Remarks
by
FDIC Chairman Sheila Bair
Nikkin 18th Special Seminar
on
International Finance
Tokyo, Japan
November 14, 2007

Today, I'd like to talk about banking conditions in the United States, and the recent difficulties associated with subprime mortgage lending.

The FDIC insures some 8,600 banks and thrifts, which together hold more than $12 trillion in assets.

While over 90 percent of U.S. banks and thrifts are small community-based institutions, the 25 largest banking organizations hold about 71 percent of the industry's assets.

The U.S. banking industry remains well-capitalized and profitable. 2006 was the sixth year in a row of record earnings.

Nearly all banks and thrifts are considered "well capitalized" ... according to U.S. regulatory standards for Prompt Corrective Action ... and the industry's leverage ratio, the ratio of Tier 1 capital to total assets, exceeds 8 percent.

But it's clear that conditions are changing.

Net income was below 2006 levels in each of the first two quarters, and a majority of institutions reported lower earnings.

Credit quality, which has been very strong in recent years, has begun to decline. And the volume of past-due and charged-off loans is rising.

The large syndicated loan market has experienced slight erosion in credit quality and weakened underwriting standards.

In recent weeks, several of the nation's largest banks have disclosed substantial losses from exposures to subprime mortgage assets ... from their leveraged lending activities ... and in their securities portfolios.

These trends suggest that when third quarter industry results are available later this month ... a rise in loan loss provisions, and write-downs of problem assets ... will further reduce earnings.

We are closely following trends in commercial real estate markets and in construction and development loans. Historically, these loans are among bank's riskiest assets.

Due to strong commercial real estate sales earlier in the year ... property sales through the first three-quarters of 2007 surpassed the total for all of 2006.

But the financial market turmoil in August was followed by slower originations of commercial mortgage-backed securities, and an increase in asset-backed spreads.

U.S. commercial real estate valuations are rich by historic standards. But the increase in financing costs may pressure these valuations.

Construction and development loan concentrations have increased at our banks, notably at mid-sized institutions -- those with assets between $1 billion and $10 billion.

As of June 30, 2007, the median ratio of construction and development loans to total capital for mid-sized banks stood at nearly 100 percent.
These concentrations are an issue because we are beginning to see some deterioration in construction-loan quality.

The share of noncurrent construction loans has risen to 1.29 percent, more than double the ratio seen a year ago.
Our biggest concern is the condition of mortgage markets, especially the difficulties faced by many subprime borrowers.

Responsibly underwritten loans to consumers with less than perfect credit profiles can be a prudent and profitable activity.

But the problems that have emerged in the subprime mortgage market underscore my longstanding view, that consumer protection and safe and sound lending are two sides of the same coin.

Failure to uphold uniform high standards in our increasingly complex mortgage industry is causing serious problems for consumers, lenders, investors, and, potentially, the economy.

The subprime share of mortgage originations more than doubled in 2004, peaking at just over 20 percent in 2005 and 2006.

At the same time, an increasing percentage of mortgages were being funded through privately-issued asset-backed securities.

Issuers created trillions of dollars of investment grade securities, along with a smaller amount of unrated or speculative-grade securities.
Ready access to market funding, in turn, contributed to what is recognized now as a serious weakening of underwriting practices.

Lenders allowed a number of potentially risky features, such as low credit scores ... high loan-to-value ... and little or no documentation of income --- all in the same loan.

As long as home prices were rising, these layered risks were overlooked by many lenders, borrowers, and investors because rising prices allowed homeowners to tap those gains with home equity loans or refinancing.

Consequently, defaults were a relatively rare occurrence.

The combination of greater credit availability ... relaxed underwriting standards ... and rising home prices opened the door to abuse by speculators and unscrupulous lenders.

But the root cause of the problem was lax lending standards and inadequate consumer protections. The result is widespread failure by lenders to make loans based on borrowers' ability to repay.

The most troublesome loan type is the subprime hybrid "2/28" or "3/27" mortgage, which typically has a fixed starter rate for the first two- to three-years, followed by a reset to an adjustable rate.

The new monthly payment is often substantially higher than the starter rate.

These loans were never designed to be affordable at the fully-indexed rate. We estimate that only one in 30 of these loans made just four years ago is still paying at the indexed rate.

Most were either refinanced ... paid off when the home was sold at a gain ... or foreclosed.

There are about 2 million hybrid ARMs outstanding that were originated in 2005 and 2006. Most have, or will, reset by the end of next year.

The performance of these loans began deteriorating late last year. Over 300,000 of these loans are now over 90 days past due or in foreclosure.

In the middle of this year, rating agencies began to downgrade substantial numbers of mortgage securities.

These downgrades, plus continued deterioration in the subprime market, contributed to investor uncertainty about the value of these securities.

In turn, this triggered redemptions at hedge funds ... margin calls ... and episodes of illiquidity in commercial paper and other instruments.

These problems are not behind us. And to be honest, the worst may not be over.

These loans were made assuming that home prices would continue to rise, and that borrowers would be able to refinance or pay off the loans.

The widespread housing slump has limited those options. Many borrowers are facing foreclosure as their loans reset to high floating rates.

Losing your home is not good for anyone. Foreclosure is costly, it adds to an already glutted housing market, and puts additional pressure on home prices.

So what can we do?

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.

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 a coordinated policy to address this mounting problem.

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

A more streamlined approach for modifying the terms of subprime hybrid arms also will serve the interests of investors.

In today's conditions, the typical servicing approach of allowing delinquencies to accumulate and go into foreclosure simply makes no sense for investors.

Net present value analysis suggests that investors will be better off under a streamlined mortgage modification program that allows current borrowers to retain the starter rate, and avoid unnecessary foreclosures.

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 recently approved legislation 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.

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.

Let me give you a few specifics that the FDIC believes should be part of a national standard for the subprime market.

A requirement that lenders underwrite to, and fully disclose, the borrower's monthly payment at the fully-indexed rate, not just the introductory rate. This is consistent with the guidance that the FDIC and other agencies have already issued.
A "bright line" test for affordability of the loan based on indicators such as a debt-service-to- income-ratio that includes taxes, insurance, housing expenses, and other recurring debts.
A requirement that marketing information for adjustable rate mortgages include a benchmark comparison of the rate and payment being offered by the same lender for a traditional, 30-year fixed rate mortgage.
A prohibition on stated income loans in the absence of strong mitigating factors.

Restrictions on prepayment penalties.
And perhaps most important: a level playing field that ensures that all lenders, brokers and others who help originate mortgages must comply with the highest standards of fairness ... disclosure ... and reliability.
I believe that strong standards such as these would provide consumers with significantly enhanced protections.

And they would provide investors with greater transparency of the true costs and risks of financial products backed by these types of mortgages.

The recent problems in the mortgage market and the associated market disruptions demonstrate how weak credit practices in one sector can lead to a wider set of credit market uncertainties.

However, FDIC-insured financial institutions entered the recent period of uncertainty with strong earnings and capital overall.

While some banks may have difficulty in the current environment, the industry as a whole is in a position both to absorb the current stresses, and to provide much needed credit if other sources dry up.

Before concluding, let say a few words about global capital standards.

Along with other members of the Basel Committee on Banking Supervision, the FDIC and its Japanese counterparts have been engaged in a complex and time-consuming process known as Basel II.

The U.S. banking agencies recently approved the final rule implementing the advanced approaches for large banks.

Basel II represents a significant change in regulatory practice and one that carries with it some risks and uncertainties.

Current conditions highlight the risks of basing capital requirements on historical loss experience, and on credit ratings assigned by national ratings organizations.

Recent market events emphasize the importance of maintaining adequate capital buffers.

We are quite concerned by the low capital requirements that Basel II generates for some structures.

And we believe that the Basel Committee should revisit the assumptions that were used in assigning capital requirements to exposures ... such as CDOs ... to see if these decisions are still appropriate in light of recent market events.

I applaud the recent efforts by Japanese banking supervisors to improve transparency and disclosure in the structured finance market. Structured finance is an opaque segment of the market, and any additional transparency would be very welcome.

I also believe that implementation by both the U.S. and Japan of the Basel II framework gives banks the incentives for getting more information on the bank's underlying exposures in hedge funds.

Under both frameworks, the capital requirements can be quite high if banks are unaware of the composition or the leverage of hedge funds.

The additional emphasis on hedge fund exposures is ... in my judgment ... both reasonable and appropriate.

Again, thank you to my hosts for inviting me to speak and visit Japan.

I know that we've enjoyed a close, and productive working relationship over the years. I look forward to getting to know you better, and to working with you in the future.

Thank you very much.

Last Updated 11/14/2007