Remarks by
Sheila C. Bair, Chairman,
Federal Deposit Insurance Corporation
before the
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Thank you. I'm very honored to be here this morning.

I've been at the FDIC since June 26 – so my 100 day "honeymoon" is over. It hasn't exactly been a Caribbean cruise – more like an Outward Bound survival course. As you know, the FDIC has been grappling with some major issues lately; one you may not have heard of – the color scheme of the FDIC logo. One commenter wrote in concerned that our proposed black and gold FDIC logo would clash with the décor of the bank's lobby.

With so many high profile issues before it ranging from implementing deposit insurance reform to capital reform to Industrial Loan Companies, the FDIC Board has been engaged in daily efforts to chart our way through a morass of legal issues. Faced with these challenges, we are fortunate to have four lawyers and a former banker on the FDIC Board as we strive to implement statutes involving important public policy issues. As a lawyer involved in finance and academics, it is hard to imagine a more interesting and exciting array of legal issues than those facing the FDIC Board today.

As lawyers involved in bank regulatory matters, you share a keen interest in many of the matters before us. Today, I'd like to address three of these issues – deposit insurance reform, the Basel capital standards and ILCs. I know this is an "inside the beltway" group – so I will not go into too much detail, knowing that many of you spend your day focusing on these issues. At the conclusion of my brief remarks, I will be happy to take your questions.

Deposit Insurance Reform

Many of you have closely followed the deposit insurance reform effort from the beginning. On February 8th of this year, President Bush signed into law the Federal Deposit Insurance Reform Act of 2005, a law containing sweeping improvements for our federal deposit insurance system. Securing enactment of this legislation was a long, multi-year process and I thank my predecessors, former Chairmen Don Powell and Donna Tanoue, Vice Chairman Marty Gruenberg and former Vice Chairman Skip Hove, for their efforts toward passage of this comprehensive law.

We all know that reform was needed because of the flaws inherent in the deposit insurance system. It required safer banks to subsidize riskier ones and allowed banks to grow rapidly without contributing to the insurance fund. Because premiums were directly linked to the reserve ratio, the system raised the specter of high rates during downturns when banks could least afford to pay.

Congress gave us nine months to implement most of the provisions of the reform legislation – that is, until November 5th of this year – two days from now. I'm happy to say that, yesterday, the FDIC Board of Directors adopted the last of the final rules needed to implement reform. We have had a lot to do in a short time. I'm proud of what we accomplished. Here are some of our key accomplishments.

The Bank Insurance Fund and the Savings Association Insurance Fund were merged into the new Deposit Insurance Fund. Increased coverage for retirement accounts became effective in April. Coverage for other deposit accounts can be indexed to inflation beginning in 2011.

On October 10, the FDIC Board of Directors approved a final rule to implement a one-time assessment credit to banks and thrifts. The credit will be used to offset future assessments charged by the FDIC and will recognize the contributions that certain institutions made to capitalize the funds during the first half of the 1990s.

Yesterday, the Board adopted a final rule on the pricing structure and approved a more risk-sensitive framework for the 95 percent of insured institutions that are well-capitalized and well-managed. The new rule will enable the FDIC to more closely tie each bank's premiums to the risk it poses to the deposit insurance fund. As proposed, the FDIC will evaluate each institution's risk based on three primary sources of information — supervisory ratings for all insured institutions, financial ratios for most institutions, and long-term debt issuer ratings for large institutions that have them. The ability to differentiate on the basis of risk will improve incentives for effective risk management and will reduce the extent to which safer banks subsidize riskier ones.

This new rule reflects the many comments received on the proposal. Most commenters were supportive of using examination ratings to differentiate risk among the best-rated institutions. For large banks, we received feedback on how we proposed to use market data and recommendations to avoid large changes in rates for small changes in risk measures. With respect to the use of financial ratios for smaller banks, we received comments on measures of volatile liabilities and non-performing loans. Although we did not propose including Federal Home Loan Bank advances in our pricing proposal, we received many comments suggesting that these should be excluded.

The assessment rates will take effect at the beginning of 2007. The rates for well-capitalized and well-run institutions will be between five and seven cents per $100. About 40 percent of institutions will initially be charged the minimum five cent rate.

Beginning in 2010, with a few specific exceptions, well-capitalized and well-run new banks—those less than five years old—will be charged the highest rate applicable to well-capitalized and well-run banks. (Right now, that rate would be seven cents per

$100.) New banks tend to fail at a higher rate than established institutions and their financial data is much more difficult to interpret.

However, before 2010, we will charge new institutions as all other institutions are charged. Most new institutions did not receive any of the one-time credits and the FDIC recognizes that the lack of credits, in combination with charging 7 basis points to new institutions, means a sharp increase in rates paid by these institutions. Consequently, the final rule delays the effective date of the new institution provision until January 1, 2010.

Not surprisingly, many comments focused on the rates. Most requested that the FDIC not set rates too high. Several suggested lower rates for the best-rated banks or changing the spread between the lowest and highest rates. Most important for the banks that we insure was the bottom line: what would they pay?

In fact, most insured institutions initially will continue to pay nothing for deposit insurance – as has been the case for the past 10 years – because of the assessment credits that Congress awarded to recognize the high insurance premiums paid in the past to bolster the FDIC's insurance reserves.

As we begin implementing the new risk-based system, it is important to keep in mind that even without the new law, all institutions would have been assessed premiums next year because the reserve ratio is already below the 1.25 percent reserve ratio target. What would have been different is that without the reform law, institutions would not receive credits for their past contributions.

Congress intended the fund to grow in good economic times so that it can withstand periods of financial stress without the need to raise premium rates sharply. Keeping the fund strong now, when industry conditions are favorable, will help ensure that assessment rates remain stable and moderate over the longer term.

Capital Reform

There is another matter of reform at the forefront—capital reform, which I'd like to turn to now. The current capital position of the banking system is a recognized strength that provides a cushion for when economic and banking conditions are less favorable than they are today. On September 5th, the FDIC Board of Directors, along with the other federal banking regulators, voted to publish the Basel II Notice of Proposed Rulemaking (NPR) for public comment. In conjunction with Basel II, U.S. bank and thrift regulators also are developing a more risk-sensitive capital framework for non-Basel II banks, known as Basel IA, which we hope to publish for comment in the near future.

Quantitative impact studies indicate that the Advanced Approaches in Basel II could result in significant reductions in the risk-based regulatory capital requirements of large banks. For this reason, we included a number of essential and important safeguards in the NPR. U.S. banks have demonstrated over the past ten years that strong bank capital levels are compatible with record profitability. It seems both unnecessary and imprudent to allow significant reductions in industry capital to occur as a result of reform.

We look forward to receiving the comments on the NPR and will approach them with an open mind. I am particularly interested in comments on the question of whether the regulators should allow alternatives to the Advanced Approaches. The U.S. is the only country proposing to make the Advanced Approaches mandatory for some banks. Several large banks have asked to be allowed to use the Basel Standardized Approach for calculating their requirements.

The Standardized Approach links risk weights to external ratings and includes a greater array of risk classes than are included in the current rules. It is simpler and less costly to implement than the Advanced Approaches. In addition, because there is a floor for each risk exposure, it does not provide the same potential for dramatic reductions in capital requirements and therefore would not pose the same issues about competitive inequity. On the other hand, there is the argument that only the Advanced Approaches provide an adequate incentive for strengthening risk measurement systems at our largest banks. Whether our largest banks should be required to use the Advanced Approaches is an important policy issue.

I'd like to point out that Basel II is not simply a large-bank issue. We are concerned about the effect this could have on system stability and on community banks. The U.S. financial system benefits from a balance between large complex banks, regionally focused banks and community banks. Our capital framework should not place community banks at a competitive disadvantage.

My final comment on the topic of Basel relates to the leverage ratio. As many of you know, the FDIC has consistently supported the idea that the leverage ratio is a critically important component of our regulatory capital regime. I am pleased that the other regulators have expressed their support for preserving the leverage ratio. I also believe that an international supplemental capital measure, such as a leverage ratio, would ensure a minimum cushion of capital for safety and soundness throughout the global banking system. I hope that the Basel Committee will give thorough consideration to this question as it takes stock of the approaches currently used by its member countries to ensure a stable base of capital.

Industrial Loan Companies

I'd like to briefly address the issue of Industrial Loan Companies. ILCs have been a hotly debated issue, as you know, and I probably will not be able to answer your many questions about what direction the FDIC Board will take – because we haven't yet decided. Last July we placed a six-month moratorium on ILC deposit insurance applications and change in control notices. We put the moratorium in place for a number of reasons: we wanted time to assess developments in the ILC industry; to determine if any emerging safety and soundness or policy issues exist; and to evaluate whether statutory, regulatory or policy changes need to be made in the oversight of these institutions. The moratorium also allows us time to further evaluate the various issues, facts and arguments raised in connection with the ILC industry, and to assess whether statutory or regulatory changes or revised standards and procedures for ILC applications and supervision are needed to protect the deposit insurance fund.

We have sought the public's input on the many questions surrounding ILCs. In August, the FDIC Board published a request for comment on a broad range of ILC-related issues—issues that go beyond just those related to individual ILC applications. The request included 12 specific questions on ILCs that cover a wide range of topics, such as the current legal and business framework of ILCs and the possible benefits, risks and supervisory issues associated with them.

During the 45-day comment period that ended on October 10, we received more than 9,600 comments. We are carefully—and thoroughly—evaluating the comment letters we received. This is an issue with strong opinions on all sides. The public comments will be helpful in assessing the full range of issues implicated in the growth and development of the ILC industry. However, we owe the applicants and the public decisions on those issues. I think it is important that we provide clarity on the key issues and reach some decisions by the end of the moratorium in January. As we do so, you can be assured that our Board will be guided by the FDIC's mission to protect the federal deposit insurance fund and to maintain public confidence in the deposit insurance system.

Conclusion

I would like to conclude my remarks by thanking you for the opportunity to discuss some of the important issues before the FDIC. At this time, I'd be happy to take your questions.

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