

**Statement of Donald E. Powell Chairman Federal Deposit Insurance Corporation
Oversight Hearing on the Federal Deposit Insurance Corporation Before the
Subcommittee On Oversight And Investigations of the Committee On Financial
Services U.S. House Of Representatives
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Room 2128, Rayburn House Office Building**

Chairwoman Kelly, Congressman Gutierrez and members of the Subcommittee, thank you for the opportunity to testify at today's oversight hearing on the Federal Deposit Insurance Corporation. My testimony will briefly discuss the condition of the deposit insurance funds, the need for deposit insurance reform, the condition of the banking industry, and our efforts to reshape the FDIC for the future. Much of my testimony will focus on the issues facing the industry and the regulatory community and the initiatives the FDIC is taking to address these issues.

The Condition of the Deposit Insurance Funds

The strong performance of FDIC-insured institutions is reflected in the strength and soundness of the FDIC insurance funds. As of December 31, 2003, the balance in the Bank Insurance Fund (BIF) represented 1.32 percent of estimated BIF-insured deposits, well above the statutory target reserve ratio of 1.25 percent. The Savings Association Insurance Fund (SAIF) ratio stood at 1.37 percent at yearend 2003. The BIF reserve ratio rose during 2003 as expected losses fell, while the SAIF reserve ratio remained essentially unchanged from yearend 2002.

In November 2003, the FDIC Board of Directors voted to maintain the existing BIF and SAIF premium rate schedules for the first-half of 2004. The FDIC's analysis indicates that it is unlikely the reserve ratio for either fund will fall below 1.25 percent during this period. As a result, most FDIC insured institutions will not pay deposit insurance premiums during the first-half of 2004.

However, the FDIC does not expect the BIF and SAIF reserve ratios to continue to rise going forward. Although the FDIC forecasts little in the way of insurance losses in the near term, we expect at least moderate deposit growth. BIF and SAIF reserves for expected bank failures are already at low levels and the funds will not benefit from unrealized gains on their portfolios of Treasury securities in a moderately increasing or stable interest rate environment. Thus, it is likely that the interest income generated by the funds will not support the expected rate of BIF- and SAIF-insured deposit growth, and the reserve ratios will decline even in the absence of significant bank failure activity.

Deposit Insurance Reform

An effective deposit insurance system contributes to America's economic and financial stability by protecting depositors. For more than three generations, our deposit insurance system has played a key role in maintaining public confidence.

While the current system is not in need of a radical overhaul, flaws in the system could actually prolong an economic downturn, rather than promote the conditions necessary for recovery. As you know, there are three elements of deposit insurance reform that the FDIC regards as most critical: merging the funds, improving the FDIC's ability to manage the fund and pricing premiums properly to reflect risk. These changes are needed to provide the right incentives to insured institutions and to improve the deposit insurance system's role as a stabilizing economic factor, while also preserving the obligation of banks and thrifts to fund the system. There is widespread general agreement among the bank and thrift regulators for these reforms and the House of Representatives has demonstrated its agreement twice by passing reform legislation. I am hopeful that deposit insurance reform legislation will be enacted this year, and I thank you for your efforts in this regard.

The Condition of the Industry

FDIC-insured institutions are as healthy and sound as they have ever been. The industry earned a record \$31.1 billion in the fourth quarter of 2003, marking the fourth quarter in a row that earnings set a new high. The results for the fourth quarter also brought the industry's earnings for the full year to a record \$120.6 billion, surpassing the previous annual record of \$105.1 billion set in 2002. The return on assets (ROA) in the fourth quarter and for the entire year was 1.38 percent, equaling the quarterly record set earlier in the year and easily surpassing the previous all-time annual high of 1.30 percent in 2002.

Underlying the current financial strength of the industry has been the cumulative effects of the ten-year economic expansion of the 1990s and certain factors that tended to insulate banks from the most severe effects of the 2001 recession. Improvements in underwriting and risk management practices helped to limit the effect of credit losses on industry earnings during and after the recession. Meanwhile, strong growth in mortgage loans and a steep yield curve helped boost the net operating income of the industry. As a result, the banking industry has been one of the leading sectors of the economy in the current economic recovery.

But we cannot simply assume that the economic environment of the next decade will necessarily be as favorable to the industry as our recent experience. The world is changing in unprecedented ways. The FDIC sees several trends that could pose difficulties for the banking industry in the future. One potential difficulty arises from future higher interest rates. It is inevitable that interest rates will eventually rise from their current, historically low levels, and this will pose a particular challenge to mortgage lenders. The sharp slowdown in mortgage refinancing in recent months has the effect of making mortgage lenders even more vulnerable than usual to the effects of higher interest rates.

Another potential difficulty for the industry arises from a rapid increase in household indebtedness. The lowest mortgage rates in more than a generation have prompted households to take out \$1.4 trillion in new mortgage debt since the end of 2001. This unprecedented level of borrowing raises concerns not about credit quality, but about the

sustainability of growth in consumer spending. Associated with these concerns is the possibility that low mortgage rates could be contributing to home price volatility in some housing markets that have outperformed the rest of the nation in recent years.

Household indebtedness also has increased as a result of a revolution in consumer lending. This revolution, brought about by advancements in technology and market-based financing, has created a system with unprecedented access to credit and convenience in its use. These changes helped make it possible for the household sector to largely support the U.S. economy during and after the 2001 recession. However, one side effect of this revolution is a world where personal bankruptcy filings exceed 1.5 million a year. This trend is not solely a consequence of the recession-bankruptcies averaged over 1.1 million per year in the late 1990s when the economy was booming. The challenge for consumer and mortgage lenders is to identify the changes that have occurred in household finances and effectively manage the new risks inherent in these lines of business.

In addition to the potential problems raised by these macroeconomic trends, the FDIC is closely monitoring the economic fundamentals of certain commercial real estate markets, principally in the Southeast and the West. Some institutions have high loan concentrations in these markets, although overall bank loan performance in this sector remains very solid at this stage.

FDIC Financial Statement and Annual Budget

The FDIC takes very seriously its stewardship responsibilities for the deposit insurance funds. The General Accounting Office audits the financial statements of the BIF, SAIF, and FSLIC Resolution Fund in accordance with statutory requirements. For 2003, the FDIC received a clean financial opinion for the twelfth consecutive year.

In addition, the FDIC has aggressively sought to reduce personnel, leasing and information technology costs. The FDIC's 2004 Corporate Operating Budget of \$1.1 billion is slightly below the 2003 budget. When combined with anticipated investment spending of \$115 million in 2004 for multi-year investment projects previously approved by the Board, total 2004 spending is expected to total approximately \$1.2 billion. The approved budget will provide funds for the projected 2004 workload of the Corporation's three major business lines-Insurance, Supervision, and Receivership Management-as well as its major program support functions. It provides increased funding next year for policy and banking research, financial risk measurement, and the FDIC's newly-established Corporate University.

Reshaping the FDIC for the Future

In response to the banking and thrift crisis of the late 1980s and early 1990s, the FDIC substantially increased its workforce. However, the FDIC has been in a period of downsizing for the past ten years, declining from a peak of 23,000 employees in 1992 (FDIC and Resolution Trust Corporation combined) to about 5,300 employees today.

Having come through a long period of downsizing, the FDIC is now in an era of constant change. The number of banks, for example, continues to decrease while their average size and complexity increases. These changes mean that the FDIC must continually adjust the size of its workforce and the composition of the skills among its employees. We have taken the following steps to position the FDIC as a flexible organization with a forward looking posture:

Building a Flexible, Permanent Workforce.

The FDIC has streamlined its organizational structure over the past two years and delegated greater decision making authority throughout the corporation to allow for quicker and more effective decisions. Further, in order to have the greatest flexibility in reassigning employees where they are needed, the FDIC established a training program as part of our "Corporate University." Employees cross-train in other areas and gain a corporate perspective on the different activities conducted by the FDIC as deposit insurer, regulator and receiver of failed institutions.

Establishing Clear Performance Expectations and Incentives.

If the FDIC is to keep pace with the challenges posed by a rapidly evolving financial sector, we must maintain a highly skilled workforce that is performing at the highest levels. This requires that appropriate incentives are in place to recognize and reward performance. The FDIC has taken considerable steps over the past two years toward establishing a culture that provides a direct link between performance and rewards. We instituted a "pay for performance" program for all employees in the organization that links the amount of compensation to an employee's achievement of corporate goals. FDIC's executives no longer receive automatic pay increases for satisfactory performance, but are subject to "pay at risk" completely dependent on their accomplishments.

As I have noted, the FDIC's statutory framework has a number of flexibilities in the pay, benefits and job classification areas that we are already putting to good use. But there is far more that we could do if we had the flexibility to fine tune that package so it promotes the utmost in performance and excellence. In January, the GAO issued a report, Implementing Pay for Performance at Selected Personnel Demonstration Projects. The report notes that there is a growing understanding that the federal government needs to fundamentally rethink its current approach to pay and better link pay to individual and organizational performance. GAO notes that Congress has taken important steps to implement results oriented pay reform and modern performance management systems across the government. The FDIC is carefully analyzing the current flexibilities we have, and the additional authorities that we could use, to best complete our mission of preserving the public's trust in the nation's banks and the deposit insurance system. At a later time, we will propose legislation that will allow us to hire employees for specific needs with more flexibility, hire executives with the same flexibilities enjoyed by other agencies, retain employees with an increased emphasis on performance and more closely link compensation to contributions.

FDIC Advisory Committee

One of my priorities as Chairman was to establish an advisory committee at the FDIC. The FDIC Advisory Committee on Banking Policy was chartered in February 2002 and, just recently, had its charter renewed. The Advisory Committee is composed of 12 members who represent a cross-section of distinguished leaders from all over the country and from many disciplines, including academia, economics, financial services, private industry, public affairs, and the public interest community. The Committee has provided the agency with valuable insights on banking-related issues as well as on corporate management, operations, and structure.

The FDIC Advisory Committee was established under the Federal Advisory Committee Act (FACA), which, among other things, generally requires that meetings of advisory committees be open to the public. Under current law, the FDIC must follow FACA's procedures and requirements when establishing or using committees to provide advice or recommendations to the agency relating to its supervisory responsibilities.

As useful as the Advisory Committee has been to the FDIC, it (and any future advisory committees) would be even more useful if the FDIC had an exemption to FACA similar to the Federal Reserve System's exemption. The banking industry and the way banks deliver products and services are changing rapidly; the FDIC must be able to keep abreast of these changes and their effect on the ability of banks to respond to customer and community needs. Because the kind of information that the FDIC needs can be sensitive, public meeting requirements could prevent the FDIC from obtaining frank, open, and candid advice from industry and community representatives and the customers the banks serve.

To solve this problem, we requested an amendment last year to FACA as part of our suggested regulatory burden relief proposals that would provide the FDIC and the other federal banking agencies, which share similar concerns, with an exemption similar to that already provided by law to the Federal Reserve System. This amendment would enable the regulatory agencies to more effectively establish and use committees to provide advice and recommendations with respect to safety and soundness, product and service developments and delivery, consumer issues affecting supervised institutions, and deposit insurance issues, without concerns that confidential information will be publicly disclosed.

Industry Challenges for the Future

There is a well known adage that generals are always well prepared to fight the last war. One of my chief goals as Chairman of the FDIC has been to ensure that the FDIC is ready to fight the next one. In that regard, I asked the FDIC to undertake a study of the Future of Banking in America in order to chart likely trends in the next 5 to 10 years, and to anticipate the issues that will confront the industry and the regulatory community. The FDIC is nearing the end of this study and I would like to share with you some of its findings and also discuss some of the initiatives the FDIC is taking to address these and other issues.

The view of banking presented in our study is of a strong, competitive industry that continues to serve vital economic purposes. Within the banking industry, the FDIC has

concluded that each of the three main sectors—community banks, regional and other mid-size banks, and the largest banking organizations—has favorable prospects for the years immediately ahead.

In presenting this view, however, the FDIC is mindful of the ever-changing nature of the financial market. One of the primary ongoing changes highlighted by the Future of Banking study is banking industry consolidation into fewer, larger organizations. Since the mid-1980s, consolidation has reduced the number of federally-insured banks and thrifts from just over 18,000 to just under 9,200. During the 1980s and early 1990s, much of that consolidation occurred as a result of bank and thrift failures. But during the 1990s, consolidation proceeded apace through voluntary mergers and charter consolidation within holding companies.

From 1984 to June 2003, the share of industry assets held by the ten largest insured banking organizations rose from approximately 19 percent to just over 44 percent. Similar trends are evident in the concentration of industry deposits and revenues, where the share of the top ten organizations now stand at 40 percent and 44 percent, respectively. Currently, the combined assets of the 18 largest insured banking organizations are greater than the combined assets of the more than 7,800 other banking companies.

Large Institutions

The greater size and complexity of some of our largest institutions pose significant challenges for management, supervisors, and the deposit insurance funds. The FDIC works closely with its fellow regulators to monitor the performance of large banks. Toward that end, the FDIC has placed dedicated examiners in the eight largest insured institutions. In addition, FDIC examiners continually analyze and review all institutions with assets greater than \$25 billion, either by assigning full-time examiners to those banks for which the FDIC is the primary federal regulator or by communicating closely with the institution's primary federal regulator.

Bank supervisors continue to adapt to the consolidation trend and have encouraged the use of cutting-edge risk management methods that require both sophisticated analysis and sound judgment. The Basel II Accord, which, as you know, is an international initiative to improve the system of evaluating capital adequacy at the largest banks, is an example of supervisors' attempts to encourage the use of advanced risk-management techniques.

Basel II.

As I have testified before, the outcome of the current deliberations on Basel II is of crucial importance. There are significant issues relating to the adequacy of the capital requirements coming out of the Accord that must be addressed, in the FDIC's view, before the Basel document should be endorsed as the basis for national rulemaking processes. If these issues can be resolved—and the will to do so clearly exists—the result will be an international agreement that will serve our financial system well.

If Basel II were implemented without change to the capital formulas now being contemplated, the result most likely would be, over time and on average, a substantial decline in risk-based capital requirements. While some reduction in risk-based capital requirements may be appropriate, any reduction in capital requirements must be justified by the underlying risk, and must not simply result from unrealistic modeling assumptions.

At present, the Basel II formulas contain certain assumptions, made in the name of simplicity, that can in some situations substantially underestimate the true economic capital requirement. To offset this possible bias, supervisors have assumed that they will be able to require banks to provide appropriately conservative risk assessments in the formulas. Banks' comment letters, and the FDIC's own experience, suggest that determining these appropriately conservative assessments will be easier said than done. The FDIC is working closely with the other U.S. agencies and the Basel Committee to address the banks' legitimate concerns, the interests of bank supervisors, and the FDIC's interests as deposit insurer.

The FDIC's other fundamental concern with the Accord, as now drafted, is that its Pillar 1 minimum capital requirements are inconsistent with current U.S. regulatory practice. The draft Accord explicitly provides that the current amount of capital required for a bank cannot decrease by more than 20 percent during the first two years of implementation. Thereafter, there is no lower boundary on the amount of capital that is necessary to meet regulatory capital requirements. Absent a regulatory minimum capital requirement, bank capital would be governed solely by the Basel formulas, supplemented by the exercise of supervisory judgment.

The statistical estimation of a bank's future loan losses and operational losses is subject to great uncertainty. The capital formulas in Basel II's advanced approaches reflect specific modeling choices, important simplifying assumptions, calibration based on historical data and a degree of political compromise. Moreover, the Basel formulas neither measure, nor provide capital against, other important risks that banks face, such as interest rate risk on loans outside the trading account and liquidity risk. The smaller the economic capital required by these formulas, the greater the likelihood that the requirements are driven by the assumptions and limitations of the formulas, rather than by underlying risk. For these reasons, the FDIC believes that clear minimum capital standards, such as those we have in our country's Prompt Corrective Action (PCA) requirements, are needed to complement the output of any risk based capital framework.

The FDIC does not intend to try to export our country's PCA framework to the rest of the world. Nevertheless, we believe it is important that the Accord not appear to explicitly repudiate a cornerstone of U.S. legislative and regulatory policy toward the federal safety net underlying insured depository institutions. There is no disagreement among the U.S. regulators on this issue that I am aware of, and we believe it is an issue that can be resolved to the satisfaction all Basel committee members.

Looking to the future, we expect that at the appropriate time there will be a robust debate in the U.S. about the appropriate levels of the leverage ratio requirements imbedded in the PCA regulations. We believe the result of that debate will be a capital regulatory structure that integrates Basel II with the PCA framework in a way that strengthens the U.S. financial system.

Community Banking

The consolidation trend also has led to concerns about the long-term viability of community banking. The challenge from non-bank competitors, such as credit unions, brokerage firms and insurance companies, and the effects of deregulation have-along with technology-created a world that, in general, favors fewer and larger institutions.

Much of this concern has come from the exodus of many small banks from rural communities where demographic shifts have taken the most significant toll. However, there is reason to believe that community banking is not disappearing. The data show that the location of community banking is shifting from rural areas to faster-growing suburbs with population growth and economic vibrancy. Nonetheless, the number of community banks overall has shrunk from about 14,000 in 1985 to about 7,400 today, a drop of approximately 47 percent. Many expect this trend to continue, but we believe the picture is more complex.

Many rural areas in America are suffering from a depopulation trend and are often dependent upon declining industries. These areas are likely to lose more community banks going forward. However, densely populated areas with strong economic growth are likely to see new bank formation. Some 1,100 new banks have been chartered in the past ten years, primarily in fast-growing suburban areas. The large number of new bank charters reflect healthy competition. There are low barriers to entering the U.S. banking system, which is an important structural feature that helps to ensure a vibrant industry. Consolidation would be a much greater concern in a stagnant industry.

In the FDIC's view, the community-banking business model is viable and the FDIC expects that small banks will continue to play a vital role in their communities. The challenge for regulators is to guard against placing disproportionate burdens on smaller banks.

One concern the FDIC hears from community bankers pertains to the cumulative weight of regulatory burden and the fact that this may unduly impair their chances for success. From my own personal experience as a banker, I know all too well how heavy this burden can be. Larger banks are able to spread the fixed costs of regulatory compliance across a larger volume of business. I believe we have a special obligation to eliminate all unnecessary regulatory burdens. I will discuss more about this later in the testimony.

FDIC Risk Management

As the banking industry has become more sophisticated, the FDIC has developed cutting edge risk-management techniques to identify, measure and manage risk to the insurance funds. The FDIC employs a robust, integrated risk analysis process that was strengthened by several initiatives in 2003. The focal point of the FDIC's integrated risk

management infrastructure is its National Risk Committee (NRC). Created in early 2003, this executive committee oversees and coordinates the risk analysis activities of the FDIC and provides strategic direction and appropriate policy responses to emerging risk issues. The NRC receives regular input from other risk oversight groups throughout FDIC.

One of these other oversight groups is the FDIC's Risk Analysis Center (RAC), which was established in March 2003 to better coordinate risk monitoring and action plans among the various business units in the FDIC. The RAC, located here in Washington, D.C., is a best practice that brings together economists, examiners, financial analysts, and others involved in assessing risk to the banking industry and the deposit insurance funds. Individuals from these disciplines work together to monitor and analyze economic, financial, regulatory, and supervisory trends and determine the implications for banks and the deposit insurance funds. Comprehensive solutions are developed to address risks that are identified during this process. We anticipate that this process will enable the FDIC to respond to emerging risks quickly and effectively. One of the lessons learned from the last banking and thrift crisis is the need to constantly coordinate efforts to monitor and analyze current and future risks in the industry.

The principle of a coordinated approach to analyzing and addressing risks also extends to the regions. In each of the FDIC's six regional offices individuals from various disciplines, both from within and outside the FDIC, meet to analyze and address unique risks facing the region.

In 2003, the FDIC hired an independent, outside consultant to review the FDIC's financial risk management practices, in particular, the methodology and processes used to develop the quarterly value of the FDIC's contingent liability for anticipated failures. The final report, *Strengthening Financial Risk Management at the FDIC*, validates our methods and procedures and includes meaningful suggestions-which we have implemented-to enhance the overall accuracy, robustness, and transparency of the FDIC's reserving process. Finally, the report endorses and enhances a road map to use in developing the next-generation tools and organizational practices for managing risk at the FDIC.

One of these next-generation tools is the Loss Distribution Model, which employs many of the same advanced techniques used by large financial companies to measure and manage risk. A prototype version of this model was developed in 2003 and represents a significant step toward developing a fully integrated approach to quantifying risks to the insurance funds that includes factors such as investment returns, premium income, insured deposit growth, and failure-related losses.

Regulatory Burden Relief

With the rapid pace of change in the financial services industry, it is important that regulators ensure that their actions and regulations-while continuing to maintain safety and soundness and ensure consumer protection-do not unnecessarily stifle innovation

or impair banks' ability to compete. As I mentioned earlier, this is particularly important for community banks.

EGRPRA.

The FDIC is leading an interagency effort to identify unnecessary burden, duplication, and outmoded restrictions on both large and small financial institutions. Under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA), Congress required the federal banking agencies and the National Credit Union Administration to review all regulations every ten years for areas that are outdated, unnecessary or unduly burdensome. FDIC Vice Chairman John Reich is leading this interagency review.

The agencies have jointly published the first two of a series of notices soliciting comment on regulations in a number of areas, and have been conducting outreach sessions with bankers and consumer/community groups. Armed with input from these efforts, the agencies will conduct a comprehensive review of banking regulations and will report to Congress on their findings and the actions they have taken, or plan to take, to reduce the level of burden. The agencies also anticipate sending this Committee a list of legislative areas for consideration.

Community Reinvestment Act. On February 6, 2004, the FDIC, along with the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Office of Thrift Supervision, published a joint interagency notice of proposed rulemaking (NPR) regarding the Community Reinvestment Act (CRA). This NPR fulfilled the commitment the agencies made in 1995, when the current CRA regulations were adopted, to review the regulations to determine whether they were producing objective, performance-based CRA evaluations that did not impose undue burden on institutions. The NPR reflects the agencies' analysis of about four hundred comments on an Advance Notice of Proposed Rulemaking published in 2001 on the same subject.

The proposed rulemaking underscores the agencies' conclusion that the CRA regulations are essentially sound, but need to be updated to keep pace with changes in the financial services industry. The NPR proposes two fundamental changes, one of which should help substantially reduce unwarranted burden. First, for purposes of the streamlined small bank CRA test, the agencies propose to amend the definition of "small institution" to mean an institution with total assets of less than \$500 million, without regard to holding company assets. The gap in assets between the largest and smallest institutions has grown substantially since the 1995 CRA regulations were implemented. The number of institutions considered small has declined by more than 2000 since 1995. This proposal would expand the number of institutions eligible for evaluation under the streamlined small bank test, while only slightly reducing the portion of industry assets subject to the large retail institution test.

Second, the NPR expands and clarifies the adverse effect on the CRA rating of an institution engaging in discriminatory, illegal or abusive credit practices. The bank

regulatory agencies are seeking comment on this proposal until April 6 and we encourage interested parties to provide input.

MERIT Program.

The FDIC has continued to refine its risk-focused examination processes in several stages. The latest refinement was implemented in January 2004, when the FDIC expanded the use of a streamlined examination program called MERIT - for Maximum Efficiency, Risk-Focused, Institution Targeted Examinations. The MERIT program, originally implemented in April 2002, was applicable to banks that met basic eligibility criteria, such as total assets of \$250 million or less and satisfactory regulatory ratings. The MERIT program now applies to well-capitalized insured depository institutions with total assets of \$1 billion or less that meet basic eligibility criteria, including component and composite safety and soundness ratings of "1" or "2," stable management and effective loan-grading systems.

During a MERIT examination, examiners devote significant attention to the overall assessment of the institution's risk-management processes, and spend less time engaged in transaction testing. Examiners review an institution's lower-risk activities primarily through discussions with management and by monitoring the activities through various off-site analytical programs.

Revised Compliance Examination Process.

In July 2003, the FDIC also implemented a risk-focused approach to consumer compliance examinations. This approach begins by evaluating an institution's compliance management system, which consists of its management, internal controls, and compliance audits. The intensity and extent of further testing is then based upon the institution's risk profile. The FDIC believes that this approach will maintain examination quality while allowing the FDIC, over time, to spend less time examining institutions with good compliance management systems and more time examining institutions with weak systems.

In addition to the revised compliance examination approach and the MERIT program, the FDIC recently established a special task force to reevaluate the FDIC's examination process and supervisory practices for any excesses or inefficiencies that impose undue costs on insured institutions. The FDIC's examination processes will continue to evolve to ensure that the Corporation's resources are focused on the greatest areas of risk, while preserving the integrity of the examination process.

Call Report Modernization

The FDIC and other banking regulators are employing the latest technology to collect and release more timely information. Under the sponsorship of the Federal Financial Institutions Examination Council, the FDIC, along with the OCC and the Federal Reserve, initiated an effort last year to modernize the process for collecting and publishing Reports of Condition and Income (Call Reports) from banks. The new process will use modern technology so that banks can identify and correct errors in their data before they submit their Call Reports, thereby enabling the banking regulators to collect and release more timely information in a format that can readily be shared

among all those who use Call Reports in their business. Currently, the FDIC and the other agencies are working to develop a central data repository that will be shared by the FDIC, OCC and Federal Reserve. Banks and other users will be instructed on the new process well in advance of implementation. While banks may have to begin preparation of their Call Reports slightly earlier, the new process should not increase the overall burden of preparing the reports. In fact, the new process will give banks greater confidence that they have submitted reports that are in compliance with federal requirements. The agencies anticipate implementing the new process for the third quarter 2004 report, after it has been tested by regulators and the industry. Once the process has been put in place for Call Reports, the agencies anticipate that it will be used for other types of financial information.

Consumer Protection

Financial Education and Money Smart. While much of the world has become increasingly technologically and financially sophisticated, the FDIC has long recognized that a large portion of American families do not have bank accounts and lack an understanding of basic financial concepts. The FDIC is committed to continuing its efforts to open up opportunities for people to enter the financial mainstream. A little over two years ago, the FDIC rolled out Money Smart, an award-winning financial education curriculum designed specifically to meet the needs of low- and moderate-income adults, who are often unbanked (i.e., they have no bank accounts or other financial relationships with a bank).

Unbanked households represent a category of customers that can be potentially profitable to depository institutions. Many banks have recognized this and are taking steps to expand their banks' presence, activities, and customer base in underserved emerging markets. The FDIC, for its part, is committed to furthering these efforts through Money Smart. Since the rollout of Money Smart, FDIC has distributed more than 111,000 copies of the curriculum and trained over 5,000 instructors. Money Smart is currently available in English, Spanish, Chinese, Korean and Vietnamese. The FDIC has taken the lead in establishing financial education partnerships with communities and bankers. The FDIC has entered into over 600 local Money Smart Alliances across the country, including national partnerships with the U.S. Department of Labor, the U.S. Department of Housing and Urban Development, the Association of Military Banks of America, Goodwill Industries International, the National Coalition for Asian Pacific American Community and the Internal Revenue Service. Last year, for example, the FDIC's work during the 2002 tax season with the "Back of the Yards" voluntary income tax assistance site in Chicago helped over 600 families file tax returns and receive \$1.1 million in earned income tax credit refunds. Many of these families also opened their first bank accounts through this initiative.

Later this year, the FDIC will broaden its outreach efforts by releasing an interactive version of Money Smart in English and in Spanish that can be accessed directly through a CD-ROM or on the FDIC's website either at home or at public libraries. The FDIC also is working closely with its faith- and community-based organization partners to integrate the interactive versions into their programs. In addition, the FDIC will play an important

role as a member of the Financial Literacy and Education Commission established by section 513 of the Fair and Accurate Credit Transactions Act of 2003. We will lead one of the two stated projects outlined in the bill creating the commission-the establishment of a single government toll-free number for financial education matters.

Expanded Fair Lending Examination Specialist Program.

Building on improvements made in recent years to the FDIC's fair lending program, in January, the FDIC expanded the program by appointing fair lending examination specialists in each of its six regions. These specialists will provide expert guidance and assistance to compliance examiners during complex fair lending examinations to help focus examinations and identify discrimination.

The Bank Secrecy Act and the USA Patriot Act

The FDIC is responsible for ensuring that state nonmember banks comply with the Bank Secrecy Act (BSA). At each safety and soundness examination, the adequacy of an institution's BSA compliance program and procedures is assessed, and a review for compliance with the BSA is conducted. Over the past three years, the FDIC has conducted more than 7,500 BSA compliance examinations.

The FDIC employs a variety of supervisory methods to ensure that financial institutions correct BSA-related infractions. The majority of BSA violations are corrected while the examiners are still in the institution or shortly after their departure. Occasionally, some institutions fail to correct violations or implement adequate compliance programs at subsequent examinations. The FDIC visits these institutions between the regularly scheduled examinations and takes supervisory action if appropriate. Over the past three years, the FDIC has imposed 23 formal actions and entered into 32 informal agreements with institutions that demonstrated significant BSA compliance weaknesses. The FDIC also has taken many measures to implement the USA Patriot Act and to combat money laundering and terrorist financing. Since the enactment of the USA Patriot Act, we have participated in numerous interagency working groups led by the Department of Treasury to draft revisions to the Bank Secrecy Act as required by the USA Patriot Act and to develop interpretive guidance for the financial services community.

For years, the FDIC has worked with the Department of Treasury, the Financial Crimes Enforcement Network and the other banking agencies to develop policies, best practices and international standards to combat money laundering and more recently, terrorist funding. We have also worked with the other federal banking agencies and the Conference of State Bank Supervisors to issue risk-focused examination procedures designed to evaluate a financial institution's anti-money laundering program and compliance with the Bank Secrecy Act and the final rules implementing the USA Patriot Act. Last fall, we revised our Bank Secrecy Act examination procedures for reviewing compliance with the new provisions of the USA Patriot Act and released them to examiners.

The FDIC believes that strong supervision of foreign banks contributes to the stability of foreign economies, enhances trade opportunities for U.S. companies, and reduces opportunities for money laundering. Therefore, we actively participate in working groups and technical assistance missions sponsored by the Departments of State and Treasury to assess vulnerabilities to terrorist financing activity worldwide and to develop and implement plans to assist foreign governments. We have assembled a team of experts ready to assist with foreign missions under the auspices of the Department of State's Financial Systems Assessment Team. Since 2002, we have assisted in the evaluation of eight countries and have provided training and technical assistance to over thirty-eight countries.

Resolutions and Receiverships

During the 1980s and early 1990s, nearly 2,950 banks and thrifts failed with almost \$950 billion in assets. By 1991, these failures had left the FDIC and RTC with an inventory of over \$170 billion in assets to sell, which would have made the combined agency one of the largest banks in the United States. Since that time, the FDIC has resolved virtually all of these assets and receiverships, and today there are only \$800 million assets and 90 receiverships remaining to be resolved.

Fortunately, the pace of bank and thrift failures has declined dramatically since 1991, but the failures that do occur today tend to involve more complex assets and operations. Banking industry consolidation, globalization, technology and increased use of such nontraditional banking business lines as internet banking, securitization, expanded credit card banking, and subprime lending pose new challenges for the FDIC in resolving failed banks and thrifts. The FDIC has developed innovative approaches and tools in response to these challenges.

First, the FDIC has taken advantage of new technologies. To assess the marketability of an institution and its assets before failure, the FDIC uses statistical models and sampling techniques. In its marketing efforts, the FDIC uses a secure web site-called Intralinks-that allows prospective acquirers of failing banks or their assets to obtain asset information quickly and conduct due diligence largely off-site. This results in less interference with a failing bank's efforts to conduct day-to-day business and market itself or attract new capital to help it survive. Intralinks also allows the FDIC to conduct bid meetings over the Internet (or by regional video-conference).

This innovation has greatly increased bidder participation (over 6,500 banks and thrifts are now participating) and has served to reduce due diligence expenses for the FDIC and for prospective investors. The FDIC also uses another website, FDICSales.com, to notify potential bidders of sales, distribute information, and hold asset sales and auctions. In late 2003, the President's Quality Award Program recognized the FDIC's leadership in "Expanded Electronic Government" with an award for its efforts to apply technology to bank and thrift resolutions.

Second, the FDIC relies on sound business principles to resolve banks. The FDIC has developed business plans to guide pre-resolution planning and to manage customer

service and asset sales. The FDIC has developed plans for responding to insolvencies involving credit card banks, large complex banks, internet banks, subprime assets, securitized assets, and other new banking issues. As a result, the FDIC successfully protected depositors in the sudden failure of Superior Bank, F.S.B., which had an extensive subprime mortgage securitization program, and in the failure of NextBank, which was the first Internet-only bank to fail. The FDIC also continues to work with other regulators to enhance contingency strategies to ensure that the regulators can properly respond if one of the largest banks ever threatens to fail.

Third, the FDIC has focused on maximizing the flexibility of employees and enhancing their skills. The FDIC cross-trains employees in different closing functions and has a systemized training program that now offers over 30 comprehensive courses in the critical resolutions and receivership functions. As a result, the FDIC sells the more complex assets of failed banks and thrifts much more quickly than ever before, all while giving insured depositors access to their funds virtually overnight.

Conclusion

Over the past 20 years, the banking industry has changed greatly. Consolidation has created large, complex institutions and technology is adding to the complexity. Community banks have had to develop new business strategies in response to the changing financial environment. Banks and thrifts have come through the most recent economic cycle well, which attests to their success in responding to change. As a result, the industry and the deposit insurance system are strong and well-positioned for the future.

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