Message from the Chairman • Sheila C. Bair

I am pleased to present the Federal Deposit Insurance Corporation's (FDIC) 2006 Annual Report (also referred to as the Performance and Accountability Report). The condition of the banking and thrift industry continues to be healthy and profitable and 2006 saw continuation of the longest period in the Corporation's 73-year history without a failure of an FDIC-insured institution – a record 31 months. Nevertheless, we continued in 2006 to actively pursue our mission of ensuring the stability of and public confidence in the nation's financial system.

The past year was a particularly significant one for the FDIC. On February 8, 2006, President Bush signed into law the Federal Deposit Insurance Reform Act of 2005, culminating a lengthy, multi-year effort by the FDIC, the Administration, and the Congress to make sweeping improvements to the federal deposit insurance system. The law requires the FDIC to make fundamental changes in its deposit insurance policies and business processes in 2006 and 2007, and we are well on our way toward full compliance with the provisions of that Act.

We focused much of our attention during 2006 on three high priority areas of activity: (1) addressing significant policy issues, (2) maintaining a strong supervisory program, and (3) concentrating our efforts on promoting economic inclusion. I would like to share with you some of our major successes during 2006 and some of our challenges for 2007 and beyond.

Policy Challenges

In accordance with the requirements of the deposit insurance reform statute, the FDIC in early 2006 merged the Bank Insurance Fund and the Savings Association Insurance Fund into the new Deposit Insurance Fund, and adopted new regulations increasing coverage for certain retirement plan deposits from $100,000 to $250,000. This was the first major change in deposit insurance coverage since 1980. The reform statute also provided the FDIC Board of Directors (Board) with greater flexibility to manage the Deposit Insurance Fund. The Board adopted final rules on a new assessment system that will make assessments more risk-sensitive and distribute the assessment burden more fairly across insured institutions, and it established new premium rates effective for deposit insurance beginning January 1, 2007. In addition, the Board adopted final rules on the distribution and use of $4.7 billion in one-time assessment credits, a temporary plan for the allocation of future dividends, and a designated reserve ratio. In 2007, the FDIC will complete and issue guidance on how limited adjustments may be made in the pricing of deposit insurance for large banks and publish an advance notice of proposed rulemaking seeking comment about how to implement a permanent dividend system.

Capital reform was a major area of focus in 2006. The FDIC continued to work with the other federal regulators and to participate actively on the Basel Committee on Banking Supervision, and many of its subgroups, in planning for the implementation of the new Basel II capital framework. The Board approved in September 2006 the publication of a notice of proposed rulemaking (NPR), jointly with the Federal Reserve Board, the Office of the Comptroller of the Currency and the Office of Thrift Supervision, seeking comment on draft regulations to implement the advanced approaches of the Basel II Accord. As a result of the findings in the fourth quantitative impact study (QIS-4), which examined the potential impact that the Basel II capital framework might have on the minimum risk-based capital requirements of a select group of financial institutions, safeguards were incorporated into the Basel II NPR to protect against an unacceptable decline in minimum risk-based capital requirements.

On December 5, 2006, the Board also approved the publication of a second NPR seeking comment on draft regulations to implement a new capital framework, referred to as Basel IA, which banks that do not use the Basel II capital framework may opt to apply. The Basel IA NPR was also issued jointly with the Federal Reserve Board, the Office of the Comptroller of the Currency and the Office of Thrift Supervision.

Both draft regulations represent an effort to enhance the risk sensitivity of the existing risk-based capital framework while maintaining safety and soundness within the banking and thrift industry. Throughout the interagency deliberations on both Basel II and Basel IA, the FDIC has maintained an unwavering commitment to the maintenance of strong capital requirements and to the principle that any changes to these requirements should have a minimal impact on competitive equity among banks of all sizes. In 2007, the FDIC will continue to provide leadership in this effort. It will explore the potential of using simplified approaches as an alternative to the advanced approaches in the Basel II Accord and, with the other banking agencies, work to achieve consensus on the overall package of regulatory capital changes for final publication.

Another significant policy challenge is presented by the continuing consolidation in the banking industry. While this presents challenges for all federal banking regulators, it poses unique issues for the FDIC because of its multiple roles as regulator, deposit insurer, and receiver. Fortunately, the banking industry and our largest banks are strong and have made many improvements to their risk management processes in recent years. Even so, the FDIC must be prepared to respond to instability in any size insured institution. To meet these challenges, the FDIC continues to enhance its capabilities to protect insured depositors and maintain stability in our banking system. Some of the initiatives involved in this ongoing process are contingency planning exercises, system and process improvements for determination of deposit insurance claims and management of failing bank assets, consultations with domestic and international regulators, improvements to the FDIC's supervisory program for larger banks, and the designation of internal and external expertise to focus on larger bank issues. This effort will continue and evolve as the challenges change in the future.

Matters that received significant public interest in 2006 included applications to the FDIC for deposit insurance filed by commercial companies for proposed industrial loan companies (ILCs). To obtain the public's insight on the issues, on July 28, 2006, the FDIC placed a six-month moratorium, ending on January 31, 2007, on ILC deposit insurance applications and change in control notices to give the FDIC time to assess developments in the ILC industry; to determine whether any emerging safety and soundness or policy issues exist; and to evaluate whether statutory, regulatory or policy changes need to be made in the oversight of these institutions. The moratorium also allowed FDIC time to further evaluate the various issues, facts and arguments raised in connection with the ILC industry, and to assess whether statutory or regulatory changes or revised standards and procedures for ILC applications and supervision are needed to protect the Deposit Insurance Fund or important Congressional objectives. In August, the FDIC Board requested public comment on a broad range of ILC-related issues. During the 45-day comment period that ended on October 10, 2006, we received more than 12,600 comments which were carefully and thoroughly evaluated.

Supervisory Program
In addition to managing an unusually large policy agenda, the FDIC also continued to administer strong and effective supervisory programs in 2006 in both the risk management and compliance areas. The FDIC performed 2,388 safety and soundness examinations, 1,959 compliance and Community Reinvestment Act exams and 3,052 specialty exams.

During the year, the FDIC enhanced the quality of fair lending examinations through the use of residential mortgage pricing data. This year represented the first opportunity for the FDIC to use pricing data collected by financial institutions pursuant to the 2004 changes to the Home Mortgage Disclosure Act. Also in 2006, the FDIC established the Large Bank Program to address challenges associated with supervising and insuring the deposits of large and complex institutions. In addition, the FDIC completed and issued guidance on concentrations in commercial real estate. This guidance provides supervisory criteria to assist in identifying institutions with significant concentrations of commercial real estate.

Further, the FDIC became increasingly concerned with the expansion of nontraditional mortgage products and the potential risk posed by these products to the DIF. To address these concerns, the FDIC implemented certain enhancements to the supervisory oversight of nontraditional mortgage banking activities and, with the other financial institution regulatory agencies, developed and issued guidance to address the growing risks in these loan products.

During the year, the FDIC conducted a comprehensive review of the compliance examination program's workload and resources. Based on workload projections, we identified the need for additional staffing in this area. In December, the Board authorized 72 new examiner positions to be phased in over a three-year period with the majority added in 2007. This will result in an increase of human resources dedicated to the compliance and CRA examination areas.

Reflecting our commitment to provide current and consistent guidance for examiners and banking organizations to comply with the Bank Secrecy Act (BSA) and Anti-Money Laundering (AML) requirements, we worked closely with the other federal banking regulators to revise the Federal Financial Institutions Examination Council (FFIEC) BSA/AML Examination Manual. The FFIEC BSA/AML Working Group, which the FDIC chairs, collaborated with other federal banking agencies and the Financial Crimes Enforcement Network (FinCEN) on the revision project.

Promoting Economic Inclusion

The FDIC has long been committed to bringing all segments of society into the financial mainstream. This year, the Board approved the establishment of the FDIC Advisory Committee on Economic Inclusion to provide the FDIC with advice and recommendations on important initiatives focused on expanding access to banking services by underserved populations. The Committee members represent a broad cross section of interests from the banking industry, state regulatory authorities, government, academia, consumer and public advocacy organizations, community-based groups and others impacted by banking-related practices.

This year, the FDIC took two important steps to focus attention on the need for affordable small-dollar loan products. First, the FDIC released *Affordable Small-Dollar Loan Guidelines* for public comment. The guidelines explore several aspects of product development, including affordability, streamlined underwriting and savings. Second, the FDIC hosted a conference in December on meeting the needs of military personnel and their families, who are frequently turning to high-cost providers for short-term loans and other financial services. The banks that attended the conference developed a template for an affordable, small denomination loan product with a savings component. We will continue to work with the industry to find ways to promote both affordable short-term loan products and creative ways to encourage savings.

To reach an even wider audience of unbanked and underbanked with our successful *Money Smart* financial education program, this year the curriculum was released in Russian, large print and Braille. Release of the Braille and large-print versions was the first time that a financial education program has been specifically targeted for individuals with visual impairments. The FDIC also completed development of a Spanish-language version of our online Electronic Deposit Insurance Estimator and a Spanish-language video on federal deposit insurance coverage.

As part of our ongoing effort to help combat identity theft, we continued to take a leadership role in consumer education initiatives and released an online training tool called *Don't Be an Online Victim: How to Guard Against Internet Thieves and Electronic Scams.* The training tool is available through the FDIC's Web site and via disc.

In 2006, we continued to analyze the economies adversely affected by Gulf Coast hurricanes and worked closely with banks and consumers to address issues of concern. We also worked closely with other federal and state regulatory agencies to issue guidance outlining examination procedures for assessing the financial condition of institutions adversely affected by the hurricanes. The FDIC, working jointly with NeighborWorks® America, released a homeownership and financial counseling guide called *Navigating the Road to Housing Recovery in the Gulf Coast.* This guide was a focal point of an FDIC/NeighborWorks® Gulf Coast Housing Summit held in New Orleans in October that was attended by bankers, housing experts, homeownership counselors and others.

Conclusion

Finally, I am pleased to note that we were able to enhance our efforts in each of our major business lines during 2006 while maintaining strong fiscal discipline. As detailed elsewhere in the report, the FDIC has had an extraordinary record of controlling its operating expenses over the past five years. Spending against the FDIC's operating budget in 2006 was 18 percent lower than it was in 2002, due primarily to a 27 percent reduction in the Corporation's staffing and limited resolution and receivership management activities during that period. These staff reductions completed more than a decade of downsizing that followed the Corporation's rapid workforce buildup to address the banking crisis of the late 1980s and early 1990s. I am indebted to my predecessor, Donald Powell, for his efforts to move the FDIC past the difficult era of downsizing, and for leaving me with a revitalized workforce that is eager and willing to address the new and emerging challenges to the safety and stability of our banking system.

Our agenda for 2007 will be full of challenges. Along with continuing to implement the changes brought about by deposit insurance reform, we will focus our energies on continuing to ensure the safety and soundness of our banking system, the effectiveness of our consumer protection efforts and the efficiency of our internal operations.

On a personal note, I would like to say that I am honored to serve as the 19th Chairman of the FDIC. Having been sworn in as Chairman on June 26, 2006, I clearly joined the FDIC at a critical – but exciting – time for the agency and the industry. I look forward to working alongside our outstanding Board and the dedicated employees of the FDIC as we face the challenges of the future together.

Sincerely,

Sheila C. Bair

Sheila C. Bair becomes FDIC Chairman as Executive Secretary Robert Feldman administers the oath and Deputy to the Chairman Alice Goodman holds the Bible.