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Statement
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Domestic Policy Subcommittee
Oversight and Government Reform Committee

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"Examining the Continuing Crisis in Residential Foreclosures and the Emerging Commercial Real Estate Crisis: Perspectives from Atlanta."

Chairman Kucinich, Ranking Member Jordan, 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 credit conditions and bank underwriting standards, with a particular focus on commercial real estate (CRE), and I will briefly address conditions in the state of Georgia. I will then describe Federal Reserve activities to enhance liquidity and improve conditions in financial markets. 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, 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 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. The Federal Reserve is not the primary federal supervisor for the majority of commercial banks. 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 safety and soundness of supervised state member banks. A key aspect of the supervisory process is evaluating risk-management practices.

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. 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 has also risen this year.

Conditions in Financial Markets and the Economy

Although conditions and sentiment in financial markets have improved in recent months, significant stress and weaknesses persist. Corporate bond spreads remain high by historical standards as both expected losses and risk premiums remain elevated. Encouragingly, economic growth moved back into positive territory last quarter, in part reflecting a pickup in consumer spending and an increase in residential investment. However, the unemployment rate has continued to rise, reaching 9.8 percent in September.

In this environment, borrowing by businesses and households has remained weak. The available data suggest that household and nonfinancial business debt likely decreased in the third quarter after having contracted in the first half of the year. For households, residential mortgage debt and consumer credit fell sharply in the first half of the year, and the decline in consumer credit continued in July and August. Nonfinancial business debt also decreased modestly in the first half of 2009 and appears to have contracted further in the third quarter as net decreases in commercial paper outstanding and bank loans more than offset solid net issuance of corporate bonds.

Loans outstanding at depository institutions fell in the second quarter of 2009. In addition, the Federal Reserve's weekly bank credit data suggest that bank loans to households and to nonfinancial businesses contracted sharply in the third quarter as well. These declines reflect the fact that weak economic growth can both dampen demand for credit and lead to tighter credit supply conditions. Tighter credit conditions are especially challenging for small businesses, which tend to rely more heavily on despository institutions for credit. 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. In a recent National Federation of Independent Business survey, small businesses reported that credit conditions were about as tight as in previous recessions; at the same time, their main economic concern was lower sales.

Results from the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices in July 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 indicated that demand for consumer and business loans had weakened further. Indeed, decreased loan demand from creditworthy borrowers was the most common explanation given by respondents for the contraction of business loans this year.

Loan quality deteriorated significantly for both large and small institutions during the second quarter of this year. 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.[1] 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 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.

As a result, credit losses at banking organizations continued 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 slowed in the second quarter, 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,

[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.

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 raised significant amounts of capital and have achieved greater access to funding. Importantly, 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.[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, the condition of the banking system is far from robust. Two years into a substantial economic downturn, loan quality is poor across many asset classes and, as noted earlier, continues to deteriorate 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 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.

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[2] 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, www.federalreserve.gov/newsevents/speech/bernanke20090511a.htm.

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.

In Georgia, the performance of banking organizations has deteriorated significantly over the past several quarters as the region's real estate expansion reversed course. Like their counterparts nationally, Georgia banks have seen a steady rise in non-current loans and provisions for loan losses, which have weighed on bank earnings and capital. Since the turmoil in financial markets emerged more than two years ago, 25 banks in Georgia have failed. Notably, almost all of the banks that have failed in Georgia thus far were located in the metro-Atlanta market and had a high percentage of total loans in land acquisition, development, and construction. Most of the lending activity at these failed banks was related to the region's housing boom in the first half of this decade. Also of note, many of the failed banks relied heavily on brokered deposit funding to support what had been very strong asset growth. At the end of 2007, the average ratio of brokered deposit funds was 13 percent at banks in the state of Georgia, compared to just 7 percent at the national level.

It is clear that substantial financial challenges remain for banking institutions, both in Georgia and across the United States. 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.

Current Conditions in Commercial Real Estate Markets

The Federal Reserve has been focused on CRE exposures at supervised institutions for some time. As part of our supervision of banking organizations in the early part of this decade, we observed rising CRE concentrations, especially in some large regional and community

banking firms. Given the central role that CRE lending played 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. 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 were needed to identify the potential 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 regulated institutions' CRE portfolios. These efforts include monitoring the impact of declining cash flows and collateral values, as well as assessing the extent to which banks have been complying with the CRE guidance. Reserve Banks that are located in more adversely affected geographic areas have been particularly focused on evaluating exposures arising from CRE lending. We have found, through horizontal reviews and other examination activities, that many institutions would benefit from portfolio-level stress testing, improved management information systems, and more robust appraisal practices. Additionally, some institutions need to improve their understanding of how single-name, sectoral and geographic concentrations can impact capital levels during downturns.

Prices of existing commercial properties have already declined substantially from the peak in 2007 and will likely decline further. As job losses have accelerated, 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.

As a result, 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, $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 in bank portfolios 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 financed residential development. More than 16 percent of all construction and development loans were considered delinquent at the end of the second quarter.

Of particular concern, almost $500 billion of CRE loans will mature during each of 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. The 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 previously had financed about 30 percent of originations and completed

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

construction projects, has remained closed since the start of the crisis. 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), which was announced 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) closed in mid-2008, with most of the issuance since that time importantly dependent on government support. 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. More recently, investors have also been able to 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 had some success in restarting securitization markets. Rate spreads for asset-backed securities have declined substantially, and there is some new issuance that does not depend on 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 lending and credit intermediation. Guidance issued during the CRE downturn in 1991 and in effect today 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 that loans are being reviewed in a consistent, prudent, and balanced fashion to prevent inappropriate downgrades of credits. It is consistent with guidance published in early 2007 that addressed risk management of CRE concentrations. The 2007 guidance 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. Banks have raised concerns that Federal Reserve examiners are not always taking a balanced approach to the assessment of CRE loan restructurings. At the same time, our examiners have observed incidents where banks have been slow to acknowledge

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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), www.federalreserve.gov/BoardDocs/SRLetters/1991/SR9124.htm; 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," joint policy statement, November 7,www.federalreserve.gov/BoardDocs/SRLetters/1991/SR9124a1.pdf.
[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), www.federalreserve.gov/boarddocs/srletters/2007/SR0701.htm.

declines in CRE project cash flows and collateral values in their assessment of potential loan repayment. This new guidance supports balanced and prudent decisionmaking with respect to loan restructuring, accurate and timely recognition of losses, and appropriate loan classification. The guidance reiterates 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.

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 real estate lending and is reflected in the agencies' appraisal regulations. In that regard, the Federal Reserve requires its 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 guidance documents 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 market sales in many 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. Bank examiners generally will not challenge an institution's appraisal and other collateral valuation information that are based on well-supported analysis.

Guidance issued in November 2008 by the Federal Reserve and the other federal banking agencies also encouraged banks to meet the needs of creditworthy borrowers in a manner consistent with the principles of safety and soundness while taking 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 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 in the United States have improved notably over the past year, the overall environment continues to be somewhat strained, and some geographic areas like the Southeast are experiencing more difficultly than others. 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 have provided liquidity to help repair the

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

financial system. 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 this environment, the economy will need a strong and stable financial system that can make credit available. We want banks to deploy capital and liquidity, but 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.