Remarks of
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Tennessee Bankers Association
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Good afternoon everyone. It is a pleasure to be here in Knoxville today. I would like to thank Brad Barrett and the Tennessee Bankers Association for inviting me to speak to you. I would also like to thank the University of Tennessee's Department of Finance for co-hosting this event.

Today I would like to talk to you about a number of important banking issues that currently face the FDIC. First, I would like to discuss the state of the banking industry, signs of emerging credit risk, and how the FDIC and other agencies are addressing these risks. Second, I'll highlight the progress the FDIC has made this year implementing the new deposit insurance reform law. Finally, I'll highlight a very important initiative at the FDIC concerning economic inclusion. Following my remarks I would welcome any questions you may have.

The State of the Banking Industry

The condition of the banking industry in the United States as well as in Tennessee generally remains very strong. Both bank profitability and bank capital are at or near record levels. Loan growth remains strong and loan portfolios continue to exhibit good health.

Our analysts from this region inform us that the overall performance of Tennessee banks is generally good, and that loan growth among Tennessee banks remains strong, driven by increased commercial real estate lending and, in particular, construction and development lending.

While there is much good news to report on the condition of the banking industry, there are some areas that we are watching very closely. As a general matter, bank regulators are concerned that as interest rates have risen and the margin earned by banks has narrowed, there is a tendency by banks to undertake riskier loans in order to maintain yield.

Although asset quality at banks currently remains relatively benign, our two biggest areas of credit risk concern are the so-called "non-traditional" mortgage market and commercial real estate lending. I'd like to talk to you about these two issues. While credit losses remain low in percentage terms, we are beginning to see increases in non-current and problem loans in certain of these categories. This suggests that we may be at a turning point in the current credit cycle.

Credit Risk – Non-Traditional Mortgages

The first area of credit risk concern relates to so-called non-traditional mortgages, which have experienced rapid growth in recent years. Non-traditional mortgages include "interest-only" mortgages where a borrower pays no loan principal for the first few years of the loan and "pay option" adjustable-rate mortgages where a borrower has flexible payment options with the potential for negative amortization. Negative amortization results in an increased loan balance over time if monthly mortgage payments do not cover the amount of interest due and the unpaid interest is then added to the outstanding loan balance. They raise the potential that over time borrowers could owe more on their homes than their homes are worth. Payment shock results in significantly higher payment requirements when a loan begins to fully amortize and raises the potential for delinquency or default. According to one industry source, interest only and pay option mortgages accounted for over thirty five percent of mortgages originated this year.[1]

Another worrisome trend relates to the potential risk posed by a particular type of subprime lending referred to as the 2/28 mortgage. These are mortgages with a low fixed initial interest rate for 24 months where the payment can rise significantly – as much as 6 percentage points – at the end of the initial period. Borrowers with these types of mortgages can face significant payment shock at the end of the initial term if they are unable to refinance. According to data I've seen, these types of mortgages have accounted for approximately 60 to 70 percent of subprime mortgages originated over the past several years.[2] And over this period, subprime lending overall has grown to account for over 20 percent of total mortgage originations.[3] Subprime 2/28 type mortgages are risky because of the potential payment shock the borrowers may face upon expiration of the initial fixed period and because a substantial volume of these loans are expected to reach the end of the initial low fixed interest rate period in the coming years.

While non-traditional mortgages have been offered for many years to financially sophisticated borrowers, in recent years many lenders have offered these products to a much broader range of borrowers. We worry that less sophisticated borrowers simply do not understand the complex terms that these products involve and may not have the financial cushion to bear the risks they may face with these products.

As you know, the housing market has been slowing in many areas of the country. This obviously heightens our concerns because it raises the potential for near-term distress in some mortgage markets, especially in areas where economic conditions are weak and home prices are falling. We are already seeing increases in delinquency and foreclosures of recently originated subprime mortgage loans and are closely monitoring mortgage performance at banks and thrifts.

A few months ago the FDIC joined the other federal financial institution regulatory agencies in publishing final guidance on non-traditional mortgages. The guidance focuses on qualification standards for borrowers and payment shock and emphasizes that borrowers should be qualified at the fully indexed rate including potential negative amortization amounts. It also recommends that promotional materials and other product

descriptions provide consumers with full and balanced information about the costs, terms, features, and risks of non-traditional mortgage products at the points in time when consumers are making critical decisions. Without such information, consumers cannot make rational product selections. All information must be sufficiently clear to the borrower to enable them to make the appropriate product choice – not just for today, but in the future should interest rates and payment requirements change.

Credit Risk – Commercial Real Estate

As I mentioned earlier, we also have concerns about credit risk on the commercial lending side. These concerns stem from rising bank portfolio concentrations in commercial real estate assets. At the end of September, there were 1,795 insured banks and thrifts -- 20.5 percent of all insured institutions -- with construction and development loans greater than total capital and commercial real estate loans greater than 300 percent of total capital. Construction loan growth has been very high, almost 32 percent over the past year.

In the past, high concentrations of commercial real estate loans have been associated with a higher frequency of failure among FDIC-insured institutions, particularly when coupled with weak underwriting and local economic conditions. While today's commercial real estate underwriting standards and loan performance are strong relative to the past and the banking industry is currently very healthy, these trends have caused the regulators to take a close look at how banks are managing risk in this type of lending.

Just last week the FDIC and the other federal bank regulators issued final guidance on commercial real estate lending. The guidance provides criteria for identifying institutions with commercial real estate loan concentrations that may be subject to supervisory scrutiny and recommends the use of appropriate risk management practices at such institutions. We received many comment letters about the proposed guidance throughout the year and made significant changes to the proposed guidance to clarify its purpose and scope.

One area of considerable interest in the proposed guidance concerned the suggestion that banks with construction, land development, and other land of 100 percent or more of total capital, and commercial real estate loans (excluding loans secured by owner-occupied properties) of 300 percent or more of total capital should employ heightened risk management practices. Many comment letters expressed concern about these thresholds and how they would be employed. In the final Guidance, the Agencies addressed these concerns by clarifying that numeric indicators will be used as supervisory monitoring screens, not limits, and added an additional condition to the 300 percent screen, that is, whether the bank's commercial real estate portfolio has experienced rapid growth of 50 percent or more during the prior 36 months. The final guidance recognizes the important role banks play in providing credit for commercial real estate activity and makes it very clear that the intent of the guidance is not to establish a limit on commercial real estate lending.

Deposit Insurance Reform

Now I would like to update you on our implementation of deposit insurance reform this year. Historically, major deposit insurance reform in the US has coincided with a banking crisis. We were fortunate in this case that we were able to introduce these reforms during a period of economic strength, which will place us in a stronger position to deal with less favorable economic conditions that may occur in the future.

The reform act that was signed into law in February of this year contained five key elements of reform: (1) merging the two separate funds that existed for our banking and thrift industries, (2) strengthening the FDIC's authority to manage the merged fund, (3) allowing the FDIC to price premiums to more accurately reflect risk, (4) raising deposit insurance coverage on certain retirement accounts at a bank or thrift to $250,000 from $100,000, and (5) providing for an inflation adjustment on both the basic insurance coverage of $100,000 and retirement account coverage of $250,000 every five years beginning in 2011.

Of these five elements, perhaps the two most critical reforms were strengthening our authority to manage the deposit insurance fund and allowing us to price premiums to more accurately reflect risk.

Under the old law, if the reserve ratio fell below the statutory target, the FDIC was required by law to impose very large premiums to return the reserve ratio to the target regardless of economic conditions. This system created an undesired strong pro-cyclical effect and raised the possibility that we would have to raise premiums during economic downturns when banks would be least able to afford them. The new law gives us flexibility to raise premiums during good economic times so that we don't have to raise premiums during bad economic times. This strengthens our ability to manage the fund and is a key feature of the reform's intent to maintain a stable and strong banking system. The second key element of deposit insurance reform allows us to charge all banks for the risk they pose to the system.

In November, the FDIC Board adopted a new risk-based deposit insurance premium system effective January 2007. The assessment approach adopted relies on an institution's supervisory ratings, financial ratios, and long-term debt issuer ratings. For most institutions, supervisory ratings will be combined with financial ratios to determine assessment rates. For large institutions with long-term debt issuer ratings, assessment rates will be based on supervisory ratings combined with debt ratings.

The Board also established a deposit insurance premium rate schedule at its November meeting. Not surprisingly, this was an area of considerable interest to the industry. The recommended final rule sets the minimum assessment rate at 5 basis points of domestic deposits and most institutions will pay rates between 5 and 7 basis points. The Board based this rule on several factors, including strong deposit growth and the need to address a recent downward trend in the reserve ratio. The adopted rule also reflects

the intent of Congress to build up the deposit insurance fund in good economic times so that premiums do not have to be imposed during economic downturns, thus providing for long-term stability in premiums.

Economic Inclusion

Finally, I'd like to say a few words about an important initiative at the FDIC, one that is a high priority for our Chairman, Sheila Bair, and for me. This is the issue of economic inclusion, promoting expanded access for all Americans to the financial mainstream. Studies have indicated that a substantial portion of the U.S. population lacks access to the insured banking system and spends significantly more on financial transactions as a result. One recent study estimated that there are 28 million unbanked people in the U.S., and 45 million underserved people who lack adequate access to credit.[4] Another recent study indicates that the population underserved by banks is significantly concentrated among minorities. According to this study, 46 percent of African Americans and 34 percent of Hispanic Americans are unbanked.[5]

Promoting expanded access to the financial mainstream is central to the FDIC's mission and one of our top priorities. Entering and becoming part of the financial mainstream is in many ways the starting point for economic citizenship in the U.S. Banking relationships provide individuals with the opportunity to save, borrow, invest, and build a credit record. It increases their participation in housing and credit markets which can promote stable neighborhoods and better living conditions. Promoting economic inclusion is a top priority for the FDIC.

The FDIC's New Alliance Task Force (NATF), a project started in our Chicago Region, plays a key role in the FDIC's economic inclusion initiatives. NATF was launched in 2003 by the FDIC as an initiative to encourage immigrants to enter mainstream banking, learn basic financial skills and become homeowners. NATF has successfully brought immigrants into the financial mainstream by promoting financial education and outreach programs and innovative banking products.

As of late 2005, NATF was composed of 65 members including 40 banks, government agencies, and nonprofit advocacy and community groups in the Chicago and Milwaukee areas. Moreover, the success of the NATF Chicago/Midwest model led to the initiative's expansion in 2005 to the FDIC's Atlanta, Boston, Dallas, Kansas City, New York and San Francisco regions. As a result of these efforts and programs, more than 10,000 people have participated in NATF financial education workshops and more than more than 157,000 new bank accounts have been opened in the areas where NATF operates, with more than $100 million in deposits. Also, since NATF was launched, more than 800 immigrant families have received mortgage loans totaling $100 million.

Looking forward, the FDIC now plans to expand these efforts in a national campaign which we call the National Alliance for Economic Inclusion (NAEI). NAEI is focused on the entire unbanked population in the U.S. through the organization of broad-based coalitions in each of the FDIC's six regions composed of banks, community

organizations, foundations, educators, and local, state, and federal agencies. Building on our experiences to date, the FDIC will seek to build partnerships among public, private, and non-profit organizations to bring the unbanked and underserved into the financial mainstream.

In addition, the FDIC recently announced the establishment of an Advisory Committee on Economic Inclusion to provide the agency with advice and recommendations on ways to expand access to banking services and bring more consumers into the financial mainstream. The committee members represent a cross section of interests from the banking industry, consumer and public advocacy organizations, community-based groups, state and local government, and academia. Diana Taylor, the New York State Superintendent of Banks, has agreed to chair the Committee.

The Committee will consider many issues, including basic retail financial services like check cashing, money orders, remittances, and stored value cards, as well as how to encourage banks to make small, short-term loans. We look forward to receiving a wide range of recommendations and to promoting a dialogue among regulators, bankers, and consumer advocates on this important issue.

The last item I would like to mention in this area is the work the FDIC is doing to encourage banks to offer small-dollar loan products that are affordable as alternatives to high cost payday loans which can trap individuals and families in a cycle of debt and financial hardship. Just last week the FDIC held a conference to encourage banks located near military bases to offer military personnel and their families alternative, affordable options to meet their credit needs and help them regain their financial bearing. You may be aware of the Department of Defense's (DoD) recently issued report on predatory lending, which highlights the adverse impact of costly credit on the military. We are actively working to find ways to encourage the industry to develop financial products and services to help such consumers.

As part of this effort, last week the FDIC also released for public comment guidance to FDIC-supervised institutions on Affordable Small Loans. The guidance explores several aspects of product development, including affordability and streamlined underwriting. We encourage banks to offer products with affordable, reasonable interest rates with no or low fees; payments that pay down the principal balance of the loan; and a savings component incorporated into the loan. In addition, institutions offering these loan products may receive favorable consideration under the Community Reinvestment Act. We welcome bank comments on the proposed affordable short term loan guidance, and if any of you have an interest in lending to the military and helping us address this issue, we welcome your input and involvement.

In conclusion, allow me to thank the Tennessee Bankers Association once again for inviting me to come to Knoxville to speak with you.

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[1] Inside Mortgage Finance, "Longer Amortization Products Gain Momentum in Still-Growing Nontraditional Mortgage Market", July 14, 2006. Nontraditional mortgages accounted for 37% of 2006 originations through second quarter.

[2] LoanPerformance ABS Securities database.

[3] Inside B&C Lending, "Subprime Volume Slides Amid Home Price and Rate Pressures", November 10, 2006. Subprime share of total originations was greater than 20% in each of the first three quarters 2006; subprime originations comprised 21.3% and 18.2% of total originations in 2005 and 2004 respectively.

[4] "Private-Label Card Program From GE Offers 'Road to Credit' To Tap Greater Portion of Market," citing statistics from Bearing Point, *The Wall Street Journal*, July 7, 2006.

[5] Sherrie L. W. Rhine, "A Closer Look at the Unbanked," May 22, 2006, and Sherrie L. Rhine and William H. Greene, "The Determinants of Being Unbanked for U.S. Immigrants," *Journal of Consumer Affairs*, summer 2006, Vol. 40 Issue 1, p. 21-40. Statistics cited refer to U.S. born African Americans and Hispanic Americans.

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