Remarks by
FDIC Chairman Sheila Bair
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I have a great affinity for America's community bankers.

My first plunge into banking was working temporarily as a teller at a savings and loan in Lawrence, Kansas before going to law school. Working retail you learn a lot about people ... how their kids are doing ... how their jobs or businesses are going ... what they're thinking.

And you learn what's going on in the community. Which companies are hiring or laying off ... where new buildings or schools or homes are going up ... in short, all the things that give life to a community.

And this is why community bankers ... all of you here today ... make such a difference.

You know your customers better than anyone. You know the local markets. You have that personal touch that bigger banks simply cannot offer. And that's a big advantage.

Since I work in Washington, and we're in the middle of the election season, let me take a poll:

- How many of you originated subprime hybrid ARMs?
- How many of you are talking with consumers about refinancing options for resetting ARM products?
- How many of you will suffer reduced earnings over the next 12-18 months because of the current market turmoil?
- How many of you think that, longer term, your institutions will be helped by the current turmoil?

Well, thanks for voting.

You've given me a good idea where you stand.

And as for me ... **I always hope for the best, and prepare for the worst.**

Long term, I hope the problems we are having in the mortgage markets will present opportunities for community banks and thrifts to regain market share in this important sector.

Short term, however, all financial institutions ... and their regulators ... will be challenged. But there are steps we can take to mitigate the damage.

As the nation's Main Street bankers, you have a major role to play in the months ahead as we work through the problems in today's credit markets.

And I believe this will create new opportunities to grow your businesses.

As consumers turn away from teaser rate lending and other misleading,"too good to be true" schemes ... you can expand your market share by providing the basic, savings and loan products and services that are your bread and butter.

You can establish profitable relationships with these consumers.

While the industry has done very well in recent years, it's no secret that market conditions are far more challenging now than they were a year ago when we met in San Diego.

The credit problems associated with subprime mortgages are serious and far reaching.

What started last spring with a rise in loan defaults, escalated over the summer into a full-blown credit crisis.

And to be honest, the worst may not be over.

Second-quarter bank earnings remained strong -- the fourth highest on record – and only 3.5 percent below the all-time high. More than 90 percent of all FDIC-insured institutions were profitable.

However, while the results from bank regulatory reports won't be available for a few more weeks, we expect the trends in declining asset quality to reduce industry earnings in the third quarter.

In recent weeks, a number of large banks and investment banks disclosed sizable third quarter charges related to subprime lending ... leveraged lending ... and capital market activity.

Since large banks drive the regulatory report results, we expect that these charges will have a major impact on industry earnings.

Given the current environment, we would expect credit quality to be an important issue going forward, as banks ramp up provisions for bad debts.

As most of you know, CRE concentrations ... and the subset of construction and development lending (C&D) ... rose rapidly during recent years. They are now higher than they were in the early 1990s.

This trend was fueled by rapid home price appreciation that led to sharp increases in residential construction projects in the early years of this decade.

Community banks were a natural for this kind of "high touch" lending, especially as consumer loans and mortgages became commoditized by Wall Street.

But now that the housing boom is clearly over, there will likely be consequences for these banks as we move through this credit cycle.

While the market is vastly different than it was during the 1980's ... and bank risk management practices and capital cushions are superior ... there are signs of concern.

- As of June 2007, the industry's median ratios of C&D and CRE loans to total capital were 40 percent and 192 percent, respectively.

- Concentration ratios for mid-sized institutions ($1 billion to $10 billion) are notably higher, with median concentration ratios of C&D and CRE of 97 percent, and 343 percent of total capital.

In releasing third quarter earnings, several publicly traded mid-size banks have reported credit problems in their 1-4 family construction lending portfolios.

Problem markets include California, Florida, Indiana, Michigan, and Ohio.

As you know, in December 2006, the FDIC and the other federal agencies issued best practice guidance for understanding and managing CRE risks.

Let me reiterate a couple key aspects of that guidance.

First, you should perform periodic market analyses for the various property types and geographic markets represented in your CRE portfolios.

Be especially careful when going into new markets, pursuing new lending activities, or expanding in existing markets.

Market information also may be useful for developing sensitivity analysis or stress tests to assess portfolio risk.

Second, develop and apply strong underwriting standards.

Lending policies should reflect the level of risk acceptable to your board of directors ... and should provide clear and measurable underwriting standards that enable lending staff to evaluate all relevant credit factors.

When loan concentrations are rising, sound underwriting is critical. So a word to the wise: keep an eye on your CRE portfolios.

But the subprime market remains the more immediate challenge.

Causing the most headaches are some $150 billion in subprime hybrid loans that have undergone payment reset so far this year. And another $300 billion are scheduled to do so before the end of 2008.

We're also seeing rising delinquencies in the Alt-A market.

Problems in these markets stem from high loan-to-values ... "piggy-back" second mortgages ... little or no documentation of income ... and the widespread practice of qualifying borrowers based only on their ability to make payments at the starter rate.

Along with rising delinquencies have come rising foreclosures.

But foreclosure is not the best option. I'm alarmed by the rise in foreclosures, which have nearly doubled in the past two years.

The threat to your communities is real. Foreclosures hurt not only borrowers who lose their homes. They drive down home values in their neighborhoods and communities, and potentially, hurt the economy as a whole.

We have a huge problem on our hands with some 2 million subprime hybrid ARMS, and the surge in interest rate resets.

These resets can result in significant payment shock to borrowers, increasing the likelihood of default.

Community banks are responding to the crisis in a major way: committing hundreds of millions of dollars to refinancing ... homeownership counseling ... and other foreclosure intervention programs.

But you cannot do it alone.

Many of these loans have insufficient equity to refinance. As home prices continue to decline, the number of home owners who can refinance will decline.

For borrowers who cannot refinance and cannot afford the payment shock, the only alternative to losing their homes, will be loan modifications. But so far ... servicers have modified the terms of very few of the resetting mortgages.

It's no surprise that foreclosure rates continue to rise dramatically.

We're beginning to see some servicers take a more pro-active approach. But much more needs to be done, and sooner rather than later.

We urgently need systematic approaches to this mounting problem.

That's why I've been urging servicers and lenders to voluntarily restructure some of their loans.

For instance, if a subprime borrower occupies the home ... is current at the starter rate but cannot make the reset payments ... then restructure the mortgage to make it sustainable.

Convert that hybrid ARM into a fixed-rate mortgage. Keep it at the starter rate. And make it permanent.

- These borrowers would continue to make monthly payments and at premium rates (starter rates have ranged between 7 and 9 percent). Avoiding foreclosures is in the best interest of lenders and investors, families and communities.

Stream-lining loan modifications for such performing loans at the starter rate will allow servicers to reallocate their resources to address more distressed loans.

And this should help prevent rising foreclosures from becoming a major drag on our housing industry, and our communities.

- The Wall Street Journal said it best: "if there's a case of enlightened business self-interest, this is probably it."

Servicers and lenders should get proactive in other ways.

Get on the phone with borrowers. Make human contact.

And work with community groups to help build trust with borrowers. Passive letter-writing won't get the job done.

The FDIC, through the Alliance for Economic Inclusion, has entered into partnerships with Neighbor-Works USA, and with other local organizations across the country.

We're enlisting more lender-support for their foreclosure intervention efforts. Banks, mortgage companies, servicers and others need to sign on as well.

- In this regard, I strongly commend the ACB and your new partner, the ABA, for helping form the HOPE NOW Alliance to help keep people in their homes.

We cannot allow widespread foreclosures to undermine all the work that you have done in your communities.

"Kicking the can down the road" will only prolong current borrower distress and investor uncertainty.

We have proposed industry led, voluntary action to address bad loans that have already been made.

Going forward, it's clear we need stronger lending standards for all mortgage market participants to prevent these problems from recurring.

The Federal Reserve has said it will propose national standards for all mortgage originators by the end of the year ... which would be the ultimate solution.

But it's unrealistic to expect Congress to ignore what's going on -- especially given the impact on their constituents and communities.

The leadership on both sides of the aisle on the Senate Banking Committee, and the House Financial Services Committee, are exploring legislative options.

The House committee approved legislation on Tuesday to create national standards for all mortgage market participants, banks and non-banks alike.

The bill seeks to address many of the worst practices that have contributed to today's record numbers of foreclosures. The Committee vote was 45-19 and the full House of Representatives may vote on the bill before Thanksgiving.

I'm very hopeful that, be they legislative or regulatory, these efforts will help strengthen and validate the responsible mortgage lending that you have done for many years in serving your communities.

Community banks should be the beneficiaries, not the target, of efforts to create a more level playing field for bank and non-bank originators.

Consumer groups and industry need to work with regulators and Capitol Hill to assure that we stamp out abusive lending while assuring adequate credit to support sustainable, affordable mortgage products.

Despite the current turmoil ... there is a silver lining when you look past the problems.

We could see a renaissance in Main Street banking.

Traditional banks and thrifts are increasing their mortgage lending. They are bringing back old customers and winning over new ones.

Responsible subprime lending can increase access to credit for borrowers from all walks of life, who before had no or very limited access.

The economic and social benefits of home ownership are well known. Home ownership has long been viewed as a primary vehicle to build savings for the future and as a gateway to the middle class American Dream.

There are other opportunities to expand market share.

Last week, we officially launched our new small-dollar loan pilot program. Interest is very strong. And we very much appreciate ACB's involvement.

We expect some 60 banks and thrifts to apply in 28 states with over 4,000 branches.

This business model will be good both for consumers, and for banks.

A very special group of Americans will benefit from responsibly-priced, small dollar loans: the men and women who serve in the armed forces

Yesterday ... a group from the 48th brigade, Georgia National Guard ... gave the FDIC a flag that flew over Bagdad when they entered the city to help bring liberty to the Iraqi people.

I was honored to accept this symbol of American freedom, and their appreciation for our efforts with banks in offering affordable loans to military personnel.

I hope you'll think about them ... and those no longer in uniform ... this Sunday, on Veterans Day.

Before concluding, let me give you an update on the new risk-based capital standards under Basel II that regulators finalized a few days ago.

While these new rules are for the nation's biggest institutions ... the FDIC would like to move ahead expeditiously with a proposed rule for a standardized approach that smaller banks may want to use.

This is a priority for us. Our capital framework should not put community banks at a competitive disadvantage.

I truly believe that we are on the verge of a renaissance in American banking. And community bankers can lead the way.

If we've learned anything from the subprime meltdown, it's that banks and their customers are best served by safe and sound products that average people can understand.

It would be returning to a tradition that could be very good for community bankers because you know and care deeply about the communities you serve.

I agree with Bradley Rock, who told Congress recently, that "As bankers we intend to be in our communities for the next 100 years and beyond .... [and] we know that we must be part of the solution."

So while you haven't been part of the current problem ... you can now be a BIG part of the solution.

And for that, your customers ... your FUTURE customers ... and the communities where you bank will be the winners.

Thank you for inviting me today. I look forward to working with all of you as we move forward.

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