Remarks by
Sheila C. Bair, Chairman,
Federal Deposit Insurance Corporation;
Before the American Bankers Association;
Phoenix, Arizona
October 16, 2006

Good morning everyone and thank you, Harris, for that very warm welcome. I am pleased to be here today to talk about three key issues that mean a lot to both of us: the FDIC's implementation of a new deposit insurance system; capital reform; and economic inclusion through such means as education, outreach and other programs. I know there is a great deal of interest in deposit insurance reform, so I will spend most of my time on that. At the conclusion of my remarks, I will be happy to answer questions on these topics or others that may be of interest to you.

Deposit Insurance Reform

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 ABA's cooperation and willingness to 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 funds 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.

Capital Reform

Deposit insurance reform is not the only reform under consideration today – I will now turn to 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. 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.

I look forward to receiving the comments on the NPR and I will approach them with an open mind. It is appropriate and necessary that we move forward with the Basel II process. However, I will support implementing Basel II only if I can develop a comfort level that strong capital levels will be preserved.

A word to the community and mid-sized banks -- I encourage you to not 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.

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.

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 affordable financial services. Bankers 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 high-cost 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 mentioned, 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. Again, 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 deposit insurance implementation, capital reform or economic inclusion. Your engagement on these issues is critical for both of us. I look forward to building on this productive and open dialogue during my tenure as Chairman of the FDIC. Thank you.

Last Updated 10/17/2006