Remarks by
Sheila C. Bair, Chairman,
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Good morning, everyone. Thank you, Arthur, for that very kind introduction, and thank you, Diane and Chairman Meyer, for inviting me to speak. I am pleased to be here today to talk about the state of the banking industry, focusing on some of the challenges to community banks, Basel II capital reforms and how they might affect your business model, give you an update on deposit insurance reform implementation, and discuss how we can provide for greater economic inclusion in the nation's community banking system.

The State of the U.S. Banking Industry

In financial terms, the condition of the banking and thrift industry has rarely, if ever, been better. The industry has posted five consecutive annual earnings records. Since 2000, the annual net income of FDIC-insured institutions has risen by some 65 percent, from just under $82 billion to $134 billion. The first half of 2006 has brought two new quarterly earnings records, driven by strong balance-sheet growth, and low credit losses.

No FDIC-insured institution has failed since June 2004, marking the longest stretch without a failure in our 73-year history. The number and assets of institutions on the "Problem List" are also near historical lows. More than 99 percent of all insured institutions meet or exceed the standards for the highest regulatory capital category.

Community Banks

Community banks are certainly well positioned to compete in the industry. Notwithstanding the long-term consolidation of the industry, the community banking franchise continues to show signs of strength. There are still more than 8,700 insured institutions, new chartering activity has been growing in recent years, and the pace of industry consolidation has slowed as merger activity has cooled.

While large institutions appear to have important competitive advantages in household lending and capital markets activities, small and mid-sized institutions may have advantages of their own in small business and commercial real estate lending. These business lines above all require local knowledge and the ability to customize products to meet the needs of individual customers. These are skills that are not necessarily the strong suit of larger banks. Surveys show that small businesses prefer to do business with small, locally controlled banks. Community banks have proven to be highly skilled

at the "high-touch" retailing that has helped to drive the industry's revenue growth in recent years.

CRE

While there is much good news to report as we look at the overall performance of the industry, there are nonetheless areas that we are watching closely. Net interest margins are quite narrow in historical terms – in fact, they are at a 15-year low – the result of a relatively flat yield curve and a high degree of competition on both sides of the balance sheet. While margins have narrowed more for larger institutions, smaller and mid-sized institutions that depend heavily on net interest income are especially feeling margin pressure.

Credit losses remain low in percentage terms, but we are beginning to see increases in the dollar volume of problem loans in certain loan categories. Recently, we have seen increases in the amount of noncurrent commercial and industrial loans and noncurrent real estate construction and development loans. While these increases are relatively modest, and are what we would expect to see at this stage of the credit cycle, they are nonetheless an indication that the best days of credit performance for this cycle may be behind us.

Portfolio concentrations in CRE assets have been increasing. At the end of June, over 1,700 insured banks and thrifts -- almost 20 percent of the industry – reported both construction and development loans that exceeded their total capital and commercial real estate loans that exceeded 300 percent of total capital. Construction loan growth has been very high, almost 32 percent over the past year. These trends have caused the regulators to take a close look at risk management practices in this type of lending.

As you know, in January the FDIC and the other federal bank and thrift regulators issued proposed guidance that, and I quote, "provides criteria for identifying institutions with commercial real estate loan concentrations that may be subject to supervisory scrutiny." It further says that "such institutions should have in place risk management practices and capital levels appropriate to the risk associated with these concentrations." The concentration benchmarks contained in the proposed guidance have generated significant controversy; I assure you that they are meant to be just that – benchmarks, not caps. We do not intend to disrupt CRE lending that is prudently underwritten and well-managed. I expect that will be made clear in the final guidance.

The risks associated with commercial real estate, and between real estate and construction, are coming into focus at a time when the industry has strong earnings and capital and an effective risk management culture. I believe these strengths position the industry to focus attention on these areas before problems emerge.

Capital Reform

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. As you know, on September 5, the FDIC Board of Directors, along with the other federal banking regulators, voted to publish the Basel II Notice of Proposed Rulemaking for public comment.

Quantitative Impact Studies indicate that the Advanced Approaches under Basel II could result in significant reductions in the risk-based regulatory capital requirements of the large banks. Basel II banks would most likely face lower risk-based capital requirements in all the major asset categories in which community banks are most active. 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.

I encourage you, as community bankers, not to dismiss Basel II as 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. Community banks are integral to their local economies and to the customers they serve – individuals and businesses alike. Our capital framework should not place community banks at a competitive disadvantage.

We address these issues by including a number of essential safeguards in the Basel II proposal to mitigate capital reductions. Second, in conjunction with Basel II, we are also developing a more risk sensitive capital framework for non-Basel II banks, known as Basel I-A. We hope to publish this NPR very soon. Basel I-A will revise the existing rules for institutions that will not be subject to Basel II. It is intended to be more risk sensitive, provide a feasible and straightforward framework for calculating capital, and limit changes in reporting requirements. I hope the members of America's Community Bankers will weigh in on these critical aspects of both proposals. I look forward to receiving your comments.

The Leverage Ratio

No discussion of capital reform can be complete without a few words about the leverage ratio. 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. In addition, I believe 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.

Deposit Insurance Reform

Capital reform is not the only reform underway today. As you know, the FDIC is currently implementing the deposit insurance reform legislation enacted by Congress earlier this year. I know many doubted that this legislation would ever pass in the absence of a crisis. My observation is that deposit insurance reform would not have been enacted without the kind of open dialogue the FDIC has had with the industry and the trade associations. We greatly appreciate the ACB's cooperation and willingness to study and comment constructively during the legislative process and on our proposals as we implement the reforms.

The implementation of the new system is well underway. The Bank Insurance Fund and the Savings Association Insurance Fund have been 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 of $4.7 billion to bank 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. The FDIC Board will take up the other components of deposit insurance reform -- including risk-based assessments -- next month.

Reform was essential 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 you could least afford to pay.

We proposed a pricing structure that involves using CAMELS component ratings as an input for all banks, supplemented with market data for large banks and financial ratios for small banks. We received comments that addressed each of these areas. Most were supportive of using CAMELS component ratings to differentiate risk among the best-rated institutions. For large banks, we also received feedback on the types of market data we should consider and suggestions about using incremental pricing rather than pricing subcategories. Finally, with respect to financial ratios, we received comments on the use of volatile liabilities and non-performing loans in pricing for small banks. Although we did not propose including Federal Home Loan Bank advances in our pricing proposal, we received many comments agreeing that these should be excluded. We are reviewing all of these comments and are looking at ways that our pricing proposal can reflect this feedback.

Not surprisingly, many comments focused on the rate structure. Most were concerned that the FDIC not set rates too high. Several suggested lowering the base rate for the best-rated banks or changing the spread between the lowest and highest rates. We understand that for many of you the most important part of reform is the bottom line: what will you pay?

The assessment rates will be set by the FDIC Board in early November. Under the proposed base rate assessment schedule, most institutions would be charged an annual rate between 2 and 4 basis points. However, due to recent growth in insured deposits, rates higher than the base rate schedule may be necessary initially.

Most of you, of course, will have assessment credits that you can use to offset your premiums. For instance, the average credit for a bank or thrift that helped to build up the insurance fund is about 8 basis points. Thus, if you were assessed 5 basis points in 2007 and 3 basis points in 2008, you would face no real increases in assessments until 2009.

If you have not done so, you can get an idea of your potential premium based on our pricing proposal by logging on to the FDIC home page. We have created an assessment rate calculator to help you determine your assessment rate and a search tool to provide a preliminary estimate of your one-time assessment credit amount.

As we begin implementation of a new risk-based system, we should all keep in mind that even without the new law, all institutions would be assessed premiums next year since the reserve ratio is already below the 1.25 percent reserve ratio target. What is different is that without the reform law, institutions would not receive credits for their past contributions. Also, depending upon conditions, premium rates could have increased sharply in order to comply with the 1.25 percent target.

Congress intended that in good economic times the fund should grow 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.

I want to assure you, however, that the intent of the new system is not to raise overall revenue. Rather, it is to provide the FDIC Board greater latitude to maintain the fund at a prudent level while spreading the assessment burden more evenly over time and more fairly among insured institutions.

Economic Inclusion

The final issue I want to raise today is one that I have been involved in for many years, long before I came to the FDIC – economic inclusion.

We need to ensure that all consumers have reasonable access to full service banking and other financial services. I believe that banks can provide a gateway into the financial mainstream for those who need these financial services. Community bankers, in particular, know how to build relationships, and relationship-building is essential to bringing those who have a fear or an aversion to financial institutions into the equation. Banks have the infrastructure and the imagination needed to create an array of affordable-lending services to meet the needs of all their customers.

Currently, a large segment of the population relies on a mix of non-bank financial service providers for their needs. Check-cashing stores, payday lenders, pawn shops and remittance services provide access to financial services for the underserved. Some of the credit products are very high cost – take most payday loans, for instance, where annual interest rates are usually several hundred percent. Most borrowers who use payday loans already have a checking account and a regular paycheck – so why do they turn away from their bank to meet these short-term needs?

I would like to work with the banking industry to see if we can do a better job in offering lower-cost products and services to meet the needs of those now turning to high-cost providers. In particular, I'm interested in small denomination loan products at reasonable interest rates for working men and women – along with savings plans. Common sense tells me that this business has manageable risks and can be profitable, especially if the bank ties regular loan payments to a savings account so that borrowers have an automatic mechanism to build some financial cushion.

As I said, I would like to work with the industry to find ways to promote both affordable short-term loan products and creative ways to encourage individual and household savings.

To start this initiative, the FDIC has been in contact with the Association of Military Banks of America and more than 125 banks located near military bases. These banks have indicated a willingness to try and work with the FDIC on developing and providing an affordable, small denomination loan product, possibly with a savings component. To that end, in the next month or so in Washington, D.C., the FDIC will convene a conference for these banks, to provide information and share ideas on successful product and marketing strategies for consumers in the military. In light of the recently passed legislation sponsored by Senator Talent of Missouri that caps interest rates on loans to military personnel, I hope the banking industry will work with the FDIC on this project. As I said, I see this as a win-win proposition.

Concluding Remarks

Throughout my remarks today, I have pointed to the importance of your feedback in helping to shape the future of the industry – be the issue supervisory guidance, capital reform, deposit insurance implementation, or economic inclusion. Your engagement on these issues is critical for the future health of community banks within the larger banking system. I look forward to building on this productive and open dialogue during my tenure as Chairman of the FDIC. Thank you.

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