of the Corporation.

As we work to accomplish our mission at the FDIC, we must always be vigilant about how we can improve and how we can better meet our responsibilities to you and to the public. I believe we demonstrated this in our recommendations for reforming our deposit insurance system.

We must also remain concerned about the burden we are placing on the industry with the regulations we issue. In Washington there are a lot of smart people with a lot of good ideas for fixing this, regulating that, and solving something else. And each of these policies — taken individually — may make all the sense in the world. But I see my job as not only evaluating each proposal as it comes, but also ensuring that the collective impact of our decisions isn't counterproductive, burdensome, and unworkable for the industry we're supervising.

And finally, I believe we in the regulatory community must not let an over-reliance on procedure and process substitute for clarity of mission and soundness of work. Just as process can establish clear responsibilities and ensure accountability, it can also stifle creativity and become an end unto itself. I've seen it happen elsewhere, and I'm sure you have too. This is a difficult balance, and those of us in government sometimes miss the mark on this one. Our processes and procedures must support and add value to our fundamental mission, and they must be easily understood and implemented by the industry. They must not become missions unto themselves.

These are some of the principles that will be guiding me as I continue my service at the FDIC. The sign on your window has always meant confidence, stability, and public trust. I will do my part to make sure it always does.

So thank you again for your invitation to join you here today. It's truly been a pleasure. I do appreciate the vital and important work you're doing for your communities every day and I look forward to a productive relationship with you throughout my term on the Board of the FDIC.

Thank you.

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