Remarks of
Sheila Bair, Chairman, FDIC
to the
Korea Deposit Insurance Corporation
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Good morning. Thank you for inviting me to be here today. The FDIC and the KDIC have many mutual interests, both within the International Association of Deposit Insurers and between our agencies. The FDIC hosted the IADI's recent executive training program. Executive Director Choi, Mr. Chung, Ms. Kim, Mr. Cho all attended this flagship meeting and presented KDIC's case study: "A Resolution System and Strategy in Korea". Their work significantly contributed to the success of IADI's first executive training program.

The cooperation between our agencies is underscored by the MOU that we just signed. Technical exchanges are a great way for KDIC experts to sharpen their skills. Today I would like to talk about the turmoil in U.S. financial markets. I will focus on the broad problems that are evident in subprime lending.

I also want to identify two key policy lessons: First, the importance of consumer protection regulation to financial stability and second, the need for a credible deposit insurance system. 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.

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. And 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. At present, over 300,000 of these loans are 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 included in 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 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 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.

So what have we learned? The first lesson is that regulating for bank safety and soundness, and protecting consumers are two sides of the same coin. Safe and sound lending practices help banks keep their problem loans manageable when a downturn comes. And well-informed customers, who feel that they are being treated fairly by mainstream financial institutions and who understand the banking products they use make the best customers. The second lesson is that a well-designed and fully funded deposit insurance system promotes public confidence.

Deposit insurance systems are unlikely to be effective unless authorities can promptly resolve weak institutions and quickly honor deposit guarantees. Without these capabilities, the resolution of a failed institution may unsettle markets. It also can

threaten the ability of healthy institutions to retain deposits without more extensive government guarantees. There is a growing appreciation around the world for the critical role that deposit insurance systems play in maintaining financial stability. About 100 countries either have, or are planning, deposit insurance schemes -- virtually every major economy (except Australia).

IADI is well-positioned to encourage cooperation ... provide valuable training and technical assistance ... and develop the core principles for effective deposit insurance systems. Our two agencies can play a leadership role in IADI by integrating our experience and skills for the good of all our members.

Indeed the FDIC is honored by Vice Chairman Martin Gruenberg's recent election to serve as chairman of the executive Council and president of the organization. We're strongly committed to its goals, and proud to be one of the founding members.

This is a time of great opportunity for IADI. Our agencies remain strongly committed to the work of the association. I believe that IADI can contribute significantly to enhancing the effectiveness of deposit insurance systems around the world.

Thank you very much for the opportunity to speak with you today.

I'm happy to answer your questions.

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