Remarks
by
Martin J. Gruenberg Acting Chairman
Federal Deposit Insurance Corporation
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Good morning. I am very pleased to be here today to review with you some of the FDIC's leading priorities for the remainder of this year: the implementation of the deposit insurance reform legislation; the impact of last year's hurricane on the community banks in the Gulf Coast area and the efforts of the federal banking agencies to assist those institutions; and proposed interagency guidance on nontraditional mortgage products and commercial real estate.

As most of you know, the deposit insurance reform legislation was signed into law by the President in February. The Congress has given us only nine months from the date the Reform Act was signed to implement the Act's provisions. That means that we have until November 5th to adopt most of the final regulations. Given the complexity of the law, nine months is not a long time. And I can assure you this is not lost on FDIC staff.

We have already taken two steps. First, we merged the Bank Insurance Fund and Savings Association Insurance Fund into the Deposit Insurance Fund, effective March 31st. Those of you who have had to deal with Oakar deposits will be happy to know that they are now relics of the past.

Second, the FDIC Board adopted regulations implementing the substantive changes to the FDIC's insurance coverage rules contained in the law, effective April 1st. The new law maintains coverage for individual accounts at $100,000; increases coverage for certain retirement accounts to $250,000; and provides for pass-through coverage for employee benefit plans. In addition, it allows the FDIC and the National Credit Union Administration – NCUA – jointly to index these limits for inflation every five years beginning in 2011. But that won't take place for a while.

Just to be clear, the FDIC Board and the Board of the NCUA have each adopted interim final regulations effecting insurance coverage as required by the law, specifically to increase it to $250,000 for certain retirement accounts effective April 1st.

I am sure that you are keenly interested in hearing how we plan to implement the rest of the law. In order to meet the November 5th deadline for the remaining regulations, the FDIC plans to publish notices of the proposed rulemaking for public comment and industry input during the months of May and June.

On May 9th, less than one week from today, the FDIC Board will meet to consider three notices of proposed rulemaking.

One of these will be the regulation concerning the large assessments that some institutions paid to capitalize the insurance funds in the early- and mid-1990s. The law provides institutions that paid into the fund before 1996 with a one-time $4.7 billion transitional premium assessment credit.

The law also requires the FDIC to define "successor" for purposes of allocating these credits if an institution eligible for the one-time credit was merged or consolidated. Given the changes in the industry since year-end 1996, any definition of successor will have a significant effect on the way initial assessment credits are allocated. The proposed regulation will request comment on alternative definitions of successor, and we look forward to receiving public and industry comments on this important issue.

Another proposed rulemaking that the FDIC Board will consider on May 9th concerns the allocation of future dividends. The new law generally requires the FDIC to declare a dividend on all amounts above 1.50 percent in the fund when the reserve ratio exceeds 1.50 percent, and one-half of any amount in the fund above 1.35 percent when the reserve ratio is between 1.35 and 1.50 percent. Given the present level of the DIF reserve ratio, which was 1.25 percent as of December 31, 2005, and the availability of assessment credits when the new rules take effect, this new rule will probably have little practical implication in the near future.

The third proposed regulation that will be on the FDIC Board's May 9th agenda requests comment on a variety of operational and administrative changes to the assessment system.

At the June Board meeting, the FDIC Board is expected to consider proposed rulemakings concerning deposit insurance pricing. The law provides the FDIC with the discretion to price the cost of insurance according to the risk for all insured institutions.

The FDIC will attempt, first and foremost, to price premiums fairly. And any system we adopt will be open and transparent. Let me emphasize that the industry, with the help of the public, will have an opportunity to weigh in on any changes we propose.

As the result of much discussion with bankers, trade group representatives and other regulators, as well as our own analysis, the FDIC is looking at several pricing methodologies. The primary thrust of these methodologies is to incorporate a variety of measures to distinguish and price for risk more accurately. For example, we are considering whether a different pricing system for the largest banks and thrifts may be appropriate, given the scope and complexity of operations at these institutions. Again, the FDIC Board will meet in June to adopt a proposed regulation for comment on alternatives for pricing deposit insurance premiums.

We expect to adopt final regulations on deposit insurance implementation by November 5th. That's our working plan. These reforms have been the subject of much discussion and debate, and I expect this dialogue to continue as we move forward with implementation. The FDIC welcomes your input as we develop the policies and regulations that will make deposit insurance reform a reality.

Now let me turn briefly to the impact of last year's hurricanes on banks in the affected areas and our efforts in that regard. When Hurricanes Katrina and Rita hit the Gulf Coast last year, they impacted the operations of 280 financial institutions. One hundred and twenty of these institutions were headquartered in the 49 counties and parishes in Alabama, Louisiana and Mississippi designated by FEMA – the Federal Emergency Management Agency – as eligible for individual and public assistance.

As with other sectors of the Gulf Coast economy, financial institution facilities were destroyed, communication and data processing capabilities were disrupted, and financial institution employees saw their homes destroyed or inundated by flood waters.

In the aftermath of the storms, the FDIC and the other state and federal regulatory agencies were committed to doing everything possible to preserve public confidence in the financial system and to restore essential financial services. Fortunately, due to disaster preparedness procedures that all insured institutions are required to have in place, most institutions resumed operations within hours or days. They used facilities that were not severely damaged, establishing temporary locations, or sharing facilities and even employees in order to provide services to areas where facilities were heavily damaged.

The FDIC also worked to connect customers with their financial institutions and to maintain public confidence in the financial industry. We immediately established a 24-hour consumer hotline and a website with information about how to contact financial institutions.

From the outset, the agencies recognized that we were not dealing with ordinary circumstances. Immediately after Katrina hit, the agencies urged financial institutions to be flexible with borrowers and others experiencing disruptions due to the storm.

Historically, no financial institutions are known to have failed as a result of natural disasters. In fact, community financial institutions traditionally have played a critical role serving areas most severely affected by the hurricanes. However, due to the scale of destruction left by these storms, it remains difficult to determine the applicability of experiences from previous disasters to the current situation.

The 120 insured institutions headquartered in the 49 designated disaster counties and parishes are relatively small community financial institutions. Although most of these institutions were financially strong before the hurricanes, financial results to date do not yet provide a clear picture of the full effects of the storms since many of the institutions

in the area continue to extend loan deferrals and are still communicating with customers to develop long-term rebuilding plans.

Post-hurricane data reveal that a number of institutions operating in areas hit hard by Katrina are moving fairly aggressively to build loan-loss allowances, and have experienced a pickup in charge-off rates. Consistent with this, 20 institutions reported new operating losses for the fourth quarter. We have received first-quarter results for 93 of these institutions, and none of the 93 reported a net loss for the quarter, even though four were unprofitable in the first quarter of 2005, before Katrina. Despite the losses some institutions experienced in the second half of 2005, all institutions currently are "well capitalized" or "adequately capitalized," reflecting the strong capital positions of most institutions prior to the hurricanes. Liquidity for most of the institutions also remains strong.

Looking ahead, there is considerable uncertainty about the prospects for the financial institutions most directly affected by the hurricanes. Over the medium term, the greatest source of uncertainty and concern is the effect of the hurricanes on credit quality. Over the longer term, the prospects for these institutions will be determined largely by the economic prospects of the communities they serve.

With respect to credit quality, the outlook for each institution will depend on a number of currently unknown factors, including reimbursements, the timing of insurance proceeds, borrowers' repayment capability, collateral protection, and the availability of financial assistance programs. The FDIC is utilizing both supervisory outreach and data analysis to assess the extent to which insured institutions in the region may experience medium- to long-term credit quality and profitability issues.

Our supervisory outreach started immediately after Hurricane Katrina hit. The FDIC and other agencies contacted all 120 institutions previously mentioned. During December, examiners from the FDIC and the other agencies also visited many of these insured institutions. And beginning in January, the agencies resumed their comprehensive examination programs that were suspended at the time of the storms.

As a result of these efforts, we have narrowed our focus to a small group of institutions, which we will continue to monitor closely. As suggested earlier, the prospects for the financial institutions most affected will depend in large measure on the efforts underway to rebuild and revitalize the communities these institutions serve.

Directly connected to that effort, the FDIC, Federal Reserve, OCC and OTS sponsored a conference on March 2nd and 3rd entitled "The Future of Banking on the Gulf Coast: Helping Banks and Thrifts Rebuild Communities." This conference brought together institutions seriously affected by the storms with other institutions that could help in their recovery. More than 250 individuals attended, representing large and small institutions, many from the Gulf Coast region but from other parts of the country as well.

The conference's goal was to promote future dialogue among Gulf Coast community financial institutions, national and regional institutions, and federal government agencies involved in the rebuilding effort. At breakout sessions, conference participants developed a list of critical issues and needs, and a working charter for the Gulf Coast Banking Task Force. More than 20 executive bank officers joined the task force on the last day of the conference. These individuals will develop the means to match the resources of the larger banks from around the country with the needs of community banks in hurricane-stricken areas on an ongoing basis. The needs of these community institutions include staffing for operations, accounting and computer programming. Some of these institutions are receiving strong insurance proceeds and have strong liquidity, but would benefit from opportunities for loan participations with larger institutions as well as non-controlling capital investments to help them get through the difficult months ahead.

You have to visit the area and gain a sense of the scale of the devastation to appreciate the dimensions of the challenge. And I will tell you, it was rather inspirational to meet with the community bankers. The banking agencies are committed to doing everything that we can to help those institutions and the communities they serve.

While the FDIC has been very busy with deposit insurance reform implementation and our efforts on behalf of banks affected by last year's storms, we've also been working on two important supervisory policy issues that have attracted considerable interest and have potential significance for insured institutions of all sizes across the nation.

These supervisory issues involve so-called nontraditional mortgages – particularly interest-only and pay-option ARMs – and commercial real estate lending. Both of these supervisory issues reflect our attention to developments in credit markets. Although bank credit performance has been very strong for some time, we cannot lose sight of the fact that credit risk has historically been one of the primary causes of bank failures.

In late December 2005, in response to recent trends in mortgage lending that raise potential risks for both lenders and consumers, the FDIC joined the other federal banking, thrift and credit union regulatory agencies in seeking comment on proposed interagency guidance relating to nontraditional mortgage products. The comment period was extended and closed on March 29th. The agencies are currently reviewing comments on the proposed guidance.

Nontraditional mortgages have been offered by some insured institutions for many years, and can provide beneficial financial flexibility for credit-worthy borrowers. Over the past two years, however, nontraditional mortgages have experienced rapid growth and are now being offered to a broader range of borrowers.

Our concern is that these products may have the potential for an accumulation of negative amortization. In addition, these products are being offered to a wider spectrum of borrowers who may not qualify for a traditional fixed-rate or other adjustable-rate mortgage loan, and who may not fully understand the associated risks.

The proposed interagency guidance sets forth our expectations for institutions to effectively assess and manage the risks associated with nontraditional mortgages. We want to make sure that these new and relatively untested types of mortgages are being appropriately underwritten, managed and marketed. Our intent is to encourage institutions to communicate clearly with consumers, particularly unsophisticated borrowers, about the risks inherent in these products.

Another supervisory policy initiative is the proposed guidance issued in January 2006 by the FDIC and the other regulatory agencies that addresses risk-management practices in commercial real estate – or CRE – lending. The proposed guidance, which largely pulls together in one place guidance previously issued, defines CRE concentration thresholds calling for heightened risk-management practices and capital requirements for insured institutions. The guidance focuses on the types of CRE loan concentrations that are most vulnerable to cycles.

The proposed CRE interagency guidance was issued in response to a long-term rise in the number of insured institutions with high concentrations of CRE loans to equity capital. CRE concentrations at insured institutions have grown significantly in recent years, particularly in the western and southeastern regions of the country. As of year-end 2005, approximately one-third of insured institutions reported CRE loans in excess of 300 percent of capital – significantly more than at the height of the late-1980s and early-1990s real estate crisis.

Historically, high concentrations of CRE loans have been associated with a higher frequency of failure among FDIC-insured institutions, particularly when coupled with weak underwriting and local economic conditions. While CRE underwriting standards and loan performance are generally stronger now than in the past, and the banking industry is currently very healthy, higher concentrations in CRE loans at some institutions remain a concern since real estate markets are cyclical and local CRE market conditions can change significantly.

In conclusion, 2006 promises to be a very busy and significant year for the FDIC. I look forward to the challenges and the opportunities that we will certainly face, and to working with the banking community to meet them.

Thank you.

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