

## **Ben S Bernanke: Banks and bank lending – the state of play**

Speech by Mr Ben S Bernanke, Chairman of the Board of Governors of the Federal Reserve System, at the 48th Annual Conference on Bank Structure and Competition, Chicago, Illinois (via satellite), 10 May 2012.

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I am pleased to speak this morning at what has become, over nearly 50 years, perhaps the most prestigious conference for bankers, academics, and bank supervisors in the United States. The first part of my remarks will highlight the significant progress that has been made over the past several years toward restoring the banking system to good health. I will also talk about some of the challenges banks face as they adapt to the post-crisis economic and regulatory environment. I will then review recent trends in credit conditions, noting that bank lending has generally been improving but remains restrained in some areas.

### **The state of the banking system**

Since the financial crisis, banks have made considerable progress in repairing their balance sheets and building capital. Risk-based capital and leverage ratios for banks of all sizes have improved materially and are significantly above their previous highs. Importantly, the 19 largest banking institutions that participated in the 2009 stress tests, as well as the two subsequent Comprehensive Capital Analysis and Review (CCAR) processes, have considerably more and better-quality capital than a few years ago. Indeed, those firms have increased their Tier 1 common equity, the best buffer against future losses, by more than \$300 billion since 2009, to nearly \$760 billion. The Tier 1 common ratio for these firms, which compares this high-quality capital to risk-weighted assets, stood at 10-1/2 percent at the end of last year.

The latest CCAR, conducted earlier this year, demonstrated that most of the 19 firms would likely have sufficient capital to withstand a period of intense economic and financial stress and still be able to lend to households and businesses. The hypothetical supervisory stress scenario used in the CCAR was quite severe; it included a peak unemployment rate of 13 percent, a 50 percent drop in equity prices, and a 21 percent further decline in housing prices, as well as steep falls in prices of financial assets most exposed to conditions in Europe. Under this highly adverse scenario, the 19 bank holding companies were projected to incur aggregate losses of more than \$500 billion through the fourth quarter of 2013. Nevertheless, their aggregate Tier 1 common ratio was projected to be 6.3 percent at the end of the scenario period, and 15 of the 19 bank holding companies were projected to maintain capital ratios above all four of the regulatory minimum levels – even after taking into account their proposals for capital actions such as dividends, share buybacks, and share issuance in the baseline scenario.

The banking sector overall also has substantially improved its liquidity position over the past few years. Indeed, large banks in the aggregate have more than doubled their holdings of cash and securities since 2009. Large banks have reduced their collective dependence on short-term wholesale funding, and many are flush with retail deposits, which tend to be a more stable funding source. Challenges on the liquidity front remain, however: Some large firms still rely heavily on wholesale short-term funding; and the liquidity needs of the banking system as a whole may become somewhat higher for a while as some of the securities issued under the Federal Deposit Insurance Corporation's Temporary Liquidity Guarantee Program come due, and as the unlimited insurance on noninterest-bearing transaction accounts expires at the end of the year. Nevertheless, over time, greater liquid asset positions and reduced dependence on wholesale short-term funding, together with more and

better capital, will make the banking sector less susceptible to unexpected disruptions in short-term funding markets.

The credit quality of large banks' assets is looking better as well, although the improvements have been uneven across types of loans. In the aggregate, delinquency rates on loan portfolios at large banks have declined substantially from their peaks. However, while delinquencies on commercial and industrial (C&I) loans and consumer loans have fallen to the lower end of their historical ranges, delinquencies on loans backed by commercial or residential real estate have declined only moderately and remain elevated.

The profitability of large banks has been edging up as credit quality has firmed and banks have trimmed noninterest expenses. Even so, large banks' profitability remains well below the levels that prevailed before the financial crisis began, and banks continue to struggle to expand their revenues. Developments that can be traced back to the financial crisis – including a still-weak economy, changes in market conditions and practices, and tighter financial regulations – are clearly important reasons for these trends.

Community banks play important roles in local economies, and so it is notable that their condition has also improved. Their regulatory capital ratios have increased significantly since 2009 and stand well above their recent norms. As has been the case at large banks, delinquency and charge-off rates at community banks have declined across most major categories of loans, and fewer institutions failed in 2011 than in each of the previous two years. That said, clusters of small bank failures can affect credit availability in a community while bank-dependent borrowers work to establish new relationships with surviving institutions. In addition, while standard measures of community banks' profitability, such as return on equity and assets, improved last year, as was also true at larger institutions, most of the gains were due to reductions in loan loss provisions rather than to more sustainable sources of profit such as expanded lending.

Financial-market indicators reflect the substantial improvements in banks' financial conditions since the crisis as well as the sizable challenges remaining. Bank credit default swap (CDS) premiums are now well below their crisis peaks, and bank stock prices have retraced some of their earlier losses and have outperformed the broader market this year, boosted somewhat by the release of the CCAR results in March and first-quarter earnings that largely beat analysts' expectations. However, CDS premiums remain elevated for some of the larger, more globally connected firms, and their stocks continue to trade at market-to-book ratios of less than 1.

A number of key systemic risk measures that evaluate the potential performance of firms during times of financial market stress have improved in recent months. These indicators of systemic risk are now well below their levels in the crisis, and, overall, they present a picture of a banking system that has become healthier and more resilient.<sup>1</sup>

## **Regulatory and financial challenges**

Banks face a number of significant challenges as they adapt to the post-crisis economic environment and to new domestic and international regulatory requirements. The most systemically important financial firms will face meaningfully higher capital and liquidity requirements and continue to undergo regular supervisory stress tests. They will also be

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<sup>1</sup> Such measures include the conditional value at risk, or CoVaR, which is an estimate of the extent to which a bank's distress would be associated with an increase in the downside risk to the financial system; the distress insurance premium, or DIP, which measures the cost of insuring a firm against systemwide distress; and the systemic expected shortfall, or SES, which estimates the extent to which the market value equity of a firm would be depleted by a marketwide decline in equity prices. These measures are based on firms' stock prices, CDS premiums, and stock price volatility, as well as the correlation in asset prices across firms.

required to submit so-called living wills to facilitate their orderly resolution if necessary. Additionally, banks must enhance their reporting systems and improve disclosure. These new requirements are critical to safeguard the stability of the financial system and to help prevent another costly crisis. At the same time, regulators appreciate that the new rules impose significant burdens on banks. For that reason, and to minimize adverse effects on the supply of credit, many of the most significant rules are being phased in gradually and only after extended processes of consultation with industry and other stakeholders.

It is worth reiterating that most of these enhanced regulatory and supervisory measures focus on the largest, most interconnected financial institutions, and we are working to ensure that community banks are not subjected to rules designed primarily to constrain risks at larger institutions. We have an ongoing dialogue with community banks through many channels, including, for example, our Community Depository Institutions Advisory Council. The council, whose membership is drawn from smaller banks, credit unions, and savings associations in each of the 12 Federal Reserve Districts, meets with the Board in Washington twice a year to discuss supervisory and regulatory issues that affect their institutions. We have also established a special supervisory subcommittee of the Board which focuses on community banking issues.

In addition to strengthened regulatory and supervisory requirements, banks face market demands that they operate with more resilient business models. In many contexts, counterparties are demanding greater security in the form of more and better-quality collateral or higher margins. In addition, lenders to banks may be requiring greater compensation for risk, thereby raising banks' funding costs.

Banks have also been navigating an economic recovery that has been halting at times. Consequently, although the condition of the banking system is improving, demand for credit generally has remained sluggish, and the creditworthiness of some borrowers that would normally turn to banks for loans remains impaired. These factors, together with tighter credit policies imposed by many lenders, have restrained somewhat the expansion of bank credit.

### **Credit conditions and bank lending**

Notwithstanding the various headwinds, credit conditions in the United States have improved significantly in a number of areas. Many – though certainly not all – businesses and households are finding it easier to borrow than they did a few years ago, in part because of better conditions in financial markets more broadly. Large businesses with access to capital markets have generally been able to raise funds at attractive terms, with both investment- and speculative-grade firms taking advantage of historically low interest rates to issue bonds at a robust rate. Moreover, consumers with strong credit histories have ready access to credit cards and auto loans, supported by solid issuance of consumer-related asset-backed securities.

Banks also supply credit by purchasing securities, and their purchases have grown rapidly in recent months – in particular, those of agency-guaranteed mortgage-backed securities (MBS). In this challenging time for housing markets, banks are attracted by the securities' government guarantee. Additionally, some larger banks may be accumulating these securities in preparation for more-stringent liquidity regulations.

Signs of improvement notwithstanding, credit conditions in some sectors and for some types of borrowers remain tight. Mortgage lending is an important example. Since its peak, U.S. home mortgage credit outstanding has contracted about 13 percent in real terms. Many factors suggest that this situation will be difficult to turn around quickly, including the slow recovery of the economy and housing market, continued uncertainty surrounding the future of the government-sponsored enterprises (GSEs), the lack of a healthy private-label securitization market, and cautious attitudes by lenders.

Financing conditions in the commercial real estate sector also remain strained as fundamentals, including high vacancy rates, depressed property prices, and the poor quality of existing loans, continue to be weak. Moreover, the market for commercial MBS – a source of liquidity for some lenders in this sector – is still struggling to regain its footing.

The Federal Reserve's quarterly Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS) offers a more-nuanced view of how lending terms are changing. The SLOOS indicates that standards and terms in many loan categories have eased somewhat further in recent quarters from the very tight conditions that prevailed earlier in the recovery.<sup>2</sup> For example, the April SLOOS pointed to the first material net easing in lending standards for commercial real estate loans since 2005 and to a further easing of standards for most types of consumer loans. In addition, SLOOS respondents suggested that stepped-up competition has induced a large number of domestic banks to reduce fees and spreads on C&I loans to firms of all sizes. The SLOOS also indicates that demand for many types of loans has continued to increase, with demand for C&I loans having risen to relatively high levels.

Consistent with the results of the SLOOS, C&I lending has indeed been rising sharply lately. Banks have focused on C&I lending because business borrowers' creditworthiness is improving and because the majority of C&I loans carry floating interest rates that reduce interest rate risk. In addition, domestic banks reportedly are picking up customers as a result of a pullback by some European institutions. Auto lending also has reportedly been solid, reflecting strong fundamentals in auto markets – such as robust demand for used cars and relatively low delinquency rates on existing auto loans. The strong fundamentals for auto loans in turn also appear to have contributed to an easing of lending standards and terms.

But, as I mentioned earlier, residential mortgage lending has been particularly sluggish. Tight lending standards and terms remain especially evident. To be sure, a return to pre-crisis lending standards for residential mortgages wouldn't be appropriate; however, current standards may be limiting or preventing lending to many creditworthy borrowers. For instance, in the April SLOOS, we asked banks a hypothetical question about their willingness to originate GSE-eligible mortgages relative to 2006 for borrowers with a range of credit scores and available down payments. The SLOOS found that even when the loans were accompanied by a 20 percent down payment, many banks were less likely to originate loans to borrowers with given GSE-eligible credit scores, despite the originating bank's ability to sell the mortgage to the GSEs. Most banks indicated that their reluctance to accept mortgage applications from borrowers with less-than-perfect records is related to "putback risk" – the risk that a bank might be forced to buy back a defaulted loan if the underwriting or documentation was judged deficient in some way.

Small businesses owners, who in the past might have tapped into the equity in their homes or used their homes as collateral for small business loans, also have found conditions challenging in recent years. The stock of small loans to businesses on bank balance sheets at the end of last year was more than 15 percent below its peak in 2008. These loans looked to have ticked up in the fourth quarter of 2011, consistent with the reported increase in demand for loans by small firms in the SLOOS. Responses to the monthly National Federation of Independent Business survey also suggest some modest improvement in the small business sector: The share of respondents reporting a need for credit has moved up from lows of recent years, and the net share of respondents who say that credit is more difficult to obtain than it was three months ago is notably below its peak in 2009.

The Federal Reserve is keenly interested in understanding how shifts in loan supply, loan demand, and borrower quality may be affecting lending and, by extension, the broader economy. Of course, sorting out the relative effect of changes in loan demand from the effect of changes in loan supply can be quite difficult because they can be influenced by the same

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<sup>2</sup> The SLOOS is available on the Board's website at [www.federalreserve.gov/boarddocs/snloansurvey](http://www.federalreserve.gov/boarddocs/snloansurvey).

factors. For example, a shift in the economic outlook can affect both the willingness of banks to lend and the desire and ability of firms and households to borrow.

Recent research at the Federal Reserve examines cyclical changes in banks' lending standards as reported in the SLOOS – a commonly used indicator of loan supply. It attempts to assess how much of those changes were a “typical” response to macroeconomic and bank-specific factors, and how much was “atypical” or unexplained.<sup>3</sup> This analysis suggests that the tightening of lending standards that occurred between 2007 and 2009 was much greater than a model based on historical experience would predict, contributing to the subdued pace of lending. These results are consistent with other evidence that the crisis induced exceptionally high levels of risk aversion and uncertainty on the part of both lenders and borrowers, constraining the flow of credit. As these factors have receded and the economy has improved, lending standards have become less stringent.

Some bankers and borrowers believe that enhanced supervision and regulation has made it more difficult for banks to expand their lending. The Federal Reserve takes seriously its responsibility to ensure that supervisory actions to protect banks' safety and soundness do not unintentionally constrain lending to creditworthy borrowers, and we have taken a variety of steps to address these concerns. For example, we have issued guidance to supervisors stressing the importance of taking a balanced approach to supervision and of promptly upgrading a bank's supervisory rating when warranted by a sustainable improvement in its condition and risk management. Some analysis has indicated that, all else being equal, banks with lower supervisory ratings tend to lend less; prompt upgrades by supervisors when such upgrades are appropriate may thus ease an unnecessary constraint on lending. Indeed, in the fourth quarter of 2011 and the first quarter of this year, the number of ratings upgrades for banks and bank holding companies supervised by the Federal Reserve exceeded the number of downgrades. The last time that upgrades exceeded downgrades was in 2005. In addition, we have stepped up examiner training on relevant lending issues, and we have emphasized to examiners that an open dialogue with bank management is essential.

We have also looked into specific concerns raised about the examination process and its effect on banks' willingness to lend. For example, during 2011, we reviewed commercial real estate loan classification practices to assess whether examiners were properly implementing the interagency policy statement on workouts of commercial real estate loans. We analyzed documentation for more than 300 loans with identified weaknesses in six Federal Reserve Districts. We found that Federal Reserve examiners were appropriately implementing the guidance and were consistently taking a balanced approach in determining loan classifications. Moreover, the documentation we reviewed indicated that examiners were carefully considering the full range of information provided by bankers, including relevant mitigating factors, in determining the regulatory treatment for the loans.

## **Conclusion**

To sum up, conditions in the banking system – and the financial sector more broadly – have improved significantly in the past few years. Banks have strengthened their capital and liquidity positions. The economic recovery has facilitated the rebuilding of capital and helped improve the quality of the loans and other assets on banks' balance sheets. Nonetheless, banks still have more to do to restore their health and adapt to the post-crisis regulatory and economic environment. As the recovery gains greater traction, increasing both the demand

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<sup>3</sup> For example, see William F. Bassett, Mary Beth Chosak, John C. Driscoll, and Egon Zakrajšek (2012), “Changes in Bank Lending Standards and the Macroeconomy (PDF),” Finance and Economics Discussion Series 2012–24 (Washington: Board of Governors of the Federal Reserve System, May); and Jose M. Berrospide and Rochelle M. Edge (2010), “The Effects of Bank Capital on Lending: What Do We Know, and What Does It Mean?” *International Journal of Central Banking*, vol. 6 (December), pp. 5–54.

for credit and the creditworthiness of potential borrowers, a financially stronger banking system will be well positioned to expand its lending. Improving credit conditions will in turn help create a more robust economy.