Remarks by Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation at the ICBA Annual Convention Honolulu, Hawaii March 7, 2007

Good morning. I am pleased to be with you here in beautiful Hawaii to talk about some of the challenges facing community banks and a few of the initiatives underway at the FDIC to address them.

Currently, there are over 8,600 insured institutions in the United States. Roughly 8,000 of you have total assets under \$1 billion. Over 61 percent of these community banks are regulated by the FDIC and we're proud to be your primary federal regulator.

In the nine months since I became Chairman of the FDIC, I have enjoyed working with the leadership of the Independent Community Bankers Association on a number of important issues. I have come to appreciate your candor and willingness to consider the full range of issues affecting our industry. Your support helped to propel Congress to enact deposit insurance reform legislation that has resulted in a fairer, more flexible system. Your views on the disproportionately high regulatory costs facing community banks helped us reduce burden by raising asset thresholds in a number of key areas. Your voice in the debate on proposed changes to capital regulations has been critical, as we work to help Washington policy makers remember that Basel II is supposed to be about improving risk management, not reducing big bank's capital. I look forward to continuing our dialogue on these and other important issues during my time at the FDIC.

Like each of you, I have a long history with community banks. As a child growing up in rural Kansas, I was fascinated by the small community bank in my hometown. I loved going with my father to the bank when he had business there. We would see our neighbors and the town's business owners. It felt like an important place to be. And, it was. Even at that young age, I realized the bank was the heart of our community. It is no different today.

Community banks, like yours, play a critical role in the economic well-being of the towns and neighborhoods they serve, including my hometown of Independence, Kansas. Despite the long-term trend of consolidation, community banks remain a vital part of the banking system. Like the industry as a whole, community banks continue to report solid earnings, as well as high capital and asset quality.

As of year-end 2006, the return on assets for banks with total assets under \$1 billion was a respectable 1.14 percent, the ratio of noncurrent loans to total loans was 0.74

percent, and after increasing for nine of the past ten years, the average leverage capital ratio was 10.38 percent.

Despite these favorable numbers, there are challenges. For example, the return on assets for the smallest institutions – those with total assets under \$100 million – was only 0.93 percent. These banks typically have higher overhead expenses and fewer means of generating non-interest income than their larger competitors.

Also, a persistent flat-to-inverted yield curve and stiff competition on both sides of the balance sheet have created a difficult operating environment. As a result, net interest margins have narrowed to an 18-year low.

While this erosion has occurred across the spectrum of institutions, shrinking margins tend to disproportionately affect you. This is because community banks typically derive most operating revenue from net interest income. Despite this, I believe community banks are well-positioned to compete.

While large institutions may have advantages in business lines that require economies of scale, you have advantages of your own in "high touch" business lines. With local knowledge, you have the ability to customize products to meet the needs of individual customers.

Although the industry remains strong, insured institutions – especially community banks – face a number of challenges, both in the near-term and over the long haul. I want to talk to you today about a few of those challenges and what the FDIC is doing to ensure that bankers and regulators are up to the task of dealing with them.

Let's start with Commercial Real Estate Lending.

The realities of the new market are drawing some institutions further out along the risk curve in search of yield. The shift toward a riskier asset mix is reflected in part by an increase in commercial real estate concentrations. In 2006, the industry's median ratio of commercial real estate loans to total capital was 191 percent. Concentrations have been more significantly pronounced in institutions with assets between \$1 and \$10 billion. In fact, the median concentration of commercial real estate loans for this group of institutions is 335 percent of total capital. As concentration levels rise, we are starting to see an uptick in the level of both charged off and noncurrent commercial real estate loans.

While conditions remain generally strong, current trends suggest that the best days in this credit cycle may be behind us. In December 2006, the federal banking regulators issued guidance regarding best practices in underwriting and managing commercial real estate and construction loans. I would like to say a few words about what this guidance is – and is not.

The guidance is intended to remind bankers that risk management practices need to keep pace with increasing exposures to commercial real estate and construction activity. This message is an important one, both for community banks and for larger, more complex banks.

Community banks generally hold their loans, relying on market knowledge and underwriting skill to mitigate credit risk. Banks that securitize or sell their loans, on the other hand, shed credit risk, but may find themselves with other, more complex, exposures.

Make no mistake, weak underwriting can create problems for securitizing banks, and this guidance applies to those banks as much as it does to traditional community banks. Strong underwriting is important whether a bank is securitizing an asset or holding the loan on its books.

That brings me to what the guidance is not. The guidance does not impose new limits on banks' commercial real estate lending.

CRE is a broad category and, for many of you, it is a well-managed specialty area. For that reason, concentrations alone should not necessarily be viewed as problematic. That is precisely why I sought to include a three-year, 50 percent or greater growth overlay for the commercial real estate portfolio in the final guidance.

We do not intend to disrupt or limit the volume of commercial real estate lending that is prudently underwritten and well-managed. But we also do not intend to back away from the risk management expectations we have always placed on institutions in this sometimes volatile line of business. In short, regulators are watching this sector carefully and all banks – large and small – should be as well.

Now, let's talk about mortgages.

On top of issues related to commercial real estate, the industry is now dealing with stress in a residential mortgage market that has changed dramatically over the past several years. Booming home prices, favorable interest rates, innovations in underwriting and strong demand by investors for mortgage paper have fueled the use of new complex mortgage products. In some cases, these products have been layered with other features that compounded risk, such as second-lien "piggy back" mortgages and low or no documentation requirements for the borrower's ability to repay. Notably, some of the layered risk products have been extended to subprime borrowers – those with impaired credit histories.

In the current market – characterized by weaknesses in home price appreciation and higher interest rates – some problems are emerging. Yields have widened on mortgage securities that are below investment quality, and the cost to insure subprime credit risk has increased considerably. Data from non-agency securitizations show that among subprime mortgages originated in early 2006, over 8 percent of active loans are more

than 90 days delinquent, or in foreclosure. These weaknesses will start to become evident within some insured institutions.

In fact, in the fourth quarter of 2006, residential mortgage charge-offs at insured institutions nearly doubled. While this increase is from a very low starting point, it draws attention to the need for strong underwriting and monitoring programs.

Last Friday, the banking regulators issued for comment a proposed statement on subprime mortgage lending to address risk management and compliance issues associated with so-called 2/28 and 3/27 mortgages that have become very popular in the last several years. Our goal with this statement is to make clear to banks that these types of loans should be underwritten so that the borrower will be able to repay – not just during the starter period, but also after the loan adjusts.

The comment period for the proposed statement closes in 60 days and we hope to get feedback on a number of issues central to this discussion.

These products are characterized by supposedly low two-to-three year starter rates, high pre-payment penalties, and most notably the prospect for significant payment shock once the interest rate resets. In the current interest rate environment, the starter rates on these loans are so high that the difference between the monthly payment on a 2/28 ARM and a 30-year, fixed rate mortgage is negligible.

One issue we are looking at very closely is the availability of credit to subprime borrowers and whether there will be alternative credit products for which they qualify. It appears that there are comparably priced alternatives that don't put borrowers at risk of losing their home three to four years down the road. I am very interested in reading the comments on this point. While these are probably not the type of products that most of you offer, I think it is important for you to know how we are addressing these risks. We all have a stake in both the condition and the perception of the mortgage lending business.

I'd like to turn to another issue where ICBA involvement has been extremely effective – Regulatory Burden.

Last October, President Bush signed the Financial Services Regulatory Relief Act of 2006. This law capped a three-year effort spearheaded by OTS Director John Reich to reduce regulatory burden while maintaining the safety and soundness of the industry, protecting important consumer rights, and fulfilling our other statutory obligations.

Perhaps one of the most significant aspects of the Act for community banks is the increase in the size of well-capitalized and well-managed banks eligible for 18-month examination intervals from \$250 million to \$500 million.

On top of the legislative amendments, the banking agencies have taken a number of steps to reduce regulatory burden through rulemaking and the supervisory process. For example, the agencies revised the CRA small bank threshold from \$250 million to \$1 billion and included a new community development test that better captures the way institutions with assets under \$1 billion serve their communities. Also, in late 2005, the FDIC raised the asset size threshold from \$500 million to \$1 billion for internal control assessments and attestation reports by management and external auditors.

Going forward, we will continue to review initiatives that had considerable industry and regulatory support, but didn't quite make it in the 2006 Regulatory Relief bill.

One issue, and in fact the number one regulatory burden complaint I hear from the industry, is the significant reporting burden associated with the commitment to fighting financial crime. I am very sensitive to your concerns. While it can be difficult to reconcile the volume of reports that must be filed to comply with anti-money laundering laws and the value these add to the efforts of law enforcement, our experience of the past five years confirms that our vigilance in this area cannot waver.

It is important that we analyze these reporting requirements to see if there are opportunities to become more targeted and risk-focused without compromising the quality of the information that law enforcement needs and has benefited from in the past few years.

I would like to close my remarks by discussing an issue that is important to me, and one that I think is in your best business interest. And that is, making the mainstream banking system available to more consumers.

Currently, a large and growing segment of the population relies on a mix of non-bank financial service providers for their credit needs. While it is uncertain just exactly how large this segment is, some estimates peg the figure at 40 million households.

Estimates for the payday lending industry alone indicate that payday lenders generated revenues in the range of \$28 billion last year and that revenues have doubled every year for the past five years.

In 2006, the FDIC took two very important steps to address this issue – we helped focus attention on the need for affordable small-dollar loan products, and we created the Advisory Committee on Economic Inclusion.

Each of you here knows how to build relationships, and I want to learn how we can leverage that strength to help meet the needs of the underserved. After all, borrowers who use payday loans already have a checking account and a regular paycheck. Recognizing this, a growing number of banks and credit unions have developed successful and profitable short-term loan programs. These programs charge affordable rates and help borrowers escape the trap of high cost credit through features like mandatory savings components.

As customers turn to you for affordable short term credit and help building their savings, they will eventually migrate to more traditional bank products — and then become the very customers that you desire. That's not just good news for consumers, it's good business for you.

The FDIC wants to work with you to find innovative ways to lower the barriers to financial service affordability by offering responsibly priced small-dollar loans to consumers who need them.

In December, the FDIC released Affordable Small Loan Guidelines for public comment that explore several aspects of product development, including affordability, streamlined underwriting and built-in savings components. The ICBA was among the first to respond – and to share their support for this effort. I look forward to continuing to work with you to find ways to promote both affordable short-term loan products and creative ways to encourage savings.

Also in 2006, we launched the FDIC Advisory Committee on Economic Inclusion. I'm very excited to be working with the members of this committee. They represent a cross section of interests from consumer and public advocacy organizations, community-based groups, the banking industry, state regulatory authorities, government, academia, and others affected by banking-related practices. I am especially pleased that two of your members – Alden McDonald, President and CEO of Liberty Bank in New Orleans, and Ron Grzywinski of Shore Bank in Chicago – have agreed to serve on the Committee. I am convinced that the experience and insight of Alden and Ron, and their fellow Committee members, will help identify and remove obstacles that hinder economic inclusion and block each of you from tapping a potentially huge market of new customers. I look forward to communicating some of their ideas to you in the future.

Thank you for your attention this morning. I would be happy to take your questions.

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