

## Message from the Chairman • Sheila C. Bair



I am pleased to present the Federal Deposit Insurance Corporation's (FDIC) *2007 Annual Report* (also referred to as the *Performance and Accountability Report*). The year posed major challenges to financial institutions and to the economy as a whole. Slumping housing markets and escalating problems, particularly related to subprime mortgage lending, were among the chief contributors to increased uncertainty in the financial markets and widespread reductions in asset values. In spite of these challenges, the FDIC continued to ensure public confidence and stability in the nation's financial system. FDIC-insured institutions entered 2007 with strong earnings and capital, and consequently, were in a good position to absorb the initial stresses associated with last summer's market events.

The problems that have emerged in the subprime mortgage market underscore my longstanding view that consumer protection and safe and sound lending go hand in hand. Most insured institutions have a good performance record in both areas. However, failure by some lenders to uphold adequate standards in the increasingly complex mortgage industry has caused serious problems for consumers, lenders, investors, and the economy. Many of the more troubling lending practices were found in institutions that are not subject to federal supervision, rather than in insured banks and thrifts. Nationally, the home foreclosure rate has nearly doubled in the past two years. An estimated 1.7 million owner-occupied, subprime hybrid adjustable rate mortgages (ARMs) will reset in 2008 and 2009, and the combination of declining home prices and scarce refinancing options could result in hundreds of thousands of additional foreclosures. The FDIC is committed to working with market participants to develop solutions that would help prevent unnecessary foreclosures and keep homeowners in their homes.

Throughout 2007, I urged servicers and lenders to voluntarily restructure some of their performing loans. Specifically, I endorsed a streamlined process to keep homeowners with resetting subprime mortgages at their starter rate for five or more years if they were current on their payments, but could not make the higher payments after the loan reset. Using a streamlined process to keep subprime borrowers paying affordable mortgages frees up resources for lenders and servicers to respond to problems in other categories of loans. On December 6, 2007, Treasury Secretary Paulson called for accelerated and systematic loan modifications – a plan endorsed by President Bush along with the other federal banking regulators, and agreed to by many representatives of the mortgage lending industry. I view this as a very positive initial step towards avoiding hundreds of thousands of foreclosures and the ensuing economic consequences.

Three FDIC-insured banks failed in 2007. All three failures posed unique challenges for the FDIC – one, in particular, because it was an Internet bank with no physical branches. It was also the FDIC's largest bank closing in 14 years. While the industry had experienced no failures for two-and-a-half-years, the FDIC remained ready and able to respond and incorporated innovations to address new and challenging issues. In all three bank failures, the FDIC effectively responded to the needs of the failed banks' depositors – as it has since 1934 – ensuring timely payments of insured deposits.

In spite of its record of success, the FDIC has remained focused on improving its ability to resolve financial institution failures. As financial institutions have grown in both size and complexity, the challenges facing the FDIC, if one or more should fail, have likewise grown. In response, the FDIC has strived to balance the need for readiness with the goal of maximizing operational efficiencies. These objectives are being met through a combination of contingency planning, cross-training of staff, development of enhanced systems for managing both the assets and liabilities of future failures, and proposed improvements in financial institution recordkeeping. Through this combination of strategies, the FDIC will continue its strong record of service, reliability, efficiency, and providing outstanding value to its stakeholders.

The U.S. financial system benefits from a balance between large and complex banks, regionally focused banks, and community banks. Community banks are integral to their local economies and to the customers they serve – individuals and businesses alike. Overall it is impressive that community banks, while facing intensified competition, have been able to achieve both respectable earnings and growth in recent years. Community banks possess certain advantages as lenders to local households, small businesses, and farmers. The willingness of private investors to risk their own money to create new banks is a powerful market indicator of the viability of small banks, especially in areas of high population density. Community banks will continue to occupy an important position in the banking industry for the foreseeable future.

We were busy in other areas as well, among them: implementing significant policies to implement deposit insurance reform, working towards an agreement on Basel II capital standards, modernizing the claims business process, maintaining a strong supervisory program, and promoting economic inclusion. Below are a few highlights of our activities in 2007, as well as some challenges we will face in 2008.

### **Policy**

On January 1, 2007, new risk-based deposit insurance assessment rates became effective as part of implementation of the Federal Deposit Insurance Reform Act of 2005. We distributed credits totaling \$4.7 billion to those institutions that contributed to the buildup of the insurance funds through 1996, and issued an Advance Notice of Proposed Rulemaking (ANPR) seeking comments on alternative methods for allocating future dividends.

Our efforts on capital reform continued in 2007, with our active participation – along with our fellow U.S. banking regulators – in shared implementation of the Basel II Capital Accord. On November 5th, the FDIC Board of Directors jointly approved, along with the other federal banking regulators, the final rule to implement the advanced approaches of the Basel II Capital Accord in the U.S. (Basel II AIRB final rule). The final rule is consistent in most respects with the rules that are being implemented in other jurisdictions. At the request of the FDIC, the agencies also included safeguards in the event that the new rules do not work as intended. For instance, the final regulation implements the agencies' agreement not to allow any bank to exit its transitional risk-based capital floors unless and

until the agencies publish a study finding that there are no material deficiencies in the framework after two years experience in implementation or unless identified defects are remedied. If any agency allows its banks to exit the floors in a way that departs from this consensus approach, the rule requires that agency to publish a report explaining its reasoning. The final rule will become effective on April 1, 2008.

The agencies have agreed to issue a proposed rule that would provide all non-core banks with the option to adopt a standardized approach under the Basel II Capital Accord. This would replace the earlier proposed rule to adopt the “Basel IA” option. Basel IA was a new capital framework to be used by banks that chose not to use the Basel II framework. As we enter the new year, the FDIC will continue to provide leadership for this effort and work toward the goal of publishing a Notice of Proposed Rulemaking (NPR) to implement the standardized approaches of Basel II in the U.S. (Basel II Standardized NPR). Both the Basel II AIRB final rule and the Basel II Standardized NPR are part of our effort to enhance the risk sensitivity of the existing risk-based capital framework, while maintaining safety and soundness within the banking and thrift industries.

We also moved forward with our deposit insurance claims and modernization initiative that has been ongoing for the past several years. We published an NPR broken into two parts. The first part applies to all FDIC-insured institutions and governs the specific time and circumstances under which account balances will be determined, for deposit insurance purposes, in the event of a failure. The second part applies only to the largest FDIC-insured institutions – approximately 160 institutions with at least \$2 billion in domestic deposits and more than 250,000 deposit accounts, or total assets of more than \$20 billion, regardless of the dollar amount of deposits or number of accounts. Under the proposal, these institutions would be required to adopt mechanisms that would, in the event of the institution’s failure: place provisional holds on large deposit accounts in a percentage specified by the FDIC; provide the FDIC with deposit account data in a standard format; and allow automatic removal of provisional holds once the FDIC makes an insurance determination. The FDIC places a high priority on providing access to insured deposits promptly and, in the past, has usually been able to allow most depositors access to their deposits on the next business day. If adopted, the proposed rule would better enable the FDIC to continue this practice, especially for the larger, more complex institutions it insures.

### **Supervisory Program**

Along with successfully managing an unusually large policy agenda in 2007, we continued to administer strong and effective supervisory programs in both the risk-management and compliance areas. We performed 2,258 safety and soundness examinations; 1,773 compliance and Community Reinvestment Act exams; and 2,941 specialty exams. The FDIC is the primary federal regulator for state nonmember banks, the vast majority of which are community banks. The core work of our examination staff continues to be the on-site evaluations and assessment of these banks’ risk management, compliance and consumer programs. Our field examiners are on the frontline and their work in identifying emerging risks and promoting stability in our nation’s economic system has been the hallmark of the FDIC for 75 years.

During the year, as the FDIC and fellow banking regulators became increasingly concerned with the expansion of subprime hybrid ARMs and the potential risk posed by these products, we took a leading role with the other regulators in issuing the *Statement on Subprime Mortgage Lending*. The statement describes the prudent safety and soundness and consumer protection standards that institutions should follow to ensure borrowers obtain loans they can afford to repay. We also took a leading role in developing the interagency *Statement on Working with Mortgage Borrowers*, encouraging financial institutions to pursue strategies to mitigate losses while preserving homeownership for borrowers that are delinquent or in default, or are at imminent risk of default. To provide guidance to entities that service residential mortgage loans for others, the FDIC, along with the other federal financial regulatory agencies, issued the *Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages*.

To improve the quality of our examination programs, we launched our successful Joint Examination Teams (JETs) initiative, in which examiners from both the compliance and the risk-management sides examine FDIC-supervised institutions identified as offering certain consumer credit products, such as subprime loans, nontraditional mortgage loans, and third-party loan origination arrangements. Through this team effort, we can more fully assess institutions' various risks as well as their ability to control those risks. Our compliance examiners have expertise in such areas as unfair and deceptive acts or practices, the Truth-in-Lending Act, the Real Estate Settlement Procedures Act, and the Equal Credit Opportunity Act, while our risk-management examiners' expertise covers such areas as credit card and mortgage banking activities, securitization and asset-liability modeling.

As part of our continued effort to develop and maintain a highly skilled and flexible workforce, we have expanded our internal certificate program to include the Bank Secrecy Act, Receivership Claims, Franchise and Asset Marketing, and Basic Compliance Examination functions. This program allows employees to earn industry-recognized professional certifications.

Also in 2007, we implemented a number of regulatory relief provisions included in the Financial Services Regulatory Relief Act of 2006. These included revising Regulation R, which sets forth circumstances and conditions under which banks can continue to effect securities transactions for customers without being subject to registration as a broker under the Securities Exchange Act of 1934; expanding the examination cycle for "1" and "2"-rated banks to 18 months by raising the program's asset threshold from \$250 million to \$500 million; and developing model privacy notices – along with other federal financial institution regulatory agencies, the Securities and Exchange Commission and the Federal Trade Commission – which financial institutions have the option to use. We are mindful of unnecessary regulatory burden and will continue to eliminate it where possible.

Finally, during a year in which we witnessed a range of natural disasters around the country, we issued 12 financial institution letters announcing steps to provide regulatory relief to institutions and to facilitate recovery in areas damaged by fire, flood and other natural disasters. Recognizing the lasting damage caused by Hurricane Katrina, we also issued guidance to remind examination personnel and the industry that communities and families impacted by Hurricane Katrina may need additional time to recover.

### **Economic Inclusion**

The FDIC is strongly committed to advancing economic inclusion for all segments of society. In 2007, we launched our Alliance for Economic Inclusion initiative in nine markets across the country, promoting the expanded use of insured financial institutions by segments of the U.S. population that are currently underserved by the banking industry. Broad-based coalitions of financial institutions, community-based organizations and other partners were formed to focus on expanding basic retail financial services for underserved populations. Services include savings accounts, affordable remittance products, small-dollar loan programs, targeted financial education programs, alternative delivery channels and other asset-building programs. Also, foreclosure-prevention efforts have been integrated.

As part of our economic inclusion effort this year, we focused on assisting financially stressed residential borrowers. Working through our Alliance for Economic Inclusion and with NeighborWorks® America, we are promoting a broad foreclosure-prevention initiative for consumers at risk of foreclosure from subprime and nontraditional mortgage lending.

In addition, we hosted three meetings of the FDIC Advisory Committee on Economic Inclusion (ComE-IN), which was approved by the FDIC Board of Directors pursuant to the Federal Advisory Committee Act in November 2006. The Committee provides the FDIC with advice and recommendations on important initiatives focused on expanding access to banking services by underserved populations. The topics addressed during the 2007 meetings were access to small dollar loans, the subprime mortgage situation and money services businesses and their access to the banking system.

Based on a recommendation from the Advisory Committee on Economic Inclusion, the FDIC Board approved a two-year pilot project to review affordable and responsible small-dollar loan programs in thirty diverse financial institutions across the country. This program will assist bankers by identifying and disseminating information on replicable business models for small-dollar loans by evaluating data submitted to the FDIC about the bank's small dollar loans, the overall value and profitability of their program, and the benefit to consumers.

During 2007, the FDIC also commenced work on two surveys intended to provide extensive new data regarding economic inclusion. Both of these survey efforts are related to a mandate in section 7 of the Federal Deposit Insurance Reform Conforming Amendments Act of 2005 requiring the FDIC to conduct a survey of FDIC-insured institutions every two years regarding their efforts to serve the unbanked. The first of these surveys, the Survey of Banks' Efforts to Serve the Unbanked and Underbanked, will be conducted during 2008 and is expected to yield significant insight about bank efforts to serve unbanked and underbanked populations. The FDIC is also exploring the feasibility of conducting a survey of U.S. households to estimate the percentage of the U.S. population that is unbanked and underbanked. The survey is scheduled to be conducted in January 2009 as a supplement to the Bureau of the Census's Current Population Survey. It is expected to yield significant new data on the extent of the population that is unbanked and/or underbanked and the reasons why some households do not make greater use of traditional banking services.

We also continued promoting financial education to the unbanked and underbanked populations around the country, expanding our efforts to integrate our *Money Smart* financial education program into public schools. To reach an even wider audience with *Money Smart*, we distributed a revised version of our instructor-led curriculum and an online computer-based instruction. In 2007, the FDIC surpassed its goal established at the inception of the *Money Smart* program to provide financial education to 1 million consumers. To date, over 1.4 million consumers have taken the *Money Smart* curriculum.

#### **Conclusion**

As we begin 2008, the FDIC aspires to be recognized by its employees and stakeholders as an outstanding employer with a highly motivated and engaged workforce that understands and is committed to the Corporation's mission, goals and objectives. To that end, during 2007 we conducted a comprehensive employee survey and have plans underway to further improve the Corporation in the areas of communication, empowerment, employee performance, and compensation systems. Our employees have been and always will be the FDIC's most important resource in completing its mission. I look forward to continued work with our dedicated staff and exceptional Board of Directors in 2008.

The FDIC remains committed to working with bankers, consumers, fellow regulators, Congress and others to keep the banking industry healthy and the economy strong – a commitment that we will continue to keep into 2008 and well beyond.

Sincerely,

A handwritten signature in blue ink that reads "Sheila C. Bair". The signature is written in a cursive style with a large initial 'S' and a distinct 'C' and 'B'.

**Sheila C. Bair**