

**Remarks of  
Martin J. Gruenberg, Vice Chairman  
Federal Deposit Insurance Corporation  
Before the  
2007 America's Community Bankers  
Government Affairs Conference  
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Thank you, Mark, and good afternoon, everyone. It is a pleasure to be with you today. I would like to use our time together today to update you on three areas - the newly-released proposed subprime mortgage lending guidance, deposit insurance reform implementation, and the FDIC's economic inclusion initiatives.

#### Subprime Mortgage Guidance

As you all know, last fall the FDIC joined with the other federal financial institution regulatory agencies in publishing final guidance on nontraditional mortgages, which include "interest-only" mortgages and so-called "pay option" adjustable-rate mortgages. According to one industry source, interest only and pay option mortgages accounted for over thirty percent of mortgages originated in 2006. The agencies were concerned that borrowers did not fully understand the terms of these mortgages and were unprepared for the payment shock and negative amortization features.

To address these concerns, the nontraditional mortgage guidance focused on qualification standards for borrowers and payment shock and emphasized that borrowers should be qualified at the fully indexed rate including potential negative amortization amounts. The guidance also emphasized that effective management of the risks inherent in these mortgages involves more than prudent underwriting and that lenders should carefully consider risks associated with a slowing housing market, interest rate changes, or shifting economic climate.

The nontraditional mortgage guidance also recommended 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. The guidance required that all information 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.

The nontraditional mortgage guidance is now being used by our supervisory examiners in their risk management examinations at all insured institutions.

But in recent months the agencies became concerned that the nontraditional mortgage guidance did not address a form of subprime lending that also features substantial

potential payment shock – the so-called subprime hybrid ARM products, with mortgages referred to as 2/28s or 3/27s the most common of these types of mortgages. These are mortgages with a low fixed initial interest rate for a period such as 24 months or 36 months where the payment can rise significantly – as much as 6 percentage points – at the end of the initial period.

Many of these subprime hybrid ARM mortgages that have been originated over the past several years appear to have been underwritten to the introductory rate. Many also appear to be based on stated income and most do not escrow taxes and insurance. Furthermore, interest rates on a large volume of these mortgages have now begun to adjust to higher market rates. Borrowers holding these mortgages can face substantial payment shock at the end of the initial term.

These trends are particularly worrisome because hybrid ARM mortgages have come to account for the majority of subprime lending in recent years. According to recent data, subprime hybrid ARMs accounted for up to 70 percent of subprime mortgages from 2004 through 2006. Moreover, subprime lending itself has grown significantly since 2000, and as of the third quarter of 2006 accounted for 28 percent of total mortgage originations, a new record.

In recent months the performance of the subprime mortgage market has begun to deteriorate significantly. Delinquency rates on subprime mortgages have risen substantially in recent quarters and many subprime lenders are showing serious signs of stress.

To address these concerns, last Friday the four federal bank agencies and the National Credit Union Administration jointly issued for comment a proposed Statement on Subprime Mortgage Lending. The guidance addresses the various aspects of subprime mortgage lending, including risk management practices, consumer protection principles, and the lending institution's internal control systems. Like the nontraditional mortgage guidance, the proposed subprime guidance specifies that borrowers should be qualified at the fully indexed rate, assuming a fully amortizing repayment schedule.

The guidance reiterates that institutions marketing subprime mortgages should ensure that they do not engage in predatory lending practices such as collateral-based lending and encouragement of loan flipping. It also recommends that communications provide consumers with full and balanced information about the benefits and risks of these mortgages. Finally, the guidance makes it clear that the agencies will review risk management and consumer protection compliance processes, policies, and procedures at scheduled examinations and will take action against institutions that fail to implement or adhere to safe and sound practices.

I believe this guidance will not have a negative impact on subprime borrowers. There is an opportunity here for the industry to respond by offering subprime borrowers appropriate mortgage products. Rate sheets suggest that there may be other options for these borrowers and we need to figure out ways to better serve them. The underlying

goal of the guidance is to keep people in their homes, not give them a loan that they have no chance of repaying.

For example, a quick review of the current term sheets of major subprime lenders indicate that several 30-year fixed rate mortgages have lower interest rates than the teaser rate on the so-called 2/28 hybrid ARMs. Other fixed rate loans, available from these same lenders, are only 70 basis points higher. On a \$200,000 loan, that amounts to only \$70 per month more during the initial two-year period. For the remaining 28 years, the fixed-rate loan has the potential to save the borrower as much as \$450 per month.

The comment period on the proposed guidance is sixty days and we welcome your feedback.

### Deposit Insurance Reform

As you know, throughout last year the FDIC was very focused on deposit insurance reform implementation. Last November we successfully completed all mandated actions within the 270 days given us by Congress. The reform act merged the two separate funds that existed for our banking and thrift industries, raised deposit insurance coverage on certain retirement accounts at a bank or thrift to \$250,000, provided for a \$4.7 billion one time assessment credit in recognition of the premiums banks have paid into the system, and requires the FDIC to charge all banks for the risk they pose to the system.

Throughout this past year the FDIC staff worked hard to develop the new risk-based deposit insurance premium system, which the FDIC Board adopted in November and which became effective in January. The new system will enable the FDIC to more closely tie each bank's premiums to the risk the bank poses to the deposit insurance fund. The FDIC will evaluate each institution's risk based on three primary sources of information — 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 (those over \$10 billion in assets) with long-term debt issuer ratings, assessment rates will be based on supervisory ratings combined with debt ratings. 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.

As you likely are aware, in November the Board also established a deposit insurance premium rate schedule. 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. When we made this recommendation in November, the reserve ratio was projected to be 1.21 at year end 2006. That projection was proven correct. In November, we also projected that the reserve ratio would end up around 1.20 at year end 2007. The adopted rule also

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

Based upon recent data, the FDIC anticipates that approximately 95 percent of institutions will be in Risk Category I and that these institutions will be assessed 5 to 7 basis points annually, depending upon the institution. The FDIC intends to issue deposit insurance assessment invoices for the first quarter of 2007 by June 15, 2007. Payment will be due June 30.

It is worth noting that even without the new law, all institutions would have been assessed premiums this year because the reserve ratio is already below the 1.25 percent reserve ratio target. Moreover, approximately 82 percent of Risk Category I institutions are expected to have sufficient one-time credits to offset their entire assessment payment for the first quarter.

The adopted rule also allows for some pricing discretion by the FDIC with respect to certain large institutions, recognizing that proper assessment of the risk of large complex institutions cannot always be adequately measured using a formulaic approach. We continue to work out the final details of this process. Recently, the FDIC Board voted to publish for comment a Financial Institution Letter on the Category 1 (large bank) assessment rate adjustment methodology and the additional risk factors the FDIC will rely on to determine whether a ½ basis point adjustment up or down to an institution's assessment rate is warranted. The additional risk factors include market data, financial performance measures, considerations of the ability of an institution to withstand financial stress, and loss severity indicators. The intent of these adjustments is to preserve a reasonable and consistent rank ordering of risk among large institutions.

The FDIC is seeking public comments on this proposed Financial Institution Letter until March 23 and we welcome your input on this issue.

## Economic Inclusion

Now I would like to turn to an important initiative at the FDIC, one that is a matter of considerable passion for our Chairman, Sheila Bair, and which I share. This is the issue of economic inclusion, promoting expanded access for all Americans to the financial mainstream. 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 credit markets, and ultimately housing markets, which can promote stable neighborhoods and better living conditions.

But the fact is that there are millions of Americans without a bank account. We don't know exactly what portion of the U.S. population is unbanked and underbanked, but we do know that it is substantial and that many spend more on financial transactions as a

result. The Federal Reserve has estimated that up to 10 percent of families are unbanked and a recent study estimated that there are 28 million unbanked people in the U.S., and 45 million underserved who lack adequate access to credit. Another study indicates that the population underserved is significantly concentrated among minorities. According to this study, 46 percent of African Americans and 34 percent of Hispanic Americans do not have an account at a federally insured financial institution.

The FDIC is pursuing a number of initiatives to encourage insured depositories to break down barriers to the unbanked and underbanked.

A new national campaign that we call the Alliance for Economic Inclusion (AEI) is an expansion of the FDIC's New Alliance Task Force (NATF), a project started in our Chicago Region in 2003 to encourage Hispanic immigrants to enter mainstream banking, learn basic financial skills, and become homeowners. NATF has successfully brought thousands of immigrants into the financial mainstream by promoting financial education and outreach programs and innovative banking products.

The NATF model has been expanded into a national program that focuses on all unbanked and underbanked populations in each of the FDIC's six regions. In each region, the FDIC is forming coalitions composed of banks, community organizations, foundations, academics, 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 officials, and academia. Diana Taylor, the former New York State Superintendent of Banks, has agreed to chair the Committee and the first meeting will take place later this month.

And finally, pursuant to a requirement in the deposit insurance bill enacted last year, the FDIC will undertake two major surveys related to the unbanked. The first will survey banks and their efforts to reach the unbanked, including innovative ways banks are serving this segment of the population. The second will be a national survey of the unbanked, the first of its kind undertaken, in which we will try to assess both the number of unbanked people in the U.S. and the reasons they are unbanked.

And with that I would be happy to take any questions if we have time.

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