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Chairman
Federal Deposit Insurance Corporation
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Good morning. It is, as always, a pleasure to be with you today. We appreciate the friendship and support over the years provided by your organization. In particular, I am personally grateful for Ken Guenther's service to the community banks of America. He has been a stalwart friend and ally during my tenure in Washington and we wish him well as he moves on toward a well-deserved retirement.

But as friends like Ken move on - and new friends like Cam Fine fill their shoes - many of the fundamental trends in our industry remain with us. And many of these trends could have profound consequences for your banks and your communities. The banking marketplace continues to shift under your feet, and you have reason to be optimistic. There are clear signs that community banks are transforming their businesses to meet the needs of their communities in ways - and indeed in markets - you could not have dreamed of a few short years ago. This is the wonderful, transformative power of the American economy at work and you should be proud of what you've done.

And it is also important to realize that the survivors - those of you who will attend this gathering ten years from now - will be those who recognized these shifts and followed your customers and your markets toward the banking products and services demanded by their communities. The American consumer is relentlessly leading businesses into a world of high efficiencies, high productivity, and low costs. Fighting this is like trying to hold back the tide, and I'm gratified by the work you're doing to improve your business models, improve your banks, and add to the common wealth of your communities.

These are sometimes hard trends to spot when things are as good as they've been for you over the past decade. Banks continue to return record profits to their shareholders. Low interest rates have spurred customer demand for more products. Technology, and the transformation in customer relationships it allows, has been demanding a lot of your time. We know regulatory compliance consumes a lot of your attention. You face renewed competition - both from large banking organizations eyeing your market share on one side to other organizations like credit unions on the other.

And, by the way, I have a position on that issue: credit unions ought to pay taxes. The playing field has shifted in recent years. We've gone from 20 credit unions with assets of more than $1 billion ten years ago to 83 such institutions today. More and more we're

seeing credit union advertising touting the benefits of membership over doing business with a bank. In my view, if they are going to compete with banks then we should do our best to ensure that the competition is fair. Our back-of-the-envelope research shows that taxing credit unions would bring in about $2 billion to the Federal Treasury - and would eliminate a current credit union subsidy of between 33 and 36 basis points.

That being said, there are other issues you must consider. Consolidation has been relentless. The number of community banks declined by almost half between 1985 and 2001. Market share dropped significantly. The hardest hit were banks with assets of less than $100 million. But if you can pull back from this for a moment, and look at the longer-term trends, there is a positive story in the numbers.

Community banks continue to maintain presence in all types of markets - urban, suburban, and rural. They remain profitable in both regions of population growth and population decline. Further, community bank performance is satisfactory when compared to that of the largest banks. From 1992, ROA, for example, has been at least 100 basis points - and this remains true even in those markets experiencing population declines.

Finally, the community bank business model is still sought-after as you follow your customers into the suburbs and inner cities. We've seen more than 1,100 new banks formed since 1992, and their continued strength in small business and neighborhood lending has helped serve new customers, create jobs, bank the unbanked, and add to the economic vitality of their communities.

As you take comfort in these trends, we know you are aware of the risks in the economy and that you have controls in place to measure and manage them. By definition, these controls are based on the world you're familiar with - the way things have been in the past. I could list ten things you should look out for, but, really, your biggest challenge is to know when your world might fundamentally shift. That is when your models and controls will fail and you will be vulnerable to problems of a type and scale you never thought possible.

I know this is true because I've lived it. When it came to oil, real estate and other commodities in West Texas in the 1980s, the conventional wisdom - the notion that "they're not making any more of it" - was deeply ingrained in our decision-making and it was dead wrong. The more entrenched our wisdom became, the more we saw a herd mentality develop. This allowed minor problems to assume a scale and scope large enough to cause serious damage when these underlying assumptions were proved wrong.

What about your business? Let's take a look at today's fads, where the herd is heading, and see if there are weaknesses there we might be missing. Consumer mortgage lending has been the saving grace for much of the banking industry over the last three years as commercial loan demand remains weak. Early last year, for example, mortgage lending made up 70 percent of the industry's asset growth. In the second half

of the year, credit card lending and home equity lending combined to make up 79 percent of asset growth. For now, losses on mortgage loans are near historic lows, and the large spreads and fees earned by credit card lenders outweigh persistently high loss rates. FDIC-insured credit card lenders earned a return-on-assets of more than 4 percent last year.

But let's look closer. We're in uncharted waters when it comes to households' financial situation. Mortgage indebtedness has risen by more than $1.4 trillion - or 27 percent - in just two years. About one-fifth of total growth in disposable income last year came from the tax cut alone. Further, homeowners liquidated about $390 billion in home equity last year. The financial obligations ratio, as calculated by the Federal Reserve, remains near its record level set two years ago. And personal bankruptcies hit a record high of more than 1.6 million.

The real question in all this is - and the thing you should think about on the plane ride home - what happens when interest rates rise significantly from these historic lows? What will be the impact on borrowers' ability to service debts or continue their historic consumption levels? And rate sensitivity doesn't end with mortgages and consumer debt. The performance of commercial real estate loans has remained historically strong during the past three years even though market fundamentals have been poor. Low interest rates have bailed out many projects that would have sunk if the environment had been different. When the tide of low interest rates and heavy fiscal stimulus recedes, we'll see some vulnerabilities exposed that are currently hidden from view. It is hard to predict how serious these are because we've never seen a cycle quite like this before.

I want you to think about these things and be wary of following the herd into the next big thing. It behooves all of us to look at these potential vulnerabilities now in this period of stability, record earnings, and low rates. History shows that when the fundamentals shift and market conditions change, events can overtake you in a hurry.

We know, also, that there are risks in the Washington process that concern you. We believe there are things we can do together that will strengthen the fundamentals of our industry and shore up our safety net. If we are successful in this, we believe you can survive whatever shifts occur in the future and that you will be well-positioned to let the marketplace guide the process by which American consumers receive financial services. We also believe good fundamentals will allow regulators to redefine our relationship with the banks we supervise and maintain the low barriers to entry that ensure the continued life and health of the banking sector.

For me, this process begins with capital. Capital must be real, it must be tangible, it must be pure. Further, there must be enough of it to ensure your bank can inspire trust in the community, grow with confidence, and absorb the consequences of unexpected developments. For me, the bank safety net begins with capital. This is the first and best line of defense for the deposit insurance funds and the taxpayers and is the founding indicator of trust, confidence, and stability. I believe we have a great opportunity,

because our industry is so strong right now, to strengthen our notion of capital and put the industry on a solid footing for whatever challenges may present themselves in the future.

It is no secret that I am concerned about trust-preferred securities and other hybrid instruments being considered part of Tier-1 capital. To date, more than 750 bank holding companies have issued $76 billion in trust-preferred securities and included them in their Tier-1 capital. These products make up about 14 percent of the current Tier-1 base. Clearly there is a market niche for these products; I'm not suggesting they are not useful to you. If you look at these products closely, I think you'll conclude that they have clear attributes of debt and I want to ensure that Tier-1 capital is free of any liabilities or other interests that fail to provide meaningful capital support.

You know my view. It is important as we consider these issues, however, that we hear your views as well. We'd like for the federal banking agencies to solicit the industry's views on this subject - and I've asked my staff to draw up some options for how we can do that. I hope you'll participate in that process and that you will work with us to ensure the industry's capital footing is as strong as possible going forward.

Beyond capital, there are some accounting issues that are likely of concern to you as well. In particular, the FASB is reviewing the treatment of loan participations and how they can qualify for sale accounting under the FASB Statement 140. I know this is an important issue for community banks because they use participations to ensure they can retain large borrowers who may well have needs beyond any single bank's lending limit.

My concern is this: the FDIC is involved because questions have come up about the right of setoff in the event of an FDIC receivership and whether this right would prevent a participation from meeting the legal isolation test in Statement 140. We understand the FASB is also considering whether to require the setup of a special purpose entity to facilitate participations - a cumbersome process I know you'd like to avoid if you can.

The bottom line is that participations are a valuable industry tool and we do not want to do anything at the FDIC that would diminish their utility to the industry or increase the burden associated with them. If we're part of the problem, we'll be part of the solution. I've asked my staff to work with the other banking agencies on this issue and to try to resolve this issue with the FASB. We've been successful on some other issues - like the loan-loss reserving issue over the last few months - and I hope we can be similarly successful on this one.

There are some internal FDIC initiatives underway which might interest you as well. First, we're continuing our effort to streamline our bank examination process and focus more of our resources on risk rather than process. We're working to develop a relationship-based approach to bank examinations that I think you'll find is much more in line with how regulators ought to interact with the industry in today's marketplace. We'll maximize the utility and use of offsite information to zero in on those areas that provide

the most risk. This is an important and ongoing effort and we'll be looking forward to your feedback.

Further, we'll be asking Congress for some additional flexibility in how we manage our people that will result in a more efficient and effective FDIC organization. Like most government agencies, our hiring process is often cumbersome, job performance doesn't have the prominence it should in how we organize and rightsize our operations, and we don't have a streamlined process for ensuring our most productive workers are fully compensated for their efforts. I'd like additional flexibility to deal with these issues, and said as much to the Congress during an oversight hearing two weeks ago.

I've directed my staff to put together a legislative proposal and send it to Congress within 30 days. I think you'll agree that what we'll send up is a commonsense set of authorities that aren't much different than all of you have in running your banks. These proposals will let me run the FDIC more like a business, and ensure we are good stewards of the money you sent to Washington to administer the deposit insurance system. I'll be asking for your help in getting these passed and look forward to working with you to get it done.

These are a few of the issues we're working on and studying at the FDIC. I want to close by thanking you for the work you do in your communities every day. You contribute to the economic health and vitality of our nation and I hope we can continue to add value to your efforts in the year ahead.

I wish you safe travels home. Thank you for the opportunity to speak here today.

Congress created the Federal Deposit Insurance Corporation in 1933 to restore public confidence in the nation's banking system. The FDIC insures deposits at the nation's 9,182 banks and savings associations and it promotes the safety and soundness of these institutions by identifying, monitoring and addressing risks to which they are exposed. The FDIC receives no federal tax dollars - insured financial institutions fund its operations.

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