Daniel K Tarullo: State of the banking industry

Testimony of Mr Daniel K Tarullo, Member of the Board of Governors of the US Federal Reserve System, before the Subcommittee on Financial Institutions, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington DC, 14 October 2009.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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Chairman Johnson, Ranking Member Crapo, and members of the Subcommittee, thank you for your invitation to discuss the condition of the U.S. banking industry. First, I will review the current conditions in financial markets and the overall economy and then turn to the performance of the banking system, highlighting particular challenges in commercial real estate (CRE) and other loan portfolios. Finally, I will address the Federal Reserve's regulatory and supervisory responses to these challenges.

Conditions in financial markets and the economy

Conditions and sentiment in financial markets have continued to improve in recent months. Pressures in short-term funding markets have eased considerably, broad stock price indexes have increased, risk spreads on corporate bonds have narrowed, and credit default swap spreads for many large bank holding companies, a measure of perceived riskiness, have declined. Despite improvements, stresses remain in financial markets. For example, corporate bond spreads remain quite high by historical standards, as both expected losses and risk premiums remain elevated.

Economic growth appears to have moved back into positive territory last quarter, in part reflecting a pickup in consumer spending and a slight increase in residential investment – two components of aggregate demand that had dropped to very low levels earlier in the year. However, the unemployment rate has continued to rise, reaching 9.8 percent in September, and is unlikely to improve materially for some time.

Against this backdrop, borrowing by households and businesses has been weak. According to the Federal Reserve's Flow of Funds accounts, household and nonfinancial business debt contracted in the first half of the year and appears to have decreased again in the third quarter. For households, residential mortgage debt and consumer credit fell sharply in the first half; the decline in consumer credit continued in July and August. Nonfinancial business debt also decreased modestly in the first half of the year and appears to have contracted further in the third quarter as net decreases in commercial paper, commercial mortgages, and bank loans more than offset a solid pace of corporate bond issuance.

At depository institutions, loans outstanding fell in the second quarter of 2009. In addition, the Federal Reserve's weekly bank credit data suggests that bank loans to households and to nonfinancial businesses contracted sharply in the third quarter. These declines reflect the fact that weak economic growth can both damp demand for credit and lead to tighter credit supply conditions.

The results from the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices indicate that both the availability and demand for bank loans are well below pre-crisis levels. In July, more banks reported tightening their lending standards on consumer and business loans than reported easing, although the degree of net tightening was well below levels reported last year. Almost all of the banks that tightened standards indicated concerns about a weaker or more uncertain economic outlook, and about one-third of banks surveyed cited concerns about deterioration in their own current or future capital positions. The survey also indicates that demand for consumer and business loans has remained weak. Indeed, decreased loan demand from creditworthy borrowers was the most common explanation given by respondents for the contraction of business loans this year.

Taking a longer view of cycles since World War II, changes in debt flows have tended to lag behind changes in economic activity. Thus, it would be unusual to see a return to a robust and sustainable expansion of credit until after the overall economy begins to recover.

Credit losses at banking organizations continued to rise through the second quarter of this year, and banks face risks of sizable additional credit losses given the outlook for production and employment. In addition, while the decline in housing prices slowed in the second quarter, continued adjustments in the housing market suggest that foreclosures and mortgage loan loss severities are likely to remain elevated. Moreover, prices for both existing commercial properties and for land, which collateralize commercial and residential development loans, have declined sharply in the first half of this year, suggesting that banks are vulnerable to significant further deterioration in their CRE loans. In sum, banking organizations continue to face significant challenges, and credit markets are far from fully healed.

Performance of the banking system

Despite these challenges, the stability of the banking system has improved since last year. Many financial institutions have been able to raise significant amounts of capital and have achieved greater access to funding. Moreover, through the rigorous Supervisory Capital Assessment Program (SCAP) stress test conducted by the banking agencies earlier this year, some institutions demonstrated that they have the capacity to withstand more-adverse macroeconomic conditions than are expected to develop and have repaid the government's Troubled Asset Relief Program (TARP) investments.[1] Depositors' concerns about the safety of their funds during the immediate crisis last year have also largely abated. As a result, financial institutions have seen their access to core deposit funding improve.

However, the banking system remains fragile. Nearly two years into a substantial recession, loan quality is poor across many asset classes and, as noted earlier, continues to deteriorate as lingering weakness in housing markets affects the performance of residential mortgages and construction loans. Higher loan losses are depleting loan loss reserves at many banking organizations, necessitating large new provisions that are producing net losses or low earnings. In addition, although capital ratios are considerably higher than they were at the start of the crisis for many banking organizations, poor loan quality, subpar earnings, and uncertainty about future conditions raise questions about capital adequacy for some institutions. Diminished loan demand, more-conservative underwriting standards in the wake of the crisis, recessionary economic conditions, and a focus on working out problem loans have also limited the degree to which banks have added high quality loans to their portfolios, an essential step to expanding profitable assets and thus restoring earnings performance.

These developments have raised the number of problem banks to the highest level since the early 1990s, and the rate of bank and thrift failures has accelerated throughout the year. Moreover, the estimated loss rates for the deposit insurance fund on bank failures have been very high, generally hovering near 30 percent of assets. This high loss level reflects the rapidity with which loan quality has deteriorated during the crisis and suggests that banking organizations may need to continue their high level of loan loss provisioning for some time. Moreover, some of these institutions, including those with capital above minimum requirements, may need to raise more capital and restrain their dividend payouts for the

[1] For more information about the SCAP, see Ben S. Bernanke (2009), "The Supervisory Capital Assessment Program," speech delivered at the Federal Reserve Bank of Atlanta 2009 Financial Markets Conference, held in Jekyll Island, Ga., May 11.

foreseeable future. Indeed, the buildup in capital ratios at large banking organizations has been essential to reassuring the market of their improving condition. However, we must recognize that capital ratios can be an imperfect indicator of a bank's overall strength, particularly in periods in which credit quality is deteriorating rapidly and loan loss rates are moving higher.

Comparative performance of banking institutions by asset size

Although the broad trends detailed above have affected all financial institutions, there are some differences in how the crisis is affecting large financial institutions and more locally-focused community and regional banks. Consider, for example, the 50 largest U.S. bank holding companies, which hold more than three-quarters of bank holding company assets and now include the major investment banks in the United States. While these institutions do engage in traditional lending activities, originating loans and holding them on their balance sheets like their community bank competitors, they also generate considerable revenue from trading and other fee-based activities that are sensitive to conditions in capital markets. These firms reported modest profits during each of the first two quarters of 2009. Second-quarter net income for these companies at $1.6 billion was weaker than that of the first quarter, but was still a great improvement over the $19.8 billion loss reported for the second quarter of last year. Net income was depressed by the payment of a significant share of the Federal Deposit Insurance Corporation's (FDIC) special deposit insurance assessment and a continued high level of loan loss provisioning. Contributing significantly to better performance was the improvement of capital markets activities and increases in related fees and revenues.

Community and small regional banks have also benefitted from the increased stability in financial markets. However, because they depend largely on revenues from traditional lending activities, as a group they have yet to report any notable improvement in earnings or condition since the crisis took hold. These banks – with assets of $10 billion or less representing almost 7,000 banks and 20 percent of commercial bank assets – reported a $2.7 billion loss in the second quarter. Earnings remained weak at these banks due to a historically narrow net interest margin and high loan loss provisions. More than one in four of these banks reported a net loss. Earnings at these banks were also substantially affected by the FDIC special assessment during the second quarter.

Loan quality deteriorated significantly for both large and small institutions during the second quarter. At the largest 50 bank holding companies, nonperforming assets climbed more than 20 percent, raising the ratio of nonperforming assets to 4.3 percent of loans and other real estate owned. Most of the deterioration was concentrated in residential mortgage and construction loans, but commercial, CRE, and credit card loans also experienced rising delinquency rates. Results of the banking agencies' Shared National Credit review, released in September, also document significant deterioration in large syndicated loans, signaling likely further deterioration in commercial loans.[2] At community and small regional banks, nonperforming assets increased to 4.4 percent of loans at the end of the second quarter, more than six times the level for this ratio at year-end 2006, before the crisis started. Home mortgages and CRE loans accounted for most of the increase, but commercial loans have also shown marked deterioration during recent quarters. Importantly, aggregate equity capital for the top 50 bank holding companies, and thereby for the banking industry, increased for the third consecutive quarter and reached 8.8 percent of consolidated assets as of June 30, 2009. This level was almost 1 percentage point above the year-end 2008 level and exceeded

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[2] See Board of Governors of the Federal Reserve System, FDIC, Office of the Comptroller of the Currency, and Office of Thrift Supervision (2009), "Credit Quality Declines in Annual Shared National Credits Review," joint press release, September 24.

the pre-crisis level of midyear 2007 by more than two percentage points. Risk-based capital ratios for the top 50 bank holding companies also remained relatively high: Tier 1 capital ratios were at 10.75 percent, and total risk-based capital ratios were at 14.09 percent. Signaling the recent improvement in financial markets since the crisis began, capital increases during the first half of this year largely reflected common stock issuance, supported also by reductions in dividend payments. However, asset contraction also accounts for part of the improvement in capital ratios. Additionally, of course, the Treasury Capital Purchase Program also contributed to the increase in capital in the time since the crisis emerged.

Despite TARP capital investments in some banks and the ability of others to raise equity capital, weak earnings led to modest declines in the average capital ratios of smaller banks over the past year – from 10.7 percent to 10.4 percent of assets as of June 30 of this year. However, risk-based capital ratios remained relatively high for most of these banks, with 96 percent maintaining risk-based capital ratios consistent with a "well capitalized" designation under prompt corrective action standards.

Funding for the top 50 bank holding companies has improved markedly over the past year. In addition to benefiting from improvement in interbank markets, these companies increased core deposits from 24 percent of total assets at year-end 2008 to 27 percent as of June 30, 2009. The funding profile for community and small regional banks also improved, as core deposit funding rose to 62 percent of assets and reliance on brokered deposits and Federal Home Loan Bank advances edged down from historically high levels.

As already noted, substantial financial challenges remain for both large and small banking institutions. In particular, some large regional and community banking firms that have built up unprecedented concentrations in CRE loans will be particularly affected by emerging conditions in real estate markets. I will now discuss the economic conditions and financial market dislocations affecting CRE markets and the implications for banking organizations.

Current conditions in commercial real estate markets

Prices of existing commercial properties are estimated to have declined 35 to 40 percent since their peak in 2007, and market participants expect further declines. Demand for commercial property has declined as job losses have accelerated, and vacancy rates have increased. The higher vacancy levels and significant decline in the value of existing properties have placed particularly heavy pressure on construction and development projects that generate no income until completion. Developers typically depend on the sales of completed projects to repay their outstanding loans, and with the volume of property sales at especially low levels and with prices depressed, the ability to service existing construction loans has been severely impaired.

The negative fundamentals in the CRE property markets have caused a sharp deterioration in the credit performance of loans in banks' portfolios and loans in commercial mortgage-backed securities (CMBS). At the end of the second quarter of 2009, approximately $3.5 trillion of outstanding debt was associated with CRE, including loans for multifamily housing developments. Of this, $1.7 trillion was held on the books of banks and thrifts, and an additional $900 billion represented collateral for CMBS, with other investors holding the remaining balance of $900 billion. Also at the end of the second quarter, about 9 percent of CRE loans on banks' books were considered delinquent, almost double the level of a year earlier.[3] Loan performance problems were the most striking for construction and development loans, especially for those that finance residential development. More than 16

[3] The CRE loans considered delinquent on banks' books were non-owner occupied CRE loans that were 30 days or more past due.

percent of all construction and development loans were considered delinquent at the end of the second quarter.

Almost $500 billion of CRE loans will mature each year over the next few years. In addition to losses caused by declining property cash flows and deteriorating conditions for construction loans, losses will also be boosted by the depreciating collateral value underlying those maturing loans. These losses will place continued pressure on banks' earnings, especially those of smaller regional and community banks that have high concentrations of CRE loans.

The current fundamental weakness in CRE markets is exacerbated by the fact that the CMBS market, which had financed about 30 percent of originations and completed construction projects, has remained virtually inoperative since the start of the crisis. Essentially no CMBS have been issued since mid-2008. New CMBS issuance came to a halt as risk spreads widened to prohibitively high levels in response to the increase in CRE-specific risk and the general lack of liquidity in structured debt markets. Increases in credit risk have significantly softened demand in the secondary trading markets for all but the most highly rated tranches of these securities. Delinquencies of mortgages backing CMBS have increased markedly in recent months. Market participants anticipate these rates will climb higher by the end of this year, driven not only by negative fundamentals but also by borrowers' difficulty in rolling over maturing debt. In addition, the decline in CMBS prices has generated significant stresses on the balance sheets of financial institutions that must mark these securities to market, further limiting their appetite for taking on new CRE exposure.

Federal Reserve activities to help revitalize credit markets

The Federal Reserve, along with other government agencies, has taken a number of actions to strengthen the financial sector and to promote the availability of credit to businesses and households. In addition to aggressively easing monetary policy, the Federal Reserve has established a number of facilities to improve liquidity in financial markets. One such program is the Term Asset-Backed Securities Loan Facility (TALF), begun in November 2008 to facilitate the extension of credit to households and small businesses.

Before the crisis, securitization markets were an important conduit of credit to the household and business sectors; some have referred to these markets as the "shadow banking system." Securitization markets (other than those for mortgages guaranteed by the government) have virtually shut down since the onset of the crisis, eliminating an important source of credit. Under the TALF, eligible investors may borrow to finance purchases of the AAA-rated tranches of certain classes of asset-backed securities. The program originally focused on credit for households and small businesses, including auto loans, credit card loans, student loans, and loans guaranteed by the Small Business Administration. More recently, CMBS were added to the program, with the goal of mitigating a severe refinancing problem in that sector.

The TALF has had some success. Rate spreads for asset-backed securities have declined substantially, and there is some new issuance that does not use the facility. By improving credit market functioning and adding liquidity to the system, the TALF and other programs have provided critical support to the financial system and the economy.

Availability of credit

The Federal Reserve has long-standing policies in place to support sound bank lending and the credit intermediation process. Guidance issued during the CRE downturn in 1991 instructs examiners to ensure that regulatory policies and actions do not inadvertently curtail the availability of credit to sound borrowers.[4] This guidance also states that examiners should ensure loans are being reviewed in a consistent, prudent, and balanced fashion to prevent inappropriate downgrades of credits. It is consistent with guidance issued in early 2007 addressing risk management of CRE concentrations, which states that institutions that have experienced losses, hold less capital, and are operating in a more risk-sensitive environment are expected to employ appropriate risk-management practices to ensure their viability.[5]

We are currently in the final stages of developing interagency guidance on CRE loan restructurings and workouts. This guidance supports balanced and prudent decisionmaking with respect to loan restructuring, accurate and timely recognition of losses and appropriate loan classification. The guidance will reiterate that classification of a loan should not be based solely on a decline in collateral value, in the absence of other adverse factors, and that loan restructurings are often in the best interest of both the financial institution and the borrower. The expectation is that banks should restructure CRE loans in a prudent manner, recognizing the associated credit risk, and not simply renew a loan in an effort to delay loss recognition.

On one hand, banks have raised concerns that our examiners are not always taking a balanced approach to the assessment of CRE loan restructurings. On the other hand, our examiners have observed incidents where banks have been slow to acknowledge declines in CRE project cash flows and collateral values in their assessment of the potential loan repayment. This new guidance, which should be finalized shortly, is intended to promote prudent CRE loan workouts as banks work with their creditworthy borrowers and to ensure a balanced and consistent supervisory review of banking organizations.

Guidance issued in November 2008 by the Federal Reserve and the other federal banking agencies encouraged banks to meet the needs of creditworthy borrowers, in a manner consistent with safety and soundness, and to take a balanced approach in assessing borrowers' ability to repay and making realistic assessments of collateral valuations.[6] In addition, the Federal Reserve has directed examiners to be mindful of the effects of excessive credit tightening in the broader economy and we have implemented training for examiners and outreach to the banking industry to underscore these intentions. We are aware that bankers may become overly conservative in an attempt to ameliorate past weaknesses in lending practices, and are working to emphasize that it is in all parties' best interests to continue making loans to creditworthy borrowers.

Strengthening the supervisory process

The recently completed SCAP of the 19 largest U.S. bank holding companies demonstrates the effectiveness of forward-looking horizontal reviews and marked an important evolutionary step in the ability of such reviews to enhance supervision. Clearly, horizontal reviews –

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[4] See Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation (1991), "Interagency Examination Guidance on Commercial Real Estate Loans," Supervision and Regulation Letter SR 91-24 (November 7); and Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board, and Office of Thrift Supervision (1991), "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans (814 KB PDF)," joint policy statement, November 7.

[5] See Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation (2007), "Interagency Guidance on Concentrations in Commercial Real Estate," Supervision and Regulation Letter SR 07 1 (January 4).

[6] See Board of Governors of the Federal Reserve System, FDIC, Office of the Comptroller of the Currency, and Office of Thrift Supervision (2008), "Interagency Statement on Meeting the Needs of Creditworthy Borrowers," joint press release, November 12.

reviews of risks, risk-management practices and other issues across multiple financial firms – are very effective vehicles for identifying both common trends and institution-specific weaknesses. The SCAP expanded the scope of horizontal reviews and included the use of a uniform set of stress parameters to apply consistently across firms.

An outgrowth of the SCAP was a renewed focus by supervisors on institutions' own ability to assess their capital adequacy – specifically their ability to estimate capital needs and determine available capital resources during very stressful periods. A number of firms have learned hard, but valuable, lessons from the current crisis that they are applying to their internal processes to assess capital adequacy. These lessons include the linkages between liquidity risk and capital adequacy, the dangers of latent risk concentrations, the value of rigorous stress testing, the importance of strong governance over their processes, and the importance of strong fundamental risk identification and risk measurement to the assessment of capital adequacy. Perhaps one of the most important conclusions to be drawn is that all assessments of capital adequacy have elements of uncertainty because of their inherent assumptions, limitations, and shortcomings. Addressing this uncertainty is one among several reasons that firms should retain substantial capital cushions.

Currently, we are conducting a horizontal assessment of internal processes that evaluate capital adequacy at the largest U.S. banking organizations, focusing in particular on how shortcomings in fundamental risk management and governance for these processes could impair firms' abilities to estimate capital needs. Using findings from these reviews, we will work with firms over the next year to bring their processes into conformance with supervisory expectations. Supervisors will use the information provided by firms about their processes as a factor – but by no means the only factor – in the supervisory assessment of the firms' overall capital levels. For instance, if a firm cannot demonstrate a strong ability to estimate capital needs, then supervisors will place less credence on the firm's own internal capital results and demand higher capital cushions, among other things. Moreover, we have already required some firms to raise capital given their higher risk profiles. In general, we believe that if firms develop more-rigorous internal processes for assessing capital adequacy that capture all the risks facing those firms – including under stress scenarios – and maintain adequate capital based on those processes, they will be in a better position to weather financial and economic shocks and thereby perform their role in the credit intermediation process.

We also are expanding our quantitative surveillance program for large, complex financial organizations to include supervisory information, firm-specific data analysis, and market-based indicators to identify developing strains and imbalances that may affect multiple institutions, as well as emerging risks to specific firms. Periodic scenario analyses across large firms will enhance our understanding of the potential impact of adverse changes in the operating environment on individual firms and on the system as a whole. This work will be performed by a multidisciplinary group composed of our economic and market researchers, supervisors, market operations specialists, and accounting and legal experts. This program will be distinct from the activities of on-site examination teams so as to provide an independent supervisory perspective, as well as to complement the work of those teams. As we adapt our internal organization of supervisory activities to build on lessons learned from the current crisis, we are using all of the information and insight that the analytic abilities the Federal Reserve can bring to bear in financial supervision.

Conclusion

A year ago, the world financial system was profoundly shaken by the failures and other serious problems at large financial institutions here and abroad. Significant credit and liquidity problems that had been building since early 2007 turned into a full-blown panic with adverse consequences for the real economy. The deterioration in production and employment, in turn, exacerbated problems for the financial sector.

It will take time for the banking industry to work through these challenges and to fully recover and serve as a source of strength for the real economy. While there have been some positive signals of late, the financial system remains fragile and key trouble spots remain, such as CRE. We are working with financial institutions to ensure that they improve their risk-management and capital planning practices, and we are also improving our own supervisory processes in light of key lessons learned. Of course, we are also committed to working with the other banking agencies and the Congress to ensure a strong and stable financial system.