Remarks
By
FDIC Chairman Don Powell
ABA Annual Convention
New York, New York

FOR IMMEDIATE RELEASE
PR-101-2004 (10-4-2004)

Media Contact:
Frank Gresock (202-898-663

Greetings from the Federal Deposit Insurance Corporation. It's very nice to be here today and it's great to see so many friends. I want to thank you for giving me this opportunity to speak with you. Over my many years as a banker and more recently as Chairman of the FDIC, I've gotten to know many of you well, and I look forward to these chances to meet with you.

I am often struck, when I speak to bankers these days, by the marvelous contrast between the golden age of banking we've lived in for the past decade and the near-death experience that preceded it in the late 1980s and early 1990s.

Some of you experienced first-hand what banking is like when the only management plan is day-to-day survival.

Fortunately for all of us, the prosperity that followed the banking crisis has lasted for a long time. A simple comparison drives this home. The decade of the 1980s saw virtually no growth in total earnings for the commercial banking industry-the figure hovered around $15 billion. By contrast, during the 1990s annual earnings grew almost five-fold to just over $70 billion. And the golden era continues in this decade; last year commercial banks earned just over $100 billion. This represents about 40 percent of the profits in the financial services sector and almost 17 percent of the profits of all U.S. firms.

But living through an experience like that made me realize-I think it made all of us realize-that the regulatory and economic environment that banks operate in makes an enormous difference. It also made me realize that tomorrow won't necessarily be like today for the banking industry.

So I'd like to share my thoughts with you on what that future might look like.

I think that there are four key trends driving the future of the industry.

First, traditional banking has become a smaller part of the financial system and of banking organizations themselves. But banks remain critical players in the modern flow of funds that has made credit available to more businesses and consumers.

Second, continuing consolidation of the banking industry has lead to a two-tiered industry. This will have implications for how the FDIC insures, supervises, and resolves banks.

Third, financial services companies are becoming global. And the distinctions between the kinds of financial service companies are blurring.

These trends raise questions about the financial regulatory structure in the U.S. In the past, we have seen changes in the marketplace drive major changes in the law. The deregulation of interest rates, the elimination of branching restrictions, and the repeal of the depression era Glass-Steagall restrictions come to mind. The next wave in this evolution is likely to be the mixing of banking and commerce.

Finally, technology will continue to drive consolidation of the industry. It will also continue to be a major focus of risk management, presenting banks with both new opportunities and new challenges in serving consumers and businesses.

Today, I want to focus on consolidation and the implications of a two-tiered industry. I will share some of the steps we've taken in the past few years in response to these trends and my thoughts on what more needs to be done.

In recent remarks to the National Association for Business Economists, I said that the story of banking in the U.S. is fast becoming a tale of two industries. At one end are the dozen or so large complex banking organizations whose size is measured in the hundreds of billions of dollars. Some have assets in the range of one trillion dollars. At the other end are thousands of community banks, which typically have less than one billion dollars in assets.

At the FDIC, we have asked ourselves how this bifurcation of the industry should affect how we do our business.

Let me start with community banks as the first of the two tiers.

By our count, in the past 20 years the number of these banks has declined from 14,000 to under 7,000. Will this trend continue? If you believe, as I do, that community banking is important to the country, this is an important question.

There are two ways of looking at this question. In the optimistic view, the decline in the number of community banks over the past two decades had two main causes: the banking crisis and the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. In this optimistic view, there is no longer a banking crisis to cause any further decline and Riegle-Neal will eventually lead to a somewhat lower but relatively stable number of community banks, unless something else comes along to cause a decline.

But there is also a pessimistic view. In this view, the cost of regulatory burden is disproportionately higher for small banks, and that is the "something else" that may cause the decline in community banks to continue indefinitely.

The pessimists may have a point, but I am a natural optimist.

In my view, it is still relatively easy to charter a new bank and succeed. I read recently about a group of investors who chartered a bank in 1997 and sold it seven years later for quadruple their investment. This kind of success is not unique. New bank formation has served to expand choice in the marketplace and check the economic power of large institutions.

Americans will continue to want locally controlled financial institutions that understand their needs and participate in their way of life. That is what the marketplace is telling us. Amid this long-term wave of bank consolidation, we've seen over 1,200 new banks chartered since 1994, and about 1,100 of those are still operating independently today.

Chartering small, locally controlled banks and thrifts is an American tradition. These community banks play a critical role in meeting the needs of households, small businesses, entrepreneurs, and civic life across America. They are part of the fabric of our traditions of self-reliance, homeownership, and entrepreneurship. And they are part of the reason that up to three quarters of all net new jobs are created in firms with fewer than 500 employees.

We will continue to see this healthy growth of new banks, though, only so long as chartering new banks remains fairly simple and easy, and the economic environment continues to provide opportunities for profit. If we stifle the innovation that comes from community banking, we threaten the process of entrepreneurship in the U.S. economy and the vitality of communities around the country.

The cost of regulatory compliance is an important issue for banks large and small. Some believe, however, that these costs weigh heavier on small banks relative to their size. If so, at some point, shareholders may be better served by selling their bank. While we may not have reached that tipping point yet, we come closer with each new law and regulation. Moving toward a two-tiered approach in supervising, regulating, and insuring banks may help minimize the burdens of regulation.

With this in mind, the FDIC has begun taking steps to reduce regulatory burden.

In January 2004, the FDIC expanded the use of a streamlined examination program called MERIT. This program is designed for well-capitalized, well-managed banks and thrifts that meet basic safety-and-soundness criteria. Those of you in this program will have noticed that the time that examiners spend in the banks is reduced.

This year, the FDIC is also piloting a new program in some parts of the country. We call this the Relationship Manager Program, which means that the primary point-of-contact

for each bank will normally be a local examiner who will coordinate supervision of the institution.

Instead of occurring at a single point in time, examination activities can be tailored to each bank. Most will continue to occur all at once, but others may not. For example, we may examine an ag bank's loans in the fall, when loans are being paid down, and liquidity in early spring, when loans are being funded. This approach should result in a more effective examination process, and, over time, result in additional risk-focusing efficiencies.

We have also made changes to the way we ensure compliance with consumer protection laws and regulations. As supervision of this important area became more complex and detailed over the years with each new law and regulation, the FDIC decided its compliance examination approach was in need of an overhaul. In 2003, we implemented a re-focused compliance examination program that placed greater emphasis on an institution's administration of its compliance responsibilities. The purpose of the examination report under this re-focused program is to alert bank management to areas where controls and systems are in need of improvement rather than being simply a list of violations. Just as in the safety-and-soundness area, the extent of transaction testing depends on the areas where a bank is at higher risk.

CRA is another area where we may be able to reduce regulatory burden. Under an FDIC proposal that is out for comment until October 20, just over 1,100 additional banks would be subject to streamlined CRA examination processes for small banks. This proposal would not in any way exempt these institutions from their CRA obligations-all banks, regardless of size, will be thoroughly evaluated. And, under the August proposal, those with assets between $250 million and $1 billion would be subject to a mandatory community development test.

Many people have expressed concern about our proposed changes, and they should be assured that I have not made up my mind on the CRA issue. I do not want to do anything that will hurt our nation's communities by impairing the flow of credit to the underserved or otherwise undermining CRA objectives. I strongly believe that lending for community development is good business. I remain hopeful that the U.S. banking agencies can come together at the end of the day on an approach that makes sense for all parties to the debate.

Let me pause one moment here to speak more generally about the FDIC's commitment to both safety and soundness and consumer protection. That commitment is steadfast and unshakable. I have described today some steps we've taken to become more efficient and more business-like in our approach to examinations for both safety and soundness and consumer protection. We believe these steps will provide for effective supervision of insured institutions and will reduce regulatory burden as well as FDIC costs of doing business. But make no mistake-if we begin to see evidence that our supervision programs are becoming less effective, we will make the necessary changes

to fulfill our supervisory responsibilities. We will never compromise our fundamental objectives of maintaining safety and soundness and protecting American consumers.

Another issue in the community banking arena relates to capital rules for non-Basel II banks. The FDIC and the other federal banking regulators are considering possible changes to the capital rules for these institutions. I consider this an important issue. We will need to balance the competing goals of risk-sensitivity and simplicity and ensure the end result is a level playing field for all banks.

Before I turn to large banks, I want to clarify that I don't favor one group of banks over another.

Community banking is important because competition in the marketplace is important. As I mentioned earlier, when I express my concerns about regulatory burden, I include the burden placed on all banks, large and small. The economy and the American people are best served through healthy competition among banks of all sizes.

For the financial exposure of the deposit insurance safety net, however, community banks are less important than banks in the other half of our two-tiered industry. So I also want to say a word about how trends affecting large banks can affect the FDIC's risk exposure.

The FDIC underwrites a significant share of the risk in the financial system. Currently, there are over $9.5 trillion in banking assets, almost $5.5 trillion in domestic deposits, and about $3.5 trillion in insured deposits. Of the 25 largest banks and thrifts, as of June 30th of this year, 13 were supervised by the OCC, 7 by the Federal Reserve, 3 by the OTS and 2 by the FDIC. As consolidation proceeds, the banks the FDIC supervises may well represent a smaller and smaller portion of the FDIC's financial exposure as deposit insurer. Put differently, more and more of the FDIC's financial risk will not be directly observable to us in the normal course of business.

There are times when the FDIC's lack of direct connection to the risks it insures causes us some concern. While our system of overlapping regulatory responsibilities generally has worked well, there is room for improvement.

Congress gave clear roles and responsibilities to each of the four federal banking agencies. We accept those defined roles. In cases of overlapping interest or responsibility, it is appropriate for every agency to look first to the primary regulator for information. To ignore that precept can cause burden and confusion for institutions and duplication of supervisory efforts.

The FDIC' statutory responsibilities are unique. We must evaluate the adequacy of the insurance funds, operate a risk-based premium system, and at times consider whether participation in special examination activities for insurance purposes of an institution we do not supervise is warranted.

The use of special examination authority at the FDIC is not undertaken lightly. The cost and burden of the activity, both for the bank and the expenditure of our own resources, and due regard for the prerogatives of the primary regulator must be weighed against our desire for more information. In our evaluation of this tradeoff during the last ten years, we have clearly come down on the side of deference to the primary regulator. During those ten years, the FDIC has not exercised its special examination authority without the agreement of the relevant primary regulator.

I want to emphasize that during the tenure of Comptroller Hawke and Director Gilleran, the FDIC has not had concerns about its ability to use its special examination authority. We have an Interagency Agreement and our Board delegated to the staff the ability to implement that agreement.

Going forward, however, there are issues the agencies will need to work together to address.

The growing use of model-driven calculations of capital requirements is forcing banks to enhance risk-management discipline. It is helping supervisors differentiate banks in terms of relative risk. Those are good things. Yet there is a tradeoff. The subjectivity in implementing these and other new approaches to measuring risk, assets and income can make it harder to implement the capital requirements consistently across banks.

Certain critical assumptions could, at times, have material financial effects relative to a bank's capital structure or overall risk profile, and that is certainly not an issue unique to future "Basel banks."

In most cases these situations will not involve troubled banks, but they will be situations the regulators need to understand-and understand together. As the industry concentrates and measures its risks in new ways, I believe unquestioned access to critical information and the ability to participate, if need be, with the primary regulator in certain supervisory processes will be part of what the FDIC needs to do its job effectively.

Let me close today with some implications for the FDIC of the future: how must the deposit insurance program evolve to keep pace with a rapidly changing industry?

I should first point out that we have already made many changes in the way the FDIC does business since I arrived three years ago. Many of these changes you have heard about today.

Our stewardship of the fund is an important corporate value at the FDIC. Senior management has developed and implemented a centralized capital investment review process, enhanced our approach to pay for performance, including "pay at risk" for executives, substantially reduced the number of executives and managers, and maintained a flat budget. We made the decision to go through a painful and difficult reduction in staff-our most precious resource-from 6,300 three years ago to about 5,250

today. This decision was not driven by dollars, but by our belief that our declining workload, and resulting overstaffing in parts of the organization, would have posed a long-term threat to the health and effectiveness of the FDIC.

We have and will continue to do what we can on our own, but we believe that some of what we need must come from the Congress.

First, deposit insurance reform. As you know, there are three elements of deposit insurance reform that the FDIC regards as most critical: merging the funds, improving the FDIC's ability to manage the fund and pricing premiums properly to reflect risk. We believe that reform should grant assessment credits to recognize the contributions that banks made to build the funds in the first half of the 1990s. We also believe that the FDIC should be allowed to create a credit and rebate system to keep the fund from growing too large in the future.

These reforms are needed to provide the right incentives to insured institutions-to ensure that new institutions, fast growing institutions and riskier institutions pay for the risks they pose. They are also needed to improve the deposit insurance system's ability to help stabilize the economy, while preserving the obligation of banks and thrifts to fund the system. There is widespread general agreement among the bank and thrift regulators for these reforms and the House of Representatives has demonstrated its agreement twice by passing reform legislation.

But ultimate passage of these important deposit insurance reforms has been delayed by concerns over indexing the coverage limit.

These concerns are misplaced.

The primary objection to indexing arises from concerns over undue interference in the marketplace. But the coverage limit today is smaller relative to per capita personal income than it was at the inception of the deposit insurance program, and this would still be true under the reform packages being considered by the Congress.

Federal deposit insurance as implemented by the FDIC has proven to be the right kind of government intervention. It has prevented instability without unduly distorting incentives or impairing the functioning of the marketplace.

We have identified some flaws that need to be corrected; we can make the needed repairs quickly and easily in the current environment while the banking industry is strong.

The second area where we need help from Congress is in human resource flexibility.

The inability to effectively manage our human resources has been among my greatest frustrations as Chairman (second only to not yet getting deposit insurance reform).

Many of you run a business, as I have done. Imagine not having the flexibility to manage your human resources in a way you felt was most critical to your future success; imagine that in the face of all the dramatic changes in the business environment that you still managed your human resources in ways that had not really changed since the days of the Great Depression.

The FDIC has in many ways been an innovator and leader in its human resources policies. Although we have gained some flexibility through many of our new programs, it is not enough.

This is why I recently delivered a human resources flexibilities package to the Congress for its consideration. We need to able to attract the best people and retain the best people in order to remain the high-performance organization that you deserve.

The changes I've asked for will have no effect on the protections afforded FDIC employees. They will continue to be covered by existing merit systems principles and equal employment opportunity and whistleblower statutes and guidelines. Veterans' preference will continue to be considered in hiring and retention practices.

Most of what we've asked for is based on statutory authority Congress has already granted to other government agencies. There isn't one of you out there who doesn't have the kind of flexibility we're asking for in your own business and who wouldn't find it intolerable otherwise.

If Congress enacts deposit insurance reform and gives the FDIC the minimal human resources flexibility it needs, I am convinced that the FDIC will be well prepared to continue to evolve with the industry and meet the challenges that lie ahead.

A deposit insurance system that works well and a deposit insurer that is well run are important for a simple reason: the alternative can be disastrous for banking. We saw that with the thrift crisis of the late 1980s.

And, in the final analysis, it is almost impossible to overstate the importance of banking. Not long after the bank and thrift industry began to recover from the last crisis, Bill Gates was quoted as saying that "banks are dinosaurs."

Events proved him wrong, and they will continue to prove him wrong. Banking will continue to be important. Before, during, and after the 2001 recession, banks were a pillar of strength for the U.S. economy. That should serve to remind us of something we all learned in undergraduate economics-a healthy, well-functioning banking industry is key to the economic vitality of our nation. Banks allocate and provide credit-you decide which companies are most likely to succeed and you finance that success.

Beyond their purely economic role, banks play a vital role in their communities and in the nation. Bankers have traditionally been civic and charitable leaders. Their communities depend on them for business leadership, and as sources of lending for

schools, churches, cities and counties. Nowadays, banks also serve as the nation's first line of defense in preventing terrorists from obtaining funds.

And, of course, banks' customers depend on them for the full range of banking services.

It is no exaggeration to say that not only our economy, but our country itself, depends on you. I am confident that you will remain the bulwark you have always been.

Thank you.

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 9,079 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.

FDIC press releases and other information are available on the Internet via the World Wide Web at www.fdic.gov and may also be obtained through the FDIC's Public Information Center (800-276-6003 or (703) 562-2200).

Last Updated 10/04/2004