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Statement of

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Chairman Moore, Ranking Member Biggert, and members of the Subcommittee, I appreciate the opportunity to appear before you today to examine several issues related to the condition of the banking system. First, I will discuss overall credit conditions and bank underwriting standards, credit availability to small businesses, and I will briefly address conditions in this region, particularly in Michigan. I will then describe current conditions in commercial real estate markets (CRE), and outline Federal Reserve activities to enhance liquidity and improve conditions in financial markets to support the flow of credit to households and businesses. Finally, I will discuss the ongoing efforts of the Federal Reserve to ensure the overall safety and soundness of the banking system, as well as actions taken to promote credit availability.

Background

The Federal Reserve has supervisory and regulatory authority for bank holding companies (BHCs), 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 stability of the financial system, and provide for the fair and equitable treatment of consumers in financial transactions. While the Federal Reserve is not the primary federal supervisor for the majority of commercial banks, it is the consolidated supervisor of BHCs, 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 BHC's depository subsidiaries. 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 BHC's depository, 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 conducts on-site examinations and off-site monitoring to ensure the safety and soundness of supervised state member banks.

The Federal Reserve is involved in both regulations, establishing the rules within which banking organizations must operate, and supervision, ensuring that banking organizations abide by those rules and remain safe and sound. 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. The number of bank failures also has risen this year.

Conditions in Financial Markets and the Economy

While conditions and sentiment in financial markets have improved, corporate bond spreads are high by historical standards as expected losses and risk premiums remain elevated. Encouragingly, 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.

However, the nationwide unemployment rate has continued to rise, reaching 10.2 percent in October.

Throughout the year, borrowing by households and businesses has remained weak. Residential mortgage and consumer debt outstanding fell sharply in the first half of the year, and the decline in consumer credit continued in the third quarter. Outstanding obligations of nonfinancial businesses also decreased modestly in the first half of 2009 and 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.

Loan quality deteriorated significantly for both large and small institutions during the third quarter of this year. At the largest 50 bank holding companies, nonperforming assets climbed more than 10 percent, raising the ratio of nonperforming assets to 4.8 percent of loans and other real estate owned. Most of the deterioration was concentrated in residential mortgage and CRE, but commercial loans also experienced rising delinquencies. Results of the banking agencies' Shared National Credits review; released in September, also document significant deterioration in the performance of large syndicated loans, signaling likely further deterioration in commercial loans.[1] At community and small regional banks, nonperforming assets increased to 4.6 percent of loans at the end of the third quarter, more than seven times the level for this ratio at year-end 2006, before the financial crisis began. Home mortgages and CRE loans accounted for most of the increase, but commercial loans have also shown marked deterioration during recent quarters.

When combined with job losses and lower consumer spending, the environment is very challenging for both large and small businesses. Small businesses, which tend to have less

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[1] See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, 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.

financial flexibility in a recessionary environment, have been particularly affected during this cycle. Of note, small businesses rely on banks for 90 percent of their financing needs, compared to large businesses, which use banks for only 30 percent of their financing. There are more than 27 million small businesses nationally that employ about half of the nation's private-sector workforce and these businesses have approximately $1 trillion in debt outstanding. Access to credit markets is expected to remain a challenge for these firms, but at the same time, with inventory and capital spending levels at near historic lows, the demand for credit has remained weak.

The most recent 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 October, more banks reported tightening their lending standards on consumer and business loans than reported easing, although the degree of net tightening continues to decline from peaks reached late last year. The survey also confirms 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.

Credit losses at banking organizations continue to rise, and banks face risks of sizable additional credit losses given the outlook for production and employment. In addition, while the year-on-year decline in housing prices has slowed, continued adjustments in the housing market suggest that foreclosures and mortgage loss severities are likely to remain elevated. Moreover, the value of both existing commercial properties and land, which collateralize commercial and residential development loans, has declined sharply, suggesting that banks are vulnerable to

significant further deterioration in their CRE loans. In sum, banking organizations continue to face significant challenges, and credit conditions remain tight.

Performance of the Banking System

Despite these challenges, the stability of the banking system has improved since last year. Importantly, the rigorous Supervisory Capital Assessment Program (SCAP) stress test, a program that was led by the Federal Reserve earlier this year, helped to increase public confidence in the banking system during a period of high stress. A number of institutions in the SCAP demonstrated that they have the capacity to withstand more-adverse macroeconomic conditions than are expected to develop and have repaid the investments made under the Troubled Asset Relief Program. Many financial institutions have accessed various sources of funding and have raised significant amounts of new capital. The firms that were determined to need to raise capital increased common equity by more than $75 billion since the SCAP results were released in May.[2] 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, a number of banking organizations face significant challenges. Two years into a substantial economic downturn, loan quality continues to deteriorate across many asset classes and, as noted earlier, has declined further as 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

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[2] For more information about the SCAP, see November 9, 20009 Federal Reserve Board Press Release http://www.federalreserve.gov/newsevents/press/bcreg/20091109a.htmsee

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, weak economic conditions, and a focus on working out problem loans also have 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.

For banking organizations in this region of the country, including Michigan, Ohio, and Indiana, the overall weakness of economic conditions has had a negative impact on institutions. In particular, for banking organizations in Michigan, aggregate net earnings have turned negative, due mostly to high provision expenses; and asset quality indicators continue to trend downward, driven by weakness in commercial and residential real estate. Michigan entered the recession about three years before the rest of the country and has the highest unemployment rate in the nation. Moreover, weak economic conditions have become more pronounced as the manufacturing sector continued to decline and shed jobs. Notably, statistics from the Michigan Association of Realtors indicate that the average statewide residential home sales' price has fallen to 1995 levels.

Against this backdrop, banking organizations in Michigan face a number of challenges. Four Michigan institutions with assets totaling nearly $842 million have been closed in recent months. Of particular concern, 15 percent of Michigan banks reported recently that they are less than well-capitalized.

Current Conditions in Commercial Real Estate Markets

All across the country and in this region in particular, it is clear that significant financial challenges remain. Indeed, 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.

The Federal Reserve has been focused on CRE exposures at supervised institutions for some time. In response to rising CRE concentrations, especially in some large regional and community banking firms in the early part of this decade, and the central role of CRE loans in the banking problems of the late 1980s and early 1990s, we led an interagency effort to develop supervisory guidance on CRE concentrations. The guidance was finalized in 2006 and published in the Federal Register in early 2007.[3] In that guidance, we emphasized our concern that some institutions' strategic- and capital-planning processes did not adequately recognize the risks arising from their CRE concentrations. We stated that institutions actively involved in CRE lending should perform ongoing assessments to identify and manage concentrations through stress testing and similar exercises that identify the impact of adverse market conditions on earnings and capital.

As weaker housing markets and deteriorating economic conditions have impaired the quality of CRE loans at supervised banking organizations, the Federal Reserve has devoted significantly more resources to assessing the quality of CRE portfolios at regulated institutions. These efforts include monitoring the impact of declining cash flows and collateral values on CRE portfolios, as well as assessing the extent to which banks have been complying with our CRE guidance. Federal Reserve Banks that are located in more adversely affected geographic areas have been particularly focused on evaluating exposures arising from CRE lending.

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[3] 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), www.federalreserve.gov/boarddocs/srletters/2007/SR0701.htm.

As job losses have accelerated nationwide, demand for commercial property has declined 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 do not generate income until after completion. Developers typically depend on the sales of completed projects to repay their outstanding loans, and with prices depressed amid sluggish sales, many developers are finding their ability to service existing construction loans strained.

Federal Reserve examiners are reporting 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 amount, $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 nine percent of CRE loans in bank portfolios were considered delinquent, almost double the level of a year earlier. [4] Loan performance problems were the most striking for construction and development loans, especially for those that finance residential development. More than 16 percent of all construction and development loans were considered delinquent at the end of the second quarter.

The current fundamental weakness in CRE markets is exacerbated by the fact that the CMBS market, which previously had financed about 30 percent of originations and completed construction projects, completely shut down. Until mid-November, when the first CMBS issuance came to market with financing provided by the Federal Reserve's Term Asset-Backed

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

Securities Loan Facility (TALF), essentially no CMBS have been issued since mid-2008. 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 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 TALF, a joint Federal Reserve – Treasury program that was 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. Securitization markets (other than those for mortgages guaranteed by the government) closed in mid-2008, and the TALF was developed to promote renewed issuance. Under the TALF, eligible investors may borrow to finance purchases of the AAA-rated tranches of various 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. Investors may also use the TALF to purchase both existing and newly issued CMBS, which were included to help mitigate the refinancing problem in that sector.

The TALF has been successful in helping restart securitization markets. Issuance has resumed and rate spreads for asset-backed securities have declined substantially. The TALF program has helped finance 2½ million auto loans, 750,000 student loans, more than 100 million credit card accounts, 480,000 loans to small businesses, and 100,000 loans to larger businesses. Included among those business loans are 4,700 loans to auto dealers to help finance their inventories. Perhaps even more encouraging, a substantial fraction of Asset Backed Securities (ABS) is now being purchased by investors that do not seek TALF financing, and ABS-issuers have begun to bring non-TALF-eligible deals to market.

The availability of TALF financing facilitated the first issuance of CMBS backed by newly originated mortgages in almost 18 months on November 16. Investor demand for the new issuance was high, in part because of the improved investor protections put in place so that securities would be eligible collateral for TALF loans. In the end, non-TALF investors purchased almost 80 percent of the TALF-eligible securities. By improving credit market functioning and adding liquidity to the system, the TALF and other Fed programs have provided critical support to the financial system and the economy.

Availability of Credit

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, including small businesses.[5] 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' abilities to repay and making

[5] 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, www.federalreserve.gov/newsevents/press/bcreg/20081112a.htm.

realistic assessments of collateral valuations. This guidance has been reviewed and discussed with examination staff within the Federal Reserve System and ongoing training continues.

More recently, the Federal Reserve led the development of interagency guidance issued on October 30 regarding CRE loan restructurings and workouts. [6] This policy statement provides guidance for examiners, and for financial institutions that are working with CRE borrowers who are experiencing diminished operating cash flows, depreciated collateral values, or prolonged delays in selling or renting commercial properties. The statement is especially relevant to small businesses because owner-occupied CRE often serves as collateral for many small business loans.

The Federal Reserve recognizes that prudent loan workouts are often in the best interest of both financial institutions and borrowers, particularly during difficult economic conditions. Accordingly, the policy statement details risk-management practices for loan workouts that support prudent and pragmatic credit and business decision-making within the framework of financial accuracy, transparency, and timely loss recognition.

To underscore expectations regarding the guidance, the Federal Reserve has already conducted a System-wide teleconference with examiners that focused specifically on the new guidance. In addition, on November 20, we participated in an industry outreach teleconference call to discuss the guidance. Examiner training and industry outreach will be ongoing. Beginning in January 2010, a comprehensive, System-wide training initiative will commence to further underscore our expectations.

Prudent real estate lending depends upon reliable and timely information on the market value of the real estate collateral. This has been a cornerstone of the regulatory requirements for

[6] Interagency Policy Statement on CRE loan Restructurings and Workouts (November 2009); http://www.federalreserve.gov/newsevents/press/bcreg/20091030a.htm

real estate lending and is reflected in the agencies' appraisal regulations. In that regard, the Federal Reserve requires a regulated institution to have real estate appraisals that meet minimum appraisal standards, including the Uniform Standards of Professional Appraisal Practice, and contain sufficient information to support the institution's credit decision. Over the past several years, the Federal Reserve has issued several appraisal-related guidances to emphasize the importance of a bank's appraisal function and the need for independent and reliable appraisals. More recently, the Federal Reserve and the other federal agencies issued a proposal to revise the Interagency Appraisal and Evaluation Guidelines, which is expected to be finalized in the coming months. These guidelines reinforce the importance of sound appraisal practices.

Given the lack of sales in many real estate markets and the predominant number of distressed sales in the current environment, regulated institutions face significant challenges today in assessing the value of real estate. We expect institutions to have policies and procedures for obtaining new or updated appraisals as part of their ongoing credit review. An institution should have appraisals or other market information that provide appropriate analysis of the market value of the real estate collateral and reflect relevant market conditions, the property's current "as is" condition, and reasonable assumptions and conclusions

The Federal Reserve has directed examiners to be mindful of the effects of excessive credit tightening in the broader economy, and we have taken steps, including additional examiner training and industry outreach, to underscore these intentions. We are aware that bankers may become overly conservative in an attempt to ameliorate past weaknesses in lending practices, and we are working to emphasize that it is in all parties' best interests to continue making loans to creditworthy borrowers.

Conclusion

While financial market conditions have improved in the United States, the overall environment remains under stress, and some geographic areas are experiencing more difficulty than others, as is the case in Michigan, Ohio, and Indiana. The Federal Reserve, working with the other banking agencies, has taken strong action to ensure that the banking system remains safe and sound and is able to meet the credit needs of our economy. We also have aggressively pursued monetary policy actions and have provided liquidity to help restore stability to the financial system and support the flow of credit to households and businesses. In our supervisory efforts, we are mindful of the risk-management deficiencies at banking institutions revealed by the financial 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 fully recover. In order to promote credit availability, the Federal Reserve is encouraging banks to deploy capital and liquidity in a responsible way that avoids past mistakes and does not create new ones. The Federal Reserve is committed to working with other banking agencies and the Congress to promote the concurrent goals of fostering credit availability and a safe and sound banking system.

Thank you again for your invitation to discuss these important issues at today's hearing. I would be happy to answer any questions that you may have.