# Elizabeth A Duke: Credit availability and prudent lending standards

Testimony of Ms Elizabeth A Duke, Member of the Board of Governors of the US Federal Reserve System, before the Committee on Financial Services, US House of Representatives, Washington DC, 25 March 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 Frank, Ranking Member Bachus and members of the Committee, I am pleased to appear today to discuss several issues related to the state of the banking system. First, I will discuss the condition of the banking system, credit conditions, and bank underwriting standards. Then I will describe Federal Reserve activities to enhance liquidity in financial markets and improve conditions in financial markets. Finally, I will discuss the Federal Reserve's efforts to ensure the overall safety and soundness of the banking system as well as promote credit availability.

As you are well aware, the Federal Reserve has taken significant steps to improve financial market conditions, and has worked with the Treasury and other bank and thrift supervisors to address issues at U.S. banking organizations. We remain attentive to the need for banks to remain in sound financial condition while at the same time to continue lending prudently to creditworthy borrowers. Fortunately, many banks continue to lend in this environment, but with the shutdown of most securitization markets and the evaporation of many types of nonbank credit, it is that much more important right now for the U.S. banking system to be able to carry out its credit intermediation function.

## Background

The Federal Reserve has supervisory and regulatory authority for bank holding companies, state-chartered banks that are members of the Federal Reserve System (state member banks), and certain other financial institutions and activities. We work with other federal and state supervisory authorities to ensure the safety and soundness of the banking industry, foster the stability of the financial system, and provide for fair and equitable treatment of consumers in their financial transactions. The Federal Reserve is not the primary federal supervisor for the majority of commercial bank assets. Rather, it is the consolidated supervisor of bank holding companies, including financial holding companies, and conducts inspections of those institutions.

The primary purpose of inspections is to ensure that the holding company and its nonbank subsidiaries do not pose a threat to the soundness of the company's depository institutions. In fulfilling this role, the Federal Reserve is required to rely to the fullest extent possible on information and analysis provided by the appropriate supervisory authority of the company's bank, securities, or insurance subsidiaries. The Federal Reserve is also the primary federal supervisor of state member banks, sharing supervisory responsibilities with state agencies. In this role, Federal Reserve supervisory staff regularly conduct on-site examinations and off-site monitoring to ensure the soundness of supervised state member banks.

The Federal Reserve is involved in both regulation – establishing the rules within which banking organizations must operate – and supervision – ensuring that banking organizations abide by those rules and remain, overall, in safe and sound condition. A key aspect of the supervisory process is evaluating risk-management practices. Because rules and regulations in many cases cannot reasonably prescribe the exact practices each individual bank should use for risk management, supervisors design policies and guidance that expand upon requirements set in rules and regulations and establish expectations for the range of acceptable practices. Supervisors rely extensively on these policies and guidance as they conduct examinations and assign supervisory ratings.

Beginning in the summer of 2007, the U.S. and global economies entered a period of intense financial turmoil that has presented significant challenges for the financial services industry. These challenges intensified in the latter part of 2008 as the global economic environment weakened further. As a result, parts of the U.S. banking system have come under severe strain, with some banking institutions suffering sizable losses.

## State of the banking system

I would now like to briefly summarize overall conditions at U.S. commercial banks and large banking holding companies (BHCs). For U.S. commercial banks as a group, profitability measures deteriorated dramatically during 2008. Indeed, commercial banks posted a substantial and rare aggregate loss for fourth quarter of 2008, the first time this has happened since the late 1980s. This loss in large part reflected write-downs on trading assets, high goodwill impairment charges, and, most significantly, increased loan-loss provisions taken in response to deteriorating asset quality, higher net charge-offs, and weakening economic conditions. As of year-end 2008, loans delinquent 30 days or more or on nonaccrual status exceeded 4.5 percent of total loans, the highest level since the early 1990s. Moreover, nonaccruing loans – those most likely to result in additional charge-offs – reached almost two-percent of loans, a ratio more than double that of year-end 2007. Despite poor earnings performance, capital ratios held up relatively well, with reported tier 1 and total risk-based capital ratios increasing over the course of the year. The performance of state member banks tracked that of the industry as a whole.

The earnings performance of the 50 largest U.S.-based bank holding companies (BHCs) as a group, which together represent more than three-fourths of all assets at BHCs, deteriorated rapidly during the last two quarters of 2008. In aggregate, these companies reported a fourth quarter net loss of $42.7 billion – versus a $25.5 billion third-quarter loss – due mainly to elevated loan-loss provisions, very large goodwill impairment charges, and a continuation of heavy trading asset write-downs. For the year, these companies generated a $67 billion loss. Nonetheless, regulatory capital ratios actually improved during 2008 – supported by substantial private capital investments in these companies during the first half and by the Troubled Assets Relief Program (TARP) investments by the U.S. Treasury toward the end of the year. As a consequence, these bank holding companies in aggregate continued to maintain capital ratios well in excess of minimum regulatory requirements.

## Conditions in credit markets

As Chairman Bernanke noted in presenting the Board's most recent monetary policy testimony to Congress in February, the U.S. economy is undergoing a severe contraction. From past experience, we know that borrowing by households and nonfinancial businesses has tended to slow during economic downturns. Since 1953, the inflation-adjusted growth rate of debt owed by households and nonfinancial businesses has fallen, on average, about 2 percentage points at an annual rate in the year following a business cycle peak (as dated by the National Bureau of Economic Research, or NBER). The inflation-adjusted slowdown in debt growth during the past year has been much more pronounced than in previous downturns: Annualized debt growth for households and nonfinancial businesses in the fourth quarter of 2008 (the most up-to-date reading) was, adjusted for inflation, about 7 percentage points slower than it was during the NBER-designated peak in the fourth quarter of 2007.

The slowdown in debt growth has differed by type of borrower. For example, after increasing nearly 6 percent in the fourth quarter of 2007 (unadjusted for inflation), home mortgage debt declined at an annual rate of 1.5 percent in the fourth quarter of last year. The decline in home mortgage debt has been sharper in this period than in any other recession for which we have good data – dating back to the 1950s. Non-mortgage consumer credit also declined in the fourth quarter of last year – at an annual rate of 3.25 percent. The pull-back in consumer credit has also been somewhat sharper than the average experience during the previous nine NBER recessions. Among businesses, growth in debt for nonfinancial corporations slowed from a 12.5 percent annual rate in the fourth quarter of 2007 to a 1.5 percent annual rate in the fourth quarter of last year. The slowdown in debt growth for this sector is also more substantial than has been experienced in past recessions.

This simple comparison of the current slowdown in credit market flows to those in previous recessions ignores the many important changes to the financial landscape that have occurred during the past half-century. Significant among those changes was the large increase in the flow of credit coming from nonbank sources. For example, holdings of household mortgages by banks, savings institutions, and credit unions decreased from a share of more than 50 percent in 1985 to a share of about 30 percent of the total at the end of 2007. Similarly, banks held about 70 percent of outstanding consumer credit in 1985, but only about 45 percent in 2007. Of course, banks remain vital financial intermediaries, as the current financial crisis demonstrates. The severe turmoil in markets for securitized assets has served to increase banks' importance. And the significance of banks in the provision of credit extends far beyond their direct loans. Banks supply credit indirectly by providing back-up liquidity and credit support to other financial institutions and conduits that also intermediate credit flows.

In 1950, banks' share of financial intermediation was about 50 percent, it fell and then rose to about 48 percent in the mid-1970s, then declined to about 33 percent at the turn of the century. If one adjusts the data to include "credit equivalents" for the off-balance-sheet activities of banks, then the adjusted market share of financial intermediation for banks would remain above 40 percent in recent years.

In terms of direct lending, weekly data that the Federal Reserve Board collects from banks shows that total bank loans and leases increased almost 4 percent during 2008. The increase in bank lending for the year as a whole was below the roughly 10 percent pace of growth seen in both 2006 and 2007. Much of the increase in bank lending last year likely reflected households and businesses drawing down existing lines of credit rather than extensions of new loans. In addition, the freeze-up of the securitization markets likely contributed to banks' balance sheet growth.

According to the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices, banks have tightened lending standards sharply over the past 18 months. The January 2009 Survey found that respondents had tightened their lending policies for all major loan categories further in late 2008. Respondents also indicated that demand for loans from both businesses and households continued to weaken, on balance, over the survey period.

With regard to commercial loans in particular, many survey respondents pointed to a less favorable or more uncertain economic outlook as a reason for tightening their lending standards and terms over the previous three months. Most respondents indicated that a worsening of industry-specific problems and their bank's reduced tolerance for risk were also important factors in their decision to tighten lending policies for commercial loans. Among the few respondents that saw an increase in loan demand over the previous three months, all indicated that business borrowing had shifted to their bank from other bank or nonbank sources because the other sources had become less attractive. In addition, more than 30 percent reported that inquiries from potential business borrowers had decreased during the survey period.

For commercial real estate (CRE) lending, 80 percent of domestic banks reported that they had tightened their lending standards over the previous three months, slightly less than the roughly 85 percent that reported doing so in the October survey. Of note, about 30 percent of the respondents indicated that the shutdown of the commercial mortgage backed-securities (CMBS) securitization market had led to an increase in CRE lending at their bank over the second half of 2008, whereas about 15 percent indicated that the shutdown of the CMBS securitization market had reduced the volume of their CRE lending.

Survey respondents also noted continued tightening for consumer products, including residential real estate lending and revolving home equity lines of credit (HELOCs). Notably, only four of the nearly 80 respondents reported making subprime mortgage loans over the previous three months.

Stepping back, it is now clear that in recent years banking and financial markets experienced a period in which risk was generally under-priced and where credit was too freely available. The realization by many market participants that risks were larger than anticipated has contributed to the decline in prices for financial assets. As a result, some financial institutions – including some banking organizations – have experienced significant losses, leading to the need to raise additional capital or, in some cases, sell or shut down operations. It is apparent that all banking institutions have now been impacted in some way by the adverse conditions of the current environment.

## Federal Reserve actions since 2007

The Federal Reserve has responded forcefully to the financial and economic crisis and it will continue to do so. In discussing Federal Reserve actions, I will first summarize monetary policy actions and those related to liquidity provision, and then highlight our supervisory actions.

### *Monetary policy and liquidity provision*

In terms of monetary policy, the Federal Reserve has been aggressive. As you know, the Federal Open Market Committee (FOMC) began to ease monetary policy in September 2007, and in December 2008, the Committee set a range of 0 to 25 basis points for the target federal funds rate. We have also employed additional tools to ease financial conditions, improve the functioning of credit markets, and thereby support economic activity. To improve mortgage market functioning and support housing markets and economic activity more broadly, the Federal Reserve has begun to purchase large amounts of agency debt and mortgage-backed securities, and we recently announced substantial additional purchases of such securities through year-end. In addition, the Federal Reserve announced plans to purchase up to $300 billion of long-term Treasury securities to help improve conditions in private credit markets. Since first announcing such purchases last November, the conforming fixed mortgage rate has fallen more than 1 percentage point.

The Federal Reserve has also established new lending facilities and expanded existing facilities to enhance the flow of credit to businesses and households. In response to heightened stress in bank funding markets, we increased the size of the Term Auction Facility to help ensure that banks could obtain the funds they need to provide credit to their customers, and we expanded our network of swap lines with foreign central banks to ease conditions in interconnected dollar funding markets at home and abroad. Last fall, when money markets tightened considerably following the failure of Lehman Brothers, we established new lending facilities to provide liquidity to money market mutual funds and to support the functioning of the commercial paper market.

The U.S. Treasury, the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve have taken a number of actions to strengthen the financial sector and to promote the availability of credit to businesses and households. This included injecting additional capital into banks, increasing FDIC deposit coverage, providing guarantees of selected senior bank obligations and noninterest-bearing deposits, and establishing new liquidity facilities to financial markets. In addition, the Federal Reserve and the Treasury recently launched the Term Asset-Backed Securities Loan Facility (TALF) to facilitate the extension of credit to households and small businesses and anticipates that the range of eligible collateral for this facility is likely to be expanded to other financial assets. The Federal Reserve expects to assist in the Treasury's Public-Private Partnership Investment Program, announced on Monday, by expanding the range of collateral eligible for the TALF program to include certain legacy securities.

### *Supervisory activities and improvements to risk-management practices*

Many of the current problems in the banking and financial system stem from risk-management failures at a number of financial institutions, including some firms under federal supervision. Clearly, these lapses are unacceptable. The Federal Reserve has been involved in a number of exercises to understand, document and help address the risk-management lapses and shortcomings at major financial institutions, including those undertaken by the Senior Supervisors Group, the President's Working Group on Financial Markets, and the multinational Financial Stability Forum.[1]

Based on the results of these and other efforts, the Federal Reserve is taking vigorous steps to improve risk-management practices at regulated institutions. Our actions have covered liquidity risk management, capital planning and capital adequacy, firm-wide risk identification, residential lending, counterparty credit exposures, and commercial real estate lending, among other areas. Liquidity and capital have been given special attention.

The crisis has undermined previous conventional wisdom that a company, even in stressed environments, may readily borrow funds if it can offer high-quality collateral. For example, the inability of Bear Stearns to borrow even against U.S. government securities led to its collapse. As a result, we have been working to bring about needed improvements in institutions' liquidity risk-management practices. Along with our U.S. supervisory colleagues, we are closely monitoring the liquidity positions of banking organizations – on a daily basis for the largest and most critical firms – and are discussing key market developments and our supervisory analyses with senior management. We use these analyses and findings from examinations to ensure that liquidity and funding management, as well as contingency funding plans, are sufficiently robust and incorporate various stress scenarios. Looking beyond the present period, we also have underway a broader-ranging examination of liquidity requirements.

Similarly, the Federal Reserve is closely monitoring the capital levels of banking organizations on a regular basis and discussing our evaluation with senior management. As part of our supervisory process, we have been conducting our own analysis of loss scenarios to anticipate the potential future capital needs of institutions. These needs may arise from, among other things, future losses or the potential for off-balance-sheet exposures to return to institutions' balance sheets. Here, too, we have been discussing our analyses with bankers and ensuring that their own internal analyses reflect a broad range of scenarios and capture stress environments that could impair solvency. We have intensified efforts to evaluate institutions' capital planning and to bring about improvements where needed.

Our efforts related to capital planning and capital adequacy are embodied in the interagency supervisory capital assessment process, which began in February. We are conducting assessments of selected banking institutions' capital adequacy, based on certain macroeconomic scenarios. For this assessment, we are carefully evaluating the forecasts submitted by each financial institution to ensure they are appropriate, consistent with the firm's underlying portfolio performance, and reflective of each entity's particular business activities and risk profile. The capital assessment program will permit supervisors to assess

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[1] Senior Supervisors Group (2008), "Observations on Risk Management Practices during the Recent Market Turbulence", March 6; President's Working Group on Financial Markets (2008), "Policy Statement on Financial Market Developments", March 13; Financial Stability Forum (2008), "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience", April 7.

whether institutions' capital buffers over the regulatory capital minimum are appropriate under more severe but plausible scenarios.

To sum up our efforts to improve banks' risk management, we are looking at all areas of risk management – both on an individual and collective basis – to ensure that all institutions have their risk-management practices at satisfactory levels. More generally, where we have not seen appropriate progress, we are aggressively downgrading supervisory ratings and using our enforcement tools.

### *Maintaining balance in the supervisory process*

The Federal Reserve has long-standing policies and procedures in place to promote sound risk identification and management practices at regulated institutions that also support bank lending and the credit intermediation process. In fact, guidance issued as long ago as 1991, during the commercial real estate crisis that began in the late 1980s, specifically instructs examiners to ensure that regulatory policies and actions do not inadvertently curtail the availability of credit to sound borrowers.[2] The 1991 guidance also states that examiners are to "ensure that supervisory personnel are reviewing loans in a consistent, prudent, and balanced fashion and to ensure that all interested parties are aware of the guidance." The 1991 policy statement covers a wide range of specific topics, including:

- the general principles that examiners follow in reviewing commercial real estate loan portfolios
- the indicators of troubled real estate markets, projects, and related indebtedness
- the factors examiners consider in their review of individual loans, including the use of appraisals and the determination of collateral value
- a discussion of approaches to valuing real estate, especially in troubled markets
- the classification guidelines followed by the agencies, including the treatment of guarantees
- the factors considered in the evaluation of an institution's allowance for loan and lease losses

This emphasis on achieving an appropriate balance between credit availability and safety and soundness continues today. To the extent that institutions have experienced losses, hold less capital, and are operating in a more risk-sensitive environment, supervisors expect banks to employ appropriate risk-management practices to ensure their viability. At the same time, it is important that supervisors remain balanced and not place unreasonable or artificial constraints on lenders that could hamper credit availability.

As part of our effort to help stimulate appropriate bank lending, the Federal Reserve and the other federal banking agencies issued regulatory guidance in November 2008 to encourage banks to meet the needs of creditworthy borrowers.[3] The guidance was issued to encourage bank lending in a manner consistent with safety and soundness – specifically, by taking a balanced approach in assessing borrowers' ability to repay and making realistic assessments of collateral valuations. This guidance has been reviewed and discussed with examination staff within the Federal Reserve System.

Earlier, in April 2007, the federal financial institutions regulatory agencies issued a statement encouraging financial institutions to work constructively with residential borrowers who are

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[2] "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans," (November 1991).

[3] "Interagency Statement on Meeting the Needs of Credit Worthy Borrowers," (November 2008).

financially unable to make their contractual payment obligations on their home loans.[4] The statement noted that, "prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term interest of both the financial institution and the borrower." The statement also noted that, "the agencies will not penalize financial institutions that pursue reasonable workout arrangements with borrowers who have encountered financial problems." It further stated that, "existing supervisory guidance and applicable accounting standards do not require institutions to immediately foreclose on the collateral underlying a loan when the borrower exhibits repayment difficulties." This guidance has also been reviewed by examiners within the Federal Reserve System.

More generally, we have directed our examiners to be mindful of the procyclical effects of excessive credit tightening and to encourage banks to make economically viable loans, provided such lending is based on realistic asset valuations and a balanced assessment of borrowers' repayment capacities. Across the Federal Reserve System, we have implemented training and outreach to underscore these intentions. We are mindful of the potential for bankers to overshoot in their attempt to rectify lending standards, and want them to understand that it is in their own interest to continue making loans to creditworthy borrowers.

## Conclusion

The U.S. banking industry is facing serious challenges. The Federal Reserve, working with the other banking agencies has acted – and will continue to act – to ensure that the banking system remains safe and sound and is able to meet the credit needs of our economy. We have aggressively pursued monetary policy actions and provided liquidity to help repair the financial system. In our supervisory efforts, we are mindful of the risk-management deficiencies at banking institutions revealed by the current crisis and are ensuring that institutions develop appropriate corrective actions.

It will take some time for the banking industry to work through this current set of challenges and for the financial markets to recover. During that recovery, the economy will need a strong and stable financial system that can make credit available. The challenge for regulators and other authorities is to support prudential bank intermediation that helps restore the health of the financial system and the economy as a whole. We want banks to deploy capital and liquidity, but in a responsible way that avoids past mistakes and does not create new ones. Bankers should operate prudently in the current challenging environment, but should not let fear drive their decisions. The Federal Reserve will continue to work with other banking agencies and the Congress to promote the concurrent goals of fostering credit availability and a safe and sound banking system.

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4 "Federal Regulators Encourage Institutions to Work with Mortgage Borrowers Who Are Unable to Make Their Payments," (April 2007).