

**EXAMINING THE STATE OF THE  
BANKING INDUSTRY**

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**HEARING**  
BEFORE THE  
SUBCOMMITTEE ON  
FINANCIAL INSTITUTIONS  
OF THE  
COMMITTEE ON  
BANKING, HOUSING, AND URBAN AFFAIRS  
UNITED STATES SENATE  
ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

THE CURRENT CONDITIONS OF KEY FINANCIAL INSTITUTIONS AND  
EXAMINING THE CONTINUING CHALLENGES THESE INSTITUTIONS  
FACE

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OCTOBER 14, 2009

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## **EXAMINING THE STATE OF THE BANKING INDUSTRY**

**WEDNESDAY, OCTOBER 14, 2009**

U.S. SENATE,  
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS,  
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,  
*Washington, DC.*

The Subcommittee met in room SD-538, Dirksen Senate Office Building, Senator Tim Johnson, Chairman of the Subcommittee, presiding.

### **OPENING STATEMENT OF SENATOR TIM JOHNSON**

Senator JOHNSON. As Congress and this Committee continue its work to stabilize financial institutions and promote our Nation's economic recovery, I have called this hearing today for regulators to give us an update on the current conditions of the financial institutions in our country. It is vital that we know what continuing challenges and concerns our Nation's institutions face. Specifically, I continue to be concerned about the lending environment for small businesses, the capital needs of institutions, and the impact of commercial real estate and other loan portfolios on balance sheets. In addition, while many of the large banks in our country have stabilized, the FDIC's list of troubled banks, many of them small community banks, is growing.

While restructuring our Nation's regulatory system is this Committee's top priority, I do not think we can do that without a clear understanding of what is happening within the sector. Concerns and problems within individual financial institutions will still exist even with a new regulatory structure. Continuing to ensure the safety and soundness of viable institutions and the overall financial stability of our Nation's economy is vital to protecting all Americans' pocketbooks, savings, and retirement.

I want to thank the witnesses for being here today, and I look forward to hearing from each of you regarding any developing trends or concerns within the banking industry or throughout the economy, and to hear of the regulatory or supervisory steps your agencies are taking to respond to these challenges.

I will now turn to Senator Crapo for his opening statement.

### **STATEMENT OF SENATOR MIKE CRAPO**

Senator CRAPO. Thank you very much, Mr. Chairman, for holding this hearing to examine the current status of the banking and credit union industry. Failures of small banks continue to grow,

and the key trouble spots are looming, such as commercial real estate loans.

According to a recent New York Times article, about \$870 billion, or roughly half of the industry's \$1.8 trillion of commercial real estate loans, now sit on the balance sheet of small and medium-sized banks. I am interested in learning to what extent the TALF, or Term Asset-backed Securities Loan Facility, encouraged capital to enter the commercial real estate market and what other steps regulators can and should take to address this problem.

Many community banks and credit unions have tried to fill the lending gap created by the credit crisis. Even with these efforts, it is apparent that many consumers and small businesses are not receiving the lending they need to refinance their home loan, to extend or keep their current business line of credit, or to receive capital for new business opportunities.

Regulators need to be mindful that they strike the appropriate balance to bolster capital and meet the credit needs of our economy, and FASB's new rules on off-balance sheets will create challenges on this point.

As we begin to explore options to modernize our financial regulatory structure, it is important that our new structure allows financial institutions to play an essential role in the U.S. economy by providing a means for consumers and businesses to save for the future, protect and hedge against risk, and promote lending opportunities.

Again, Mr. Chairman, I thank you for holding this hearing. I look forward to working with you and others on these issues.

Senator JOHNSON. Senator Merkley. And I encourage members to be brief since there are seven panelists and many questions to be asked.

#### **STATEMENT OF SENATOR JEFF MERKLEY**

Senator MERKLEY. Thank you very much, Mr. Chair, for holding this hearing on the state of the banking industry. I want to be very clear that I am concerned about the effect of this crisis on our community banks. Our national economic crisis was sparked by the preemption of State predatory lending laws, the sale of mortgages, and certainly the securitization of these mortgages by Wall Street.

But it is our community banks who have been hit with repeated FDIC assessments, who have seen asset values fall, and who have seen their regulators tighten the noose. Unlike institutions that were deemed "too big to fail," our community banks apparently are deemed "small enough to fail."

Despite the fact that community banks had little to do with causing our crisis, our community banks have been unable to lend. They are stuck with a Catch-22 situation where private sector investors are unwilling to deploy money unless the banks have TARP money in them, and TARP will not go into small banks out of concern for capitalization. Instead, the small banks are told to raise more money.

I was very skeptical of TARP when first authorized because I felt it was focused too much on our Nation's largest banks. Now, given the crisis we are facing in Oregon and across the Nation, it is apparent that we need to speed credit access to the economy, and I

believe that we need to support the recapitalization of our community banks as one of the best ways to get capital flowing to Main Street and get job growth started in our economy.

Mr. Chair, over the next days and weeks, I will look forward to working with you and members of the Subcommittee and full Committee to figure out ways to break this gridlock and get capital flowing back to our community banks.

Senator JOHNSON. Senator Bunning.

#### **STATEMENT OF SENATOR JIM BUNNING**

Senator BUNNING. I have no opening statement. I want to get to questions. Thank you.

Senator JOHNSON. Thank you.

Senator Warner.

#### **STATEMENT OF SENATOR MARK WARNER**

Senator WARNER. I know we have got a lot of panelists. I will wait for my questions as well.

Senator JOHNSON. Senator Brown.

#### **STATEMENT OF SENATOR SHERROD BROWN**

Senator BROWN. Thank you, Mr. Chairman, and I will be brief.

Yesterday, I had a roundtable of 15, 16, 17 small manufacturers in my boyhood home town of Mansfield, Ohio, a community of 50,000 that has lost a lot of manufacturing jobs, as much of the Midwest and much of the country have. Over and over, the discussion turned to they cannot get credit. You know that. Small business generally cannot get credit. Manufacturers have even more trouble getting credit than other small businesses, and auto chain manufacturers, auto supply chain manufacturers have even more trouble getting credit than other manufacturers.

They typically went around the table and blamed—they did not blame the banks. They mostly blamed regulators, of course. I hope that we learn in this hearing what we can do as policymakers to increase the flow of credit, especially to manufacturers. It sort of goes without saying that pulling us out of this recession—at least in historical terms, what pulls us out of recessions are housing and manufacturing, especially auto manufacturing, understanding more in my State than some others. But it is particularly important that manufacturing get the credit it needs. They have people to sell to more and more. They have people that are working 30 hours that want to work 40, and then they want to hire more people. But they cannot do any of that. They have got skilled workers, obviously, but they cannot do any of that unless credit is more liquid to them.

So I ask your assistance in that. I said they blame the regulators. I do not necessarily. I think banks are fearful and cautious, for good reasons sometimes, and sometimes not so good reasons. But we are counting on you.

Thanks.

Senator JOHNSON. Senator Tester.

[No response.]

Senator JOHNSON. I would like to welcome our witnesses. I appreciate your taking the time out of your busy schedules to be here today.

Today our panel of witnesses includes: Sheila Bair, Chairman of the Federal Deposit Insurance Corporation; John Dugan, Comptroller of the Office of the Comptroller of the Currency; and Governor Dan Tarullo, member of the Board of Governors of the Federal Reserve System. We are also welcoming Debbie Matz, Chairman of the National Credit Union Administration, to the panel for the first time since her confirmation over the summer.

I would also like to welcome Timothy Ward, Deputy Director of Examinations, Supervision, and Consumer Protection at the Office of Thrift Supervision; Joseph Smith, the North Carolina Commissioner of Banks, on behalf of the Conference of State Bank Supervisors; and Thomas Candon, Deputy Commissioner of the Vermont Department of Banking, Insurance, Securities, and Health Care Administration, and Chairman of the National Association of State Credit Union Supervisors.

While many of you have already been before the Committee many times this year on various topics, today we are continuing the important conversation of the state of the banking sector. I will ask that the witnesses please limit their testimony to 5 minutes. Your full statements and any additional materials you may have will be entered into the record.

Chairman Bair, please begin.

**STATEMENT OF SHEILA C. BAIR, CHAIRMAN, FEDERAL  
DEPOSIT INSURANCE CORPORATION**

Ms. BAIR. Thank you. Chairman Johnson, Ranking Member Crapo, and members of the Committee, I appreciate the opportunity to testify on behalf of the FDIC regarding the condition of the banking industry and the measures being taken by the FDIC to address the challenges facing us in the current environment. We meet today just 1 year after the historic liquidity crisis in global financial markets that prompted an unprecedented response on the part of governments around the world.

The financial landscape today is more stable than a year ago. Conditions appear to be moderating, and the liquidity of financial markets has improved. Even as we seek to end the extraordinary programs that were effective in addressing the liquidity crisis, we recognize that much more work needs to be done to meet the credit needs of households and small businesses.

There is evidence that the U.S. economy is growing once again, but bank performance typically lags behind economic recovery, and this cycle is no exception. High levels of distressed assets have led to weak financial performance at many FDIC-insured institutions. These have been concentrated in three main areas: residential mortgage loans, construction loans, and credit cards. Continued high unemployment threatens to keep loss rates elevated for an extended period. As the economy improves, however, loss rates should moderate.

Looking forward, the most prominent risk during the next several quarters is commercial real estate. Property cash-flows are falling due to declining rents and rising vacancies. Also, falling property prices will make it difficult for some borrowers to renew their financing.

Given the substantial challenges faced by financial institutions, the FDIC maintains a balanced supervisory approach that focuses on strong oversight but remains sensitive to economic and real estate market conditions. We support banks' efforts to lend to credit-worthy borrowers and to work constructively with existing borrowers to restructure loans where appropriate.

I have heard reports that examiners are requiring banks to write down sound performing loans. I can assure you that that is not the policy of the FDIC. The Federal banking agencies are finalizing guidance on commercial real estate loan workouts that will make that clear.

The FDIC has expressed support for making loans to credit-worthy borrowers in numerous industry forums and in last November's interagency statement. In particular, banks should continue to provide credit to small businesses, an engine of growth that creates jobs.

Poor credit quality and weak earnings have led to a surge in bank and thrift failures. So far this year, we have had 98 failures. While we do not expect failures at the levels experienced in the late 1980s and early 1990s, our loss rates have been significant.

To address adverse market conditions, the FDIC has employed additional resolution strategies that proved successful in the 1990s: loss-sharing agreements and structured transactions. These arrangements allow the FDIC to quickly return assets to the private sector, obtain better pricing, and minimize disruption to borrowers and communities from a bank failure. They save money for the deposit insurance fund and streamline our resolution workload.

As a result of increased bank failures, the deposit insurance fund is projected to need a new infusion of cash next year. To meet the fund's liquidity needs, we are seeking public comment on a proposal to collect \$45 billion through a prepayment of deposit insurance assessments instead of a special assessment.

In addition, we are implementing a restoration plan that should return the fund to a positive balance in 2012 and the reserve ratio to the minimum of 1.15 percent within the statutory 8-year timeframe.

The FDIC will continue protecting insured depositors as we have for over 75 years. No depositor has ever lost a penny of insured deposits and never will.

In closing, I would urge Congress to consider the impact of any new legislative initiatives on the structure of the banking industry as we emerge from this crisis. If reform measures perpetuate too big to fail, there will be a further trend toward consolidation into large and more complex institutions at the expense of smaller and more transparent competitors.

I urge Congress to implement policies that will assure continuation of a robust community banking sector, and when institutions do fail, as some inevitably will, we need a strong resolution authority that will assure market discipline on all institutions, large and small.

Thank you very much.  
Senator JOHNSON. Thank you.  
Mr. Dugan.

**STATEMENT OF JOHN C. DUGAN, COMPTROLLER OF THE CURRENCY, OFFICE OF THE COMPTROLLER OF THE CURRENCY**

Mr. DUGAN. Thank you, Chairman Johnson, Senator Crapo, and members of the Subcommittee. I am pleased to testify on the current condition of the national banking system, including trends in bank lending, asset quality, and problem banks. The OCC supervises over 1,600 national banks and Federal branches, which constitute approximately 18 percent of all federally insured banks and thrifts, holding just over 61 percent of all bank and thrift assets. As described in my written statement, the OCC has separate supervisory programs for large, mid-sized, and community banks that are tailored to the unique challenges faced by each.

Today I would like to focus on three key points.

First, despite early signs of the recession ending, credit quality is continuing to worsen across almost every class of asset in banks of almost every size. The strains on borrowers that first appeared in the housing sector have spread to other retail and commercial borrowers. For some credit portfolio segments, the rate of nonperforming loans is at or near historical highs. In many cases, this declining asset quality reflects risks that have been built up over time.

While we are seeing some initial signs of improvement in some asset classes, as the economy begins to recover, it will take time for problem credits to work their way through the banking system because credit losses often lag behind the return to economic growth.

Second, it is very important to keep in mind that the vast majority of national banks are strong and have the financial capacity to withstand declining asset quality. As I noted in testimony before the full Committee last year, we anticipated that credit quality would worsen and that banks would need to further strengthen their capital and loan loss reserves. Net capital levels in national banks have increased by more than \$186 billion over the last 2 years, and net increases to loan loss reserves have exceeded \$92 billion.

While these increases have considerably strengthened national banks, we anticipate additional capital and reserves will be needed to absorb additional potential losses in banks' portfolios. In some cases, that may not be possible, however, and as a result, there will continue to be a number of smaller institutions that are not likely to survive their mounting credit problems.

In these cases, we are working closely with the FDIC to ensure timely resolutions in a manner that is least disruptive to local communities.

Third, during this stressful period, we are extremely mindful of the need to maintain a balanced approach in our supervision of national banks. We strive continually to ensure that our examiners are doing just that. We are encouraging banks to work constructively with borrowers who may be facing difficulties and to make new loans to creditworthy borrowers, although it is true that in today's weaker economic environment, credit demand among businesses and consumers has significantly declined. And we have repeatedly and strongly emphasized that examiners should not dic-

tate loan terms or require banks to charge off loans simply due to declines in collateral values.

Balanced supervision, however, does not mean turning a blind eye to credit and market conditions or simply allowing banks to forestall recognizing problems on the hope that markets or borrowers may turn around. As we have learned in our dealings with problem banks, a key factor in restoring a bank to health is ensuring that bank management realistically recognizes and addresses problems as they emerge, even as they work with struggling borrowers.

One area where national banks are stepping up efforts to work with distressed borrowers is in foreclosure prevention. Our most recent quarterly report on mortgage metrics shows that actions by national bank servicers to keep Americans in their homes rose by almost 22 percent in the second quarter. Notably, the percentage of modifications that reduced monthly principal and interest payments increased to more than 78 percent of all new modifications, up from about 54 percent the previous quarter. We view this as a positive development since modifications that result in lower monthly payments are less likely to redefault.

While many challenges lie ahead, especially with regard to the significant decline in credit quality, I firmly believe that the collective measures that Government officials, bank regulators, and many bankers have taken in recent months have put our financial system on a much more sound footing. The OCC is firmly committed to a balanced approach that encourages bankers to lend and to work with borrowers in a safe and sound manner while recognizing and addressing problems on a timely basis.

Thank you.

Senator JOHNSON. Thank you, Mr. Dugan.

Mr. Tarullo.

**STATEMENT OF DANIEL K. TARULLO, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM**

Mr. TARULLO. Thank you, Mr. Chairman, Senator Crapo, members of the Subcommittee. Let me begin by echoing a few points that my colleagues made in either their written or oral statements.

First, compared to the situation of 8 to 12 months ago, the financial system has been significantly stabilized. The largest banking institutions, each of whose financial conditions was evaluated in our stress tests and then announced to markets and the public, have raised \$60 billion in capital since last spring. We continue to see a narrowing of spreads in some parts of the market, such as corporate bonds, and in short-term funding markets.

Second, however, important segments of our credit system are still not functioning effectively. Many securitization markets have had trouble restarting without Government involvement. Lending by commercial banks has declined through much of 2009. This decline reflects both weaker demand and tighter supply conditions, with particularly severe consequences for small and medium-sized businesses, which are much more dependent on banks than on the public capital markets that can be accessed by larger corporations.

Banks will continue to suffer significant losses in coming quarters as residential mortgage markets continue to adjust. Losses on

CRE loans, which represent a disproportionate share of the assets of some small and medium-sized banks, are likely to climb. The strains on these banks, when added to the more cautious underwriting typical of recessions, compound the problems of small businesses that rely on community banks for their borrowing.

Third, it is important that bank supervisors take an even-handed approach in examining banks during these stressful times. We certainly do not want examiners to exacerbate the problems of declining CRE prices and restricted availability of credit by reflexively criticizing loans solely because, for example, the underlying collateral has declined in value. At the same time, we do not want supervisory forbearance that will put off inevitable losses, which may well increase over time, with attendant implications for the Federal Deposit Insurance Fund.

So it is relatively easy to summarize the situation and state the problem. The question on everyone's mind is when and how it can be ameliorated. There are no easy answers, but let me offer a few observations.

We as banking regulators should certainly redouble our efforts to ensure that the even-handed guidance we are issuing in Washington will be implemented faithfully by our examiners throughout the country. But we should not fool ourselves that even the best implementation of this policy will come close to solving the problems caused by significantly reduced demand for commercial properties that were in many cases highly leveraged on the assumption of rising asset prices.

The problems lie deeper. In a weak economy that has, in turn, weakened many of our banks, supervisory guidance is neither appropriate for, nor effective as, an economic stimulus measure. At the most basic level, the strengthening of CRE markets and a return to a fully healthy banking system depend on growth in the economy as a whole, and particularly on a reduction in unemployment.

I believe that the most important Federal Reserve action to promote CRE recovery is through our monetary policy. Our actions to date have helped return the Nation to growth sooner than many have expected. Nonetheless, because economic performance remains relatively weak, the Federal Open Market Committee indicated after our last meeting that conditions are likely to warrant exceptionally low levels of the Federal funds rate for an extended period.

The Federal Reserve has also taken a series of steps to increase liquidity for financing capital of interest to consumers and small businesses, including the TALF program, which we recently extended through March, with a longer extension for commercial mortgage-backed securities.

I suspect, though, that more direct efforts may be needed to make credit available to some creditworthy small businesses. Congress and the Administration may wish to consider temporary targeted programs while conditions in the banking industry normalize.

Thank you very much, Mr. Chairman.

Senator JOHNSON. Thank you.

Ms. Matz.

**STATEMENT OF DEBORAH MATZ, CHAIRMAN, NATIONAL  
CREDIT UNION ADMINISTRATION**

Ms. MATZ. Thank you, Chairman Johnson, Senator Crapo, and members of the Subcommittee. I am pleased to provide NCUA's views on the state of the industry.

As you have heard from my counterparts, the stress on the entire financial sector has translated into a challenging time for financial institutions, including credit unions. Nonetheless, I am confident that credit unions can and will weather the storm.

Corporate credit unions pose the most serious challenges to the credit union industry. Corporate credit unions are wholesale credit unions created by retail credit unions to provide investment services, liquidity, and payment systems. For four decades, this system worked well. However, in 2008, corporate exposure to mortgage-backed securities created tangible liquidity difficulties. In response to a growing crisis, NCUA asked Congress to increase the borrowing ceiling on our back-up liquidity source—the Central Liquidity Facility. Congress granted NCUA's request, and it is clear to me that if you had not acted in such a swift and decisive manner, the entire credit union system, not just the corporate network, would have been in serious jeopardy.

Despite this successful intervention, problems continued. In March, the two largest corporates were placed into conservatorship by NCUA due to the deterioration in their portfolios. Losses flowed through the system and resulted in writedowns of capital not only by other corporates but by retail credit unions that invested in these institutions. Given the tenuous real estate market, NCUA expects additional losses to materialize.

These conservatorships permit the corporate system to continue to function and to serve retail credit unions and, most importantly, their 90 million members. Again, a mechanism was developed, the Corporate Credit Union Stabilization Fund, which permitted replenishment by the industry over a 7-year period. This spreading out of costs was critical as credit union earnings were already experiencing pressures. The Corporate Stabilization Fund has permitted NCUA to maintain its mandated equity ratio in the Share Insurance Fund. At no point during this crisis has the equity ratio fallen below the 1.2 percent established by Congress, and today it stands at 1.3 percent, assuring consumers that their insured deposits are safe.

Retail credit unions have their own challenges independent of the corporates. The good news is that, despite the troubled economy, credit union lending has increased by almost 8 percent since 2007. However, delinquencies and loan losses have also increased, particularly in real estate lending. In 2007, about 0.3 percent of such loans were delinquent. The figure now stands at 1.62 percent.

Industry-wide capital, while still strong, has declined from 11.8 percent in 2007 to 10 percent. On the one hand, I am encouraged by the fact that 98 percent of the 7,700 federally insured credit unions are at least adequately capitalized. On the other hand, 21 credit unions have failed so far this year compared to 18 in all of 2008. That number could well rise in 2010. Most troubling is the increase in credit unions which have been downgraded to CAMEL

4 and 5. Between December 2008 and August 2009, the assets of credit unions in these categories have almost doubled.

Clearly, credit unions have not been spared from the harsh effects of the economic downturn. In tandem with the assessment of corporate losses described above, this presents a difficult road for credit unions to travel in 2010 and beyond.

NCUA has been proactive in our efforts to mitigate the situation. NCUA examiners work with credit unions to avoid the riskiest types of mortgage lending, and this oversight was complemented by the fact that, as member-owned cooperatives, credit unions try to put their members into lending products they can afford. As a result, the industry largely steers clear of exotic mortgage lending. Only 2.3 percent of all credit union mortgage loans are exotic.

Additionally, NCUA has enhanced our supervision. We shortened our examination cycle. We added 50 examiners in 2009 and anticipate adding 57 more in 2010, and we upgraded our risk management system to identify and resolve problems more quickly.

NCUA has an obligation to consumers. As a safety and soundness regulator, we will be successful if we preserve strong credit unions capable of meeting the financial needs of their members. Credit union members rightfully expect a reliable and well-capitalized deposit insurance regime. While the year ahead will be challenging, I am confident that we and the credit union industry we regulate will be stronger in the end.

I welcome the opportunity to answer your questions.

Senator JOHNSON. Thank you, Ms. Matz.

Mr. Ward.

**STATEMENT OF TIMOTHY T. WARD, DEPUTY DIRECTOR, EXAMINATIONS, SUPERVISION, AND CONSUMER PROTECTION, OFFICE OF THRIFT SUPERVISION**

Mr. WARD. Good afternoon, Chairman Johnson, Ranking Member Crapo, and members of the Subcommittee. Thank you for the opportunity to testify today on the financial condition and performance of the thrift industry.

As of June 30, 2009, OTS regulated 794 thrift institutions with combined assets of \$1.1 trillion. We also regulated 459 savings and loan holding companies with aggregated consolidated assets of approximately \$5.5 trillion. Most OTS regulated thrifts are smaller, community-based institutions. At the end of the second quarter, 86 percent of the thrifts had assets less than \$1 billion. Three percent, or 25 thrifts, had assets greater than \$10 billion, and those 25 large thrifts held 66 percent of total industry assets.

Thrifts in general are weathering the recession fairly well. Capital overall is strong. The industry's second quarter earnings improved to break even. And loan loss reserves have been substantially bolstered to near record levels. Because additions to loan loss reserves are direct charges to income, the industry's earnings remain weak by historical standards. Loss provisioning is expected to continue at elevated levels until inventories of unsold homes decline, home prices stabilize, and the employment picture brightens.

Problem assets are continuing to increase, rising to 3.52 percent of total assets in the second quarter, up from 2.68 percent 1 year

earlier. This compares unfavorably to an average level of 0.78 percent from 2000 to 2007.

These stresses have caused an increase in problem thrifts and a general decline in safety and soundness ratings across the industry. As of September 30, 2009, there were 42 problem thrifts representing 5.4 percent of all OTS-regulated thrifts. A year ago, there were 16 problem thrifts, or 2 percent of the total. Twelve thrifts have failed this year, compared with five last year. The OTS is working closely with problem institutions to prevent failures, but more thrifts are expected to fail before the economy fully recovers.

Foreclosures continue to be a concern. Although sustainable loan modifications and payment plans to avoid foreclosures are increasing, the number of seriously delinquent mortgages and foreclosures in process are continuing to rise. Progress is being made on this front, but when so many American families are losing their homes, the progress certainly does not seem to be fast enough.

In summary, Mr. Chairman, it is too early for us to say we have hit bottom and the worst is over. We believe significant challenges lie ahead as unemployment continues to rise and the housing market continues to work its way through a significant down cycle. Despite these challenges, the overall condition of the thrift industry is sound, with strong capital and substantially bolstered loss reserves. Recent earnings have shown signs of improvement, reflecting what we hope are indications that the nation's economy is beginning to turn around.

Thank you again for having me here today. I look forward to responding to your questions.

Senator JOHNSON. Thank you, Mr. Ward.

Mr. Smith.

**STATEMENT OF JOSEPH A. SMITH, JR., NORTH CAROLINA COMMISSIONER OF BANKS, ON BEHALF OF THE CONFERENCE OF STATE BANK SUPERVISORS**

Mr. SMITH. Chairman Johnson and Ranking Member Crapo, members of the Subcommittee, I am Joseph A. Smith, Jr. I am North Carolina Commissioner of Banks and Chairman of the Conference of State Bank Supervisors, on whose behalf I am testifying. Thank you very much, as always, for the opportunity.

The members of CSBS and our Federal partners, the FDIC and the Federal Reserve, supervise 73 percent of the banks in the United States, accounting for approximately 30 percent of total banking assets. Our banks are not, as a rule, systemically significant. However, they are locally significant in the markets they serve, which includes virtually all of the United States. State chartered banks provide healthy competition in urban markets and are often the only banks in rural and exurban markets.

While there are pockets of strength in some parts of the country, the majority of my colleagues have characterized banking conditions in their States as, and I quote, "gradually declining." This should be no surprise, given that traditional banks are a reflection of the overall health of the economy.

What cannot be ignored is that the return to health of our largest banks is the direct result of unprecedented, extraordinary efforts by Congress and Federal regulators to ensure their success.

The majority of banks, however, have not been the beneficiaries of this assistance and are experiencing a harshly, harshly procyclical regulatory environment, as required by Federal law. This explains the tale of two industries you are likely hearing from banks in your State versus the news you hear from Wall Street.

What can or should be done about this? My colleagues and I submit that the place to start is with a vision of what we, the industry, policymakers, regulators, and other stakeholders, want the U.S. banking market to look like after the current troubles have subsided. In our view, the desirable outcome is a banking industry that continues to be competitive, with thousands of banks, rather than hundreds or tens, diverse, of banks of various sizes, operating strategies, and customer focuses, and strong, with capital, liquidity, and risk management sufficient to meet the challenges of the marketplace.

This is not an argument for the status quo. In fact, my colleagues and I are in general agreement with our Federal colleagues that our banks have been too concentrated in commercial real estate and too dependent on non-core deposits. Where we sometimes disagree with them is on the severity with which we judge banks in a down market, the result of which is, in our view, to make bad situations worse. I would hasten to add that our disagreements are of degree, not kind. We generally agree with the diagnosis. The treatment is sometimes debatable.

To address the current stress of our banks, CSBS respectfully suggests, one, that on-the-ground supervisors be given greater latitude to assess the condition of banks based on reasonable economic assumptions rather than assumptions of the end of the world.

Two, that clear rules of the road be established for private equity investments and that supervisory applications by strategic investors be expedited once clearly established thresholds have been met.

Three, that the acquisition of distressed banks by healthy banks be expedited and at least considered for capital purchase investments under the TARP program.

Fourth, that troubled banks be allowed to reduce their dependence on brokered deposits in a gradual and orderly way.

And fifth, that Congress seriously consider revisions to the Prompt Corrective Action and Least Cost Resolution provisions of FDICIA, which have limited regulatory discretion in the handling of distressed institutions.

While we don't think that our suggestions will solve all the problems of the banking industry, we do think they can reduce the number of failures and the attendant cost to the Deposit Insurance Fund, which is, let it be remembered, funded by healthy banks. We believe our approach can reduce at least the pace of decline in the commercial real estate market with potential positive effects on the economy and the recovery. Importantly, it can help preserve the diversity of our financial system that is critical to the future health and even viability of our State and local economies.

Once again, thank you for this opportunity to appear before you. I would be happy to answer any questions you may have. Thank you, sir.

Senator JOHNSON. Thank you, Mr. Smith.

Mr. Candon.

**STATEMENT OF THOMAS J. CANDON, DEPUTY COMMISSIONER,  
VERMONT DEPARTMENT OF BANKING, INSURANCE, SECURITIES,  
AND HEALTH CARE ADMINISTRATION, ON BEHALF OF  
THE NATIONAL ASSOCIATION OF STATE CREDIT UNION SUPERVISORS**

Mr. CANDON. Honorable Chairman Johnson, Ranking Member Crapo, and members of the Subcommittee, thank you for the opportunity to testify. I am the Deputy Commissioner of Banking and Securities for the Vermont Department of Banking, Insurance, Securities, and Health Care Administration. I appear on behalf of the State Credit Union Regulators as Chairman of NASCUS. Today, I will share information on the conditions of State credit unions and areas for reform.

Like all financial institutions, State credit unions have been adversely affected by the current economy. However, at this point, State natural person credit unions remain generally healthy and continue to serve the needs of their members and their communities. For the most part, natural person credit unions did not engage in many of the practices that precipitated the current market downturn. However, we have several issues to bring to your attention about the impact of the economy and the need for capital options for credit unions.

State regulators remain concerned about unemployment and its effects on credit union members' ability to meet their obligations. We also see increases in delinquencies and charge-offs as well as pressure on earnings, especially in smaller State credit unions. Although loan delinquency and net charge-offs have increased, State regulators indicate that the levels remain manageable.

In response to this trend, regulators are increasing their oversight of consumer credit products, including auto loans, credit cards, real estate and home equity loans. State regulators are also closely monitoring member business lending in credit unions. Some States, including my home State of Vermont, have not experienced the fallout from commercial real estate or subprime lending because State credit unions do not engage in those activities. State regulators continue to encourage credit unions to exercise sound underwriting practices, proper risk management, and due diligence, as these are the practices that have kept credit unions healthier through the economic downturn.

In anticipation of prolonged economic problems, State regulators will closely monitor both lending and investment activities. State regulators also emphasize strong governance standards at the credit union board level. We will continue close supervision through off-site monitoring and onsite examinations and visitations. The growing trend toward consolidation is on the minds of State regulators as credit union mergers continue to occur, both voluntarily and for regulatory purposes. As economic pressures continue, finding suitable merger partners may become more difficult.

In response to your question about capital needs, access to capital for credit unions is critical. Unlike other financial institutions, credit union access to capital is limited to reserves and retained earnings. State regulators recommend capital raising options for all

credit unions. Access to supplemental capital will enable credit unions to respond proactively to changing market conditions, thereby strengthening safety and soundness and providing a buffer for the Credit Union's Share Insurance Fund.

It is NASCUS's studied belief that a change to the Federal law could provide this valuable tool to credit unions without altering their nonprofit and cooperative structure. Supplemental capital will not be appropriate for every credit union nor would every credit union need access to supplemental capital. However, the option should be available.

State regulators are also concerned about the impact of corporate credit union losses on natural person credit unions. Given the severity of the losses, it is clear that enhanced regulatory standards for capital, governance, and risk management are necessary. State regulators are working with the NCUA to ensure the safety and soundness of corporate credit unions and to mitigate future risk.

Last, I would like to emphasize the value of the dual regulatory system. State regulators have demonstrated the importance of local supervision of State-chartered institutions and the value of the dual regulatory system. State regulators have always emphasized consumer protection along with safety and soundness as an important part of their mission and accountability to Governors and State legislatures. Further, State regulators have the expertise to identify areas of risk and take enforcement actions where necessary. As regulatory modernization efforts are considered by the Senate Banking Committee, we encourage you to retain State supervision and reaffirm State authority.

NASCUS and State regulators appreciate the opportunity to testify today. I will be pleased to respond to any questions that you have. Thank you, Mr. Chairman.

Senator JOHNSON. Thank you, Mr. Candon.

Let us put 7 minutes on the clock for each member to ask questions of our witnesses.

Ms. Bair, so far, 98 institutions have failed this year and the FDIC's watch list has grown to 416 institutions. How many more of the troubled institutions do you anticipate will fail? Is the FDIC staffed up to deal with an increase in failures?

Ms. BAIR. Mr. Chairman, thank you for asking that question. There will be more failures. We do not make our failure projections public, but failures will continue at a pretty good pace this year and next. We think we will have about \$100 billion in losses over a 5-year period starting at the beginning of 2009. Twenty-five billion of that has already been realized from failures this year, and we have already reserved for another \$32 billion as of the end of the second quarter.

We are ready for this, though. We have been prepared for some time. We started staffing up in 2007, especially in our receivership and resolution staff, but also beefing up our examination staff. We have 6,300 staff on board now. That number will likely go to 7,000. We also have a significant roster of consultants that we use to help with bank closings as well as asset valuations, asset management, and asset marketing. The FDIC really is designed for this type of activity. We can expand very quickly and then contract very quickly. A lot of our hires are temporary 2-year hires.

Overall, we have got a very good track record. These closings have been seamless. Through using loss share, we have been able to, more often than not, do a whole bank transaction. So another bank that serves that same community acquires both the deposits and the assets, which is good for bank customers. Frequently, the depositors are also the borrowers at the bank.

Overall, it has been handled well. I think the staff have made a tremendous effort. We are well staffed and very much prepared for this.

Senator JOHNSON. Governor Tarullo, there has been much concern raised that commercial real estate is the next problem area for financial institutions. What are the differences between the concerns over commercial real estate and the problems we experienced last year with mortgages?

Mr. TARULLO. Senator, other than the fact that each presents a significant and troubled portfolio of assets for financial institutions, I think there are some salient differences.

First, and I think of particular interest to many Members of this Committee, the places in which the mortgages are relatively concentrated do vary. As I noted in my opening statement, although large financial institutions certainly do have CRA exposures on their books, proportionately speaking the exposures are to a much more significant extent on the books of smaller and regional institutions, and oftentimes—not always, but oftentimes, those exposures are geographically concentrated. You have a small bank that tends to lend in a fairly small area. If the commercial real estate market there goes bad, then there is a problem. So, that is number one.

Number two, in commercial real estate, generally speaking you don't have a 30-year fixed mortgage, as you do with residential mortgages. Instead, you have loans that need to be rolled over as a project proceeds or as a completed project is paid down, and that means you have a refinancing problem. So this year and next, we have got about \$500 billion each year that is going to need to be refinanced and that creates a set of challenges that are perhaps no more serious than, but different from, the case with residential mortgages.

Third, I would say that while there is some similarity, there are some different ways in which the situation plays out. We had subprime mortgages. We had Alt-A mortgages, we had prime mortgages, which as you know, Senator, presented ultimately the same set of problems, but at different times. In the commercial real estate arena, we have got very different kinds of lending, and there is an important distinction between construction and development loans, where essentially the builder is just starting to put something on the property, on the one hand, and so-called income-producing properties, a completed hotel or a multi-unit residential structure, where there is an income stream.

The most serious problems are going to be in the former category, with the construction and development loans, which have no income stream. You are going to have problems in the second category, but that is something you can at least try to work with in some cases.

Senator JOHNSON. Ms. Matz, I know that the NCUA is currently in the process of finalizing new rules for its corporate credit unions. Are you considering changes regarding the concentration of risks that corporate credit unions can have?

Ms. MATZ. Thank you for asking that question. As I think you are aware, when I was on the NCUA Board in 2002, I was the lone member who voted against the corporate rule at that time because I felt it didn't provide adequate parameters on investment authority and concentration of risk. So, we won't make that mistake again.

At our Board meeting in November, we will take up the proposed corporate rule and we will address the riskiest area, which we consider the investment authority. We will set limits on the types of securities and the concentration of securities that corporates can invest in. We will address capital. We will have stringent requirements for capital retention that will be comparable to Basel I. We will set requirements for asset liability management so that asset cash-flow and liability cash-flows match. And we will have new governance rules, which are not included in the current regulation. So, I believe we will address the issues that led to the problems we are having today.

Senator JOHNSON. Ms. Bair, do you have any concerns about smaller institutions having risk concentrated in one product area or one geographic area?

Ms. BAIR. Getting back to some of the regulatory reform issues that this Committee will be looking at, I think the community banking sector is very important to our economy and very important to our country. I do worry that because of competitive pressures and uneven playing fields, that they have become highly concentrated in commercial real estate loans and small business lending. Those are their niche areas where they have been able to hold ground against the larger banks as well as the shadow sector. I would like to see them be able to diversify their balance sheet, especially in consumer retail, and get back into providing those financial services. So, I do think that this is important.

But in the near term, clearly, there is a lot of commercial real estate on the books of smaller banks. For the most part, they have managed those exposures well. Some, though, are more distressed than others, and clearly, commercial real estate will be a bigger driver of bank failures going forward.

Senator JOHNSON. Senator Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman.

There are a lot of issues that I would like to explore with this panel, but in my first round, at least here, I want to focus on one, and that is, as I think everybody knows, amidst all the issues that we are dealing with here in Congress, one of them, one of the big ones that I expect we will be dealing with more aggressively soon is the overall financial regulatory restructuring that is being proposed.

I would like to get the opinion of the members of the panel with regard to their thoughts on one aspect of that, and that is the proposal that we consolidate all of the banking regulators into one single Federal banking regulatory agency. I don't know that in my 7

minutes I can get through the whole panel, but let us start with you, Ms. Bair.

Ms. BAIR. Thank you, Senator. My position is out there already. We have not liked this idea. The proposal was pushed in 2006 as an FSA-type model, although I know some of the ideas kicked around were a little different from FSA. We fear regulatory consolidation regardless of where it might be located. Clearly there may be some room for streamlining of bank regulation, but concentrating all the power with a single entity is a tremendous bet. If they do the right thing, then maybe we are OK. But if they do the wrong thing, we are really in the soup.

In particular, taking the FDIC out of the supervisory process and the process of setting the capital standards and the underwriting standards, *et cetera*, would go in a different direction from where this Committee would like to go. We are not perfect by any means, but we are a conservative voice. Since we have a tremendous exposure as deposit insurer, our record shows that we are conservative when it comes to supervisory measures.

Being an examiner also gives us a constant stream of information about banking trends, which helps us a lot in setting insurance premiums as well as helping our examiners prepare for working with the State regulators or the Federal chartering regulators when banks get into trouble and have to be wound down and put into resolution.

So, we are very concerned about it. We fear it would weaken the FDIC. It could overall weaken banking regulation.

Senator CRAPO. Thank you.

Mr. Dugan, do you have an opinion on this?

Mr. DUGAN. I do. As we testified here on this very subject about a month ago, I can't sit here and defend four separate Federal banking regulators and a separate holding company regulator. We don't have four food and drug agencies and the like. But I do think, on the other hand, if you moved all the way to one single regulator, you get some benefits in efficiency, but you also get some tradeoffs of the kind that Chairman Bair just described, that if you take certain regulators out of their current supervision, they don't keep their hand in it to the extent that they otherwise would.

And so if you asked me, do I think that we can have more consolidation in the industry, I would say yes. But I would say to be careful. Each step along way, the trade-offs become more pronounced.

Senator CRAPO. Thank you.

Mr. Tarullo, I want to hold off on you yet, because I want to get the perspective of the State Bank Supervisors from Mr. Smith before my time runs out, and then we will come back if we can.

Mr. SMITH. We oppose it from the tops of our heads to the bottoms of our feet—

[Laughter.]

Mr. SMITH.—for the reasons that Chairman Bair has stated, and we believe honestly and truly that a single regulator would weaken or destroy the dual banking system and think that would be a bad thing for America.

Senator CRAPO. All right. Thank you.

Mr. Tarullo.

Mr. TARULLO. Thank you, Senator. So, let me echo the approach that Comptroller Dugan took, which is to say in any proposal, you are going to have some benefits and you are going to have some costs. I think on this one, I would just add two points, or reiterate one point and make an additional point. The reiteration is the point that Chairman Bair made, which is you lose something, and part of what you lose here is the insight that the Federal Deposit insurer or the monetary policy authority gets into the functioning of the banking system by being an examiner, and that is something that does require experience. It does require actually being involved in the guts of examination and supervision.

Second, in terms of priorities, again, it is certainly debatable what model you want to have, and a lot of countries around the world have debated it, but I don't think that the existence of multiple banking regulators at the Federal level played a particularly important role in the genesis of this crisis. There are a lot of problems. There was a lot of blame to go around for a lot of reasons. But I don't think it was the coexistence of the FDIC and the Comptroller that was a particular problem here.

Senator CRAPO. Thank you.

Ms. Matz.

Ms. MATZ. The Administration proposal kept NCUA as an independent regulator, and we support that.

Senator CRAPO. So you are willing to stick with that?

Ms. MATZ. Yes.

Senator CRAPO. All right.

Mr. Ward.

Mr. WARD. We think multiple viewpoints among the regulators fosters better decisionmaking and is a very healthy thing. We have a tremendous working relationship with the FDIC. We don't always see eye-to-eye on our institutions, but that is a very healthy pressure among our examiners.

Senator CRAPO. All right.

Mr. Candon.

Mr. CANDON. Thank you, Senator. I would second what Chairman Matz responded to your question. The President had recommended the NCUA be left out of the consolidation. Thank you.

Senator CRAPO. All right. Thank you.

Let me go back to you, Mr. Smith. As you indicated, you are very opposed to the consolidation. Mr. Dugan indicated that although one single regulator wouldn't necessarily be the way you—if I am correctly representing you—would go, that we don't really need four or five. What are your thoughts about that? Is there room for some consolidation?

Mr. SMITH. Well, far be it from we poor State regulators to tell the Federal folks what to do with your territory. I think there could be consolidation, I guess, among the Federal agencies, but I will say we believe, and I agree with Governor Tarullo and Chairman Bair, that our relationships that we have with the Fed and the FDIC work very well, and we also agree with the Obama administration's proposal to leave that alone and unimpaired.

Senator CRAPO. All right. Thank you.

I am going to shift gears and come back to you, Ms. Bair, and this really is a question on the resolution authority and the process

of resolution when a bank is seized or declared a failed bank. I recently have had a couple of those experiences in Idaho and I have had those who have been borrowers from the bank contact me to indicate that they really are not happy with the resolution authority.

Just to give you an example, there are some who have contacted me who have indicated that they were in a position to repay much more than their particular loan ended up being auctioned for by the FDIC and that in that process, what happened was they were put in a bad situation because the loan was auctioned. The person or entity that purchased the loan immediately called it due. They were then put in a bind. The FDIC got 30 or 40 cents on the dollar. The one who really gained was the person who bought it at auction. The taxpayer didn't win. The FDIC didn't win. The borrower didn't win. And the bank didn't win.

What is your reaction to that kind of an inquiry?

Ms. BAIR. I do hear this a lot and I look into it when I hear it. I don't know what the specific situation is you referred to, but I have found that, frequently, what has happened is a borrower may be wanting to get a bit of a deal. We are subject to least cost resolution, and although some reasonable price could perhaps be considered that would be better than what we would get if we auctioned the pool of loans off, other times, we have been approached by borrowers who just want a really low price for themselves—50 or 60 cents on the dollar or lower. That is not something that we can justify under least cost.

Also, sometimes they will say they want to buy their loan out, but they don't have the cash resources to do it. So, when we ask for verification of their financial resources or who their new lender will be, they are not able to provide that. Sometimes the truth here is a bit more difficult than it may appear initially.

Our policy is to offer borrowers the ability to buy back their loan if they offer a reasonable price and have the financial capability to do that. At my request, our ombudsman put together a Borrower Bill of Rights, which is on our website, and I would be happy to share with you and your staff, so that borrowers understand our process and what they can do.

If the prices go too low, there is a question about least cost to our Fund, also. It is very difficult, given the volume that we have to do, to individually sell each of these loans, and at some point, you just have to market them in bulk. But, if a borrower is offering a reasonable price, has the financial capability and can show they can buy the loan back, we will sit down and accommodate them.

Senator CRAPO. Thank you very much.

Senator JOHNSON. Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair.

Chairman Bair, I wanted to go back to your testimony. You mentioned that you do not share your forecasts on the number of banks that might fail, and I can certainly understand that. Are you able to give us an order of magnitude? For example, in 2008 we had 25 banks failing; in 2009, it is up to just shy of 100. Do we expect the next year to look more like 2008 or more like 2009?

Ms. BAIR. It will look more like 2009.

Senator MERKLEY. More like 2009. Thank you.

Chairman, community banks hold 11 percent of the industry assets, but 38 percent of small business and small farm loans. Since small business is a key driver of the economic recovery, would it be fair to say that recapitalizing community banks would be a smart way to get lending flowing back to Main Street?

Ms. BAIR. We have been in discussions with Treasury for some time about making the TARP program work better for community banks. The 25 largest domestic institutions that qualified 100 percent participation in the TARP program. For the smaller institutions, it is about 9 percent. So, clearly, we think the program could be working better for the smaller institutions.

In preparation for this testimony, I went back to look at small loan balances of larger and smaller institutions. Even though year over year, as of June 30th, small loan balances were down 1.9 percent overall, for the community banks, those less than \$1 billion in assets, loan balances were up slightly over 2 percent. So community banks look like they are still in there trying to make these loans, but some additional capital support would be really helpful.

Senator MERKLEY. Could you give us some sense of what that might look like?

Ms. BAIR. While this is Treasury's program, an idea that has been discussed is a dollar-for-dollar matching program. Right now the viability standard puts a lot of pressure on our examiners to try to identify the institutions that are, without the additional money, viable. Frankly, the ones that are clearly viable without the money do not want it. It is really the institutions where the decision is less clear that will come to us. But many times they are worthy, we think, and can raise significant private capital. So we have suggested a dollar-for-dollar matching program. This would provide an additional validation of viability from the market. The market may be willing to put additional capital in, help provide some additional protection to Treasury, and perhaps make the terms a little less onerous. This could perhaps be tied to increasing small business loans.

So I think there are—and I know Senator Warner has had some thoughts on this—ways to approach this that would make the program work better for the smaller banks.

Senator MERKLEY. Thank you. And would this have—did I see a hand raised there? Oh, no. Just scratching. OK.

[Laughter.]

Senator MERKLEY. At hearings and auctions, you have to be very careful how you are moving.

In terms of the impact upon our commercial real estate, what are things that we can do to assist our community banks and, therefore, our small commercial real estate markets as we face a lot of balloon loans that will be coming due in the couple years ahead?

Ms. BAIR. I think it is a problem. We are encouraging banks to work to restructure these loans. If they have a creditworthy borrower, a restructured loan with a lower payment, can make that a performing loan. We want them to do that. That preserves value, just the way it does with home mortgages. It is the same principle with commercial real estate. And we are in the process of finalizing guidance right now that makes that very clear and provides exam-

ples to our examiners of what we consider prudent workouts. This should be encouraged, not criticized.

In the near term that is the best we can do. Of course, bringing back the securitization market for commercial mortgages is going to be much more difficult. I know the Federal Reserve Board has been working on that, as has Treasury. But that is going to be a longer haul.

Senator MERKLEY. One of the things I keep hearing back home in Oregon is from owners who have fully performed on their loans, but as their loans come up to be rolled over, the estimate of the value of their property has dropped enough that the bank is very nervous about reissuing it.

Is there any form of guarantee that the Federal Government could do for, if you will, the difference in the drop in equity on loans that have been performing for the entire period to enable those banks to be able to meet the regulators' requirements and at the same time be able to reissue those loans so we do not freeze up or seize up in those commercial markets?

Ms. BAIR. I am unaware of any current programs that would do that. That is a new idea. I would just like to think about it. Others might want to have a comment.

Senator MERKLEY. All right. Thank you very much.

Senator JOHNSON. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

This is for the primary regulators, though others may want to answer this question also. Do you have enough power to restrict the activities and risk taking of banks and holding companies? Do not be bashful.

[Laughter.]

Senator BUNNING. Usually you are not.

Ms. BAIR. Well, for holding companies, no. I would defer to the holding company regulators down the aisle here. We have no authority over holding companies.

Senator BUNNING. Well, you do have a lot of banks, though.

Ms. BAIR. That we do.

Mr. DUGAN. For the banks themselves, I think we do have adequate powers to restrict activities that we think are unsafe and unsound, but not the holding companies. Just the bank and the direct subsidiaries of the banks.

Senator BUNNING. Fed?

Mr. TARULLO. Senator, with respect to banks, I think on an ongoing basis, the answer is yes, although when it comes to closing an institution, we do not have the breadth of authority that the OCC or the FDIC has for the banks for which they are the primary Federal regulators.

With respect to holding companies, there is, as you know, some lingering ambiguity from the Gramm-Leach-Bliley Act as to the reach of Federal Reserve authority over regulated subsidiaries.

Senator BUNNING. On in the Fed's mind.

Mr. TARULLO. Well, Senator, I think it is in a number of people's minds, and as we have said before, we would welcome clarification of that in any legislation that—

Senator BUNNING. We clarified that in 1994, but that has not been interpreted by the Fed.

Mr. TARULLO. If you look at the statute and the legislative history, there was some sense that there was supposed to be deference to functional regulators of subsidiaries.

Senator BUNNING. Correct. And you were powered to write the regs and did not.

Mr. TARULLO. Well, Senator, as you know, I cannot—

Senator BUNNING. I am not going to get into that dispute with you.

Mr. TARULLO. OK. So let me just leave it there, though, with—I think with respect to the bank—

Senator BUNNING. Ms. Bair, would you like to comment about your ability to regulate the banks with the power that you now have?

Ms. BAIR. There may be certain detailed areas, for instance, back-up authority, where through our good working relationships, we are able to effectively use it. Although, if we ever needed to bring an enforcement action with back-up authority, it is a fairly protracted process.

Going forward as part of reform, we would like to see greater consistency in standards, particularly capital standards, between bank holding companies and banks. We think bank holding companies should be a source of strength for banks and should at least have as strong a capital level and quality of capital as the banks. There are a few areas where we would like to see some improvements, and that is not a secret. My fellow regulators know of our views on that.

But, overall, I think the powers for both banks and bank holding companies have been pretty adequate, and perhaps there are areas where we could have used them better. Again, in terms of reform, looking at the disparities between the bank and the non-bank sector cannot be emphasized enough. As we try to improve the robust nature and quality of bank and bank holding company regulation, if there is still a giant shadow sector out there that is basically beyond the reach of meaningful prudential oversight, you are going to have the same problem that drove this crisis. Higher-risk activity will go into that shadow sector.

Senator BUNNING. That is basically what I am asking. In other words, if there is a bank either that you are in charge of or the OCC or the holding companies, and they are doing things that you know that get them in trouble, can you stop it?

Ms. BAIR. Yes.

Mr. DUGAN. Yes.

Senator BUNNING. You have enough power to stop it.

Mr. DUGAN. Yes.

Ms. BAIR. Yes.

Senator BUNNING. The Fed also.

Mr. TARULLO. Ultimately, yes.

Senator BUNNING. Ultimately. OK.

Why should firms that are supported by taxpayers' guarantees and insured deposits and access to Fed windows be allowed to make huge profits on their own trading? What restrictions have you put on these activities?

Mr. TARULLO. Well, Senator, the restrictions that would apply to the activities of subsidiaries of financial holding companies or bank

holding companies would be the capital liquidity and risk management restraints that would apply to any holding company, which is to say there is substantially less leverage permitted for such a company today than may have been the case before it became a bank holding company. And so that puts non-trivial constraints on what they can do.

But under the structure of Gramm-Leach-Bliley, they are permitted to have subsidiaries that do engage in these trading activities so long as they conform to the capital and liquidity requirements.

Senator BUNNING. If I have heard it once, I have heard it ten times, from not only the Secretary of the Treasury but the head of the Federal Reserve, that there are institutions in this country that are too big to fail. Too big to fail.

Now, it is up to the people sitting at this desk or these all gathered here to stop that. I need suggestions.

Mr. TARULLO. Well, I think Chairman Bair alluded earlier to something with which I certainly agree, that we need to have capital and other requirements that take full account of the additional risk that may be created by very large institutions.

Senator BUNNING. The AIGs of the world.

Mr. TARULLO. The AIGs of the world for certain, Senator.

Senator BUNNING. OK.

Ms. BAIR. Well, and as we have said before, we do think—

Senator BUNNING. I wanted to ask you one more question before you get away since I only have 25 seconds. Right now the FDIC is considering forcing banks to prepay their assessments for the next 3 years. I have two questions about this.

First, earlier this year you asked Congress for a higher credit line at Treasury, and we gave it to you. Why didn't you use that credit line? Is it really because Treasury has no room under the debt ceiling?

Ms. BAIR. No, that is not the reason. We view the credit line as being there for emergencies for unexpected loss. Particularly, earlier this year, we thought it was very urgent to make sure we had plenty of breathing room there.

But what we are talking about with the prepaid assessments for losses is different.

Senator BUNNING. There is only one problem with that. The banks that have not put you in the problem are the very banks that are going to get assessed.

Ms. BAIR. Well, the prepaid assessment is different from the special assessment.

Senator BUNNING. I understand that, but they are the same banks.

Ms. BAIR. They are the same banks, and at the end of the day, that is how insurance works. The lower risk banks end up generally to some level subsidizing the higher risk banks.

Senator BUNNING. Let me finish this. Second, will that prepaid payment be enough to cover all the losses? Or will you have to raise more money again in the future?

Ms. BAIR. Based on our current projections, that will be more than ample. But, again, a lot of this depends on the economy. So

if the economy has unforeseen troubles, that could be different. But based on current projections this year, yes.

Senator BUNNING. I am only an economist, so I would tell you you've got a problem.

Ms. BAIR. OK.

Senator JOHNSON. Senator Tester.

Senator TESTER. Thank you, Mr. Chairman.

I want to step back a little bit, Chairwoman Bair, to what Senator Crapo was—just very quickly. You said that when it came to buying back loans per se, the borrowers were often given a chance to buy those loans back. How is the value of those determined?

Ms. BAIR. It is difficult. Certainly if they just want to buy their loan back at what they owe—

Senator TESTER. At 100 percent—

Ms. BAIR. Right. Then that would be great. We would welcome that. Again, they need to demonstrate they actually have the ability to do that.

If they want to have a discount, a couple of issues arise. If they have the capability to keep paying on the loans, if the loan is performing, the question becomes whether we should negotiate a deal for a borrower that is otherwise fully capable of making repayment on the loan.

Even then, we do provide some flexibility, but we are required to pursue least-cost resolution, which means we need to get the best price for all the loans that we inherit in a receivership. Frequently just trying to do them one by one is not administratively practical and would get generally lower prices than if you market them all in bulk.

Senator TESTER. Right. So seldom do you peel one loan out and sell it.

Ms. BAIR. I can get you numbers of how often it happens. But, again, if they want to pay it off completely, we welcome that. Even below that, we will work with them. But frequently they are not able to. They say they want to, but they are not able to.

Senator TESTER. OK. The deposit insurance fund, we have about what you are going to do in the short term. The Senator from Kentucky talked a little bit about the long term. Do you plan on permanently raising the rates on the long term, over the long term, to handle solvency in that fund?

Ms. BAIR. Right. Well, we would bump up the rates by three basis points beginning in 2011. That would bring the base rate up to 15 to 19 basis points for most banks. That is still well below the 23 basis points that was assessed on the industry during the S&L days. So as the economy recovers, as the banking sector heals, as our losses go down, we will constantly reassess that. We will stay within the range that Congress has prescribed, though I think perhaps Congress may want to think about giving us additional flexibility to build the fund up in good times. It is something that will be continuously monitored, but as of our projections now, we believe with the three-basis-point bump-up in 2011, we will be able to reestablish the fund and get it back to 1.15 within 8 years, which is what Congress has asked us to do.

Senator TESTER. OK. Is there a point in time in which you permanently raise their rates?

Ms. BAIR. No, I do not think so. When the FDIC Board sets risk-based assessments, consideration is given to the risks in the banking system and the needs of the DIF to cover projected losses.

Senator TESTER. This can be for Mr. Tarullo or Mr. Dugan. Actually, you can answer it, too, Ms. Bair. But there has been a lot of discussion about the make-up of systemic risk regulators and the powers entrusted to that body. I guess the question is—and, Mr. Smith, you may want to jump in on this, too. Do you believe there is a value in allowing representatives from State regulators to participate in the systemic risk regulator?

Mr. TARULLO. Senator, I think it depends, as it often does, on how one conceives of what a systemic risk regulator is doing. I think there have been discrete functions which sometimes get lumped under that umbrella.

What we have thought of in terms of the Federal Reserve's role is consolidated supervision of systemically important institutions, and so it is very much a supervisory function, making sure that you are covering everybody who could pose a risk to the system. And in that context, of course, if there is a State bank, the State banking supervisor absolutely should be participating.

A second context is thinking in terms of collective efforts to identify emerging risks and figure out what can be done, and there I think it is profitable to have people who see things from different parts of the financial system participating.

Senator TESTER. OK. If there is a council of regulators, should the State regulators be represented?

Mr. TARULLO. It depends, I think, Senator, on the functions of that council. If it is a matter of analysis and scrutiny and trying to coordinate, then I think there is a good case to be made for it. If it is a matter of actually making some binding Federal law decisions, then it probably is not.

Senator TESTER. OK. Sheila, I have heard from banks that the FDIC is becoming more and more concerned about AG loans. Is that true? And I guess the question is why, even though the markets are in the tank. That probably answers it.

Ms. BAIR. Not that I am aware of, Senator. We have been monitoring it for some time, but this is the second time in a week that somebody has asked for that so maybe I will probe a little more.

[Laughter.]

Ms. BAIR. But not that I am aware of, no. We are monitoring this.

Senator TESTER. I appreciate that.

Ms. BAIR. Senator, could I just go back to the borrower question?

Senator TESTER. Go ahead. Sure.

Ms. BAIR. One of the reasons we do whole bank transactions with loss share is if we can sell the whole bank, we do not run into this problem. A new bank gets those loans, services those loans, and it preserves the relationship with the borrower. It is only where we cannot do the whole bank transaction that we get into this problem.

Senator TESTER. OK. Well, I understand. You are kind of between a rock and a hard place, quite honestly, because it does not seem quite fair to let somebody else make a bunch of dough on it when you could cut that—anyway, I do not want to go there.

Mr. Tarullo, there was a front-page story in the Wall Street Journal—we are going down a little different avenue here now—that talked about workers at the top 23 investment banks, hedge funds, asset managers, stock and commodity exchanges can expect to earn even more this year than they did in 2007, which was the peak year. I guess the question is, getting right to it: Are we returning to the attitude of greed that really occurred before the economic downturn—and that is being kind—in 2008?

Mr. TARULLO. I do not know, Senator, that I can comment on what everybody else out there is thinking. I guess here is what I would say:

First, I do have concerns sometimes in a variety of contexts that people in general, including in financial institutions, have not come to grips with the fact that things have changed. Things have changed in a basic way, and I think the presence of many of us at this table today promises that things are going to change more. That means business models. That means the way of assessing risk. That means how you run your institution.

Second, with respect to the story itself, I do think that is a bit speculative, it is a bit projecting what is about to happen, and I think we should watch and see what, in fact, does happen and what, in fact, these firms are doing with their capital standards, which is ultimately of great importance to us.

Senator TESTER. OK. If I might, Mr. Chairman, you know what the unemployment numbers.

Mr. TARULLO. I do.

Senator TESTER. And there are folks in many of these companies that are up here right now lobbying to make sure there is no or very, very little regulation on a lot of the incidences that created the economic collapse.

Do you find that some—because they are making a ton of dough. Do you find that somewhat ironic, troublesome?

Mr. TARULLO. What I hope is that this Committee and the Congress as a whole will pass a strong set of reforms, no matter what other people out there are saying.

Senator TESTER. OK. Thank you very much.

Thank you, Mr. Chairman.

Senator JOHNSON. Senator Gregg.

Senator GREGG. Thank you, Mr. Chairman, and I want to thank the panel for their excellent testimony. It has been most interesting.

First off, I want to congratulate the FDIC for deciding to forward-fund the fees. I think that is the right approach. You do a lot of things right. You have done a lot of things right during this problem.

You did a lot of things right when I was Governor in 1989 in New Hampshire and five of our seven largest banks closed. Mr. Seidman came in and basically was our white knight.

But you did say something that really concerns me, and that is, how you interpret the TARP, this idea that the TARP should be now used as a capital source for a lot of smaller banks that are having problems raising capital. I think all of you basically in your testimony have said we are past the massive systemic risk of a financial meltdown that would have caused a cataclysmic event.

TARP came about because of that massive potential cataclysmic event, and its purpose was to basically stabilize the financial markets and be used in that manner in order to accomplish that. As one of the authors, along with Senator Dodd—we sat through the negotiations of that—I think I am fairly familiar with that purpose. That was the goal. It should not now be used as a piggy bank for housing. It should not be used as a piggy bank for whatever the interest of the day is that can be somehow—it should not have been used for the automobile industry, and it really should not be used in order to have a continuum of capital available to smaller banks who have problems, in my opinion, because then you are just going to set up a new national program which will essentially undermine the forces of the market, and that would be a mistake.

I did hear you say, Madam Chairman, that you expect \$100 billion in losses. Is that a net number? Or do you expect to recoup some percentage of that?

Ms. BAIR. No, that is what we project our losses to be over the next 5 years.

Senator GREGG. So that is a net number after recoupment?

Ms. BAIR. Yes.

Senator GREGG. Well, is it—do you expect of that \$100 billion in bad loans to be getting back 30 percent of—

Ms. BAIR. The \$100 billion would be our losses. So let us say we had a 25-percent loss rate on our bank failures so far, so you would be talking about \$400 billion in failed bank assets.

Senator GREGG. Well, OK, so it—

Ms. BAIR. That is since the beginning of 2009, though. And, again, a lot of that has already been realized and reserved for.

Senator GREGG. And you have got \$64 billion, you said, or something, that has been realized and reserved against, so you have got about—

Ms. BAIR. That is right, yes.

Senator GREGG.—\$36 billion to go. OK.

I have got a philosophical question here. If we look at this problem—granted, commercial real estate is now the problem, but commercial real estate, as I understand it from your testimony, is not—it is a serious problem. It is just not a systemic event. It is not going to cause a meltdown of our industries—of our financial industry. It may impact rather significantly especially the middle-sized regional banks and some of the smaller banks, but it is not systemic.

The systemic event was caused in large part in the banking industry by the primary residence lending activity—subprime, Alt-A, and regular loans. And all I heard about as the proposals for getting at this is regulatory upon regulatory layers to try to figure out a way to basically protect ourselves from having that type of excess in this arena occur again.

But when you get down to it, it is all about underwriting. I mean, the bottom line is this is about underwriting. It is about somebody lent to somebody who either did not have the wherewithal to pay it back or who had an asset which was not worth what they lent on that asset. And probably the person who lent it did not really care because they were just getting the fee and they were going to sell it into the securitized market anyway.

So if you really want to get at this issue, wouldn't it be more logical and simpler and—it is not the whole solution. Clearly, there has to be regulatory reform. But shouldn't we look at the issue of having different underwriting standards, both of which the OCC and the FDIC have the authority over, in the area of what percentage to asset can you lend? You know, do you have to have 90 percent, 80 percent? Shouldn't we have an underwriting standard that says you either get—that there is recourse? Shouldn't we have underwriting standards that gives you the opportunity to either have an 80-percent or 90-percent choice or a covered loan, something like that? Isn't that really a simpler way from a standpoint of not having—granted, it would chill the ability to get a house because people who could not afford to buy the house and could not afford to pay the loan back probably would not be able to get the loan. But isn't that where we should really start this exercise, with recourse and 80 percent or 90 percent equity—10, 20 percent equity value and/or, alternatively, covered funds? I would ask everybody who actually is on the front lines of lending today.

Ms. BAIR. Certainly underwriting is key, but poor underwriting is not necessarily the driver of future losses now. We are seeing loans go bad now that were good when they were made. But because of the economy—because people are losing their jobs, or retailers are having to close, or hotels cannot fill up—those loans are going bad.

The economic dynamic is kicking in in terms of the credit distress that we are increasingly seeing on bank balance sheets.

You are right, the subprime mortgage mess got started with very weak underwriting. It started in the non-bank sector. It spilled back into the banking sector. I think all of us wish we had acted sooner, but we did move to tighten underwriting standards, and strongly encouraged the Federal Reserve Board to impose rules across the board for both banks and non-banks. This, again, is the reason why you need to make sure that the stronger underwriting standards going forward apply to both banks and non-banks.

Senator GREGG. Well, what should those underwriting standards be?

Ms. BAIR. You should have to document income. You should do teaser-rate underwriting. The Federal Reserve Board has put a lot of these in effect now under the HOEPA rules. You have to document income. You cannot do payment shock loans. You have got to make sure the borrower can repay the loan if it is an adjustable rate mortgage that resets. These are just common-sense underwriting principles that have applied to banks for a long time.

Senator GREGG. Or should there be recourse?

Ms. BAIR. That has been a prerogative of the States. Some mortgage lending is recourse, some is non-recourse, depending on the State.

Senator GREGG. Should there be a requirement that you cannot lend to 100 percent of value?

Ms. BAIR. I think there is a strong correlation with loan-to-value ratios (LTVs). We actually recognize that in our capital standards that we are working on now. We would require a much higher risk weighting of loans which have high LTVs. So through capital charges, we are recognizing and trying to incent lower LTVs.

Senator GREGG. I am running out of time unfortunately.

Mr. DUGAN. Senator, I think that you are onto a very important point that I do not think has gotten the same kind of attention that it deserved and what got us here in the mortgage market, not just in subprime. I think we lost our way as a country in terms of some of our basic underwriting standards on loan-to-value and on stated income, and I think it is worth exploring having a more common set of minimum underwriting standards that apply across the board with more specificity than what we have today, which I think is what you are suggesting.

Mr. TARULLO. Senator, I think leverage on the expectation of rising asset prices was at the heart of the subprime problem, and indeed, it is at the heart of some of the other problems that we see, to some degree, in commercial real estate, as well. So, I would try to reinforce any instinct you have to push people toward better underwriting standards, and we, as the Chairman noted, are trying to do that ourselves.

Mr. SMITH. I would only add, Senator, that in the most successful period I know of in home lending in the United States, there were mainly two, maybe three varieties of loans generally in the underwriting standards world, as you say. There was a requirement of a downpayment, for standard documentation, and the people that made the loans kept them. And on the basis of that lending experience, we projected—the magicians on Wall Street did projections about the loans that weren't like that.

So, I think there is—as you point out, the issue there is the issue of access to housing, and that is what it is. There is no free lunch and no easy answer.

Senator GREGG. Thank you. Thank you very much for your testimony.

Senator JOHNSON. Senator Bennet.

Senator BENNET. Thank you, Mr. Chairman, and I would also like to thank the panel for your excellent testimony.

Every weekend when I go home to Colorado, what I hear from small businesses is they have no access to capital, no access to credit, and we are in this, as the panel has talked about, in this remarkably difficult period where, on the one hand, the securitized market that blew up or imploded is now gone and has not been replaced, which is probably a good thing from a leverage point of view, but it hasn't been replaced.

On the other hand, we have got this looming commercial real estate issue that is still out there. And sort of caught in between all that are our small businesses who need access to capital in order to grow and in order to deal with the unemployment rate that Senator Tester talked about and sort of this folding back on top of itself.

And I wondered, Mr. Tarullo, you mentioned in your testimony at the beginning your view that maybe some more direct efforts—I think you described it as temporary targeted programs—might be necessary to get our small businesses access to the credit that they need, and I wonder if you could elaborate a little bit more on that, because I suspect you are right. And in addition to that, I would ask to what extent we think the current accounting regimes are

ones that are either helping banks extend credit to small businesses or are intruding on their ability to do that.

Mr. TARULLO. So, Senator, I don't want to step on the prerogatives of the Congress, the Administration, various agencies that may have—

Senator BENNET. You can step on my prerogatives. I—

Mr. TARULLO.—but here is what I think. So what did we as a government, as a country, try to do with residential mortgages—not yet as successfully as I think many people would have wanted? We tried to do something about people losing their homes and to provide some mechanisms, some special mechanisms that would address those issues specifically, even as we all tried to put a foundation under the economy and get it growing again.

And my thought was that something similar probably needs to be done in the small business arena, because I don't think I hear as many of the stories as you do, but I hear enough of them, because I do try to get out and talk to borrowers as well as lenders. So, whether that is trying to streamline SBA lending and make the direct lending possibilities more real, or whether it is a new program which tries to provide guarantees, I don't have a strong view on that and the Federal Reserve certainly has no view on it. But I do think that something targeted is going to be an important complement to the macro, bank regulatory, and TALF efforts that we have.

Senator BENNET. Does anyone else have a view on that? Mr. Smith?

Mr. SMITH. I would say in the absence of the type of a program of the type Governor Tarullo is talking about, it seems to me what clearly is needed is for small and medium-sized banks to clear up their balance sheet problems they have right now. I mean, the problems small businesses have in part are based on the fact that balance sheets have impaired real estate on them that has to be dealt with some way and that they have insufficient capital to make additional loans until that is cleared up. So until we work through—I mean, with all due respect to Senator Gregg, until the real estate, the follow-on problem of the commercial real estate problem for many of our banks is that it clogs up the balance sheets or impairs them in a way they can't make loans.

Senator BENNET. I guess I would ask, Chairman Bair, maybe you or Mr. Smith, to what extent—I mean, I am told that in the early 1980s when we ran into trouble on agriculture, we did some things like stretch out the period of time that assets had to be marked down. And I don't want to tread into this too much, but I wonder whether, given how serious the commercial real estate problem is, whether we are in a position to unclog the assets in a way that puts banks again in a position to be able to lend to small businesses.

Ms. BAIR. You need to be careful, obviously. You want to provide flexibility to try to restructure the loans and accommodate borrowers in a way that preserves value but is fully disclosed. You don't want to defer losses. If the losses are there, they need to be realized. There is this difficult balance. You would not want to go over to the regulatory forbearance situation, which I think did get

us in trouble during the S&L days. So, like anything, it is an important balance.

I wish Senator Gregg was still here, because regarding the capital support for the smaller banks, the smaller banks are disproportionately a source of lending, particularly for small business. That is what they do. They do small business lending. They do commercial real estate. I am not normally an advocate for government support programs, but I do think the tremendous disparities in TARP between the 25 largest banks, with 100 percent participation, and for the smaller banks, less than 9 percent participation has created competitive disparities between large and small institutions—between the too-big-to-fail institutions where funding costs are going down, and the smaller institutions where funding costs are going up.

Again, with a matching program that provides market validation that an institution is viable, markets are more willing to put more capital in. Additional capital could help balance-sheet capacity to enable more of this type of lending by the smaller banks.

Ms. MATZ. Senator, I just wanted to make the point that credit unions make loans to small businesses, or club member business lending, and the average loan is only about \$170,000. So they really are targeted to small businesses. In the current year, the lending is up almost \$2 billion. Last year, it was up \$5 billion. So, *more and more*, credit unions are making *more and more* loans to small businesses.

Senator BENNET. Thank you, Mr. Chairman.

Senator JOHNSON. Senator Corker.

Senator CORKER. Mr. Chairman, thank you, and as always, I thank each of you for your testimony. I always learn something when you are here.

I also wish Senator Gregg was here. I think we share some of the same intuitions and concerns, and while you know I respect the FDIC and your leadership very much, I tend to hear regulators talking about them wanting assistance to the banks that they have liabilities to. I know Chairman Dugan, who I also respect greatly, very much appreciated the TARP assistance to the banks that he regulated so they wouldn't fail, and now you very much would like TARP assistance to the banks that you have depositor worries with. I just hate to hear us move into that mode, and again, I respect you both very, very much and have worked with you on lots of legislation. I do hate hearing that kind of thing.

Chairman Bair, I know you mentioned the underwriting wasn't really the issue because loans were underwritten well in the past today are problems. But again, I think that was driven by the fact that we had poor underwriting in the beginning and it created a financial system issue that has really put us into this situation. So, I do think those are very much tied together.

I will have to say that as we have looked at the regulatory reforms, it seems like we are just sort of rearranging the deck chairs. I mean, the issue has been always real estate in modern times. As we have had financial crises, it has always been real estate. I haven't heard anything in the regulatory reform—I know we talk about capital requirements, but the kinds of losses we have had, we would have blown through those capital requirements you all

are talking about very, very quickly. We still would have needed a systemic bailout or some kind of mechanism. So, to me, that is not it.

I know that we talked a little bit gratuitously about maybe we ought to put that in regulation—I mean, in laws. I can't imagine us writing laws up here that talk about what the equity ought to be in homes and those kind of things. You all don't really want us to do that, do you?

So, it seems to me that actually the Fed is supposed to put out that type of guidance, is that correct?

Mr. TARULLO. That is correct, Senator, and we have now, yes.

Senator CORKER. So you are sending out guidance—

Mr. TARULLO. Well, there is—

Senator CORKER.—that says that loans, you have to have 20 percent down payment—

Mr. TARULLO. This is on the consumer protection side. One of the needs to underwrite is to make sure that you are going to make an assessment based on the ability of the borrower to pay, not just on the rising value of the real estate, for example.

Mr. DUGAN. But, Senator, more generally, it is not just the Fed. All of us—

Mr. TARULLO. Right. When it comes to safety and soundness, every regulator—

Senator CORKER. I mean, I think it would be wonderful. Let us face it. In the desire for policymakers to make sure people at every income level led the life of middle-class citizens, we promoted loan making that helped destroy our system. That wasn't the whole picture, but that certainly was a part of it. Are each of you as regulators saying that you are going to put out strong standards that really counter policymakers' desire to make sure that everybody in America has a home and a ham in their pot? Is that basically what you are saying you are going to do, because I think that is the only way, by the way, we are going to keep this from happening again, is it not?

Mr. TARULLO. I think, as Chairman Bair said a little while ago—she didn't say it quite in these words, but what I heard her say was, we have got to worry about problems in the future as well as problems in the past. I do think that the problems with underwriting played a very central, though not the only role, in the financial crisis. I do think we need underwriting standards for residential mortgages and in other areas—

Senator CORKER. And each of you can write those, is that correct?

Mr. DUGAN. Yes.

Senator CORKER. And are each of you going to write standards that are dramatically different from those that got us into the situation? I mean, each of you agreed with Senator Gregg's questions, but I wonder if we are actually going to take action to make that occur.

Ms. BAIR. First of all, I want to clarify, there is plenty of bad underwriting. I want to emphasize that, the kinds of new credit problems we are seeing now are more economically driven. There was plenty of bad underwriting in both mortgage lending as well as commercial real estate.

We have tightened the standards tremendously. I think we are being criticized in other quarters. Please note that we issued commercial real estate guidance in 2006.

Senator CORKER. Well, I—

Ms. BAIR. The Federal Reserve Board has issued rules that apply to both banks and non-banks for mortgage lending that significantly tighten the standards. That already has taken place. Also, we are working on capital rules that will require greater capital charges against higher-risk loans, such as those with high LTVs. The bank regulators are doing all that, and have for some time.

You still have a fairly significant non-bank sector, one that can come back as the capital markets heal. That is why I hope that, going forward, in terms of whatever reforms you come up with, that those reforms will reflect the fact that there are two different sectors, two different providers of credit in this country. We can keep tamping down on the banks as we have been. But if the non-bank sector is left, by and large, unregulated, that is not going to fix the problem.

Mr. DUGAN. And Senator, if I could just add, if you look at the experience of Canada where they are our neighbors and have a much more conservative standard for underwriting, where they verify income and have loan-to-value ratios that are higher, you can't get a 30-year fixed-rate mortgage, but they have very high levels of home ownership and they didn't have any of these problems. So, they have more of a system that has a basic minimum that cuts across the board. It may not be the right ones for us, but I definitely think it is worth exploring.

Senator CORKER. And I would really like—I know that I am going to run out of time here and we are not going to be able to—but we talk often, I know, all of us—I would really like to see what it is we need to do on our end. I don't think we as a country have the political will to do the things we need to do to make sure that this doesn't happen again. I absolutely do not see it. I mean, this regulatory reform, again, is just moving chairs around. It is not changing anything about the way that we go about doing this business. And I hope that as we move along, you all will help with that.

Mr. Tarullo, again, I thank you for your testimony, also, as always. I am wondering, on 13(3), as we move into regulation, should we—I mean, in essence, we are going to be talking about TARP and resolution and all of those kind of things down the road, but on the 13(3) issue, exigent circumstances, should we move to narrow the Fed's ability to use 13(3) for specific institutions, move away from that so that your assistance is at the system level, but where you are not specifically—I mean, in essence, you can get around—I know that some people here support the Administration's proposal to sort of codify TARP. I don't. I think we should end TARP at the end of the year. But it seems to me that under 13(3), the way you now have it, you all can work around that at the Fed and, in essence, do the same thing at specific institutions, and I am wondering if you feel we ought to limit that.

Mr. TARULLO. So, I would say, Senator, that I think most people at the Federal Reserve would be happy if they were not in the position where people came to us when there was a need for resolving or dealing with a specific financial institution, but I do think one

needs to have a mechanism, a mechanism in law by which some part of the government can deal with the large financial institution that may be in distress.

And that is why I think all three of us, certainly, have supported moving forward with a resolution mechanism that would cover the large financial institutions. I do think within the context of that, you have to address the question of potential funding streams for short-term liabilities or the sort. So, I think it needs to be addressed somewhere. It doesn't need to be in 13(3).

Senator CORKER. If I am hearing you properly, if we had a resolution mechanism in place, which we did not have for complex bank holding companies and others, like AIG, which is not one of those—if we had a resolution mechanism that was defined and we had the ability to fund the short term, while you are resolving that, hopefully not in conservatorship but in receivership, where you are putting them out of business, in essence, we could narrow the abilities of the Fed and also not support the Administration's proposal for Treasury to hold unto itself the ability to put taxpayer money into various entities they feel might pose systemic risk. We could do away with that if we had an appropriate resolution mechanism.

Mr. TARULLO. Well, I think you do need a mechanism that can provide, in appropriate circumstances, for the sort of assistance that might be needed, and if you have that, it doesn't need to be done through 13(3), and as I said, I think the Federal Reserve would prefer that it not be done through 13(3).

Senator CORKER. And you are perfectly satisfied we are resolving them out of existence? You are not talking about that assistance to conserve an institution?

Mr. TARULLO. Well, I think—so, Senator, that is probably one of the open questions, and exactly what do we mean, I think there is—I think what is important is that there be real prospects of losses for shareholders and creditors when their large institution gets in that circumstance.

Senator CORKER. Mr. Chairman, I thank you, and I am sorry we didn't get to each of you. I do hope that what we are doing with the smaller banks, that some assistance was being sought through TARP here earlier, I hope that we are encouraging them, while they can, those who can, to raise capital. I have seen this taking place now and shareholders are being deluded and we are going ahead and raising the capital necessary to weather this storm.

I thank each of you and I look forward to seeing you again soon.

Senator JOHNSON. Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman. I want to thank you for holding this hearing. I thank the witnesses.

I would like to talk a little bit about fees and consumer protection, Consumer Protection Agency. Many of the banks we know have reacted to lost profits from their mortgage problems by raising fees on consumers, one of which is overdraft fees. There is no transparency. They don't give consumers a real chance to decide if they want—even want this kind of protection.

Banks raked in about \$24 billion in overdraft fees last year. That was up 35 percent from the year before. That ought to stick out. Even accounting for higher debit card use, a worsening credit environment due to the economy, that is a massive increase. It indi-

cates to me that consumers are bearing a disproportionate burden in maintaining the health of many banks' balance sheets.

They are also raising ATM fees, as you know. Bank of America recent raised its fee for other bank customers to \$3. That would have been unheard of a few years ago. Maybe one of these fly by-night machines would have done that, but not a major bank. And the average cost of an ATM transaction is also now over \$3.

Even if you withdraw \$100, that is a high fee in percentage terms, and, of course, the overdraft fees, you buy a \$2 cup of coffee and they charge you \$35 without even telling you. It makes your blood boil.

So, my question is this. This is to really to Comptroller Dugan, Mr. Ward. As regulators, you are responsible for not only safety and soundness, but consumer protections. Maybe Mr. Tarullo also has a role here. What are you doing to ensure that consumers don't bear the brunt of banks' efforts to repair balance sheets, particularly in these two instances?

Mr. DUGAN. On the area of overdraft fees, we actually don't have the rulemaking authority in that area. The Federal Reserve has that authority. They currently have a proposal that is out. We also don't have authority to write rules for unfair and deceptive practices. We have done, as regulators—

Senator SCHUMER. Don't you have general authority on consumer-type issues? Not at all?

Mr. DUGAN. Not on general fee regulation. Either it is mostly disclosure-based that is set by rules promulgated by others, or if it gets to a point where it is unfair and deceptive, yes. And in answer—

Senator SCHUMER. Don't you think these are unfair and deceptive—

Mr. DUGAN. I think that it is absolutely the case that consumers should be given the right to opt in—to have a choice about whether to participate in these programs or not.

Senator SCHUMER. But, Mr. Dugan, if you decided that these were unfair and deceptive, which I think average people hearing about these, they are deceptive because you don't know, they are unfair because they are so high, you could do something.

Mr. DUGAN. And I think that the proposal that the Federal Reserve has put out that has not yet been adopted does address the question of consent to these programs, which is critically important.

Senator SCHUMER. OK, the Fed, tell us what you are doing.

Mr. TARULLO. That is correct, Senator. We have a proposal that we are working on right now which would go right to the heart of the issue of opt in/opt out. And although I can't obviously prejudge what the Board will do, I expect that within the next month, that is going to come up for consideration—

Senator SCHUMER. Has that been made public, that proposal?

Mr. TARULLO. Yes. That has been made public.

Senator SCHUMER. OK. And what does it do, specifically?

Mr. TARULLO. This would provide for the ability of a consumer to know that he or she was opting into a program like this and to understand the terms under which—

Senator SCHUMER. It would let the consumer know at the time—

Mr. TARULLO. Yes.

Senator SCHUMER.—that they are in overdraft status and—

Mr. TARULLO. That is actually more difficult technically, and that is some of what is out for comment right now.

Senator SCHUMER. Well, they used to do that all the time.

Mr. TARULLO. But that is—

Senator SCHUMER. It would not honor the request because you didn't have the money.

Mr. TARULLO. Right, and with the advent of technologies like debit cards, for example, it becomes more complicated than it was before. But that is one of the things that is out for comment and consideration right now, is how this might be done.

Senator SCHUMER. OK. When did you start working on this proposal?

Mr. TARULLO. Let me see. I actually don't—

Senator SCHUMER. Not only you, but—

Mr. TARULLO. I don't know when the staff started working on it, Senator, and I will have to get back to you on that. I first became aware of it a couple of months ago.

Senator SCHUMER. Right. OK. And what about on the other issue that I mentioned?

Mr. TARULLO. On the fees issue?

Senator SCHUMER. Yes.

Mr. TARULLO. So, I don't think we have a current rulemaking on ATM fees. That has been an issue in the past, so I would have to—

Senator SCHUMER. Do you think \$3 is excessive?

Mr. TARULLO. Well, I think—again, there—

Senator SCHUMER. Well, let me ask you another question. Has the cost from 2 years ago to now gone up so that it would merit a large increase in the fee?

Mr. TARULLO. Well, I doubt that the cost has gone up very much, and so the question, as with all fees, becomes the degree to which an institution ought to be able to make that judgment if it is fully disclosed or not.

Senator SCHUMER. OK. As you know, I think the Fed does a good job in many areas, but in consumer protection, I don't think the regulatory agencies have done a good job, and here is—I mean, maybe this is a little rhetorical. It is to me, but I am going to let you guys answer it. I mean, isn't what we have just heard a good reason that we need a strong, independent agency to protect the interests of consumers, separate and apart from safety and soundness regulators?

Mr. TARULLO. Umm—

Senator SCHUMER. I mean, I have found that in the consumer area, the Fed and the OCC doesn't do much, although I think they have the power to do some things. It is slow. Still in the back of their mind is the idea of safety and soundness and bank balance sheets. And the consumer doesn't get all the protection he or she deserves. It is one of the reasons I believe the agency that Senator Dodd is proposing, and original Senator Durbin and I proposed, a Consumer Financial-Consumer Product Safety Commission, is so

needed. Also, they are able to deal with new issues as they come up. They don't—I suppose Mr. Dugan would have to go into rule-making and say what is unfair, what is deceptive, and they would figure out a way around that.

Why wouldn't it be better to have these myriad of issues—and our financial institutions are getting better and better at coming up with new ways to make fees—why isn't it better to have an agency exclusively devoted to that doing the job as opposed to a regulator which has many other important jobs to do to deal with? I would ask both Mr. Tarullo and Mr. Dugan, and then anyone else who would want to comment.

Mr. DUGAN. Sure.

Mr. TARULLO. Senator, as I think you know, the Federal Reserve, as a Board, has no position one way or the other on creation of the CFPB, but I would make the following observations. First, I think there are undoubted merits to having a single Consumer Protection Agency whose sole focus is on that function.

Second, though, you will lose something if you do it. You will lose some of the combination of understanding of safety and soundness and consumer protection. I think there is a risk. This has not necessarily happened, but there is a risk that sometimes the impact on credit availability won't be fully understood. These are things that can be addressed, but I think that there would be costs.

A third point is, as you probably also know, prior to my joining the Federal Reserve Board in January, I was quite critical of the failure of the bank regulatory agencies generally to engage in enough consumer protection on subprime, on credit cards, and many other things. I will say, though, that I think in the last few years, Chairman Bernanke has set a tone at the Fed which has been one of looking for vigorous consumer protection and that the rules on credit cards and the rules on home mortgages are evidence of that. It may not be everything you think that needs to be done, but I think it has been done.

Senator SCHUMER. Chairman Dugan?

Mr. DUGAN. Senator, I think there are two very powerful—

Senator SCHUMER. Comptroller Dugan.

Mr. DUGAN. Comptroller. That is OK. There are two very good and powerful ideas connected with the CFPB. One is to have common rules that apply to everybody, whether you are a bank or a non-bank, and to have strong authority to do that. So I think that is important.

Second, I think the part of the system that had the least attention paid to it were the non-banks in terms of how rules are implemented. You don't have the comprehensive regime today. So that part, I think, can be a very good and powerful idea.

The part that I have had concerns about is implementing those rules on banks and carrying them out through supervision, examination, and enforcement. I think that should stay with the bank regulators. I think that you do get a benefit from things that are interwoven together between consumer protection and safety and soundness, like underwriting standards in subprime mortgages, which are related to consumer protection issues. We see examples of it all the time, which I provided to the Committee in our last testimony. That is the part I would worry about.

And then, second, the notion that the new agency should focus its implementation responsibilities on the non-banks, again, very powerful idea.

Senator SCHUMER. Would you just—I know my time has expired, Mr. Chairman—in retrospect, do you think the regulatory agencies, not yours in particular, but including yours—have done as vigorous a job on consumer protection as they should have?

Mr. DUGAN. I—

Senator SCHUMER. In the areas that you have jurisdiction over, not the non-banks.

Mr. DUGAN. Well, again, you have to sort of go area by area, but in some places, no. Other places, yes, which I think are not recognized. And I do think there has been the systemic problem that we only have a part of the pie and there is a big chunk of it that no one is looking at.

Senator SCHUMER. No, that is true. That is one argument for it.

Do you agree? Mr. Tarullo, how about you? Do you think your agency and all of the agencies have done as good a job as they should have on consumer protection?

Mr. TARULLO. Senator, I am on record saying it, so I will say it again. I don't think the agencies, including the Federal Reserve, did a good enough job.

Senator SCHUMER. Thank you. Thanks, Mr. Chairman.

Senator JOHNSON. I want to thank the witnesses once again for being here today. I look forward to working with the members of the Banking Committee as we continue to consider measures to stabilize the banking sector and our economy as a whole.

This hearing is adjourned.

[Whereupon, at 4:29 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions follow:]

**PREPARED STATEMENT OF SENATOR TIM JOHNSON**

As Congress and this Committee continue its work to stabilize financial institutions and promote our nation's economic recovery, I have called this hearing today for regulators to give us an update on the current conditions of the financial institutions in our country. It is vital that we know what continuing challenges and concerns our nation's institutions face. Specifically, I continue to be concerned about the lending environment, particularly for small businesses, the capital needs of institutions, and the impact of commercial real estate and other loan portfolios on institutions' balance sheets. In addition, while many of the large banks in our country have stabilized, the FDIC's list of troubled banks, many of them small community banks, is growing.

While restructuring our nation's regulatory system is this Committee's top priority, I don't think we can do that without a clear understanding of what is happening within the sector. Concerns and problems within individual financial institutions will still exist even with a new regulatory structure unless they are addressed as well. Continuing to ensure the safety and soundness of viable institutions and the overall financial stability of our nation's economy is vital to protecting all Americans' pocketbooks, savings and retirement.

I want to thank the witnesses for being here today, and I look forward to hearing from each of you regarding any developing trends or concerns within the banking industry or throughout the economy, and to hear of the regulatory or supervisory steps your agencies are taking to respond to these challenges.

**PREPARED STATEMENT OF SENATOR MIKE CRAPO**

Thank you, Mr. Chairman, for holding this hearing to examine the state of the banking and credit union industry.

Failures of small banks continue to grow and key trouble spots are looming, such as commercial real estate loans. According to a recent New York Times article, about \$870 billion, or roughly half of the industry's \$1.8 trillion of commercial real estate loans, now sit on the balance sheet of small and medium sized banks. I am interested in learning to what extent has the Term Asset-Backed Securities Loan Facility (TALF) encouraged capital to enter the commercial real estate market and what other steps should regulators take to address this problem.

Many community banks and credit unions have tried to fill the lending gap caused by the credit crisis. Even with these efforts, it is apparent that many consumers and small businesses are not receiving the lending they need to refinance their home loan, extend their business line of credit, or receive capital for new business opportunities. Regulators need to be mindful that they strike the appropriate balance to bolster capital and meet the credit needs of our economy. FASB's new rules on off-balance sheets will create challenges on this point.

As we began to explore options to modernize our financial regulatory structure, it is important that our new structure allows financial institutions to play an essential role in the U.S. economy by providing a means for consumers and businesses to save for the future, to protect and hedge against risk, and promote lending opportunities.

Again, I thank the Chairman for holding this hearing and I look forward to working with him and other Senators on these and other issues.

**PREPARED STATEMENT OF SHEILA C. BAIR**

CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

OCTOBER 14, 2009

Chairman Johnson, Ranking Member Crapo and members of the Subcommittee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the condition of FDIC-insured institutions and the deposit insurance fund (DIF). While challenges remain, evidence is building that financial markets are stabilizing and the American economy is starting to grow again. As promising as these developments are, the fact is that bank performance typically lags behind economic recovery and this cycle is no exception. Regardless of whatever challenges still lie ahead, the FDIC will continue protecting insured depositors as we have for over 75 years.

The FDIC released its comprehensive summary of second quarter 2009 financial results for all FDIC-insured institutions on August 27. The FDIC's *Quarterly Banking Profile* provided evidence that the difficult and necessary process of recognizing

loan losses and cleaning up balance sheets continues to be reflected in the industry's bottom line. As a result, the number of problem institutions increased significantly during the quarter. We expect the numbers of problem institutions to increase and bank failures to remain high for the next several quarters.

My testimony today will review the financial performance of FDIC-insured institutions and highlight some of the most significant risks that the industry faces. In addition, I will discuss the steps that we are taking through supervisory and resolutions processes to address risks and to reduce costs from failures. Finally, I will summarize the condition of the DIF and the recent steps that we have taken to strengthen the FDIC's cash position.

### **Economy**

In the wake of the financial crisis of last Fall and the longest and deepest recession since the 1930s, the U.S. economy appears to be growing once again. Through August, the index of leading economic indicators had risen for five consecutive months. Consensus forecasts call for the economy to grow at a rate of 2.4 percent or higher in both the third and fourth quarters. While this relative improvement in economic conditions appears to represent a turning point in the business cycle, the road to full recovery will be a long one that poses additional challenges for FDIC-insured institutions.

While we are encouraged by recent indications of the beginnings of an economic recovery, growth may still lag behind historical norms. There are several reasons why the recovery may be less robust than was the case in the past. Most important are the dislocations that have occurred in the balance sheets of the household sector and the financial sector, which will take time to repair.

Households have experienced a net loss of over \$12 trillion in net worth during the past 7 quarters, which amounts to almost 19 percent of their net worth at the beginning of the period. Not only is the size of this wealth loss unprecedented in our modern history, but it also has been spread widely among households to the extent that it involves declines in home values. By some measures, the average price of a U.S. home has declined by more than 30 percent since mid-2006. Home price declines have left an estimated 16 million mortgage borrowers "underwater" and have contributed to an historic rise in the number of foreclosures, which reached almost 1.5 million in just the first half of 2009.<sup>1</sup>

Household financial distress has been exacerbated by high unemployment. Employers have cut some 7.2 million jobs since the start of the recession, leaving over 15 million people unemployed and pushing even more people out of the official labor force. The unemployment rate now stands at a 26-year high of 9.8 percent, and may go higher, even in an expanding economy, while discouraged workers re-enter the labor force.

In response to these disruptions to wealth and income, U.S. households have begun to save more out of current income. The personal savings rate, which had dipped to as low as 1.2 percent in the third quarter of 2005, rose to 4.9 percent as of second quarter 2009 and could go even higher over the next few years as households continue to repair their balance sheets. Other things being equal, this trend is likely to restrain growth in consumer spending, which currently makes up more than 70 percent of net GDP.

Financial sector balance sheets also have undergone historic distress in the recent financial crisis and recession. Most notably, we have seen extraordinary government interventions necessary to stabilize several large financial institutions, and now as the credit crisis takes its toll on the real economy, a marked increase in the failure rate of smaller FDIC-insured institutions. Following a 5-year period during which only ten FDIC-insured institutions failed, there were 25 failures in 2008 and another 98 failures so far in 2009.

In all, FDIC-insured institutions have set aside just over \$338 billion in provisions for loan losses during the past six quarters, an amount that is about four times larger than their provisions during the prior six quarter period. While banks and thrifts are now well along in the process of loss recognition and balance sheet repair, the process will continue well into next year, especially for commercial real estate (CRE).

Recent evidence points toward a gradual normalization of credit market conditions amid still-elevated levels of problem loans. We meet today just 1 year after the historic liquidity crisis in global financial markets that prompted an unprecedented response on the part of governments around the world. In part as a result of the

<sup>1</sup>Sources: Moody's *Economy.com* (borrowers "underwater") and FDIC estimate based upon Mortgage Bankers Association, *National Delinquency Survey*, second quarter 2009 (number of foreclosures).

Treasury's Troubled Asset Relief Program (TARP), the Federal Reserve's extensive lending programs, and the FDIC's Temporary Liquidity Guarantee Program (TLGP), financial market interest rate spreads have retreated from highs established at the height of the crisis last Fall and activity in interbank lending and corporate bond markets has increased.

However, while these programs have played an important role in mitigating the liquidity crisis that emerged at that time, it is important that they be rolled back in a timely manner once financial market activity returns to normal. The FDIC Board recently proposed a plan to phaseout the debt guarantee component of the Temporary Liquidity Guarantee Program (TLGP) on October 31st. This will represent an important step toward putting our financial markets and institutions back on a self-sustaining basis. And even while we seek to end the various programs that were effective in addressing the liquidity crisis, we also recognize that we may need to redirect our efforts to help meet the credit needs of household and small business borrowers.

For now, securitization markets for government-guaranteed debt are functioning normally, but private securitization markets remain largely shut down. During the first 7 months of 2009, \$1.2 trillion in agency mortgage-backed securities were issued in comparison to just \$9 billion in private mortgage-backed securities. Issuance of other types of private asset-backed securities (ABS) also remains weak. ABS issuance totaled only \$118 billion during the first 9 months of 2009 in comparison to \$136 billion during the first 9 months of 2008 and peak annual issuance of \$754 billion in 2006.

Significant credit distress persists in the wake of the recession, and has now spread well beyond nonprime mortgages. U.S. mortgage delinquency and foreclosure rates also reached new historic highs in second quarter of 2009 when almost 8 percent of all mortgages were seriously delinquent. In addition, during the same period, foreclosure actions were started on over 1 percent of loans outstanding.<sup>2</sup> Consumer loan defaults continue to rise, both in number and as a percent of outstanding loans, although the number of new delinquencies now appears to be tapering off. Commercial loan portfolios are also experiencing elevated levels of problem loans which industry analysts suggest will peak in late 2009 or early 2010.

#### **Recent Financial Performance of FDIC-Insured Institutions**

The high level of distressed assets is reflected in the weak financial performance of FDIC-insured institutions. FDIC-insured institutions reported an aggregate net loss of \$3.7 billion in second quarter 2009. The loss was primarily due to increased expenses for bad loans, higher noninterest expenses and a one-time loss related to revaluation of assets that were previously reported off-balance sheet. Commercial banks and savings institutions added \$67 billion to their reserves against loan losses during the quarter. As the industry has taken loss provisions at a rapid pace, the industry's allowance for loan and lease losses has risen to 2.77 percent of total loans and leases, the highest level for this ratio since at least 1984. However, noncurrent loans have been growing at a faster rate than loan loss reserves, and the industry's coverage ratio (the allowance for loan and lease losses divided by total noncurrent loans) has fallen to its lowest level since the third quarter of 1991.<sup>3</sup>

Insured institutions saw some improvement in net interest margins in the quarter. Funding costs fell more rapidly than asset yields in the current low interest rate environment, and margins improved in the quarter for all size groups. Nevertheless, second quarter interest income was 2.3 percent lower than in the first quarter and 15.9 percent lower than a year ago, as the volume of earning assets fell for the second consecutive quarter. Industry noninterest income fell by 1.8 percent compared to the first quarter.

Credit quality worsened in the second quarter by almost all measures. The share of loans and leases that were noncurrent rose to 4.35 percent, the highest it has been since the data were first reported. Increases in noncurrent loans were led by 1-to-4 family residential mortgages, real estate construction and development loans, and loans secured by nonfarm nonresidential real estate loans. However, the rate of increase in noncurrent loans may be slowing, as the second-quarter increase in noncurrent loans was about one-third smaller than the volume of noncurrent loans added in first quarter. The amount of loans past-due 30-89 days was also smaller at the end of the second quarter than in the first quarter. Net charge-off rates rose to record highs in the second quarter, as FDIC-insured institutions continued to recognize losses in the loan portfolios. Other real estate owned (ORE) increased 79.7 percent from a year ago.

<sup>2</sup> Source: Mortgage Bankers Association, *National Delinquency Survey*, Second Quarter 2009.

<sup>3</sup> Noncurrent loans are loans 90 or more days past due or in nonaccrual status.

Many insured institutions have responded to stresses in the economy by raising and conserving capital, some as a result of regulatory reviews. Equity capital increased by \$32.5 billion (2.4 percent) in the quarter. Treasury invested a total of \$4.4 billion in 117 independent banks and bank and thrift holding companies during the second quarter, and nearly all of these were community banks. This compares to a total of more than \$200 billion invested since the program began. Average regulatory capital ratios increased in the quarter as well. The leverage capital ratio increased to 8.25 percent, while the average total risk-based capital ratio rose to 13.76 percent. However, while the average ratios increased, fewer than half of all institutions reported increases in their regulatory capital ratios.

The nation's nearly 7,500 community banks—those with less than \$1 billion in total assets—hold approximately 11 percent of total industry assets. They posted an average return on assets of negative 0.06 percent, which was slightly better than the industry as a whole. As larger banks often have more diverse sources of non-interest income, community banks typically get a much greater share of their operating income from net interest income. In general, community banks have higher capital ratios than their larger competitors and are much more reliant on deposits as a source of funding.

Average ratios of noncurrent loans and charge-offs are lower for community banks than the industry averages. In part, this illustrates the differing loan mix between the two groups. The larger banks' loan performance reflects record high loss rates on credit card loans and record delinquencies on mortgage loans. Community banks are important sources of credit for the nation's small businesses and small farmers. As of June 30, community banks held 38 percent of the industry's small business and small farm loans.<sup>4</sup> However, the greatest exposures faced by community banks may relate to construction loans and other CRE loans. These loans made up over 43 percent of community bank portfolios, and the average ratio of CRE loans to total capital was above 280 percent.

As insured institutions work through their troubled assets, the list of "problem institutions"—those rated CAMELS 4 or 5—will grow. Over a hundred institutions were added to the FDIC's "problem list" in the second quarter. The combined assets of the 416 banks and thrifts on the problem list now total almost \$300 billion. However, the number of problem institutions is still well below the more than 1,400 identified in 1991, during the last banking crisis on both a nominal and a percentage basis. Institutions on the problem list are monitored closely, and most do not fail. Still, the rising number of problem institutions and the high number of failures reflect the challenges that FDIC-insured institutions continue to face.

#### **Risks to FDIC-Insured Institutions**

Troubled loans at FDIC-insured institutions have been concentrated thus far in three main areas—residential mortgage loans, construction loans, and credit cards. The credit quality problems in 1-to-4 family mortgage loans and the coincident declines in U.S. home prices are well known to this Committee. Net chargeoffs of 1-to 4-family mortgages and home equity lines of credit by FDIC-insured institutions over the past 2 years have totaled more than \$65 billion. Declining home prices have also impacted construction loan portfolios, on which many small and mid-sized banks heavily depend. There has been a tenfold increase in the ratio of noncurrent construction loans since mid-year 2007, and this ratio now stands at a near-record 13.5 percent. Net charge-offs for construction loans over the past 2 years have totaled about \$32 billion, and almost 40 percent of these were for one-to-four family construction.

With the longest and deepest recession since the 1930s has come a new round of credit problems in consumer and commercial loans. The net charge-off rate for credit card loans on bank portfolios rose to record-high 9.95 percent in the second quarter. While stronger underwriting standards and deleveraging by households should eventually help bring loss rates down, ongoing labor market distress threatens to keep loss rates elevated for an extended period. By contrast, loans to businesses, *i.e.*, commercial and industrial (C&I) loans, have performed reasonably well given the severity of the recession in part because corporate balance sheets were comparatively strong coming into the recession. The noncurrent loan ratio of 2.79 percent for C&I loans stands more than four times higher than the record low seen in 2007, but remains still well below the record high of 5.14 percent in 1987.

The most prominent area of risk for rising credit losses at FDIC-insured institutions during the next several quarters is in CRE lending. While financing vehicles such as commercial mortgage-backed securities (CMBS) have emerged as significant

<sup>4</sup> Defined as commercial and industrial loans or commercial real estate loans under \$1 million or farm loans less than \$500,000.

CRE funding sources in recent years, FDIC-insured institutions still hold the largest share of commercial mortgage debt outstanding, and their exposure to CRE loans stands at an historic high. As of June, CRE loans backed by nonfarm, nonresidential properties totaled almost \$1.1 trillion, or 14.2 percent of total loans and leases.

The deep recession, in combination with ongoing credit market disruptions for market-based CRE financing, has made this a particularly challenging environment for commercial real estate. The loss of more than 7 million jobs since the onset of the recession has reduced demand for office space and other CRE property types, leading to deterioration in fundamental factors such as rental rates and vacancy rates. Amid weak fundamentals, investors have been re-evaluating their required rate of return on commercial properties, leading to a sharp rise in “cap rates” and lower market valuations for commercial properties. Finally, the virtual shutdown of CMBS issuance in the wake of last year’s financial crisis has made financing harder to obtain. Large volumes of CRE loans are scheduled to roll over in coming quarters, and falling property prices will make it more difficult for some borrowers to renew their financing.

Outside of construction portfolios, losses on loans backed by CRE properties have been modest to this point. Net charge-offs on loans backed by nonfarm, nonresidential properties have been just \$6.2 billion over the past 2 years. Over this period, however, the noncurrent loan ratio in this category has quadrupled, and we expect it to rise further as more CRE loans come due over the next few years. The ultimate scale of losses in the CRE loan portfolio will very much depend on the pace of recovery in the U.S. economy and financial markets during that time.

### ***FDIC Response to Industry Risks and Challenges***

#### *Supervisory Response to Problems in Banking Industry*

The FDIC has maintained a balanced supervisory approach that focuses on vigilant oversight but remains sensitive to the economic and real estate market conditions. Deteriorating credit quality has caused a reduction in earnings and capital at a number of institutions we supervise which has resulted in a rise in problem banks and the increased issuance of corrective programs. We have been strongly advocating increased capital and loan loss allowance levels to cushion the impact of rising non-performing assets. Appropriate allowance levels are a fundamental tenet of sound banking, and we expect that banks will add to their loss reserves as credit conditions warrant—and in accordance with generally accepted accounting principles.

We have also been emphasizing the importance of a strong workout infrastructure in the current environment. Given the rising level of non-performing assets, and difficulties in refinancing loans coming due because of decreased collateral values and lack of a securitization market, banks need to have the right resources in place to restructure weakened credit relationships and dispose of other real estate holdings in a timely, orderly fashion.

We have been using a combination of offsite monitoring and onsite examination work to keep abreast of emerging issues at FDIC-supervised institutions and are accelerating full-scope examinations when necessary. Bankers understand that FDIC examiners will perform a thorough, yet balanced asset review during our examinations, with a particular focus on concentrations of credit risk. Over the past several years, we have emphasized the risks in real estate lending through examination and industry guidance, training, and targeted analysis and supervisory activities. Our efforts have focused on underwriting, loan administration, concentrations, portfolio management and stress testing, proper accounting, and the use of interest reserves.

CRE loans and construction and development loans are a significant examination focus right now and have been for some time. Our examiners in the field have been sampling banks’ CRE loan exposures during regular exams as well as special visitations and ensuring that credit grading systems, loan policies, and risk management processes have kept pace with market conditions. We have been scrutinizing for some time construction and development lending relationships that are supported by interest reserves to ensure that they are prudently administered and accurately portray the borrower’s repayment capacity. In 2008, we issued guidance and produced a journal article on the use of interest reserves,<sup>5</sup> as well as internal review procedures for examiners.

We strive to learn from those instances where the bank’s failure led to a material loss to the DIF, and we have made revisions to our examination procedures when warranted. This self-assessment process is intended to make our procedures more

<sup>5</sup> FDIC, Supervisory Insights, [http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum08/article01\\_Primer.html](http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum08/article01_Primer.html).

forward-looking, timely and risk-focused. In addition, due to increased demands on examination staff, we have been working diligently to hire additional examiners since 2007. During 2009, we hired 440 mid career employees with financial services skills as examiners and almost another 200 examiner trainees. We are also conducting training to reinforce important skills that are relevant in today's rapidly changing environment. The FDIC continues to have a well-trained and capable supervisory workforce that provides vigilant oversight of state nonmember institutions.

*Measures to Ensure Examination Programs Don't Interfere with Credit Availability*

Large and small businesses are contending with extremely challenging economic conditions which have been exacerbated by turmoil in the credit markets over the past 18 months. These conditions, coupled with a more risk-averse posture by lenders, have diminished the availability of credit.

We have heard concerns expressed by Members of Congress and industry representatives that banking regulators are somehow instructing banks to curtail lending, making it more difficult for consumers and businesses to obtain credit or roll over otherwise performing loans. This is not the case. The FDIC provides banks with considerable flexibility in dealing with customer relationships and managing loan portfolios. I can assure you that we do not instruct banks to curtail prudently managed lending activities, restrict lines of credit to strong borrowers, or require appraisals on performing loans unless an advance of new funds is being contemplated.

It has also been suggested that regulators are expecting banks to shut off lines of credit or not roll-over maturing loans because of depreciating collateral values. To be clear, the FDIC focuses on borrowers' repayment sources, particularly their cash-flow, as a means of paying off loans. Collateral is a secondary source of repayment and should not be the primary determinant in extending or refinancing loans. Accordingly, we have not encouraged banks to close down credit lines or deny a refinancing request solely because of weakened collateral value.

The FDIC has been vocal in its support of bank lending to small businesses in a variety of industry forums and in the interagency statement on making loans to creditworthy borrowers that was issued last November. I would like to emphasize that the FDIC wants banks to make prudent small business loans as they are an engine of growth in our economy and can help to create jobs at this critical juncture.

In addition, the Federal banking agencies will soon issue guidance on CRE loan workouts. The agencies recognize that lenders and borrowers face challenging credit conditions due to the economic downturn, and are frequently dealing with diminished cash-flows and depreciating collateral values. Prudent loan workouts are often in the best interest of financial institutions and borrowers, particularly during difficult economic circumstances and constrained credit availability. This guidance reflects that reality, and supports prudent and pragmatic credit and business decision-making within the framework of financial accuracy, transparency, and timely loss recognition.

*Innovative resolution structures*

The FDIC has made several changes to its resolution strategies in response to this crisis, and we will continue to re-evaluate our methods going forward. The most important change is an increased emphasis on partnership arrangements. The FDIC and RTC used partnership arrangements in the past—specifically loss sharing and structured transactions. In the early 1990s, the FDIC introduced and used loss sharing. During the same time period, the RTC introduced and used structured transactions as a significant part of their asset sales strategy. As in the past, the FDIC has begun using these types of structures in order to lower resolution costs and simplify the FDIC's resolution workload. Also, the loss share agreements reduce the FDIC's liquidity needs, further enhancing the FDIC's ability to meet the statutory least cost test requirement.

The loss share agreements enable banks to acquire an entire failed bank franchise without taking on too much risk, while the structured transactions allow the FDIC to market and sell assets to both banks and non-banks without undertaking the tasks and responsibilities of managing those assets. Both types of agreements are partnerships where the private sector partner manages the assets and the FDIC monitors the partner. An important characteristic of these agreements is the alignment of interests: both parties benefit financially when the value of the assets is maximized.

For the most part, after the end of the savings and loan and banking crisis of the late 1980s and early 1990s, the FDIC shifted away from these types of agreements to more traditional methods since the affected asset markets became stronger and

more liquid. The main reason why we now are returning to these methods is that in the past several months investor interest has been low and asset values have been uncertain. If we tried to sell the assets of failed banks into today's markets, the prices would likely be well below their intrinsic value—that is, their value if they were held and actively managed until markets recover. The partnerships allow the FDIC to sell the assets today but still benefit from future market improvements. During 2009, the FDIC has used loss share for 58 out of 98 resolutions. We estimate that the cost savings have been substantial: the estimated loss rate for loss share failures averaged 25 percent; for all other transactions, it was 38 percent. Through September 30, 2009, the FDIC has entered into seven structured transactions, with about \$8 billion in assets.

To address the unique nature of today's crisis, we have made several changes to the earlier agreements. The earlier loss share agreements covered only commercial assets. We have updated the agreements to include single family assets and to require the application of a systematic loan modification program for troubled mortgage loans. We strongly encourage our loss share partners to adopt the Administration's Home Affordable Modification Program (HAMP) for managing single family assets. If they do not adopt the HAMP, we require them to use the FDIC loan modification program which was the model for the HAMP modification protocol. Both are designed to ensure that acquirers offer sustainable and affordable loan modifications to troubled homeowners whenever it is cost-effective. This serves to lower costs and minimize foreclosures. We have also encouraged our loss share partners to deploy forbearance programs when homeowners struggle with mortgage payments due to life events (unemployment, illness, divorce, *etc.*). We also invite our loss share partners to propose other innovative strategies that will help keep homeowners in their homes and reduce the FDIC's costs.

In addition, the FDIC has explored funding changes to our structured transactions to make them more appealing in today's environment. To attract more bidders and hopefully higher pricing, the FDIC has offered various forms of leverage. In recent transactions where the leverage was provided to the investors, the highest bids with the leverage option substantially improved the overall economics of the transactions. The overall feedback on the structure from both investors and market participants was very positive.

### ***The Condition of the Deposit Insurance Fund***

#### *Current Conditions and Projections*

As of June 30, 2009, the balance (or net worth) of the DIF (the fund) was approximately \$10 billion. The fund reserve ratio—the fund balance divided by estimated insured deposits in the banking system—was 0.22 percent. In contrast, on December 31, 2007, the fund balance was almost \$52 billion and the reserve ratio was 1.22 percent. Losses from institution failures have caused much of the decline in the fund balance, but increases in the contingent loss reserve—the amount set aside for losses expected during the next 12 months—has contributed significantly to the decline. The contingent loss reserve on June 30 was approximately \$32 billion.

The FDIC estimates that as of September 30, 2009, both the fund balance and the reserve ratio were negative after reserving for projected losses over the next 12 months, though our cash position remained positive. This is not the first time that a fund balance has been negative. The FDIC reported a negative fund balance during the last banking crisis in the late 1980s and early 1990s.<sup>6</sup> Because the FDIC has many potential sources of cash, a negative fund balance does not affect the FDIC's ability to protect insured depositors or promptly resolve failed institutions.

The negative fund balance reflects, in part, an increase in provisioning for anticipated failures. The FDIC projects that, over the period 2009 through 2013, the fund could incur approximately \$100 billion in failure costs. The FDIC projects that most of these costs will occur in 2009 and 2010. In fact, well over half of this amount will already be reflected in the September 2009 fund balance. Assessment revenue is projected to be about \$63 billion over this 5-year period, which exceeds the remaining loss amount. The problem we are facing is one of timing. Losses are occurring in the near term and revenue is spread out into future years.

At present, cash and marketable securities available to resolve failed institutions remain positive, although they have also declined. At the beginning of the current banking crisis, in June 2008, total assets held by the fund were approximately \$55 billion, and consisted almost entirely of cash and marketable securities (*i.e.*, liquid

<sup>6</sup>The FDIC reported a negative fund balance as of December 31, 1991 of approximately -\$7.0 billion due to setting aside a large (\$16.3 billion) reserve for future failures. The fund remained negative for five quarters, until March 31, 1993, when the fund balance was approximately \$1.2 billion.

assets). As the crisis has unfolded, the liquid assets of the fund have been expended to protect depositors of failed institutions and have been exchanged for less liquid claims against the assets of failed institutions. As of June 30, 2009, while total assets of the fund had increased to almost \$65 billion, cash and marketable securities had fallen to about \$22 billion. The pace of resolutions continues to put downward pressure on cash balances. While the less liquid assets in the fund have value that will eventually be converted to cash when sold, the FDIC's immediate need is for more liquid assets to fund near-term failures.

If the FDIC took no action under its existing authority to increase its liquidity, the FDIC projects that its liquidity needs would exceed its liquid assets next year.

#### *The FDIC's Response*

The FDIC has taken several steps to ensure that the fund reserve ratio returns to its statutorily mandated minimum level of 1.15 percent within the time prescribed by Congress and that it has sufficient cash to promptly resolve failing institutions.

For the first quarter of 2009, the FDIC raised rates by 7 basis points. The FDIC also imposed a special assessment as of June 30, 2009 of 5 basis points of each institution's assets minus Tier 1 capital, with a cap of 10 basis points of an institution's regular assessment base. On September 22, the FDIC again took action to increase assessment rates—the board decided that effective January 1, 2011, rates will uniformly increase by 3 basis points. The FDIC projects that bank and thrift failures will peak in 2009 and 2010 and that industry earnings will have recovered sufficiently by 2011 to absorb a 3 basis point increase in deposit insurance assessments. We project that these steps should return the fund to a positive balance in 2012 and the reserve ratio to 1.15 percent by the first quarter of 2017.

While the final rule imposing the special assessment in June permitted the FDIC to impose additional special assessments of the same size this year without further notice and comment rulemaking, the FDIC decided not to impose any additional special assessments this year. Any additional special assessment would impose a burden on an industry that is struggling to achieve positive earnings overall. In general, an assessment system that charges institutions less when credit is restricted and more when it is not is more conducive to economic stability and sustained growth than a system that does the opposite.

To meet the FDIC's liquidity needs, on September 29 the FDIC authorized publication of a Notice of Proposed Rulemaking (NPR) to require insured depository institutions to prepay about 3 years of their estimated risk-based assessments. The FDIC estimates that prepayment would bring in approximately \$45 billion in cash.

Unlike a special assessment, prepaid assessments would not immediately affect the DIF balance or depository institutions' earnings. An institution would record the entire amount of its prepaid assessment as a prepaid expense (asset) as of December 30, 2009. As of December 31, 2009, and each quarter thereafter, the institution would record an expense (charge to earnings) for its regular quarterly assessment for the quarter and an offsetting credit to the prepaid assessment until the asset is exhausted. Once the asset is exhausted, the institution would record an expense and an accrued expense payable each quarter for its regular assessment, which would be paid in arrears to the FDIC at the end of the following quarter. On the FDIC side, prepaid assessments would have no effect on the DIF balance, but would provide us with the cash needed for future resolutions.

The proposed rule would allow the FDIC to exercise its discretion as supervisor and insurer to exempt an institution from the prepayment requirement if the FDIC determines that the prepayment would adversely affect the safety and soundness of the institution.

The FDIC believes that using prepaid assessments as a means of collecting enough cash to meet upcoming liquidity needs to fund future resolutions has significant advantages compared to imposing additional or higher special assessments. Additional or higher special assessments could severely reduce industry earnings and capital at a time when the industry is under stress. Prepayment would not materially impair the capital or earnings of insured institutions. In addition, the FDIC believes that most of the prepaid assessment would be drawn from available cash and excess reserves, which should not significantly affect depository institutions' current lending activities. As of June 30, FDIC-insured institutions held more than \$1.3 trillion in liquid balances, or 22 percent more than they did a year ago.<sup>7</sup>

In the FDIC's view, requiring that institutions prepay assessments is also preferable to borrowing from the U.S. Treasury. Prepayment of assessments ensures

<sup>7</sup>Liquid balances include balances due from Federal Reserve Banks, depository institutions and others, Federal funds sold, and securities purchased under agreements to resell.

that the deposit insurance system remains directly industry-funded and it preserves Treasury borrowing for emergency situations. Additionally, the FDIC believes that, unlike borrowing from the Treasury or the FFB, requiring prepaid assessments would not count toward the public debt limit. Finally, collecting prepaid assessments would be the least costly option to the fund for raising liquidity as there would be no interest cost. However, the FDIC is seeking comment on these and other options in the NPR.

The FDIC's proposal requiring prepayment of assessments is really about how and when the industry fulfills its obligation to the insurance fund. It is not about whether insured deposits are safe or whether the FDIC will be able to promptly resolve failing institutions. Deposits remain safe; the FDIC has ample resources available to promptly resolve failing institutions. We thank the Congress for raising our borrowing limit, which was important from a public confidence standpoint and essential to assure that the FDIC is prepared for all contingencies in these difficult times.

### **Conclusion**

FDIC-insured banks and thrifts continue to face many challenges. However, there is no question that the FDIC will continue to ensure the safety and soundness of FDIC-insured financial institutions, and, when necessary, resolve failed financial institutions. Regarding the state of the DIF and the FDIC Board's recent proposal to have banks pay a prepaid assessment, the most important thing for everyone to remember is that the outcome of this proposal is a non-event for insured depositors. Their deposits are safe no matter what the Board decides to do in this matter. Everyone knows that the FDIC has immediate access to a \$100 billion credit line at Treasury that can be expanded to \$500 billion with the concurrence of the Federal Reserve and the Treasury. We also have authority to borrow additional working capital up to 90 percent of the value of assets we own. The FDIC's commitment to depositors is absolute, and we have more than enough resources at our disposal to make good on that commitment.

I would be pleased to answer any questions from the members of the Subcommittee.

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## **PREPARED STATEMENT OF JOHN C. DUGAN\***

COMPTROLLER OF THE CURRENCY

OFFICE OF THE COMPTROLLER OF THE CURRENCY

OCTOBER 14, 2009

### **I. Introduction**

Chairman Johnson, Senator Crapo, and members of the Subcommittee, I am pleased to testify on the current condition of the national banking system, including trends in bank ending, asset quality, and problem banks. The OCC supervises over 1,600 national banks and Federal branches, which constitute approximately 18 percent of all federally insured banks and thrifts, holding just over 61 percent of all bank and thrift assets. These nationally chartered institutions include 15 of the very largest U.S. banks, with assets generally exceeding \$100 billion; 23 mid-sized banks, with assets generally ranging between \$10 billion and \$100 billion; and over 1,500 community banks and trust banks, with assets between \$1.5 million and \$10 billion. The OCC has dedicated supervisory programs for these three groups of institutions that are tailored to the unique challenges faced by each.

My testimony today makes three key points. First, credit quality is continuing to deteriorate across almost all classes of banking assets in nearly all sizes of banks. As the economy has weakened, the strains on borrowers that first appeared in the housing sector have spread to other retail and commercial borrowers. For some credit portfolio segments, the rate of nonperforming loans is at or near historical highs. In many cases, this declining asset quality reflects risks that built up over time, and while we may be seeing some initial signs of improvement in some asset classes as the economy begins to recover, it will generally take time for problem credits to work their way through the banking system.

Second, the vast majority of national banks are strong and have the financial capacity to withstand the declining asset quality. As I noted in my testimony last year before the full Committee, we anticipated that credit quality would worsen and that

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\* Statement Required by 12 U.S.C. § 250: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

banks would need to further strengthen their capital and loan loss reserves.<sup>1</sup> Net capital levels in national banks have increased by over \$186 billion over the last 2 years, and net increases to loan loss reserves have exceeded \$92 billion. While these increases have considerably strengthened national banks, we anticipate additional capital and reserves will be needed to absorb the additional potential losses in banks' portfolios. In some cases that may not be feasible, however, and as a result, there will continue to be a number of smaller institutions that are not likely to survive their mounting credit problems. In these cases we are working closely with the FDIC to ensure timely resolutions in a manner that is least disruptive to local communities.

Third, during this stressful period we are extremely mindful of the need to take a balanced approach in our supervision of national banks, and we strive continually to ensure that our examiners are doing just that. We are encouraging banks to work constructively with borrowers who may be facing difficulties and to make new loans to creditworthy borrowers. And we have repeatedly and strongly emphasized that examiners should not dictate loan terms or require banks to charge off loans simply due to declines in collateral values.

Balanced supervision, however, does not mean turning a blind eye to credit and market conditions, or simply allowing banks to forestall recognizing problems on the hope that markets or borrowers may turn around. As we have learned in our dealings with problem banks, a key factor in restoring a bank to health is ensuring that bank management realistically recognizes and addresses problems as they emerge, even as they work with struggling borrowers.

## **II. Condition of the National Banking System: Credit Quality Has Replaced Liquidity as Major Concern**

Beginning in the fall of 2007 and extending through the first quarter of this year, bank regulators and the industry were confronted with unprecedented disruptions in the global financial markets. In the wake of severe problems with subprime mortgages, the value of various securitized assets and structured investment products declined precipitously. Key funding and short term credit markets froze, sparking a severe contraction in the liquidity that sustains much of our economy and banking system, including uninsured deposit funding. The combination of these events led to failures, government assistance, and government takeover of several major financial institutions. Through the collective efforts and programs resulting from actions taken by Congress, the Treasury Department, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and governments around the world, there has been significant stabilization in credit and funding markets for all financial institutions, including banks of all sizes.

As reflected in both the TED and Libor-OIS spreads,<sup>2</sup> each of which has fallen to less than 20 basis points after peaking at well over 300 basis points during the crisis, the interbank funding market has vastly improved, with banks once again willing to extend credit to counterparties. There has also been a slight rebound in certain securitization markets. For example, non-mortgage asset-backed securities issuance for 2Q:2009 totaled \$49 billion, up 121 percent from 1Q:2009. Similarly, syndicated market loan issuances increased to \$156 billion in 2Q:2009, up 37 percent from 1Q:2009.

The drag on national banks' balance sheets and earnings from the overhang of various structured securities products has been very significantly reduced due to the substantial write-downs that banks took on these assets in 4Q:2008 and 1Q:2009 and the overall recovery in credit markets. Losses sustained at our 10 largest banking companies for these securities reached \$44 billion in 2008, but dropped to \$8 billion in 1Q:2009 and \$1 billion in 2Q:2009. There are some banks that still face strains in their investment portfolios, largely due to their holding of certain private label mortgage-backed and trust preferred securities. While most banks will be able to absorb the losses that may arise from these holdings, there is a small population of banks that have significant concentrations in these products that we are closely monitoring. We expect these banks will continue to take incremental credit impairments through earnings until mortgage metrics improve.

In my financial condition testimony before the full Committee last year, I observed that, as market conditions began to stabilize, the focus of supervisors and

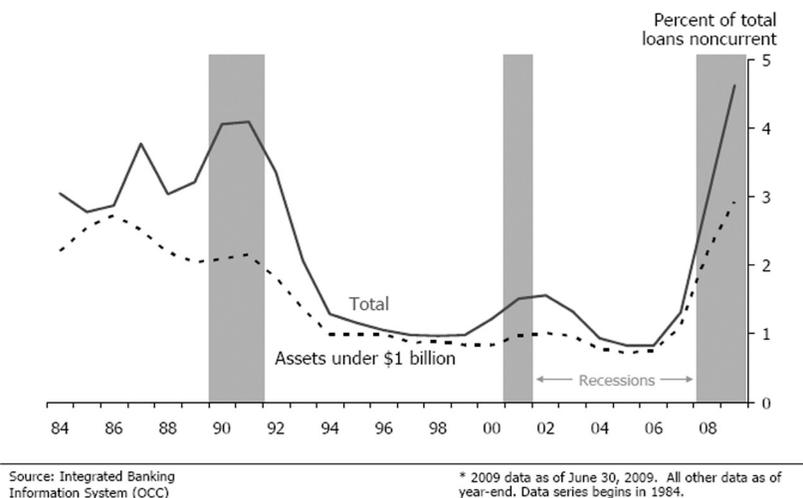
<sup>1</sup> Testimony of John C. Dugan before the Committee on Banking, Housing, and Urban Affairs, United States Senate, June 5, 2008, page 2.

<sup>2</sup> The TED spread reflects the difference between the interest rates on interbank loans in the Eurodollar market and short-term U.S. Government Treasury bills. The OIS is the overnight indexed swap rate. Both spreads are a measure of how markets are viewing the risks of financial counterparties.

bankers would increasingly turn to the more traditional challenges of identifying and managing problem credits.<sup>3</sup> That has indeed proven to be the case, as declining asset quality has become the central challenge facing banks and supervisors today. While there recently have been some signs of economic recovery, data through the second quarter of this year demonstrate that asset quality across the national bank population significantly deteriorated over the preceding twelve months, as both retail and commercial borrowers remained under stress from job losses and the overall contraction in the economy. The percentage of noncurrent loans (loans that are 90 days or more past due or on nonaccrual) increased dramatically and reached the highest level in at least twenty 5 years (see Chart 1).

Chart 1

### Noncurrent loan rate highest in at least 25 years National banks



In addition, the rate at which banks are charging off loans has also accelerated and, for some portfolio segments, now exceeds previous peaks experienced during the last credit cycle. Continued concerns about the economy are also affecting loan growth and demand as businesses, consumers, and bankers themselves retrench on the amount of leverage and borrowing they want to assume. As a result, loan growth through 2Q:2009 has slowed across the national bank population and in various portfolio segments. (See charts 2 and 3)

<sup>3</sup>Testimony of John C. Dugan before the Committee on Banking, Housing, and Urban Affairs, United States Senate, June 5, 2008, page 9.

Chart 2

### Charge-off rates continue to set records National banks

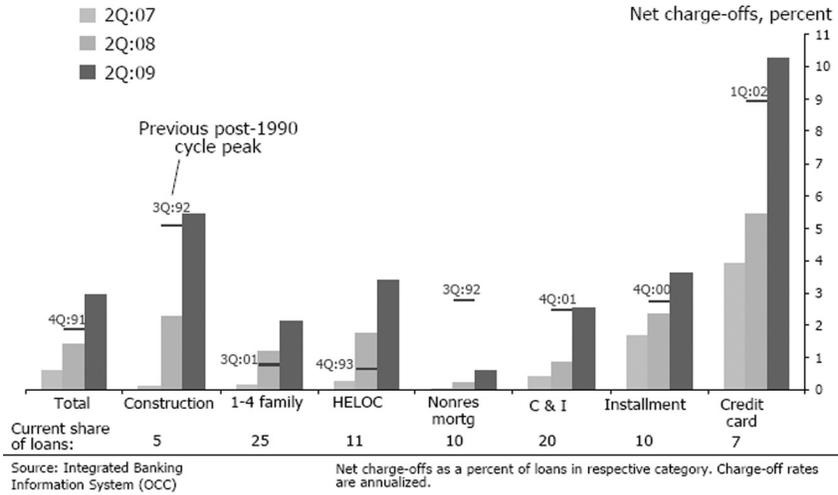
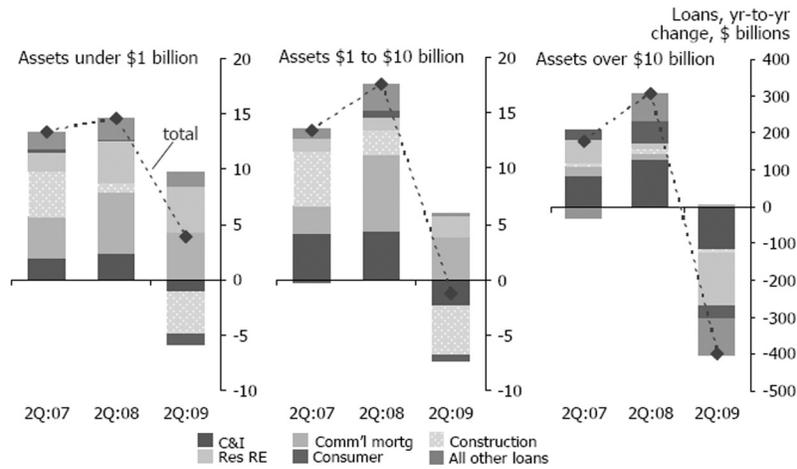


Chart 3

### Loan growth slowing sharply National non-specialty banks



A number of factors are evident for this decline in credit, including the following:

- Reduction in loan demand, as reductions in consumer spending have caused businesses to cut back on inventory and other investments;

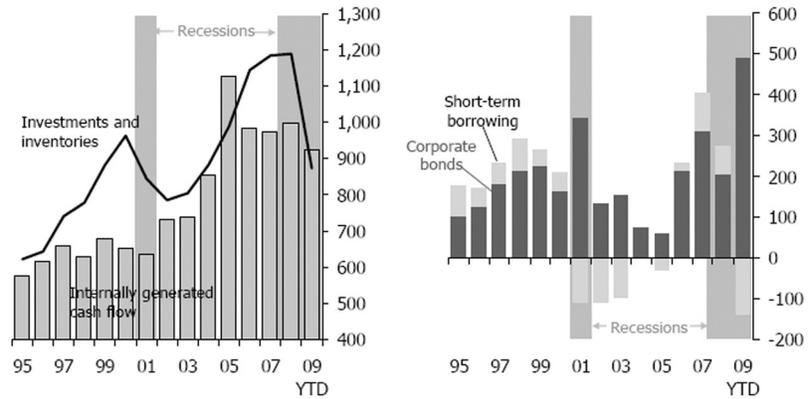
- Reduction in the demand for credit from borrowers who may have been able to afford or repay a loan when the economy was expanding, but now face constrained income or cash-flow and debt service capacity;
- Reductions in loan demand as households work to rebuild their net worth, as reflected in the increased U.S. savings rate;
- Actions taken by bankers to scale back their risk exposures due to weaknesses in various market and economic sectors, and to strengthen underwriting standards and loan terms that had become, in retrospect, too relaxed. In addition, many banks have increasingly shifted their focus and resources to loan collections, workouts, and resolutions, and some troubled banks have curtailed lending due to funding and capital constraints; and
- Continued uncertainty on the part of borrowers and lenders about the strength and speed of the economic recovery in many regions of the country.

As demonstrated in chart 4 below, businesses have significantly reduced their investments and inventories and, in an effort to strengthen their own balance sheets, many larger businesses have replaced short-term borrowing with longer-term corporate bond issues. Similarly, chart 5 shows that consumers are repairing their personal balance sheets with significant increases in their personal savings rates.

Chart 4

### Businesses need fewer C&I loans

Non-financial corporate business outlays and borrowing, \$ billions



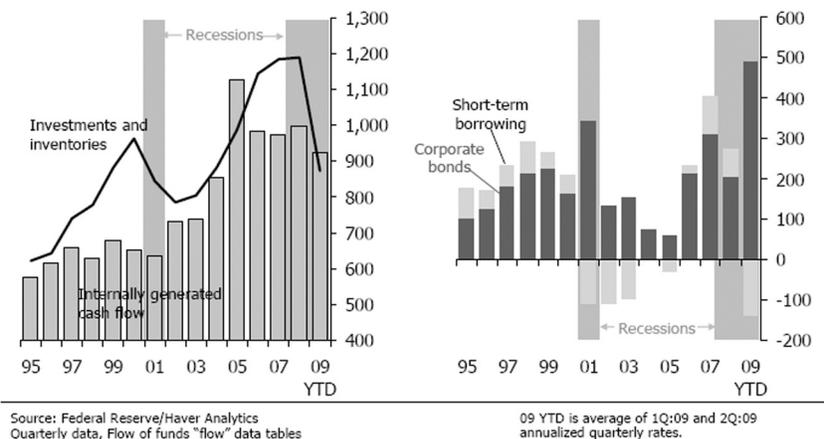
Source: Federal Reserve/Haver Analytics  
Quarterly data, Flow of funds "flow" data tables

09 YTD is average of 1Q:09 and 2Q:09 annualized quarterly rates.

Chart 4

## Businesses need fewer C&I loans

Non-financial corporate business outlays and borrowing, \$ billions



This interplay of factors and their effects on lending are consistent with our recent annual underwriting survey and the Federal Reserve Board's most recent Senior Loan Officer Survey. OCC examiners report that the financial market disruption continues to affect bankers' appetite for risk and has resulted in a renewed focus on fundamental credit principles by bank lenders. Our survey indicates that primary factors contributing to stronger underwriting standards are bankers' concerns about unfavorable external conditions and product performance.<sup>4</sup> In its July Senior Loan Officer Survey, the Federal Reserve reported that "demand for loans continued to weaken across all major categories except for prime residential mortgages."<sup>5</sup>

Some have also suggested that unnecessary supervisory actions may have significantly contributed to the decline in credit availability. While I do not believe the evidence supports this suggestion, I do believe, as addressed in more detail at the end of this testimony, that it is critical for supervisors to stay focused on the type of balanced supervision that is required in the stressful credit conditions prevalent today.

Finally, the combination of deteriorating credit quality, lower yields on earning assets, and slower loan growth is the primary factor currently affecting national banks' earnings. As shown in Chart 6, there has been a marked deterioration in the return on equity across the national banking population as modest increases in banks' net interest margins due to more favorable costs of funds have failed to offset credit quality problems and the continued need for banks to build loan loss reserves.

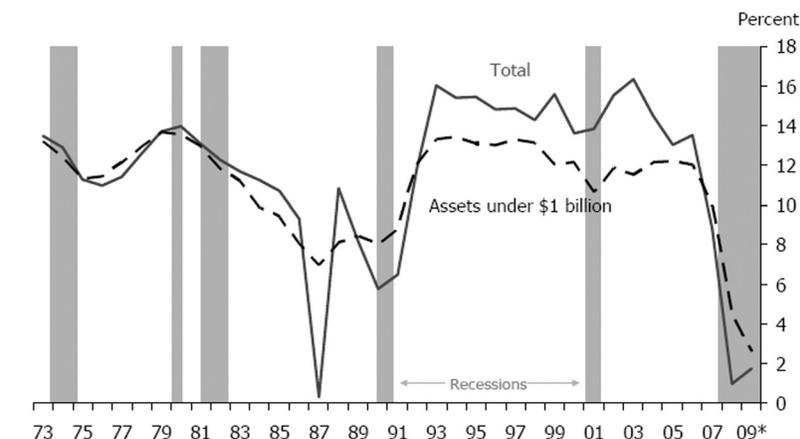
<sup>4</sup> OCC Survey of Underwriting Practices 2009, page 3.

<sup>5</sup> Board of Governors of the Federal Reserve System, "The July 2009 Senior Loan Officer Survey on Bank Lending Practices," page 1.

Chart 6

## National banking system profitability remains low

### National banking company ROE



Source: Integrated Banking Information System (OCC)

Data for all bank and thrift charters in companies where national bank assets represent at least 50% of total assets. Data are merger-adjusted and held constant on a 1-year rolling basis. \*2009 data are June year-to-date, annualized. Effects of purchase accounting overstate reported 2008 ROE; removing these effects, 2008 ROE was -1.1%.

### III. Trends in Key Credit Portfolios and Capital and Reserve Positions

Against this backdrop, let me now describe trends in major credit segments and in capital and loan loss reserve levels.

#### A. Retail Credit

Although retail loans—mortgages, home equity, credit cards, and other consumer loans—account for just over half of total loans in the national banking system, they currently account for two-thirds of total losses, delinquencies, and nonperforming credits. To a large extent, however, these problems are confined to the largest 15 national banks, which hold almost 91 percent of retail loans in the national banking system.

##### 1. First and Second Mortgages

The residential mortgage sector was the epicenter of the financial turmoil and continues to figure prominently in the current condition of the banking industry. As the economy has worsened, problems that started in the subprime market have spread to the so-called “Alt A” market, and increasingly, to the prime market. While over-leverage and falling housing prices were the initial drivers of delinquencies and loan losses, borrower strains resulting from rising unemployment and underemployment are an increasingly important factor. In the first mortgage market, the June 30, 2009 Mortgage Bankers Association’s National Delinquency Survey shows continued growth in foreclosure inventory, but a relatively flat rate of new foreclosure starts overall between the first and second quarter of this year. The rate of prime foreclosures, however, continues to increase, with starts at about 1 percent of the surveyed population as of the end of the second quarter. Although this percentage is still relatively small, the impact is significant given the much larger size of the prime market segment compared to the markets for subprime and Alt-A loans. While it is true that many first mortgages were sold to third party investors via the securitization market, and the loan quality of such mortgages retained by banks is generally higher than those sold to third parties, it nevertheless remains the case that a number of larger banks have significant on-balance sheet exposure to first mortgage losses from portfolios that continue to deteriorate.

The same is true of second mortgages—home equity loans and lines of credit—except that the overwhelming majority of these loans reside on bank balance sheets. There were some positive signs in the second quarter showing home equity loan de-

linquency rates falling, and the pace of increase in second lien charge-off rates slowing. But the hard fact is that losses on these loans through the first half of this year nearly equaled total losses for all of 2008, and loss rates are expected to continue to climb—though at a slower rate—through at least the middle of 2010.

In short, deterioration in the first and second residential mortgage markets continue to dominate the credit quality performance in national banks' retail portfolios, as it has since the second half of 2008. Total delinquent and nonperforming residential real estate loans (mortgage and home equity) in national banks now hover around 9.4 percent, with a loss rate of just over 2.5 percent—the highest level since we have been collecting this data.

There have been some positive indicators in the housing market in recent months that could slow the pace of losses in residential mortgages, including increased home sales in June and July, and slight increases in the Case-Shiller composite index for certain metropolitan areas. While these signs are encouraging, it is too early to determine whether they signal a true turning point in this sector. For example, the increase in home sales this summer is consistent with seasonal trends and may not be sustainable. In addition, sales may be enjoying a temporary boost from the First-Time Homebuyer Tax Credit program which, unless extended, will end in November. Much will depend, of course, on the extent to which economic recovery takes hold and truly stabilizes the housing market.

In terms of mortgage modifications, all of the major national bank mortgage servicers are actively participating in the Administration's Making Home Affordable Program. Servicers have been significantly expanding their staff levels in the loss mitigation/collection areas—doubling and tripling customer contact personnel, and requiring night and weekend overtime work. Servicers have also been ramping up their training efforts, customer service scripts, and automated qualification and underwriting systems to improve the processing of loan modification requests. The OCC is closely monitoring these and other home modification efforts through onsite examinations and other ongoing supervisory initiatives, as well as through our Mortgage Metrics quarterly reporting program. And examiners continue to monitor modification programs for compliance with all applicable fair lending and consumer compliance laws.

Our latest Mortgage Metrics report shows that actions to keep Americans in their homes grew by almost 22 percent during 2Q:2009.<sup>6</sup> Notably, the percentage of modifications that reduced borrowers' monthly principal and interest payments continued to increase to more than 78 percent of all new modifications, up from about 54 percent in the previous quarter. We view this as a positive development, as modifications that reduce borrowers' monthly payments generally produce lower levels of re-defaults and longer term sustainability than modifications that either increase payments or leave them unchanged.

## 2. Credit Cards

Credit card performance began to deteriorate sharply in the latter part of 2008 and has continued to weaken further this year, with record levels of losses and delinquencies. As with second lien mortgages, there have been some encouraging signs recently in the form of declining early stage delinquency rates, but loss rates continue to climb. As of June 30, the overall loss rate was 10.3 percent for national banks, and more recent data shows continued deterioration—with industry analysts predicting even higher loss rates into 2010.

In response to these trends and the overall deterioration in the economy, many credit card issuers are adjusting their account management policies to reflect and respond to the increased risk in these accounts. In some cases these actions have resulted in credit lines being reduced or curtailed. In other cases, they have led to increased interest rates, effectively increasing the minimum payment to cover the higher finance charges. In still other cases they have resulted in an increase in minimum payments to extinguish the outstanding debt more quickly. Many credit card issuers are also re-evaluating certain credit card product features, such as “no annual fees” or various reward programs, and are offering cards with simpler terms and conditions, in part due to the recently enacted Credit CARD Act.

We are monitoring these changes in credit card account terms to ensure that they comply with all applicable limit and notice requirements, including those mandated by the Credit CARD Act. For example, in July we notified national banks that, effective August 22, 2010, they must conduct periodic reviews of accounts whose interest rates have been increased since January 1, 2009, based on factors including market conditions and borrower credit risk. More recently, we issued a bulletin advising national banks about the interim final rules issued by the Federal Reserve under the

<sup>6</sup>See OCC News Release 2009–118, September 30, 2009.

Credit CARD Act that became effective on August 20, 2009. The Federal Reserve's rules require lenders to notify customers 45 days in advance of any rate increase or significant changes in credit card account terms and to disclose that consumers can have the right to reject these changes. Under the rules, the new rates or terms can be applied to any transaction that occurs more than 14 days after the notice is provided—even if the customer ultimately rejects those terms. To address the risk of consumer confusion, the OCC directed national banks to include an additional disclosure not required by the rules to alert consumers, if applicable, to the imposition of the new terms on transactions that occur more than 14 days after the notice is provided, regardless of whether the consumer rejects the change and cancels the account.

As with residential mortgages, we are encouraging national banks to work with consumers who may be facing temporary difficulties and hardships, and more banks are reaching out to assist customers before they become delinquent. Banks have a number of viable default management options to assist in this endeavor, although it is important that, as they do so, they continue to appropriately account for losses as they occur.

Card issuers are also reevaluating the size of unused credit lines in response to current credit conditions, recent regulatory changes, and recent adoption by the Financial Accounting Standards Board (FASB) of two new accounting standards, Statement No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140* (FAS 166) and Statement No. 167, *Amendments to FASB Interpretation No. 46(R)* (FAS 167). These standards become effective for an entity's first fiscal year beginning after November 15, 2009, and will have a significant impact on many banking institutions. In particular, many securitization transactions, including credit card securitizations, will likely lose sales accounting treatment, prompting the return of the securitized assets to banks' balance sheets. Although we are still evaluating the impact of these changes, we anticipate that they will have a material effect on how banks structure transactions, manage risk, and determine the levels of loan loss reserves and regulatory capital they hold for certain assets, including credit cards. The net effect of these changes is that banks will most likely face increased funding and capital costs for these products.

The combination of all these factors has resulted in a decline in overall credit card debt outstanding and—especially—overall unfunded credit card commitments, reflecting pullbacks by both consumers and lenders. For national banks, managed card outstandings (*i.e.*, funded loans both on and off banks' balance sheets) declined by 4 percent thus far this year, or roughly \$27 billion. Unfunded credit card commitments (lines available to customers) have declined more precipitously, by 14.8 percent or \$44.8 billion. These trends are consistent with overall industry data.

In summary, retail credit quality issues continue to be an area of concern, especially for the larger national banks. Although there are some early signs of delinquency rates declining, with some bankers telling us they are beginning to see adverse trends leveling off, sustained improvements in this sector will largely depend on the length and depth of the recession and levels of unemployment.

#### *B. Commercial and Industrial Loans*

The fallout from the housing and consumer sectors to other segments of the economy is evident in the performance of national banks' commercial and industrial (C&I) loan portfolios. Adverse trends in key performance measures, including 30-day or morepast due delinquencies, non-performing rates, and net loss rates, sharply accelerated in the latter part of last year and have continued to trend upward in 2009. For example, the percentage of C&I loans that are delinquent or nonperforming has risen from a recent historical low of 1.02 percent in 2Q:2007 to 3.90 percent in 2Q:2009. Although this is the highest rate since the ratio peaked at 4.15 percent in 2Q:2002 during the last recession, it is still well below the 1991 recession peak of 6.5 percent.

In contrast to retail loans, which primarily affect the larger national banks, the effect of adverse trends in C&I loans is fairly uniform across the national bank population. This segment of loans represents approximately 20 percent of total loans in the national banking system, with levels somewhat more concentrated at larger institutions than at community banks, where C&I loans account for approximately 16 percent of total loans. While credit quality indicators are marginally worse at the larger national banks, the trend rate and direction are fairly consistent across all sizes of national banks.

One measure of C&I loan quality comes from the Federal banking agencies' Shared National Credit (SNC) program, which provides an annual review of large credit commitments that cut across the financial system. These large loans to large borrowers are originated by large banks, then syndicated to other banks and many

types of nonbank financial institutions such as securitization pools, hedge funds, insurance companies, and pension funds.<sup>7</sup> This year's review, which was just recently completed, also found sharp declines in credit quality. The review, which covered 8,955 credits totaling \$2.9 trillion extended to approximately 5,900 borrowers, found a record level of \$642 billion in criticized assets—meaning loans or commitments that had credit weaknesses—representing approximately 22 percent of the total SNC portfolio. Total loss of \$53 billion identified in the 2009 review exceeded the combined loss of the previous eight SNC reviews and nearly tripled the previous high in 2002. Examiners attributed the declining credit quality to weak economic conditions and the weak underwriting standards leading up to 2008.<sup>8</sup>

### *C. Commercial Real Estate Loans*

The greatest challenge facing many banks and their supervisors is the continued deterioration in commercial real estate loans (CRE). There are really two stories here, with one related to the other.

The first involves residential construction and development (C&D) lending, especially with respect to single family homes. Not surprisingly, given the terrible strains in the housing sector over the last 2 years, delinquency rates have already climbed to high levels, with significant losses already realized and more losses continuing to work their way through the banking system. For national banks as of June 30, total delinquent and nonperforming rates were at just over 34 percent in the largest national banks; 23.4 percent in mid-size banks; and 17.5 percent in community banks. The relative size of these loss rates is somewhat misleading, however, because many community banks and some mid-size banks have much greater concentrations in residential C&D loans than the largest banks. As a result, the concentrated losses in these smaller institutions has had a much more pronounced effect on viability, with concentrated residential C&D lending constituting by far the single largest factor in commercial bank failures in the last two years. At this point in the credit cycle, we believe the bulk of residential C&D problems have been identified and are being addressed, although a number will continue to produce losses that result in more bank failures.

The second story involves all other types of commercial real estate loans, including loans secured by income producing properties. Credit deterioration has spread to these assets as well, and trend lines are definitely worsening, but thus far the banking system has not experienced anywhere near the level of delinquency and loss as it has in C&D lending.

Still, the signs are troubling. Declining real estate values caused by rising vacancy rates, increasing investor return requirements, falling rental rates, and weak sales are affecting all CRE segments. For example, Property and Portfolio Research reports that apartment vacancy rates have hit a 25-plus year high at 8.4 percent nationally, and there are similar patterns for retail, office, and warehouse space as demand falls across all segments. But unlike the CRE markets in 1991, much of the current fallout is driven more by a decrease in demand than from an oversupply of properties.

The outlook for these markets over the near term, especially for the income producing property sector, is not favorable. In general, deterioration in performance for these CRE loans lags the economy as borrowers' cash-flows may be sufficient during the early stages of a downturn, but become increasingly strained over time. There are also growing concerns about the refinancing risk within the commercial mortgage-backed securities market (CMBS) where there is a currently moderate-but-growing pipeline of loans scheduled to mature. Permanent or rollover refinancing of these loans may be difficult due to the declines in commercial property values coupled with the return to more prudent underwriting standards by both lenders and investors. While this is an area that we are monitoring, the largest proportion and more problematic of these mortgages will not mature until 2011 and 2012.

As with C&I loans, trends in total delinquent and nonperforming CRE rates (including C&D loans) have been fairly consistent across all segments of the national bank population, climbing to roughly 8.3 percent in 2Q:2009. While C&D losses will continue to be most problematic for the banks that have the largest concentrations in these assets, the extent to which other types of CRE loan losses will continue to climb will depend very much on the overall performance of the economy.

<sup>7</sup> In fact, nonbanks hold a disproportionate share of classified assets compared with their total share of the SNC portfolio, owning 47 percent of classified assets and 52 percent of nonaccrual loans, whereas FDIC-insured institutions hold only 24.2 percent of classified assets and 22.7 percent of nonaccrual loans.

<sup>8</sup> See OCC News Release 2009-11, September 24, 2009.

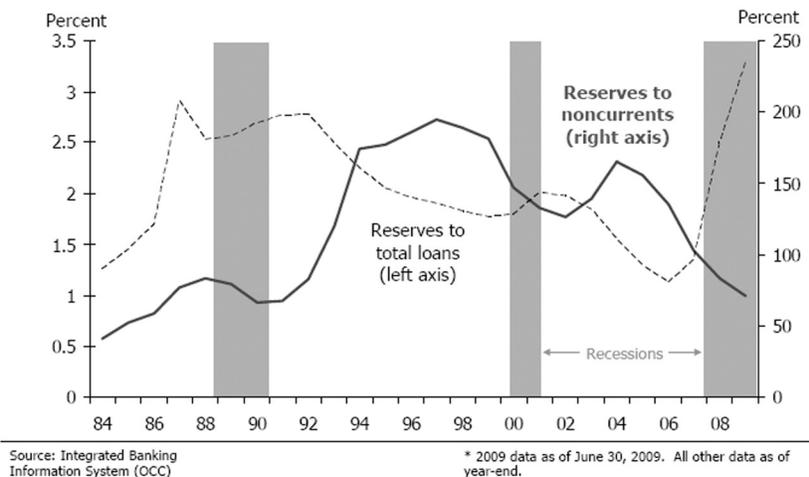
#### D. Capital and Reserve Levels

Perhaps the most critical tools for dealing with and absorbing credit losses are substantial levels of capital and reserves. As a result, in anticipation of rising credit losses over the last 2 years, the OCC has directed banks to build loan loss reserves and strengthen capital. In aggregate, the net amount of capital in national banks (*i.e.*, the net increase after items such as losses and dividends and including capital as a result of acquisitions and net TARP inflows) has risen by over \$186 billion over the last 2 years, and the net build to loan loss reserves (*i.e.*, loan loss provisions less net credit losses) has been over \$92 billion. These increases in loss-absorbing resources are critical contributors to the overall health of the national banking system.

As illustrated by the dotted line in the chart below, the level of reserves to total loans in the national banking system has increased dramatically to a ratio of 3.3 percent, the highest in over 25 years. While such high reserves are imperative for dealing with the high level of noncurrent loans, the solid line in the chart below shows that more provisions may be needed, because the ratio of reserves to noncurrent loans has continued to decline, to under 100 percent—reflecting the fact that the substantial growth in reserves is not keeping pace with the even greater growth in noncurrents.

Chart 7

### Ratio of reserves to noncurrents at lowest in 20 years despite elevated provisioning National banks



Substantially building reserves at the same time as credit conditions weaken is often described as unduly “pro-cyclical,” because bank earnings decline sharply from provisioning well before charge-offs actually occur. That is certainly an accurate characterization under the current accounting system for loan loss reserving, although there will always be a need to build reserves to some extent as credit losses rise. The issue is really about how much; that is, if reserve levels are high going into a credit downturn, then the need to build reserves is far lower than it is when the going-in levels are low. Unfortunately, our current accounting standards tend to produce very low levels of reserves just before the credit cycle turns downward, especially after prolonged periods of benign credit conditions as we had in the first part of this decade. In such periods, the backward-looking focus of the current accounting model creates undue pressure to decrease reserve levels even where lenders believe the cycle is turning and credit losses will clearly increase. I strongly believe that a more forward looking accounting model based on expected losses would *both* more accurately account for credit costs *and* be less pro-cyclical. This is an issue that I have been working on as co-chair of the Financial Stability Board’s

(FSB) Working Group on Provisioning, and I continue to be hopeful that accounting standard setters will embrace this type of change as they consider adjustments to loan loss provisioning standards.

#### **IV. Most National Banks Have Capacity to Weather This Storm**

The credit conditions I have just described are stark and will require considerable skills by bankers and regulators to work through. Despite these challenges, I believe the vast majority of national banks are and will continue to be sound, and that they have the wherewithal to manage through this credit cycle. Notwithstanding the negative trends and earnings pressures that banks are facing, we should not lose sight that, as of June 30, 2009, 97 percent of all national banks satisfied the required minimum capital standards to be considered well capitalized, and 76 percent reported positive earnings.

As previously described, the OCC has separate supervisory programs for Large Banks (assets generally exceeding \$100 billion); Mid-Sized Banks (assets from \$10 billion to \$100 billion); and Community Banks (assets below \$10 billion). Let me summarize our general assessment of the condition of each group.

##### *A. Large Banks*

In some respects, large banks faced the earliest challenges, with the disruptions in wholesale funding markets, the significant losses they sustained on various structured securities, and the pronounced losses that emerged earlier in their retail credit portfolios. As I mentioned, there are some preliminary indicators that the rate of increased problems in the retail sector may have begun to slow, but as with credit conditions in general, much of this will depend on the timing and strength of the economy, and in particular, on unemployment rates. C&I and CRE loan exposures remain a concern for these banks, but they have more diversified portfolios and exposures than many smaller banks and thus may be in a better position to absorb these problems. Collectively, the fifteen banks in our Large Bank program raised \$132 billion in capital (excluding TARP funding) in 2008 and, over the past twenty 4 months, their net build to loan loss reserves totaled approximately \$85 billion.

Earlier this year we and the other Federal regulators conducted a detailed stress test of the largest U.S. banks as part of the Supervisory Capital Assessment Program (SCAP) to examine their ability to withstand even further deterioration in market and credit conditions. I believe that was an extremely valuable exercise for four reasons. First, the one-time public assessment of individual institution supervisory results—which was only made possible by the U.S. Government backstop made available by TARP funding—alleviated a great deal of uncertainty about the depth of credit problems on bank balance sheets, which a number of analysts had assumed to be in far worse condition. Second, the reduction of uncertainty allowed institutions to access private capital markets to increase their capital buffer for possibly severe future losses, instead of requiring more government capital. Third, the additional capital required to be raised or otherwise generated now—over \$45 billion in common stock alone has already been issued by the nine SCAP institutions with national bank subsidiaries—provides these banks with a strong buffer to absorb the severe losses and sharply reduced revenue associated with the adverse stress scenario imposed under SCAP for the 2-year period of 2009 and 2010, should that scenario come to pass. Fourth, as we track banks' actual credit performance against the SCAP adverse stress scenario to ensure that capital levels remain adequate, we have found that, through the first half of 2009—which constitutes 25 percent of the overall 2-year SCAP stress period—actual aggregate loan losses were well below 25 percent of the aggregate losses projected for the full SCAP period, and actual aggregate revenues were well above 25 percent of the aggregate projected SCAP revenues. While those trends could change as the stress period continues, the early results are promising.

##### *B. Mid-Size Banks*

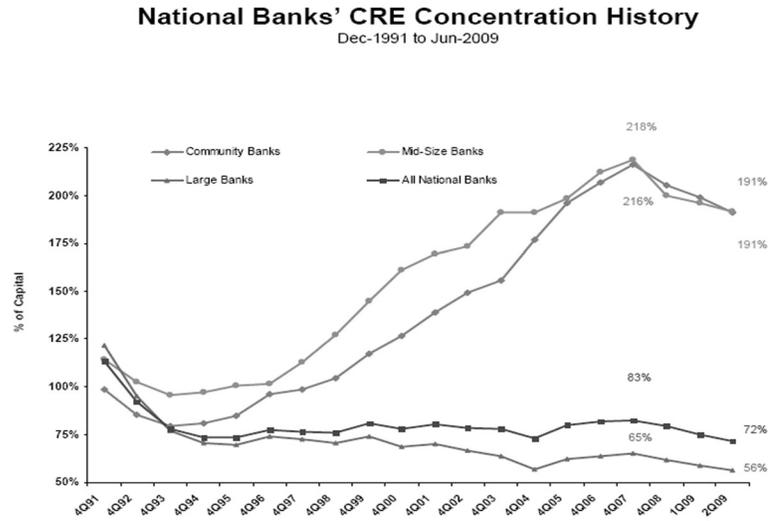
Although mid-size national banks engage in retail lending, the scope and size of their exposures are not as significant as those of the largest national banks. Mid-size banks also did not have the significant losses that larger banks did from various structured investment products. Nevertheless, loan growth at these banks turned negative in 2Q:2009, and although they experienced modest improvements in net interest margins in the second quarter, they still face downward earnings pressures, primarily due to increasing loan loss provisions. Given their exposures to the C&I and CRE markets, we expect these pressures will persist, notwithstanding the \$3.5 billion in net reserve builds over the last twenty four months. These banks have also had success in attracting new capital, raising close to \$5 billion thus far this year.

### C. Community Banks

Nearly all national community banks entered this environment with strong capital bases that exceeded regulatory minimums. As a group, they have been less exposed to problems in the retail credit sector that have confronted large and mid-size banks, and the vast majority of these banks remain in sound financial condition. As noted earlier, there is a small number of community banks that have concentrations in trust preferred and private label mortgage-backed securities that we are closely monitoring.

Of more significance are the exposures that many community banks have to commercial real estate loans. As I noted in my June 2008 testimony, we have been concerned for some time about the sizable concentrations of CRE loans found at many smaller national banks. While national banks of all sizes have significant CRE exposures, as shown in Chart 8, CRE concentrations are most pronounced at community and mid-size banks.

Chart 8



Source: Call Reports.

Because of this, the OCC began conducting horizontal reviews of banks with significant concentrations about 5 years ago. As credit conditions worsened, our efforts intensified in banks that we believed were at high risk from downturns in real estate markets. Our goal has been to work with bankers to get potential CRE problems identified at an early stage so that bank management can take effective remedial action. In most but not all cases, bank management teams are successfully working through their problems and have adequate capital and stable funding bases to weather additional loan losses and earnings pressures.

### V. Resolution of Problem Banks

Given the strains in the economy and banking system, it is not surprising that the number of problem banks has increased from the recent historical lows. In the early 1990s, the number of problem national banks—those with a CAMELS composite rating of 3, 4 or 5—reached a high of 28 percent of all national banks. Thereafter, the number of problem national banks relative to all national banks dropped dramatically and then fluctuated in a range of three to 6 percent until 2007. Since then, however, the number of problem banks has risen steadily, and it is now approximately 17 percent of national banks.

As would be expected, this upward trend in problem banks also has resulted in an increased number of bank failures. In January, 2008, we had the first national bank failure in almost 4 years, the longest period without a failure in the 146-year

history of the OCC. That began the current period of significantly increased failures. In total, since January 1 of 2008, there have been 123 failures of insured banks and thrifts. Of these, 19 have been national banks, accounting for 11 percent of the total projected loss to the deposit insurance fund from all banks that failed during this period. All of the 19 failed national banks have been community banks, although the total obviously does not include the two large bank holding companies with lead national banks that were the subject of systemic risk determinations and received extraordinary TARP assistance on an open-institution basis.

While the vast majority of national banks have the financial capacity and management skills to weather the current environment, some will not. Given the real estate concentrations in community banks, the number of problem banks, the severe problems in housing markets, and increasing concern with CRE, we expect more bank failures in the months ahead. Some troubled banks will be able to find strong buyers—in some instances with our assistance—that will enable them to avoid failure and resolution by the FDIC. But that will not always be possible. When it is not, our goal, consistent with the provisions of the Federal Deposit Insurance Corporation Improvement Act, is to effect early and least cost resolution of the bank with a minimum of disruption to the community.

#### **VI. OCC Will Continue to Take a Balanced Approach in Our Supervision of National Banks**

Finally, I want to underscore the OCC's commitment to provide a balanced and fair approach in our supervision of national banks as bankers work through the challenges that are facing them and their borrowers. We recognize the important roles that credit availability and prudent lending play in our nation's economy, and we are particularly aware of the vital role that many smaller banks play in meeting the credit needs of small businesses in their local communities. Our goal is to ensure that national banks can continue to meet these needs in a safe and sound manner.

I have heard some reports that bankers are receiving mixed messages from regulators: on one hand being urged to make loans to creditworthy customers, while at the same time being subjected to what some have characterized as "overzealous" regulatory examinations. In this context, let me emphasize that our messages to bankers have and continue to be straight-forward:

- Bankers should continue to make loans to creditworthy borrowers;
- But they should not make loans that they believe are unlikely to be repaid in full; and
- They should continue to work constructively with troubled borrowers—but recognize repayment problems in loans when they see them, because delay and denial only makes things worse.

Let me also underscore what OCC examiners will and will not do. Examiners will not tell bankers to call or renegotiate a loan; dictate loan structures or pricing; or prescribe limits (beyond regulatory limits) on types or amounts of loans that a bank may make if the bank has adequate capital and systems to support and manage its risks. Examiners will look to see that bankers have made loans on prudent terms, based on sound analysis of financial and collateral information; that banks have sufficient risk management systems in place to identify and control risks; that they set aside sufficient reserves and capital to buffer and absorb actual and potential losses; and that they accurately reflect the condition of their loan portfolios in their financial statements.

Nevertheless, balanced supervision does not mean that examiners will allow bankers to ignore or mask credit problems. Early recognition and action by management are critical factors in successfully rehabilitating a problem bank. Conversely, the mere passage of time and hope for improved market conditions are not successful resolution strategies.

We have taken a number of steps to ensure that our examiners are applying these principles in a balanced and consistent manner. For example, we hold both regular meetings and periodic national teleconferences with our field examiners to convey key supervisory messages and objectives. In our April 2008 nationwide call, we reviewed and discussed key supervisory principles for evaluating commercial real estate lending. In April of this year we issued guidance to our examiners on elements of an effective workout/restructure program for problem real estate loans. We noted that effective workouts can take a number of forms, including simple renewal or extension of the loan terms, extension of additional credit; formal restructuring of the loan terms; and, in some cases, foreclosure on underlying collateral. We further reiterated these key principles in a nationwide call with our mid-size and community bank examiners earlier this month.

Through the FFIEC, we are also working with the other Federal and state banking agencies to update and reinforce our existing guidance on working with CRE borrowers and to help ensure consistent application of these principles across all banks. This guidance will reaffirm that prudent workouts are often in the best interests of both the bank and borrower and that examiners should take a balanced approach in evaluating workouts. In particular, examiners should not criticize banks that implement effective workouts after performing a comprehensive review of the borrower's condition, even if the restructured loans have weaknesses that result in adverse credit classification. Nor should they criticize renewed or restructured loans to borrowers with a demonstrated ability to repay, merely because of a decline in collateral values. Consistent with current policies, loans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or the underlying collateral generally will not be classified. However, deferring issues for another day does not help the CRE sector or banking industry recover. It is important that bankers acknowledge changing risk and repayment sources that may no longer be adequate.

### **VII. Conclusion**

I firmly believe that the collective measures that government officials, bank regulators, and many bankers have taken in recent months have put our financial system on a much more sound footing. These steps are also crucial to ensuring that banks will be able to continue their role as lenders and financial intermediaries. Nonetheless, it is equally clear that there are still many challenges ahead, especially with regard to the significant deterioration in credit that both supervisors and bankers must work through. There are no quick fixes to this problem, and there is the real potential that, for a large number of banks, credit quality will get worse in the months ahead. Notwithstanding the significant loan loss provisions that banks have taken over the past 2 years, more may be needed as provisions and resulting loan loss reserves have not kept pace with the rapid increase in nonperforming assets.

The OCC is firmly committed to taking a balanced approach as bankers work through these issues. We will continue to encourage bankers to lend and to work with borrowers. However, we will also ensure that they do so in a safe and sound manner and that they recognize and address their problems on a timely basis.

### **PREPARED STATEMENT OF DANIEL K. TARULLO**

MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

OCTOBER 14, 2009

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

#### **Conditions in Financial Markets and the Economy**

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

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

Against this backdrop, borrowing by households and businesses has been weak. According to the Federal Reserve's Flow of Funds accounts, household and non-financial business debt contracted in the first half of the year and appears to have decreased again in the third quarter. For households, residential mortgage debt and consumer credit fell sharply in the first half; the decline in consumer credit continued in July and August. Nonfinancial business debt also decreased modestly in the first half of the year and appears to have contracted further in the third quarter.

as net decreases in commercial paper, commercial mortgages, and bank loans more than offset a solid pace of corporate bond issuance.

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

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

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

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

#### **Performance of the Banking System**

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

However, the banking system remains fragile. Nearly 2 years into a substantial recession, loan quality is poor across many asset classes and, as noted earlier, continues to deteriorate as lingering weakness in housing markets affects the performance of residential mortgages and construction loans. Higher loan losses are depleting loan loss reserves at many banking organizations, necessitating large new provisions that are producing net losses or low earnings. In addition, although capital ratios are considerably higher than they were at the start of the crisis for many banking organizations, poor loan quality, subpar earnings, and uncertainty about future conditions raise questions about capital adequacy for some institutions. Diminished loan demand, more-conservative underwriting standards in the wake of the crisis, recessionary economic conditions, and a focus on working out problem loans have also limited the degree to which banks have added high quality loans to their portfolios, an essential step to expanding profitable assets and thus restoring earnings performance.

These developments have raised the number of problem banks to the highest level since the early 1990s, and the rate of bank and thrift failures has accelerated throughout the year. Moreover, the estimated loss rates for the deposit insurance fund on bank failures have been very high, generally hovering near 30 percent of assets. This high loss level reflects the rapidity with which loan quality has deteriorated.

<sup>1</sup>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](http://www.Federalreserve.gov/newsevents/speech/bernanke20090511a.htm).

rated during the crisis and suggests that banking organizations may need to continue their high level of loan loss provisioning for some time. Moreover, some of these institutions, including those with capital above minimum requirements, may need to raise more capital and restrain their dividend payouts for the foreseeable future. Indeed, the buildup in capital ratios at large banking organizations has been essential to reassuring the market of their improving condition. However, we must recognize that capital ratios can be an imperfect indicator of a bank's overall strength, particularly in periods in which credit quality is deteriorating rapidly and loan loss rates are moving higher.

#### **Comparative Performance of Banking Institutions by Asset Size**

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

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

Loan quality deteriorated significantly for both large and small institutions during the second quarter. At the largest 50 bank holding companies, nonperforming assets climbed more than 20 percent, raising the ratio of nonperforming assets to 4.3 percent of loans and other real estate owned. Most of the deterioration was concentrated in residential mortgage and construction loans, but commercial, CRE, and credit card loans also experienced rising delinquency rates. Results of the banking agencies' Shared National Credit review, released in September, also document significant deterioration in large syndicated loans, signaling likely further deterioration in commercial loans.<sup>2</sup> At community and small regional banks, nonperforming assets increased to 4.4 percent of loans at the end of the second quarter, more than six times the level for this ratio at year-end 2006, before the crisis started. Home mortgages and CRE loans accounted for most of the increase, but commercial loans have also shown marked deterioration during recent quarters. Importantly, aggregate equity capital for the top 50 bank holding companies, and thereby for the banking industry, increased for the third consecutive quarter and reached 8.8 percent of consolidated assets as of June 30, 2009. This level was almost 1 percentage point above the year-end 2008 level and exceeded the pre-crisis level of midyear 2007 by more than 2 percentage points. Risk-based capital ratios for the top 50 bank holding companies also remained relatively high: Tier 1 capital ratios were at 10.75 percent, and total risk-based capital ratios were at 14.09 percent. Signaling the recent improvement in financial markets since the crisis began, capital increases during the first half of this year largely reflected common stock issuance, supported also by reductions in dividend payments. However, asset contraction also accounts for part of the improvement in capital ratios. Additionally, of course, the Treasury Capital Pur-

<sup>2</sup>See Board of Governors of the Federal Reserve System, FDIC, Office of the Comptroller of the Currency, and Office of Thrift Supervision (2009), "Credit Quality Declines in Annual Shared National Credits Review," joint press release, September 24, [www.Federalreserve.gov/newsevents/press/bcreg/20090924a.htm](http://www.Federalreserve.gov/newsevents/press/bcreg/20090924a.htm).

chase Program also contributed to the increase in capital in the time since the crisis emerged.

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

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

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

### **Current Conditions in Commercial Real Estate Markets**

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

The negative fundamentals in the CRE property markets have caused a sharp deterioration in the credit performance of loans in banks’ portfolios and loans in commercial mortgage-backed securities (CMBS). At the end of the second quarter of 2009, approximately \$3.5 trillion of outstanding debt was associated with CRE, including loans for multifamily housing developments. Of this, \$1.7 trillion was held on the books of banks and thrifts, and an additional \$900 billion represented collateral for CMBS, with other investors holding the remaining balance of \$900 billion. Also at the end of the second quarter, about 9 percent of CRE loans on banks’ books were considered delinquent, almost double the level of a year earlier.<sup>3</sup> 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.

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

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

<sup>3</sup>The CRE loans considered delinquent on banks’ books were non-owner occupied CRE loans that were 30 days or more past due.

generated significant stresses on the balance sheets of financial institutions that must mark these securities to market, further limiting their appetite for taking on new CRE exposure.

#### **Federal Reserve Activities to Help Revitalize Credit Markets**

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

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

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

#### **Availability of Credit**

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

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

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

<sup>4</sup> 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](http://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](http://www.Federalreserve.gov/BoardDocs/SRLetters/1991/SR9124a1.pdf).

<sup>5</sup> 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](http://www.Federalreserve.gov/boarddocs/srletters/2007/SR0701.htm).

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

### **Strengthening the Supervisory Process**

The recently completed SCAP of the 19 largest U.S. bank holding companies demonstrates the effectiveness of forward-looking horizontal reviews and marked an important evolutionary step in the ability of such reviews to enhance supervision. Clearly, horizontal reviews—reviews of risks, risk-management practices and other issues across multiple financial firms—are very effective vehicles for identifying both common trends and institution-specific weaknesses. The SCAP expanded the scope of horizontal reviews and included the use of a uniform set of stress parameters to apply consistently across firms.

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

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

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

<sup>6</sup>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](http://www.Federalreserve.gov/newsevents/press/bcreg/20081112a.htm).

rent crisis, we are using all of the information and insight that the analytic abilities the Federal Reserve can bring to bear in financial supervision.

**Conclusion**

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

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



STATEMENT

OF

THE HONORABLE DEBORAH MATZ  
CHAIRMAN  
NATIONAL CREDIT UNION ADMINISTRATION

"EXAMINING THE STATE OF THE BANKING INDUSTRY"

BEFORE THE

SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS  
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

WEDNESDAY, OCTOBER 14, 2009

## I. Introduction

The National Credit Union Administration (NCUA) appreciates the opportunity to provide views on "Examining the State of the Banking Industry." Federally-insured credit unions comprise a relatively small but important part of the financial institution community. However, some 90 million members belong to credit unions so the asset size of the industry is not proportional to its importance to consumers.<sup>1</sup>

NCUA's primary mission is to ensure the safety and soundness of federally-insured credit unions. It performs this important public function by examining all federal credit unions, participating in the supervision of federally-insured state chartered credit unions in coordination with state regulators, and insuring federally-insured credit union members' accounts. In its statutory role as the administrator for the National Credit Union Share Insurance Fund (NCUSIF), NCUA provides oversight and supervision to 7,691 federally-insured credit unions, representing 98 percent of all credit unions and approximately 90 million members.<sup>2</sup>

While credit unions were not active participants in the non-traditional and subprime mortgage lending activities which facilitated much of the financial crisis over the last 18

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<sup>1</sup> June 30, 2009 total assets for credit unions equaled \$870.13 billion, while total assets for federally-insured banks equaled \$11.9 trillion. Based on June 30, 2009 Call Report (NCUA Form 5300) data and on information available at the FDIC website: <http://www2.fdic.gov/SDI>.

<sup>2</sup> Approximately 156 state-chartered credit unions are privately insured and are not subject to NCUA oversight. The term "credit union" is used throughout this statement to refer to federally insured credit unions.

months, they have nonetheless been adversely impacted by the ripple effects of these market dislocations. Although the majority of credit unions heeded NCUA's repeated warnings about the risks of certain lending programs, some corporate credit unions, including the two largest, invested in pools of securitized subprime, Alt-A, and other non-traditional mortgage loans. The current projected credit losses on the underlying mortgages are far beyond those expected at the time of investment, resulting in significant losses to these corporate credit unions. This has had far reaching effects, impeding liquidity and capital throughout the credit union industry.

## II. Status of Corporate Credit Unions

The downturn in the residential mortgage-backed securities market had a devastating impact on the twenty-eight corporate credit unions.<sup>3</sup> As stated earlier, a number of corporate credit unions invested in mortgage-backed products. While the majority of the investments were AAA or AA rated, even highly rated securities were not immune to the market contagion. In 2005 and 2006, significant levels of non-agency residential mortgage-backed positions in the ALT-A sector, with mezzanine ALT-A tranches, were added to the portfolios of the two largest corporate credit unions – Western Corporate Federal Credit Union (WesCorp) and U.S. Central Federal Credit Union (U.S. Central). The subsequent market downturn which began in 2007 forced both WesCorp and U.S.

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<sup>3</sup> Corporate credit unions operate primarily for the purpose of serving credit unions. There are currently twenty-seven retail corporate credit unions that primarily serve natural person credit unions. Additionally, there is one wholesale corporate credit union (U.S. Central Federal Credit Union) that is a corporate credit union serving the retail corporates. As of August 31, 2009, total corporate credit union network assets were \$93.7 billion and total shares and deposits of \$94.8 billion.

Central to reflect significant losses when performing a valuation of their investment portfolios in accordance with Generally Accepted Accounting Principles.

The immediate impact of the market downturn was a critical global liquidity crisis and credit unions were also affected. Traditionally, credit unions relied heavily on corporate credit unions for liquidity needs. However, corporate credit unions were not able to liquidate the mortgage-backed securities in their investment portfolios without recognizing significant losses. NCUA took decisive action to utilize its resources to ensure adequate liquidity in the credit union system. The NCUSIF and the Central Liquidity Facility (CLF),<sup>4</sup> in its role of improving general financial stability by meeting the liquidity needs of credit unions, served as major catalysts to the NCUA's liquidity stabilization efforts in developing numerous programs. Some of the key actions include:

1. The Temporary Corporate Credit Union Liquidity Guarantee Program was introduced in October 2008.<sup>5</sup> Under this program, the NCUSIF guarantees the timely payment of principal and interest on certain unsecured debt of participating corporate credit unions.
2. The Credit Union Homeowners Affordability Relief Program (CU HARP) was adopted in December 2008.<sup>6</sup> Under the program credit unions were able to help

<sup>4</sup> The Central Liquidity Facility was created by Congress in 1979 to improve the general financial stability of the credit union industry by meeting the liquidity needs of individual credit unions.

<sup>5</sup> Information on the Temporary Corporate Credit Union Liquidity Guarantee Program can be found at <http://www.ncua.gov/Resources/CLF/Index.aspx>.

<sup>6</sup> Information on the Credit Union Homeowners Affordability Relief Program (CU HARP) can be found at <http://www.ncua.gov/Resources/CLF/Index.aspx>.

eligible members hold onto their homes while also maintaining liquidity in the credit union system. Credit unions receiving a CU HARP advance through the CLF were required to invest the proceeds in a CU HARP Note, which is a NCUSIF guaranteed senior debt of a corporate credit union. The participating credit unions receive the benefit of passing on a rate break to their members in the form of a 1 percent bonus coupon to assist in making their mortgage loan more affordable.

3. The Credit Union System Investment Program (CU SIP) was also adopted in December 2008.<sup>7</sup> Credit unions receiving a CU SIP advance through the CLF were required to invest the proceeds in a CU SIP Note, which is a NCUSIF guaranteed senior debt of a corporate credit union. CU SIP funds provided a source of liquidity to corporate credit unions within the credit union system.
4. The Temporary Corporate Credit Union Share Guarantee Program was adopted in January 2009.<sup>8</sup> Under this program, the NCUSIF was utilized to guarantee all shares (excluding paid-in capital and membership capital accounts) in corporate credit unions.<sup>9</sup>

<sup>7</sup> Information on the Credit Union System Investment Program (CU SIP) can be found at <http://www.ncua.gov/Resources/CLF/Index.aspx>.

<sup>8</sup> Information on the Temporary Corporate Credit Union Share Guarantee Program can be found at <http://www.ncua.gov/Resources/CLF/Index.aspx>.

<sup>9</sup> Paid-in capital accounts are perpetual, non-cumulative dividend accounts; are available to cover losses that exceed retained earnings; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings. Membership capital accounts are funds contributed by members that are adjustable balance with a minimum withdrawal notice of 3 years or are term certificates with a minimum term of 3 years; are available to cover losses that exceed retained earnings and paid-in capital; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings.

These efforts were critical in stabilizing the liquidity situation throughout the credit union system. Combined, credit union participation in CU HARP and CU SIP provided approximately \$8.4 billion in funding to the corporate credit union system. The Temporary Corporate Credit Union Share Guarantee Program reduced an outflow of credit union funds from corporate credit unions and allowed corporate credit unions to maintain a presence in the marketplace. Without these efforts, it is highly likely that a liquidity crisis would have devastated the credit union system, and would have forced some corporate credit unions to liquidate their mortgage-backed securities at depressed market prices and incur significant losses.

NCUA contracted for an independent third-party valuation beginning in January 2009 to evaluate the credit risk in mortgage-backed securities held by the corporate credit unions. It was imperative that NCUA have an independent means of testing the veracity of the corporate credit union modeling results before committing the NCUSIF as a means of resolving the issues. The corporate credit unions maintained internal processes for pricing investment portfolios, and also obtained independent third-party credit analyses. As the condition of the portfolios of WesCorp and U.S. Central continued to deteriorate, NCUA determined it was necessary to take action to protect the members of those corporates and to safeguard the NCUSIF. On March 20, 2009, WesCorp and U.S. Central were placed into conservatorship.

The impact of the losses at U.S. Central reverberated through the rest of the corporate credit unions. Twenty-six of the twenty-seven retail corporates are members of U.S. Central. As the losses at U.S. Central exceeded retained earnings, the paid-in capital and membership capital accounts held by the retail corporates were depleted to absorb the losses. Retail corporate credit unions' paid-in capital at U.S. Central was depleted by 100 percent and retail corporate credit unions' membership capital was depleted by 63.7 percent. The losses flowed through to natural person credit unions. Where losses exceeded retained earnings at the retail corporate credit union, then the paid-in capital and membership capital accounts invested by natural person credit unions were depleted.

Over the past year, each quarterly modeling performed by the corporate credit unions on their investment portfolios reflected increasingly negative economic information which resulted in additional losses in the portfolios. Although, the rate of change in the amount of losses is slowing, as conditions continue to deteriorate in the real estate markets, there may be additional investment losses.

NCUA is in the process of drafting significant revisions to its corporate credit union rule, Part 704. NCUA issued an Advanced Notice of Proposed Rulemaking (ANPR) in January 2009 to solicit comments on reforming the corporate credit union system. Over 400 comment letters on the ANPR were received and NCUA is currently developing a proposed rule for public comment. To supplement the comments received on the ANPR, NCUA has also been hosting a series of town hall meetings across the nation to

foster face-to-face dialogue about the proposed rule. In addition to looking at those issues that may have directly led to the current problems facing corporate credit unions, NCUA is conducting a comprehensive review of the entire corporate regulatory framework. The key areas under review are:

- Capital and Prompt Corrective Action requirements;
- Investment concentration and sector limits;
- Asset-Liability Management requirements; and,
- Corporate Governance.

It is NCUA's goal to issue the proposed rule for comment in November 2009 and have in place a new regulatory framework for the corporate credit union system by mid-2010. As the industry moves through the regulatory transition period, continued support by the NCUSIF and the CLF will be critical to natural person credit unions' ability to meet the financial needs of the 90 million credit union members.

WesCorp and U.S. Central are preparing to utilize external sources of funding through offering issuances guaranteed by the NCUSIF for terms of two to three years. This action will provide liquidity within the credit union system during the regulatory transition period, and enable NCUA to consider alternatives in the disposition of the distressed assets on the corporate credit union balance sheets.

NCUA has taken very concrete action to protect the credit union system by stabilizing the corporate credit unions and providing options for a resolution that would be the least costly to the NCUSIF. It should be noted that regardless of the final regulatory framework established, corporate credit unions will only be viable if their natural person credit union members are willing to recapitalize them.

### **III. NCUA's Actions to Stabilize the Credit Union Industry**

Since the summer of 2008, NCUA implemented actions in addition to those already discussed to help stabilize the credit union industry in the wake of the mortgage and housing crisis. One crucial step taken was to pursue Congressional action to lift the appropriated lending limit for the CLF from \$1.5 billion to its full statutory limit of \$41.5 billion. NCUA appreciates the support provided by Congressional leaders in granting this request, as it has played a key role in maintaining sufficient liquidity within the credit union system.

Following the passage of the Emergency Economic Stabilization Act, NCUA intensified its share insurance public awareness campaign, through television, radio, and print advertisements, to highlight the increased insurance amount of \$250,000 as well as the overall strength of federal insurance. An electronic Consumer Share Insurance Tool Kit was developed and posted to NCUA's website. The Tool Kit contains useful consumer brochures, a share insurance estimator, and other insurance-related publications.<sup>10</sup>

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<sup>10</sup> Available at <http://www.ncua.gov/Resources/ShareInsuranceToolkit.aspx>.

NCUA also petitioned the Department of Treasury and the Board of Governors of the Federal Reserve System to allow the agency to expand the lending authority of the CLF for other than liquidity purposes. With their concurrence, NCUA was able to move forward with the CU SIP and CU HARP initiatives addressed above.

On May 20, 2009, the Helping Families Save Their Homes Act was signed into law. Among other things, this crucial piece of legislation established the Temporary Corporate Credit Union Stabilization Fund (TCCUSF) to mitigate near-term stabilization costs by allowing costs to be spread over a 7-year period instead of being assessed in a lump sum. Within a month of the legislation, NCUA acted decisively to establish the necessary corporate governance structure of this separate stabilization fund. On June 18, 2009, the Board approved actions to legally obligate the TCCUSF for the costs of stabilizing the corporate system.

#### **IV. Status of Natural Person Credit Unions**

The credit union industry has been challenged over the last 18 months. Unprecedented high rates have been recorded for many key financial ratios, including real estate delinquency, aggregate delinquency, and net losses. During this same timeframe, however, credit unions also received large amounts of member deposits and continued lending when many other financial institutions were scaling back lending efforts. The following discussion highlights some key operating trends.

#### Credit Unions Provide Members with a Full Range of Loan Products

As often happens during economic downturns, a savings flight to quality drove an annualized increase in member deposits of nearly 16 percent through the first six months of 2009. This provided funds for credit unions to continue to lend during the economic downturn. Loans continue to be the largest credit union balance sheet item, representing an industry-wide commitment to meeting the lending needs of members with a full range of lending products and services. At the mid-point of 2009, net loans represented 65 percent of aggregate credit union assets. Loans increased \$4 billion in the first half of 2009 and increased \$37 billion during 2008. Consistent with the last few years, real estate loans accounted for the majority of all loan growth through the first half of 2009, and represent 54 percent of total loans. During this same timeframe, fixed rate first mortgages increased \$6.95 billion, or 5.66 percent, and adjustable rate first mortgages increased \$650 million, or 2.10 percent.

#### Delinquency and Net Loan Losses Have Increased in the Current Environment

The credit union industry is not immune to the macro economic impact of increasing credit risk exposure created by the current housing market. Since the end of 2006, the aggregate delinquent loan ratio has been steadily increasing, from 0.68 percent to a high of 1.58 percent of total loans as of June 2009. The aggregate net charge-off ratio for all loans also increased during the first half of 2009, from 0.85 percent to 1.15 percent of average loans.

Another key indicator of credit risk is the combined delinquency and net charge-off ratio. This ratio highlights an adverse cycle of delinquency despite aggressive charge-offs. The combined delinquency and net charge-off ratio has been increasing each quarter over the last 24 months to a high of 2.74 percent of average loans as of June 2009, compared to 1.14 percent in June 2007.

Higher Provision for Loan and Lease Losses and NCUA Corporate Stabilization Efforts Impacted Earnings

Aggregate credit union earnings through the first half of 2009 reflect actions taken by NCUA, through the NCUSIF, to stabilize the corporate credit union system and prevent interruption of services to natural person credit unions and their members. Through the first half of 2009, credit unions reported an annualized return on average assets of 0.28 percent.

Notwithstanding the NCUSIF stabilization efforts, credit union income levels were largely impacted by high levels of provision for loan and lease loss expense needed to fund reserves allocated for credit deteriorations in loan portfolios. The level of provisioning for loan losses may continue as the industry works through the current economic environment.

Credit Unions Still Have Strong Net Worth

Aggregate net worth increased \$1.11 billion, or 1.29 percent through the first six months of 2009, to \$67.34 billion, representing the highest dollar level in credit union history.

Although asset growth outpaced net worth growth during this same time period, thereby diluting the industry net worth ratio to 10.03 percent of total assets, the overwhelming majority of credit unions remain well capitalized. As of June 30, 2009, 98.35 percent of all credit unions were at least "adequately capitalized" or better, with 96.09 percent of all credit unions "well capitalized."<sup>11</sup> It is important to note, however, the influx of member shares coupled with declining net interest margins and high provision for loan and lease losses has slightly eroded the industry's net worth ratio to 2002 levels.

#### Emerging Trends

As mentioned earlier, the majority of credit unions have demonstrated sufficient restraint in avoiding the types of mortgage products which helped facilitate this financial downturn. As this downturn grew into an economic recession, even the most conservative credit unions faced unparalleled challenges resulting from declining home values and rising unemployment. NCUA will continue to monitor adverse trends stemming from this crisis. NCUA will be focusing on the following potential areas of concern:

##### *1) Interest Rate Risk*

Given the refinancing activity that typically occurs during a period of low interest rates, NCUA has observed an increasing level of fixed rate real estate loans, presently 64 percent of all mortgage loans. While NCUA recognizes the benefit to consumers of refinancing higher rate real estate loans into lower fixed rate

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<sup>11</sup> See 12 C.F.R. Part 702

loans, NCUA is concerned with the increasing interest rate risk associated with a high level of fixed rate, long-term assets should rates rise rapidly.

*2) Member Business Lending*

Subject to established regulations and a statutory lending limit, credit unions are permitted to maintain a member business loan portfolio.<sup>12</sup> NCUA supports a proper balance of serving members' business lending needs with a prudent regulatory framework to protect the NCUSIF. NCUA has been monitoring the increasing level of member business loans within the credit union community, presently at \$27.1 billion. While this figure represents only 3.11 percent of total credit union industry assets, NCUA is concerned with the increasing levels of delinquent member business loans, as well as an increasing concentration of large credit unions with supervisory concerns which are holding member business loans. As an example, a review of 71 credit unions with identified supervisory concerns was conducted as of June 30, 2009. These credit unions averaged \$1.1 billion in assets and 62 of them reported member business loans. By way of contrast, in 2005, only 50 of these same credit unions held member business loans. These credit unions hold higher levels of member business loans than the industry as a whole, both in 2005 and today. For these credit unions, the past due and charged off member business loans were lower than the credit union industry in 2005, but in the current environment the level increased to several multiples of the credit union industry aggregate levels.

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<sup>12</sup> See 12 C.F.R. Part 723.

For this group, delinquent member business loans increased from 0.17 percent to 8.34 percent in the last 42-month period, compared to the credit union trend of 0.47 percent to 3.19 percent during this same timeframe. A similar trend during this period was noted in net charge-offs, as the percent for this group increased from 0.04 percent to 0.33 percent compared to the credit union trend of 0.07 percent to 0.40 percent. Although member business lending was not identified as the primary area of concern in all of the large credit unions in this group, NCUA is concerned with the additional risks to operations member business loans can pose when coupled with other operational concerns. NCUA will be proactively monitoring member business loan exposure and plans to issue additional guidance in the near future.

*3) Increasing Number of Troubled Credit Unions*

NCUA has been adjusting our supervision programs and staffing given the increasing number of troubled credit unions as the industry moves through this stage of the economic cycle.<sup>13</sup> There are currently 326 troubled credit unions holding \$42.2 billion in assets, representing 4.2 percent of all credit unions and 4.9 percent of all credit union assets. While the number of troubled credit unions increased in the current year, the pace of that growth was slightly lower than in 2008. Troubled credit unions with over \$100 million in assets have grown at a faster rate than those with assets under \$100 million.

<sup>13</sup> NCUA defines a troubled credit union as rated either a CAMEL Code 4 or 5.

As of September 30, 2009, 66 credit unions with assets over \$100 million were considered troubled credit unions, compared to 12 in 2007. NCUA anticipates the overall number of troubled credit unions is likely to increase through the end of 2010 and into 2011. It is also likely that the rate of growth in the number and assets of troubled credit unions will decelerate as the economy recovers.

Regardless, NCUA has enhanced the examination program and dedicated additional resources to help manage the risks with troubled credit unions. These measures also include allocating appropriate on-site examination and supervision time at state chartered credit unions given their risk profile.

The NCUSIF has experienced increased losses during the past two years. In 2008 there were 18 credit union failures at a cost of \$233 million. Through September 30, 2009 there have been 21 failures at a cost of \$95 million.

#### Stress Testing the NCUSIF

The NCUSIF was created by Public Law 91-468 (Title II of the Federal Credit Union Act), which was amended in 1984 by Public Law 98-369. The Fund was established as a revolving fund in the United States Treasury under the NCUA Board for the purpose of insuring member share deposits in all federal credit unions and in qualifying state credit unions that request insurance. The NCUSIF is comprised of the 1 percent insured share deposit that credit unions contribute to the NCUSIF and the retained earnings of the fund. The NCUA Board is required to maintain the fund's equity ratio between 1.20

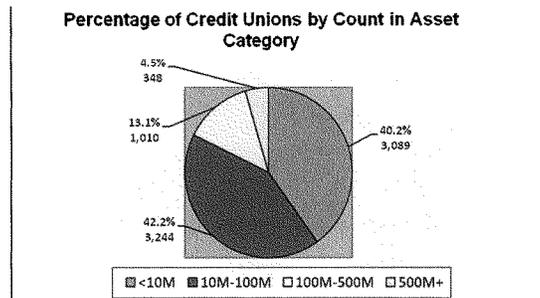
percent and 1.50 percent of insured shares. The Normal Operating Level has been maintained at 1.30 percent since December 1999.

As of December 31, 2008, the NCUSIF's equity ratio was 1.27 percent. However, the increased limit on share insurance, high levels of share growth, and increased levels of real and potential losses resulted in a reduction in the NCUSIF's equity ratio during 2009. In September, the NCUA took action to assess a 10 basis point premium on all credit unions' insured shares to restore the equity ratio to 1.30 percent.

To measure the robustness of the NCUSIF, NCUA performed a series of stress tests. The tests included analyzing the impact of further declines in real estate conditions, the impact of potential exposure to losses in the corporate credit union system, and the impact of the layering of these two stress events. NCUA also performed stress tests using the economic scenarios and the related loss rates utilized by the Department of Treasury in the Supervisory Capital Assessment Program. The result of these stress tests disclosed a wide range of losses. The amount of losses at baseline stress levels are well within the ability of the NCUSIF to absorb, but the number of credit unions that would be subject to additional supervision would create resource challenges. Should economic conditions significantly deteriorate, it is possible that losses could be greater than the level of the NCUSIF's current retained earnings, resulting in the need for credit unions having to expense and fund part of the 1 percent contributed capital deposit. NCUA will continue to assess the robustness of the fund as economic conditions change and take appropriate actions based on the results.

### V. LARGE AND SMALL CREDIT UNION CONSIDERATIONS

When comparing the size and complexity of credit unions to banks, even the largest credit unions are small in comparison to most banks. As shown in the graph below, small credit unions make up the majority of the institutions which the NCUA insures.



Eighty-two percent of credit unions have less than \$100 million in assets as opposed to thirty-eight percent of the institutions that the Federal Deposit Insurance Corporation (FDIC) insures with the same asset size.<sup>14</sup> Total assets in the entire credit union industry are less than the individual total assets of some of the nation's largest banks.

As of June 30, 2009, the credit union industry is well capitalized at 10.03 percent; however, small credit unions (less than \$10 million in assets) tend to be better capitalized than the larger credit unions. As of June 2009, small credit unions had an

<sup>14</sup> Based on information available at the FDIC website: <http://www2.fdic.gov/SDI>.

average net worth of 17 percent as compared to an average net worth of larger credit unions (more than \$10 million in assets) of 9.95 percent.

As of June 2009, there were 3,089 small credit unions as compared to 4,602 larger credit unions. These small credit unions represent 40 percent of total credit unions serving approximately 3 million members, or 3 percent of the 89 million members served by credit unions.

The impact of current economic conditions appears to weigh more heavily on small credit unions than larger credit unions. During the first six months of this year, small credit unions' net worth declined \$196 million while larger credit unions' net worth increased by \$1.3 billion. Also during this period, small credit unions reported a negative net income while large credit unions reported positive net income.

The highest share and loan growth was reported in larger credit unions; however, the larger credit unions are reporting the highest charge-offs and provision for loan and lease losses. The larger credit unions have the ability to provide a wider array of member services, including, but not limited to, electronic banking, real estate loans, and member business loans.

NCUA's Office of Small Credit Union Initiatives

In 1993, NCUA created the Office of Community Development Credit Unions dedicated to ensuring the long-term viability of small and low-income designated credit unions.

Today this activity is handled by the Office of Small Credit Union Initiatives (OSCUI), which has expanded from a staff of six and a budget of \$756,000 in 2004, to 27 staff and a \$4.7 million budget in 2009.

OSCUI conducts regional and national training workshops on a variety of topics to help small and low-income designated credit unions succeed. For example, in 2008, OSCUI conducted 20 national workshops, 10 roundtables, and 22 clinics offering topics that will assist credit unions in product development, planning, and operational and compliance issues. In attendance at OSCUI's 2008 training events were 2,494 credit union representatives representing 1,490 credit unions. NCUA scheduled another 20 workshops in 2009. Topics for these events included regulatory hot topics, collections and workout plans, and allowance for loan and lease loss funding. The 2009 workshops also included an outreach panel of representatives from various community organizations and federal agencies to discuss financial and fraudulent matters facing consumers.

OSCUI's 15 economic development specialists (specialists) provide one-on-one direct assistance and training to officials of small and low-income designated credit unions around the country. The specialists assist with areas such as strategic planning, adding new products and services, board and supervisory committee training, policy development, and grant writing.

In addition, NCUA has administered the CDRLF since 1987. This program, which is available only to low-income designated credit unions, provides Technical Assistance Grants (TAGs) and low-cost loans to those low-income designated credit unions interested in enhancing service to their membership. Since inception, the CDRLF has revolved its loan fund 4 times. With 13.4 million appropriated for loans, the CDRLF has made loans totaling \$52 million to more than 300 credit unions. Lending and relending CDRLF monies have effectively quadrupled the impact of the \$13.4 million in appropriation

In 2008, NCUA approved \$1.15 million in grants to 240 credit unions. These low-income designated credit unions used the grant and loan funds to touch the lives of the members of their communities by:

- ✓ Overcoming the language barrier with translated financial service materials;
- ✓ Offering free income tax return services;
- ✓ Opening offices to better serve their members;
- ✓ Providing financial education opportunities; and
- ✓ Providing loans to develop alternative loan programs to combat predatory lending.

#### Specialized Supervision

NCUA's mission includes serving and maintaining a safe, sound credit union community. To accomplish this, NCUA has developed specialized programs including

the National Examination Team to supervise credit unions showing a higher risk to the NCUSIF; Subject Matter Examiners to address specific areas of risk; and Economic Development Specialists to provide hands-on assistance to small credit unions.

Last fall, NCUA modified its examination program to shorten the examination cycle from 18 to 12 months, to better identify and assess emerging trends. In conjunction, NCUA also increased examination staff to address rising levels of risk within the credit union industry. In 2009 NCUA added 50 examiners to our field staff, and plans to add another 57 in 2010. Additionally, risk monitoring systems have been enhanced to facilitate more relevant and timely management reports.

In an effort to resolve problems before they become insoluble, NCUA is proactively monitoring adverse trends associated with CAMEL 3 rated credit unions,<sup>15</sup> particularly those with assets in excess of \$100 million. NCUA is concerned that the number and size of CAMEL 3 credit unions is increasing. The number of CAMEL 3 credit unions with assets greater than \$100 million represented only 7.30 percent of total credit unions as of year-end 2007; however, this ratio increased to 13.48 percent as of September 30, 2009. Similarly, total assets for this group of credit unions increased to 10.43 percent of aggregate industry assets as of September 30, 2009, up from only 3.97 percent in 2007. While credit unions rated a CAMEL 3 have not quite reached the

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<sup>15</sup> A CAMEL 3 credit union exhibits some degree of supervisory concern. These credit unions exhibit a combination of weaknesses that may range from moderate to severe. Credit unions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences. These credit unions require more than normal supervision.

threshold of a troubled credit union, discussed earlier, they require enhanced and timely supervision to ensure corrective measures are implemented.

## **VI. Mortgage Lending in the Credit Union Industry**

### Current State of Credit Union Mortgage Lending

Through the first half of 2009, the Mortgage Bankers Association estimated first mortgage loan originations in the marketplace of over \$1.05 trillion, of which credit unions originated only 2.53 percent or \$55 billion in first mortgage loans.<sup>16</sup> First mortgage loans in credit unions represent less than 8 percent of first mortgage loans outstanding in all FDIC-insured depository institutions.<sup>17</sup>

In considering trends related to all mortgage loans, 69 percent of credit unions offer mortgage loans to their members. Those not offering mortgage loans are generally smaller credit unions that cannot afford the expertise or infrastructure to grant mortgages or manage mortgage portfolios. Additionally, smaller federal credit unions have difficulty implementing a wide range of mortgage products since loans to a single member are statutorily limited to 10 percent of a federal credit union's total unimpaired capital and surplus.<sup>18</sup> Consequently, the majority of credit union mortgage lending occurs in larger credit unions, as the following chart illustrates:

<sup>16</sup> Based on information available at the Mortgage Bankers Association website for 2007 Purchase and Refinance Originations <http://www.mbaa.org/files/Bulletin/InternalResource/70290.pdf>.

<sup>17</sup> NCUA data and FDIC- *Statistics on Depository Institutions Report, 1-4 Family Residential Net Loans and Leases for all depository insured institutions as of 6/30/2009*. Federal Deposit Insurance Corporation. <<http://www2.fdic.gov/SDI/SOB>>.

<sup>18</sup> 12 C.F.R. 701.21(c)(5). Unimpaired capital and surplus equals shares plus post-closing, undivided earnings.

Credit Unions by Asset Size	Number of Mortgage Loans Originated Jan 1 – June 30, 2009	% of Credit Union Mortgage Loan Portfolio as of 6/30/2009
Greater than \$1 billion	301,449	51.5%
\$500 million-\$1 billion	117,440	15.9%
\$50 million-\$500 million	227,790	28.3%
\$10 million-\$50 million	34,976	4.0%
Less than \$10 million	2,556	0.3%

Demand for mortgage loans in credit unions has tapered somewhat, but remains high for certain mortgage categories. As mentioned earlier, mortgage loans led all loan types in growth; this trend dates to 2002. In the first six months of 2009 alone, total mortgage loans increased \$3.7 billion, 90 percent of all loan growth, to a new high of 54 percent of total loans.

As the following chart demonstrates, the majority of mortgage loans in credit unions are fixed rate, with almost all of the remainder being standard adjustable rate mortgages. Nontraditional mortgages are offered by less than 6 percent of credit unions and represent 2.3 percent of mortgage loans outstanding.

Type of Mortgage	Dollar Amount of Mortgage Loan Portfolio (billions) 6/30/2009	% of Credit Union Mortgage Loan Portfolio as of 6/30/2009
Fixed Rate	\$197.0	64.0%
Adjustable Rate	\$111.1	36.0%
Interest Only or Payment Option 1 <sup>st</sup> Mortgage <sup>19</sup>	\$7.2	2.3%

Fixed rate mortgage loans accounted for 78.5 percent of the increase in mortgage loans during the first half of 2009. The growth of fixed rate mortgages in credit unions slowed during the first half of 2009 to an annualized rate of just under 3 percent. Adjustable rate mortgage loans accounted for 21.5 percent of the increase in mortgage loans during this same period, and grew at an annualized rate of 1.42 percent. This indicates a clear preference by credit union members for fixed rate mortgage loans in the current economic environment, likely including a significant degree of refinancing of adjustable rate mortgages, and could impact credit unions' liquidity if interest rates rise rapidly.

#### Nontraditional Mortgage Lending in Credit Unions

Recognizing the increase in nontraditional mortgage products in the broader market (also referred to as "exotic," or "alternative" mortgage products), NCUA amended the 5300 Call Report in 2007 to collect data on certain nontraditional first mortgage loans.<sup>20</sup> Call Report data indicates that these mortgage products (specifically "Interest-Only" or

<sup>19</sup> NCUA does not capture information relating to the type (fixed or adjustable) of "interest-only" or "payment-option" loans, just the dollar amount outstanding for these loan products. This amount is reflected in the totals for both fixed and adjustable rate mortgage loans outstanding.

<sup>20</sup> NCUA's 5300 Call Report is the data collection tool used to collect required financial statement reports from credit unions on a quarterly basis.

"Payment Option" mortgages) are only offered in a small number of credit unions and comprise a very small portion of the industry's total mortgage portfolio.

There are several reasons why these riskier mortgage loans are not prevalent in credit unions. As addressed earlier, many credit unions are smaller institutions that lack the sophistication or resources to underwrite these types of loans. Also, as member-owned not-for-profit cooperatives, credit unions' lending motivation is designed to be member-oriented, appropriately concerned with the suitability and impact on the member. In addition, the Federal Credit Union Act prohibits prepayment penalties and establishes a statutory limit for interest rates.<sup>21</sup> Because of these statutory provisions, the regulatory environment for federal credit unions is not conducive to some of the features that make the cost of underwriting these loans more tenable to other types of institutions. NCUA was also proactively issuing guidance on the increasing risks in real estate lending as early as 2005,<sup>22</sup> and since then has consistently issued guidance on this issue (see Appendix A) followed-up with numerous warnings leading up to the current economic downturn.

<sup>21</sup> The Federal Credit Union Act establishes a limit of 15 per annum inclusive of all service charges, with authority for the NCUA Board to establish a higher ceiling when certain economic conditions are met. The ceiling is currently set at 18 per annum. 12 U.S.C. §§1757(5)(A)(vii) and 1757(5)(A)(viii).

<sup>22</sup> See NCUA Letter to Credit Unions 05-CU-15, Increasing Risks in Mortgage Lending, October 2005; NCUA Letter to Credit Unions 06-CU-16, Interagency Guidance on Nontraditional Mortgage Product Risk, October 2006; and NCUA Letter to Credit Unions 07-CU-09, Subprime Mortgage Lending, July 2007.

Mortgage Loan Performance

Over the last decade, and certainly prior to the start of the present housing crisis, aggregate mortgage delinquency has been very low, averaging only 0.38 percent; mortgage loan losses have been equally low at 0.04 percent.

As the following table illustrates, however, real estate delinquency has been increasing as the economic crisis has unfolded:

Real Estate Loan Delinquency > 2 Months					
Quarter End:	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09
1st Mortgage Fixed/Total 1st Mortgage Fixed Loans	0.48%	0.59%	0.75%	0.90%	1.06%
1st Mortgage Adjustable Rate/Total 1st Mortgage Adjustable Rate Loans	1.14%	1.54%	1.92%	2.19%	2.57%
Interest Only & Payment Option First Mortgage/Total Interest Only and Pmt Opt First Mortgage Loans	2.02%	2.46%	3.72%	4.86%	5.73%
Aggregate Del RE Loans / Total RE Loans	0.78%	0.96%	1.20%	1.38%	1.62%
RE Loan Net Charge-Offs	0.22%	0.24%	0.29%	0.42%	0.47%

Going back even further, credit union real estate delinquency more than quadrupled from early 2007 through mid-year 2009; increasing from 0.34 percent to 1.62 percent of total loans. These mortgage delinquency rates are unprecedented in the last 13 years, and present a challenge for credit unions weathering this economic storm.

The most significant concern with real estate loans is the 32.5 percent dollar increase in 2009 in delinquent first mortgage adjustable rate loans, making up 31.5 percent of the total increase in real estate loan delinquency for this same time period. NCUA noted an increase in real estate net charge-offs over this same time period from 0.29 percent to 0.47 percent of average loans.

To facilitate better risk identification and monitoring, NCUA began collecting data on foreclosed real estate in June 2006. Call Report data shows foreclosure trends have been increasing each quarter to a high of \$930 million as of mid-year 2009. Foreclosed real estate has exhibited double-digit growth each quarter, as demonstrated in the following table.

Foreclosed Real Estate					
Quarter Ending:	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09
Amount (in Millions)	\$471.4	\$549.4	\$684.5	\$826.3	\$928.7
Percentage Increase	16.6%	16.5%	24.6%	20.7%	12.4%
Percentage of Total Real Estate Loans Outstanding	0.16%	0.18%	0.22%	0.27%	0.30%

Although there has been a significant percentage increase in total real estate foreclosures during this time period, the actual dollar amount of \$930 million represents only a small fraction, 0.30 percent, of the \$308 billion in total real estate loans outstanding in credit unions. While this amount does not presently represent a threat to the safety and soundness of the credit union industry, NCUA will continue to monitor and respond to this adverse trend.

NCUA recognizes that prudent workout arrangements and loan modifications with mortgage borrowers experiencing financial difficulties may be in the best interest of credit unions and their members. NCUA began collecting data on real estate loan modifications in September 2008. Credit unions modified a total of \$3.6 billion in real estate loans at mid-year 2009, up 52 percent from the previous quarter. Modified loans reported as delinquent represent 19.78 percent of all modified loans. While the dollar value of delinquent loan modifications has been increasing each quarter, NCUA has also observed a noteworthy trend regarding delinquent loan modifications. Since peaking at a high of 21.63 percent at the end of 2008, the delinquency rate of modified loans has declined, albeit slightly, each of the last two quarters. However, over this same time period, NCUA observed a corresponding increase in losses of modified loans. NCUA will continue to review and assess delinquent modified real estate loans to ensure credit unions are not taking undue risk in meeting the financial hardship needs of members. Last month, a supervisory guidance paper on evaluating loan modification programs was issued to NCUA's examiner staff and was also provided to all credit unions.<sup>23</sup>

#### NCUA's Longstanding History of Mortgage Lending Guidance

In the late 1970s, legislation expanded services to credit union members, to include mortgage lending. This added another option for consumers who found it difficult to obtain real estate loans from commercial banks and savings institutions. For more than thirty years, mortgage lending in credit unions has been considered a relatively safe product, subject more to interest rate risk exposure than the credit risk typically

<sup>23</sup> Available at [http://www.ncua.gov/Resources/RegulationsOpinionsLaws/OpinionLetters/2009/09-CU-19\\_encl.pdf](http://www.ncua.gov/Resources/RegulationsOpinionsLaws/OpinionLetters/2009/09-CU-19_encl.pdf).

associated with lending products. As emerging risks have been identified, NCUA has provided written guidance to credit unions, in the form of Letters to Credit Unions. In recognition of the potential safety and soundness concerns stemming from poor mortgage lending controls, NCUA provided credit unions detailed real estate lending guidance, dating back as far as 1991. A table containing the title, summary, and date the relevant guidance was issued to the industry is provided in Appendix A of this testimony.

#### **VII. Conclusion**

Credit unions have been adversely impacted by the financial downturn of the last 18 months. Fortunately, the disciplines and member-centric focus instilled by the industry over the years have built a strong net worth position to help credit unions continue working through this crisis. Credit unions are not-for-profit, member-owned cooperatives that exist to provide their members with the best possible rates and service. Credit unions are chartered to serve a field of membership that shares a common bond such as the employees of a company, members of an association, or a local community. Therefore, credit unions may not serve the general public like other financial institutions and the credit unions' activities are largely limited to domestic activities, which has minimized the impact of globalization on the credit union industry. However, the severity and length of the economic downturn is being felt throughout the credit union industry. It is anticipated that the effects of the downturn will result in

increased losses to the NCUSIF in 2010 and into 2011. NCUA believes the NCUSIF is poised to withstand the challenges it will face in the next several years.

**APPENDIX A – SUMMARY OF RELEVANT GUIDANCE ISSUED BY NCUA**

The following table details specific mortgage lending guidance issued by NCUA to the credit union industry:

Date	Title	Summary
June 1991	Letter to Credit Unions #124, "Real Estate Secured Credit by Credit Union Members"	Provides guidelines for developing and maintaining an effective real estate lending portfolio, and addressing both interest rate and credit risk associated with real estate lending.
August 1995	Letter to Credit Unions #174, "Risk-Based Loans"	Discusses potential advantages and disadvantages to credit unions of risk-based lending <sup>24</sup> programs or programs where subprime credit could be offered. The letter also included a whitepaper discussing the importance of consumer compliance issues related to risk-based lending and the credit unions' obligations under the Equal Credit Opportunity Act, Fair Housing Act, and the Fair Credit Reporting Act.
June 1999	Letter to Credit Unions 99-CU-05, "Risk-Based Lending"	Restates that soundly managed risk-based lending programs are a way to reach out to all members. Explained a credit union's capital adequacy would be evaluated considering the volume and type of risk-based lending pursued and the adequacy of the credit union's risk management program.
August 1999	Letter to Credit Unions 99-CU-12, "Real Estate Lending and Balance Sheet Management"	Stresses the importance of proper balance sheet risk management for real estate loan products and formally introduced such tools as GAP analysis, income simulation models, Net Economic Value, and other Asset Liability Management concepts.

<sup>24</sup> Risk-based lending involves setting a tiered pricing structure that assigns loan rates based upon an individual's credit risk. A tiered pricing structure enables credit unions to make more loans to disadvantaged, lower income, or credit-challenged individuals.

Date	Title	Summary
September 2003	Letter to Credit Unions 03-CU-15, "Real Estate Concentrations and Interest Rate Risk Management for Credit Unions with Large Positions in Fixed-Rate Mortgage Portfolios"	Reemphasizes the importance of properly monitoring and managing an increasing portfolio of fixed-rate mortgage products.
September 2004	Letter to Credit Unions 04-CU-13, "Specialized Lending Activities"	Refocuses the industry's attention to proper credit risk management of lending, including real estate lending, in the wake of alternative lending arrangements to increase lending opportunities. Outlines the NCUA's underwriting expectations for credit unions engaged in subprime lending, noting the need to focus on borrowers' ability to repay loans as structured.
May 2005	Letter to Credit Unions 05-CU-07, "Risks Associated with Home Equity Lending"	Focuses industry attention to an increasing concentration of Home Equity Lines of Credit (HELOCs) and closed-end home equity loans. This guidance was issued jointly with the other banking agencies.
October 2005	Letter to Credit Unions 05-CU-15, "Increasing Risks in Mortgage Lending"	Addresses the use of alternative or exotic mortgage products to afford housing in areas of high housing value appreciation, as well as an apparent transition to more liberal mortgage credit standards in general. The NCUA developed guidance for staff focusing on the evolution of products in the mortgage market, the unusual volume of originations of variable rate mortgage products in a low interest rate environment, and the market trend toward liberalization of underwriting standards was included as an attachment.

Date	Title	Summary
October 2006	Letter to Credit Unions 06-CU-16, "Interagency Guidance on Nontraditional Mortgage Product Risk"	Addresses risks associated with the growing use of mortgage products that allow borrowers to defer payment of principal and, sometimes, interest. While nontraditional and subprime mortgage lending were not major components of credit union lending portfolios, the letter cautions credit unions on the potential "ripple effect" to their asset quality if some of their members have these types of loans at other financial institutions. Also, discusses prudent underwriting and risk management practices for nontraditional mortgage loans. Issued jointly with the Federal Financial Institutions Examination Council (FFIEC). <sup>25</sup>
April 2007	Letter to Credit Unions 07-CU-06, "Working with Residential Mortgage Borrowers"	Encourages financial institutions to work constructively with residential mortgage borrowers who may be unable to meet their contractual payment obligations. Explains that prudent workout arrangements consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower. Issued jointly with the FFIEC.
July 2007	Letter to Credit Unions 07-CU-09, "Subprime Mortgage Lending"	Addresses emerging risks and lending practices associated with certain subprime adjustable rate mortgage products that can cause payment shock to consumers. While these types of loans did not appear prevalent in the credit union industry, the letter again cautions credit unions on the potential "ripple effect" to their asset quality. Issued jointly with the FFIEC.

<sup>25</sup> The FFIEC includes the Board of Governors of the Federal Reserve (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the State Liaison Committee (SLC).

Date	Title	Summary
March 2008	Letter to Credit Unions 08-CU-05, "Statement on Reporting Loss Mitigation Efforts of Securitized Subprime Residential Mortgages"	Encourages credit unions servicing securitized subprime adjustable rate residential mortgages to utilize the HOPE NOW <sup>26</sup> alliance's loan modification standards to report foreclosure prevention efforts.
June 2008	Letter to Credit Unions 08-CU-14, "Consumer Information for Hybrid Adjustable Rate Mortgage Products"	Provides all credit unions with the final <i>Interagency Illustrations of Consumer Information for Hybrid Adjustable Rate Mortgage Products</i> , particularly those products that offer a low introductory "teaser" rate that could lead to payment shock when associated interest rates reset. Issued jointly with the FFIEC.
August 2008	Letter to Credit Unions 08-CU-19, "Third – Party Relationships: Mortgage Brokers and Correspondents"	Re-emphasizes the importance of proper due diligence over third-party relationships, specifically as they relate to the use of mortgage brokers and correspondents.
August 2008	Letter to Credit Unions 08-CU-20, "Evaluating Current Risks to Credit Unions"	Shares guidance with credit unions that was released to the NCUA examiners. Guidance discusses several of the current risks facing the credit union industry, provides guidance for assessing mortgage portfolio risk management, and recommends best practices for conducting risk focused supervision and monitoring.
November 2008	NCUA Letter to Credit Unions 08-CU-26, "Evaluating Loan Participation Programs"	Documents due diligence considerations for credit union officials to evaluate before entering a loan participation arrangement with another credit union.
December 2008	Letter to Credit Unions 08-CU-25	Provides guidance related to holding foreclosed properties as Foreclosed and Repossessed Assets and encourages credit unions to work constructively with residential mortgage borrowers who may be unable to meet their contractual payment obligations.

<sup>26</sup> HOPE NOW is an alliance between counselors, servicers, investors, and others formed under the direction of the Department of Treasury and the Department of Housing and Urban Affairs in 2007, which serves to maximize outreach efforts to homeowners in distress to help them stay in their homes.

Date	Title	Summary
March 2009	Letter to Credit Unions 09-CU-04, "Making Home Affordable: A Program for Mortgage Loan Refinancing and Modifications"	Announces availability of the U.S. Department of Treasury's Making Home Affordable program designed to mitigate foreclosures to the extent possible through refinancings or loan modifications.
September 2009	Letter to Credit Unions 09-CU-19, "Evaluating Residential Real Estate Mortgage Loan Modification Programs"	Provides credit union officials with guidance NCUA provided to the field staff to encourage working constructively with residential mortgage borrowers who may be unable to meet their contractual payment obligations.

**NCUA's Guidance Regarding Corporate Stabilization Efforts**

Since the onset of the economic events challenging the stability of the corporate credit union system, NCUA has provided timely guidance to the potentially affected stakeholders. The table below summarizes the key guidance NCUA issued throughout 2009.

Date	Title	Summary
January 2009	Informational Letter to Credit Union Members	Template letter designed to assist credit unions in discussing cost impact of Corporate Stabilization Program in general terms with their members. Letter reinforces continuance of federal share insurance coverage and provides key NCUA contact information for members desiring additional information.

Date	Title	Summary
January 2009	Letter to Credit Unions, "Corporate Credit Union System Strategy"	Provided credit union officials with an overview of key economic factors affecting corporate credit unions, including weak liquidity and unrealized losses on investments. Letter discusses NCUA's efforts to support corporate system's immediate liquidity needs, advocates continued support from natural person credit unions, and announces a new guarantee program to supplement existing NCUSIF coverage. Letter also provides an initial assessment of costs and encourages active stakeholder participation in commenting on proposed changes to NCUA's corporate credit union regulation.
January 2009	Advance Notice of Proposed Rulemaking	Request for comments from interested parties relative to changes the NCUA Board is considering to Part 704 of the NCUA Rules and Regulations. NCUA requests general comments regarding the structure corporate credit unions should have and specific comments about capital requirements, permissible investments, risk management, membership requirements, and corporate governance.
February 2009	Supervisory Letter 09-01, "Supervision Considerations for Natural Person Credit Unions and the Announced Corporate Stabilization Efforts"	Letter to NCUA field staff reinforcing importance of considering economic events when assessing supervisory ratings. Letter also advises the field staff to take the objectives of the Corporate Stabilization Program into consideration during contacts at individual natural person credit unions.
February 2009	Accounting Bulletin 09-1	Guidance to credit unions not subject to Generally Accepted Accounting Principles on regulatory reporting matters related to the Corporate Stabilization Program. Provides accounting entries appropriate to reflect NCUA's initial assessment of the impairment to the NCUSIF deposits held by credit unions.

Date	Title	Summary
April 2009	Accounting Bulletin 09-2	Guidance to credit unions not subject to Generally Accepted Accounting Principles on regulatory reporting matters related to the Corporate Stabilization Program. Bulletin incorporates actions NCUA Board initiated during the first quarter of 2009 into the accounting guidance.
May 2009	Letter to Credit Unions 09-CU-10, "Matters Related to 'Paid-in Capital' and 'Membership Capital' of Corporate Credit Unions"	Informs shareholders of U.S. Central Federal Credit Union and Western Corporate Federal Credit Union of the exhaustion of member capital shares. Also informs shareholders of the 23 percent and 100 percent depletion of the paid in capital of US Central Federal Credit Union and Western Corporate Federal Credit Union, respectively.
May 2009	Letter Addressed to Corporate Credit Unions	Provides general information about the Temporary Corporate Credit Union Share Guarantee Program, a program in which NCUA provides coverage of certain unsecured debt obligations issued by corporate credit unions participating in the program.
June 2009	NCUA Letter to Credit Unions 09-CU-14, "Corporate Stabilization Fund Implementation"	Discussion of new legislation enabling NCUSIF to defer costs associated with corporate stabilization over a seven year period. New law also extends the temporary increase in NCUSIF coverage to \$250,000 until the end of 2013 and provides NCUA additional emergency borrowing authority.

In addition to formal guidance issued, NCUA has also used other methods of communication to provide timely information to stakeholders. For example, NCUA issued numerous timely updates in the form of Media Advisories during the period between March 27, 2009 and August 7, 2009. The updates explained NCUA's rationale for initiating the corporate credit union conservatorships, provided resources for additional information, and encouraged credit union input during the development of a

long-term corporate credit union strategy. In addition, NCUA also hosted five webcasts to discuss the progress of the Corporate Stabilization Program, developed Fact Sheets and Frequently Asked Questions documents for related topics, and established a dedicated location on the Internet to provide information about the program in one location.

Embargoed until  
October 14, 2009, at 2:30 p.m.



Statement of

Timothy T. Ward  
Deputy Director, Examinations, Supervision and Consumer Protection  
Office of Thrift Supervision

regarding

**Examining the State of the Banking Industry**

before the

Subcommittee on Financial Institutions  
Committee on Banking, Housing, and Urban Affairs  
United States Senate

October 14, 2009

Office of Thrift Supervision  
Department of the Treasury  
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**Testimony on  
Examining the State of the Banking Industry  
Before the Subcommittee on Financial Institutions,  
Committee on Banking, Housing, and Urban Affairs  
United States Senate  
October 14, 2009**

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***I. Introduction***

Good afternoon, Chairman Johnson, Ranking Member Crapo and members of the Subcommittee. Thank you for the opportunity to testify on the financial condition and performance of the thrift industry.

Thrift institutions continue to face significant challenges because of our nation's current economic problems. Although significant challenges lie ahead, institutions are making progress to ensure that they are positioned for a positive future.

In my testimony today, I will first discuss conditions in the housing market and broader economy. Against this backdrop, I discuss the state of the thrift industry, including industry data from our earnings release for the second quarter of 2009. The next part of my statement will focus on the challenges facing thrift lenders, including a discussion of several issues that the Subcommittee asked us to address, such as the current lending environment, the capital needs of thrifts institutions, concerns regarding commercial real estate lending and concerns specific to smaller and larger thrifts. I will

conclude my statement with a discussion of developing trends throughout the thrift industry and the economy.

## **II. State of the Thrift Industry**

### *A. Conditions in the Housing Market and Broader Economy*

The U.S. economy continues to suffer from the impact of a severe recession. Some have called the current recession the “Great Recession” because, through September 2009, it has been the longest recession – at 21 months – of the 11 recessions after World War II.<sup>1</sup> Further, the increase in the nation’s unemployment rate from the beginning of the recession in December 2007 (unemployment rate of 4.9 percent) through September 2009 (9.8 percent) has been the greatest of any of the other recessions. Moreover, the nation’s “underemployment” rate – a broader measure of the health of the nation’s job markets that includes workers who are unemployed, working part-time due to economic reasons and not actively looking for work but would like to work – increased to 17 percent in September 2009, the highest level on record since this statistic was first calculated in January 1999.<sup>2</sup>

To date, the brunt of this recession has been focused on the housing sector. Home prices have dropped considerably in most markets throughout the nation. From the beginning of the recession through July 2009, home prices in major markets have declined an average of 23 percent.<sup>3</sup> In some markets, the declines have been more severe, for example Las Vegas (46 percent), Phoenix (44 percent), Miami (36 percent), San

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<sup>1</sup> Sources: National Bureau of Economic Research, Bureau of Economic Analysis, Bureau of Labor Statistics

<sup>2</sup> Unemployment and underemployment rates from the Bureau of Labor Statistics

<sup>3</sup> Measured as the 20-City Composite Index from S&P/Case-Shiller

Francisco (33 percent) and Detroit (32 percent).<sup>4</sup> Home sale declines have also resulted in an oversupply of unsold homes on the market. At current rates of home sales, there is a supply of approximately 8.5 months of existing homes on the market – about double the normal rate.<sup>5</sup>

Preliminary results of ongoing research indicate that disruption of household income through job loss, divorce, or medical emergency continue to be the primary reason for loan defaults.<sup>6</sup> However, research also suggests that declining home values are a growing reason for borrower defaults. Indeed, continued declines in home values are prompting some credit-worthy borrowers to voluntarily default. These actions contribute to continuing residential mortgage loan problems caused by job market weakness.

Rate resets of adjustable rate mortgages (ARMs) have not been a significant cause of recent loan defaults. Nonetheless, the OTS is closely monitoring the impact of the large number of ARM resets that will occur in 2010 and 2011. An estimated 75 percent of all option ARMs will reset during those two years.<sup>7</sup>

The shift in the composition of thrift troubled assets (loans more than 89 days delinquent, in nonaccrual status, and repossessed properties) from the last severe economic downturn in the early 1990s also underscores that the current recession, to date, has focused on residential mortgage markets. As of June 30, 2009, 68 percent of all thrift industry troubled assets were 1-4 family permanent loans, 22 percent in commercial real estate and 10 percent in non-mortgage consumer loans. In contrast, 1-4 permanent loans

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<sup>4</sup> S&P/Case-Shiller Index for respective markets

<sup>5</sup> U.S. Census Bureau, National Association of Realtors

<sup>6</sup> Research by First American Core Logic, Moody's Economy.com

<sup>7</sup> Moody's Economy.com

constituted just 23 percent of thrift industry troubled assets in December 1990. During 1990, commercial real estate loans represented 68 percent of troubled assets and the remainder (9 percent) were non-mortgage consumer loans.

However, there is growing evidence that economic weakness is spreading to commercial real estate and business sectors. Delinquent commercial real estate loans have increased sharply over the past year, reflecting rising vacancy rates, increases in business bankruptcies and declining profitability of many firms. For example, the vacancy rate for apartment complexes reached a 23-year high in September 2009; vacancies at retail shopping centers reached a 17-year high; and office vacancies increased in 72 of the 79 metro areas tracked by a leading real estate research firm.<sup>8</sup> Further, U.S. business bankruptcies increased 64 percent for the first half of 2009 compared with the first half of 2008; that is the highest rate of increase in the past 16 years.<sup>9</sup>

The thrift industry will not be immune to business sector weakness. Although consumer loans, residential mortgages and related securities are the dominant thrift industry assets, nonresidential mortgages, multifamily mortgages and small business loans constitute about 15 percent of thrift total assets. This is especially true for smaller thrifts, which generally hold relatively higher percentages of their assets in nonresidential and multifamily mortgages than larger thrifts do. And although smaller thrifts generally hold relatively higher amounts of capital than do larger institutions, problems in commercial-related loans can quickly translate into capital issues since such loans are

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<sup>8</sup> Reis, Inc.

<sup>9</sup> American Bankruptcy Institute

typically much larger than consumer loans. Hence, a problem with a small number of commercial-related loans have the potential of causing capital issues.

## *B. Thrift Industry Data*

### *1. Overview of the Thrift Industry*

The majority of Office of Thrift Supervision (OTS)-regulated thrifts are full-service, community-based financial institutions serving consumers and small- to medium-sized businesses in cities and towns across the nation. As of June 30, 2009, there were 794 thrift institutions with combined assets of \$1.1 trillion. Of these institutions, 38 percent are held in the mutual form of ownership, the historical form of thrift ownership, and 62 percent are stock-held depositories. Virtually all stock-held institutions operate within some form of a holding company structure.

Although the majority of thrift institutions specialize in retail mortgage and consumer lending activities, some institutions have a more narrowly focused business strategy. These other operating strategies typically involve a market niche or more narrowly focused business model such as a trust-only charter, a credit card lending focus, or mortgage banking operations.

As of June 30, 2009, the OTS also supervised 459 savings and loan holding company (SLHC) structures – including 94 mutual holding company structures – with aggregate consolidated assets of approximately \$5.5 trillion. While 80 percent of thrift holding companies are “shells”<sup>10</sup> holding few assets outside the thrift, there are a few

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<sup>10</sup> A shell thrift holding company structure is defined as having less than 5 percent of its consolidated assets in investments outside the thrift institution.

SLHCs that conduct operations in numerous non-financial activities, including some manufacturing, industrial and retail operations. Among the larger and more complex companies owning thrifts are investment banking firms, insurance companies and diversified financial services firms.

## *2. Industry Performance in the First Half of 2009*

The continued weakness in the housing markets, together with high unemployment rates, has taken a toll on the profitability of lenders, such as thrift institutions, that focus on home mortgages and consumer lending. The OTS-regulated thrift industry posted a loss of \$1.6 billion for the first half of 2009, for an annualized return on average assets of negative 0.28 percent. The industry posted a record loss of \$15.8 billion in 2008 and the return on average assets was negative 1.17 percent.

There are some signs of thrift earnings stabilization. The industry achieved break-even results in the second quarter of 2009, even after the estimated after-tax expense of \$325 million for the special assessment by the Federal Deposit Insurance Corporation. Nevertheless, industry earnings remain weak by historical standards and generally depend on the direction of the U.S. economy, particularly employment.

The economic conditions have tended to dampen consumer demand for mortgages to purchase homes. However, prevailing low interest rates for long-term, fixed-rate mortgages has resulted in strong demand for refinancing loans. Thrift industry mortgage originations (including single-family and multifamily lending) were \$150 billion for the first half of 2009 and about 55 percent of those originations were for refinancing an

existing mortgage. Total industry mortgage originations were \$341 billion in 2008; approximately 43 percent were for refinancing.

A large portion of thrifts' recent single-family mortgage origination volume was sold into the secondary market – primarily to government-sponsored enterprises. Thrifts sold 74 percent of single-family originations and purchases in the first half of 2009, up from 65 percent in 2008. Strong sales activity reflects thrift managers' interest rate risk management and their reluctance to keep on their books relatively low-rate, long-term, fixed rate loans. Low asset growth also results from strong sales activity.

Thrifts currently hold approximately 60 percent of their assets in mortgages and mortgage related instruments. As of June 30, 2009, one-to-four family mortgage loans constituted 39.9 percent of industry assets (including 4.9 percent of assets in home equity lines of credit); 3.2 percent of industry assets were in multifamily loans; and 13.0 percent of industry assets were in other mortgage-related instruments. Of total outstanding one-to-four family mortgages and mortgage-related instruments held by the industry, approximately 48.9 percent were ARMs.

Thrifts also hold commercial and business-related loans and the industry is not immune to the growing weaknesses in this sector. Nonresidential mortgage loans represented 6.5 percent of industry second quarter assets; commercial/small business loans another 5.5 percent. Loans on multifamily properties were 3.2 percent of assets. Construction loans represented 3.3 percent of thrift assets. Loans to construct single-family residences represented 37 percent of all construction loans, multifamily

constructions loans represented 22 percent of the total, and loans for the construction of nonresidential properties represent the remainder of 41 percent.

### *3. Capital, Provisioning and Loan Loss Reserves*

Reflecting the economic climate and housing market weakness, thrift managers have significantly bolstered loan loss reserves. Since additions to loan loss reserves are direct charges against current income, increases in loan loss reserves have dampened recent industry earnings. Nevertheless, stronger levels of loss reserves make the industry better positioned to absorb potential loan losses.

The industry's loan loss provision expense for all of 2008 was a record \$39.3 billion (2.92 percent of average assets). This large provision expense resulted in the industry's \$15.8 billion loss for the year. Loan loss provisions eased somewhat in 2009, but remain very high by historical standards. Loan loss provision expense was \$10.5 billion in the first half of 2009 (1.82 percent). The provision expense for the first and second quarters of 2009 were the fifth and sixth highest on record, respectively, behind only the 2008 provisions.

Despite these earnings difficulties, it is important to note that thrift capital levels remain strong. The industry's equity-to-assets ratio – a measure of capital according to generally accepted accounting principles (GAAP) – was 10.37 percent at June 30, 2009. Thrift regulatory capital measures also remain strong. As of the end of the second quarter, 96.2 percent of all thrifts – holding 95.9 percent of industry assets – exceeded the “well-capitalized” regulatory standards. Moreover, some analysts are increasingly

reviewing tangible common equity capital ratios along with regulatory capital measures as indicators of financial strength. Tangible common equity ratios are typically expressed as a percent of tangible assets and also as a percent of risk-weighted assets. For thrifts, these ratios were also strong, measuring 8.73 percent and 13.90 percent, respectively, at the end of the second quarter of 2009.

Taken together, loan loss reserves and capital provide a cushion against total loan losses. One measure of this cushion is the “loss coverage ratio,” defined as the ratio of capital and loan reserves to total loans and leases. Reflecting strong provisioning for loan losses and strong capital, the industry loss coverage ratio was a record 18.06 percent at the end of the second quarter of 2009. This combination of strong capital and bolstered loan loss reserves should help the industry withstand continued weakness in the housing and labor markets.

#### *4. Liquidity and Thrift Industry Access to Funding*

##### *a. Liquidity*

As can be expected in this uncertain operating environment, thrifts have increased their liquidity. Cash, deposits and government securities rose to 9.1 percent of assets at the end of June 2009 from 8.5 percent at the end of 2008.

##### *b. Capital Markets*

Capital markets are currently very selective regarding investments in insured depositories. However, some thrifts have had recent success in raising capital from the capital markets, from existing shareholders, and from private placements. These capital

raising efforts added approximately \$5.8 billion in new capital during the first half of 2009 for thrifts.<sup>11</sup>

*c. Deposits*

Deposits as a funding source generally rose in 2008 from 2007 levels, and that trend has continued through the first half of 2009. Deposits as a percentage of assets increased to 65.7 percent at June 30, 2009, compared to 61.2 percent at the end of 2008. All types of deposits have increased and about 60 percent of thrifts have experienced an increase in their deposit-to-asset ratio. These increases are the result of reduced consumer spending, increased savings and continued uncertainty surrounding the equities markets.

*d. Federal Home Loan Bank Advances*

Strong deposit inflows have offset declines in borrowings, including Federal Home Loan Bank (FHLB) advances. Nonetheless, such advances remain an important source of funds for thrifts. As a percent of assets, FHLB advances represented 12.8 percent of thrift assets at the end of the second quarter of 2009, down from 17.5 percent at the end of 2008. The decline was focused on short-term advances. Thrifts' use of longer-term advances increased as thrift managers utilized advances to increase the duration of their liabilities, thereby reducing interest rate risk. The weighted average maturity of all advances rose to 30 months during the second quarter, from 28 months at the end of 2008, and 26 months one year ago.

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<sup>11</sup> Excludes capital infusions of \$7.0 billion from the U.S. Treasury Capital Purchase Program.

### *C. Troubled Institutions*

While the current economic challenges have resulted in an increase in problem thrifts, the level of problem thrift institutions is consistent with the level of problem financial institutions reported by the other federal bank regulatory agencies. OTS uses the interagency ratings definitions to rate thrifts on a scale of one to five and defines “problem thrift” as an institution with a composite examination rating of “4” or “5.” As of September 30, 2009, there were 42 problem thrifts, representing 5.4 percent of OTS-regulated thrifts. This is a notable increase from September 30, 2008, when there were 16 problem thrifts, or 2.0 percent of OTS-regulated thrifts. The growth in problem financial institutions has stemmed from the challenging economic environment, including the housing downturn, rise in unemployment, and growing weaknesses in commercial lending.

In the first three quarters of 2009, 12 thrifts failed, compared with five failures in 2008. OTS is working closely with problem institutions to prevent additional deterioration, but it is likely there will be additional failures during this economic cycle. In addition to focusing on problem thrifts, OTS is closely monitoring “3” rated thrifts, which have significantly increased in the past year. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions. There were 107 thrifts with “3” composite ratings representing 13.7 percent of all OTS-regulated thrifts at September 30, 2009. In the same quarter of 2008, there were 57 thrifts, or 7 percent of all thrifts.

### ***III. Challenges Facing Thrifts***

#### ***A. Current Lending Environment***

One of the biggest challenges facing thrifts is the current lending environment. As loan performance and property values have deteriorated across the country, banks and thrifts have tightened lending standards. The rise in the national unemployment rate has also affected borrowers' repayment ability and has contributed to a decline in demand for new loans. Declining consumer confidence has resulted in businesses and households restricting spending, which has resulted in less demand for credit. Declines are apparent in lending categories for real estate mortgages, construction, consumer and commercial. Such declines vary substantially by geographic region.

To ensure that banks and thrifts are making loans to creditworthy borrowers, the OTS and the other federal banking agencies (FBAs) issued an interagency statement in November 2008 urging regulated institutions to make credit more available to such borrowers. The statement emphasized that the FBAs expect banks and thrifts to fulfill their fundamental role in the economy by providing credit to consumers, businesses and other creditworthy borrowers. "Problems in financial markets were causing the economy to become increasingly reliant on banking organizations to provide credit that purchasers of securities formerly provided or facilitated," the statement said. The statement reminded banks and thrifts to follow prudent lending practices but warned that excessive tightening in underwriting standards could make market conditions worse, leading to slower growth, potential damage to the economy, and harm to the long-term interests and profitability of banks and thrifts.

There are early indicators that real estate values are stabilizing in many geographic locations, which is a necessary first step for recovery. Despite the national trends, there are also geographic areas with improvement in credit availability and borrower demand. The low interest rate environment is positive for qualified and willing borrowers. Improved underwriting standards will also have a beneficial long-term affect once the industry recovers from this economic cycle.

The OTS examination staff continues to review lending activity for compliance with safe and sound underwriting guidelines, and the OTS is committed to encouraging lending to qualified borrowers. While there are significant challenges ahead, the thrift industry is positioning itself for a positive future.

#### *B. Capital Needs of Thrifts*

As indicated earlier, despite the turmoil that the industry has faced, capital measures for thrifts, as a whole, continue to be relatively strong and generally well in excess of regulatory minimum requirements. At the end of the second quarter of 2009, equity capital was 10.37 percent of assets, up from 8.65 percent of assets one year ago. At the end of the second quarter of 2009, more than 96 percent of the industry exceeded well-capitalized standards and only 15 thrifts were less than adequately capitalized. As mentioned earlier, the industry also continues to bolster its provisions for loan losses, which are now at or near record levels. These reserves provide an additional buffer against future loans losses.

Notwithstanding the relatively positive capital position of the industry, there are a number of stresses within the system that will continue to affect capital, both industry-wide, and particularly for some thrift institutions.

The first category of stress comes from the adverse economic conditions that continue to dampen earnings and asset quality, and thus capital. Problem assets continue to increase as a result of the ongoing housing market downturn and rising unemployment. Troubled assets (noncurrent loans and repossessed assets) rose to 3.52 percent of total assets in the second quarter of this year, up from 3.35 percent in the prior quarter, and 2.68 percent one year earlier. This compares to an average level of 0.78 percent from 2000 to 2007.

A second stress on capital is the impact of downgraded securities. Many savings associations hold investments in structured credit products, such as asset-backed and mortgage-backed securities, collateralized loan obligations and collateralized debt obligations. The underlying collateral of certain structured credit products has performed poorly. As a result of the deterioration in the performance of the underlying collateral, the level of credit support for senior and mezzanine tranches has diminished and the volume and severity of credit rating downgrades have increased. Many securities that were once rated AA or AAA have now been downgraded to below investment grade. As a result, they are much less liquid, their prices are no longer readily determinable and price volatility has increased. Consequently, an increasing number of financial institutions are recognizing other-than-temporary impairment (OTTI) charges and substantial fair value markdowns. Asset classifications are increasing as securities fall

below investment grade or are otherwise impaired. As securities are downgraded, the risk-based capital requirements have increased.

A third source of stress on capital will be the impact of recent accounting changes, namely changes to FAS 167 and FAS 168. These changes, which are being proposed for regulatory capital purposes by the federal banking agencies (with adoption as early as year-end), will bring onto the balance sheet certain assets that had been considered “off-balance sheet assets” under generally accepted accounting principles. This change in accounting will, among other things, increase the balance sheet assets of certain institutions. The capital requirements for these institutions would thus rise commensurate with the new on-balance sheet treatment.

The best response to the capital stresses faced by the entire banking industry would be for asset quality and earnings performance to improve. Although we anticipate continued stress in 2010, signs of economic recovery bode well for the longer-term earnings and capital positions of the banking system. In the shorter term, institutions may strengthen their capital position by shrinking their balance sheets through the sale of assets and by acquiring new outside capital. In the current economic environment, however, both of these alternatives pose challenges. Many assets, particularly those that institutions would most like to remove from their books, are not readily marketable. Also symptomatic of an inhospitable marketplace, access to outside capital, especially high quality capital, has been very limited for quite a while.

Although the OTS actively encourages private equity investments, there is to date, too little interest from investors in the type of high quality capital that regulators seek—in the form of common stock and non-cumulative perpetual preferred shares. Instead, we are analyzing somewhat novel proposals from thrifts and outside investors for capital in the form of hybrid capital instruments, or minority interests in consolidated subsidiaries, which might be eligible for inclusion in regulatory capital. Within the past few months, there have been positive signs of market improvement, in that a few well-managed institutions have been able to raise common stock. We hope this trend continues.

To ensure that well-capitalized but stressed institutions remain well-capitalized, and to address capital deficiencies in those that are not, we are taking the following actions:

1. Continuing to work with institutions to address asset quality problems through improved risk management, asset restructuring and loan modifications, and the sale or disposition of problem assets.
2. Assessing capital adequacy beyond the minimum regulatory capital requirements to ensure that capital is, in fact, adequate for the risks posed by the institution, both now and under further stressed market conditions.
3. Acting to help in the conservation of capital through, for example, limitations on dividend distributions, especially for troubled institutions.
4. Encouraging institutions to increase reserves—We want to ensure that the thrift industry continues to build up buffers, particularly when it has the earnings capacity

to do so, to use those buffers in times of stress. This helps ensure that the banking sector does not act in a pro-cyclical way to amplify economic and financial cycles.

5. Working aggressively with our most troubled institutions to require the development of comprehensive, near-term and long-term strategies for improving asset quality and earnings, addressing liquidity needs to withstand any anticipated or extraordinary demands against their funding bases, assessing capital adequacy and capital needs, and enhancing capital.

### *C. Commercial Real Estate Lending*

Another challenge facing thrifts is in the area of commercial real estate (CRE) loans.<sup>12</sup> As noted previously, CRE loans represent about 15 percent of total thrift assets. The CRE loan category comprises multifamily, nonresidential, and construction and land loans. As a result of the current economic environment, many of these loans are now delinquent or under significant stress.

In December of 2006, OTS issued guidance on concentrations in commercial real estate. We had observed that some institutions had high and increasing concentrations of CRE loans on their balance sheets and were concerned that these concentrations might cause some savings associations to be more vulnerable to cyclical CRE markets. The current recession has indeed confirmed our concerns. In the past, concentrations in CRE

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<sup>12</sup> Section 5(c) of the Home Owners Loan Act limits the amount of a Federal savings association's business and commercial real estate lending. The aggregate amount of a Federal savings association's loans secured by nonresidential real property may not exceed 400 percent of the association's capital. 12 U.S.C. 1464(c)(2)(B). Further, loans for commercial, corporate business or agricultural purposes are limited to 20 percent of the total assets of a Federal savings association and amounts that exceed 10 percent of such total assets may only be used for small business loans. 12 U.S.C. 1464(c)(2)(A).

lending, coupled with weak loan underwriting and depressed CRE markets, contributed to significant credit losses in the banking system.

Although CRE borrowers have in this current economic environment experienced deterioration in their financial condition, many continue to be creditworthy customers who have the willingness and capacity to repay their debts. The OTS and other FBAs realize that financial institutions face significant challenges when working with commercial real estate borrowers that are experiencing diminished operating cash flows, depreciated collateral values, or prolonged sales and rental absorption periods. The FBAs are working together to provide additional guidance on prudent workout programs, recognizing that such programs are often in the best interest of both the lender and the borrower. The guidance we are working on is intended to promote supervisory consistency, enhance the transparency of CRE workout transactions, and ensure that regulatory policies and actions do not inadvertently curtail the availability of credit to sound borrowers.

As a result of the financial stress facing institutions, OTS examiners are taking a balanced approach in assessing the adequacy of an institution's risk management practices for loan workout activity. In general, institutions that implement prudent CRE loan workout arrangements after performing a comprehensive review of a borrower's financial condition are not subject to criticism, even if the restructured loans have weaknesses that result in adverse credit classification. In addition, we expect that renewed or restructured loans to borrowers who have the ability to repay their debts according to reasonable modified terms will not be subject to adverse classification solely

because the value of the underlying collateral has declined to an amount that is less than the loan balance.

#### *D. Asset Quality*

##### *1. In General*

As the economy continues to face challenging times, many parts of the country are experiencing further reductions in home prices and real estate values. Institutions are showing increases in inventories of unsold homes, delinquencies, non-performing assets and real estate owned. In addition, job losses continue throughout most of the nation. These factors all contribute to rising levels of problem assets.

Thrifts' ratio of troubled assets to total assets continued to increase in the first half of 2009, rising to 3.52 percent at the end of the second quarter from 2.54 percent at the end of 2008. Driving the increase in troubled assets has been increases in noncurrent loans – specifically increased noncurrent loan rates for residential mortgage loans and construction loans. This is especially true for residential mortgages, which represent 40 percent of thrift assets. Construction and land loans constitute 3.3 percent of thrift assets.

In the second quarter, noncurrent single-family mortgages rose to a record 5.51 percent of all single-family mortgages, up from 3.69 percent at the end of 2008. Noncurrent construction-and-land loans also rose to a record 12.54 percent in the second quarter, up from 8.26 percent at the end of 2008.

Other types of noncurrent loans also rose in the second quarter from the end of 2008. The noncurrent loan rates for the second quarter 2009 and the end of 2008, respectively, were: for nonresidential mortgages 2.53 percent and 1.45 percent; for commercial/small business loans 2.82 percent and 1.83 percent; for multifamily loans 1.97 percent and 1.20 percent; and for nonmortgage consumer loans 1.72 percent and 1.40 percent.

Assessing asset quality is an integral part of every OTS examination. Ensuring that thrift managers perform ongoing loan monitoring and stress testing is also key. As credit risks increase in the loan portfolio and economic conditions decline, appropriate additions are required to loan loss provisions. Also, for securities, thrift managers should conduct investment monitoring and ensure necessary charges are made for other than temporary impairments. These additional provisions and charges reduce earnings, but better position the institution for the future. In some cases, additional loan loss provisioning and charges will cause net losses and declines in capital that may lead to the need to raise additional capital.

## *2. Mortgage Metrics Report and Loan Modifications*

The OTS continues to work with the Office of the Comptroller of the Currency (OCC) in collecting performance data on first lien residential mortgages serviced by national banks and federally regulated thrifts. This information is compiled in a joint report issued by both agencies referred to as the Mortgage Metrics Report. The report covers all types of first lien mortgages serviced by most of the industry's largest mortgage servicers, whose loans make up approximately 64 percent of all mortgages outstanding in

the United States. The report covers nearly 34 million loans totaling approximately \$6 trillion in principal balances. Our most recent report, issued on September 30, 2009, provides information on the performance of these residential mortgages through the end of the second quarter of 2009. This report is also provided directly to Congress.

The mortgage data reported for the second quarter of 2009 continued to reflect negative trends influenced by weakness in economic conditions. As a result, the number of seriously delinquent mortgages and foreclosures in process continued to increase. Against the backdrop of economic weakness and rising mortgage delinquencies, home retention actions—loan modifications and payment plans—rose 21.7 percent over the first quarter, to 439,574, nearly 75 percent more than were implemented a year earlier. Driving the increase were actions taken under the “Making Home Affordable” program to assist troubled homeowners.

The report also showed that home retention actions continued to increase more quickly than new foreclosures. Subprime mortgages had almost twice as many new home retention actions as new foreclosures during the quarter. By contrast, there were more foreclosures than home retention actions in prime mortgages during the quarter, but the gap shrank to its lowest level in the last year.

Loan modifications that reduced borrowers’ monthly principal and interest payments continued to increase in the second quarter, to more than 78 percent of all new modifications, up from less than 54 percent in the previous quarter. Also noteworthy, the number of modifications that reduced principal more than doubled, with 10 percent of modifications made in the second quarter reducing principal, compared with 3.1 percent

in the first quarter of 2009. This trend represented a significant shift from earlier practices in which the vast majority of loan modifications either did not change monthly payments or increased them. As noted in earlier reports, modifications that reduce the borrowers' monthly payments continue to show lower levels of re-defaults and longer term sustainability than modifications that increased payments or left them unchanged.

The OTS has had a long-standing commitment to affordable and sustainable mortgage modification efforts and has repeatedly encouraged its institutions to work constructively with troubled borrowers. For example, in April 2007, OTS and the other FBAs issued a statement that encouraged financial institutions to work with homeowners who were unable to make mortgage payments. "Prudent workout arrangements consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower," the statement said. Institutions were assured that they would not face regulatory penalties if they pursued reasonable workout arrangements with borrowers.

Borrowers unable to make their mortgage payments should contact their lender or servicer as soon as possible to discuss available options, according to the statement. Examples of constructive workout arrangements included modifying loan terms and moving borrowers from variable-rate loans to fixed-rate loans. The statement also explained that bank and thrift programs that transition low- or moderate-income homeowners from higher-cost loans to lower-cost loans may also receive favorable consideration under the Community Reinvestment Act (CRA), if the loans are made in a safe and sound manner. In January 2009, the OTS and other agencies that evaluate CRA

performance expanded this guidance to more broadly provide positive CRA consideration for foreclosure prevention programs for low- or moderate-income homeowners that have the objective of providing affordable, sustainable, long-term loan modifications and restructurings.<sup>13</sup>

In September 2007, the OTS joined the other FBAs and the Conference of State Bank Supervisors in issuing a statement “encouraging federally regulated financial institutions and state-supervised entities that service securitized residential mortgages to review to determine the full extent of their authority under pooling and servicing agreements to identify borrowers at risk of default and pursue appropriate loss mitigation strategies designed to preserve homeownership.”

The statement noted that many subprime and other mortgage loans had been transferred into securitization trusts governed by pooling and servicing agreements. The agreements could allow servicers to contact borrowers at risk of default, assess whether default was reasonably foreseeable and, if so, apply loss mitigation strategies to achieve sustainable mortgage obligations. Servicers could have the flexibility to contact borrowers in advance of loan resets.

As the statement said, “appropriate loss mitigation strategies could include loan modifications, conversion of an adjustable rate mortgage into a fixed rate, deferral of payments, or extending amortization.” In addition, institutions were asked to consider referring appropriate borrowers to qualified homeownership counseling services to work with all parties to avoid unnecessary foreclosures.

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<sup>13</sup> 74 FR 498 (January 6, 2009).

Our experiences with servicers, our data collection efforts, industry analyses, academic research, and internal analyses suggest the following:

- Loan modifications are costly for the servicer. We believe that providing additional incentives to servicers for loan modifications will likely result in more modifications.
- Providing incentives to servicers and borrowers to make successful modifications, as opposed to any modification, as measured by prompt payments over time, serves a useful purpose to properly align behavior.
- The significant difference in performance between bank-owned modified loans and those serviced for others suggests certain legal and accounting impediments exist in securitization structures that inhibit successful loan modifications.
- Analyses by market participants suggest that three major factors affect the performance of loan modifications:
  1. A decrease in the monthly payment. Larger decreases are associated with lower post-modification delinquencies.
  2. The extent to which the borrower is underwater (owes more than the home is worth) after the loan modification. Borrowers who are still underwater after a loan modification are more prone to delinquencies.
  3. The length of time the borrower has been in the home. In general, the longer the borrower has been in the home, the more likely the modified mortgage will perform.

Successful modification plans avoid unnecessary foreclosures by making changes that address affordability issues within the framework of aligning appropriate incentives. To achieve these goals, the OTS continues to collect data to report on the performance of first lien mortgages and any modification efforts undertaken by servicers. Additionally, the OTS, in conjunction with the other FBAs, worked with the Administration to develop the “Making Home Affordable” program.

The second quarter Mortgage Metric Report showed that newly initiated foreclosures decreased as servicers worked to implement the “Making Home Affordable” program. Emphasis on taking actions under the “Making Home Affordable” program contributed to a dramatic shift in the composition of home retention actions toward payment plans. There was a 73.9 percent increase in payment plans reported for the quarter, alongside a 25.2 percent drop in loan modifications. The 114,538 trial period payment plans reported in the second quarter more than offset a 47,995 decrease in loan modifications as servicers reallocated resources to the “Making Home Affordable” program.

The OTS continues to support all prudent home retention efforts through its monitoring of first lien data and its continued cooperation in the development and refinement of all aspects of the “Making Home Affordable” program. Additionally, we continue to encourage our institutions and servicers to work with borrowers to achieve affordable and sustainable home mortgage payments.

*E. Specific Concerns of Smaller and Larger Institutions*

Most of the 794 OTS-regulated thrifts are smaller, community-based institutions. As of June 30, 2009, 679 thrifts (86 percent of all thrifts) had assets of less than \$1 billion. And of these, 596 (75 percent of all thrifts) had assets less than \$500 million. As of the same date, there were 90 thrifts (11 percent) with assets of \$1 billion to \$10 billion. And 25 thrifts (3 percent) had assets greater than \$10 billion.

Though representing a small percentage of the number of thrifts, larger thrifts held the majority of industry's \$1.1 trillion in aggregate assets. As of the second quarter 2009, thrifts with assets greater than \$10 billion held \$721 billion in assets (66 percent of total industry assets). Thrifts with assets between \$1 billion and \$10 billion held combined assets of \$224 billion (20 percent). Smaller institutions -- those with assets less than \$1 billion -- held assets of \$153 billion (14 percent). And of those institutions, thrifts with assets less than \$500 million held combined assets of \$93 billion (8 percent).

OTS tailors its examination and supervisory approach to meet the unique challenges presented from thrifts of different asset sizes and operating complexities. As a general statement, it is expected that an institution's operating policies, procedures, controls, and risk management practices reflect the complexity of its operations. However, OTS on-site examination activities and supervisory approaches are also flexible and modified based on an institution's unique circumstances. These circumstances can change based on off-site monitoring of an institution's financial condition and performance, as well as other changes that could potentially impact the operations and condition of the thrift. These changes could be internal to the thrift -- such as a change in

management; local – such as changes in the institution’s local labor markets; or global – such as a significant change in accounting rules that impact capital or sudden changes in liquidity and capital markets.

### 1. *Larger Institutions*

During the past decade, both large banks and thrifts and their mortgage banking affiliates took advantage of the rapid growth of securitization markets to fund a variety of retail products to service the explosive growth in the residential housing market, growth that was fueled by steadily increasing home prices. These firms became increasingly dependent on the wholesale funding provided by securitizations. Because of extremely favorable market conditions, some of the largest institutions focused their businesses on a single mortgage-related product line, which created concentration risk.

This dependence also made these institutions unknowingly vulnerable to additional sources of risk. The sudden seizure in the asset securities markets stopped the mortgage funding pipeline in its tracks and led to enormous market uncertainty about the values of the assets supported by the loans, as well as the worth of the loans held by these institutions. A funding pipeline can often have a larger dollar volume than the net worth of the firm. As the pipeline seized up, firms had to hold on their books the loans already in the pipeline. Liquidity-strapped institutions made increasingly distressed asset sales, further pressuring security and loan prices. This market dynamic threatened the solvency or forced the insolvency of many of these firms that employed an “originate-to-sell” strategy.

The capital markets also created a plethora of structured financial securities, from credit default swaps to collateralized debt obligations, whose relationships to the performance of the underlying assets can be difficult to discern. The uncertainty concerning the risk and the valuation of these structured securities can make an assessment of the current financial condition of financial institutions a challenging task.

In an effort to ensure that loans are adequately underwritten, in September 2008 the OTS issued guidance to the industry reiterating OTS policy that for all loans originated for sale or held in portfolio, savings associations must use prudent underwriting and documentation standards. The guidance emphasized that the OTS expects loans originated for sale to be underwritten to comply with the institution's approved loan policy, as well as all existing regulations and supervisory guidance governing the documentation and underwriting of residential mortgages. Once loans intended for sale had to be kept in the institutions' portfolios, it reinforced the supervisory concern that concentrations and liquidity of assets, whether geographically or by loan type, can pose major risks.

In addition, both smaller and larger thrifts should take greater account of the risks faced, and created, by both their funding practices and their securities holdings. The focus of risk management has shifted from the "silo" approach of assessing the risk of individual asset and liabilities to an enterprise-level risk management expectation. Such an approach encompasses an assessment of not only concentration risk in its various forms but also of the effect on the firm of interaction of their assets and liabilities under

stressful conditions. For some institutions, this represents a significant change in orientation, but one important for their survival.

## *2. Smaller – Community-Based Thrifts*

Although the financial crisis did not originate in smaller thrifts, they have not escaped damage from the crisis and from the serious recession that ensued. Small thrifts are by their nature geographically concentrated and many are located in communities that have experienced significant declines. Not surprisingly, these thrifts have keenly felt the impact. Even within a single geographic area, however, thrifts that offered products they understood and maintained traditional underwriting standards have tended to withstand the stresses.

Smaller thrifts meet the financial services and credit needs of their local communities with a wide range of loan and deposit products. These thrifts are often one of few sources of small business and commercial real estate lending in their immediate market area.<sup>14</sup> As such, smaller thrifts typically hold higher relative amounts of business-related loans in portfolio than larger thrifts. With mounting weakness in the business sector, as evidenced by such trends as increasing vacancy rates and rising business bankruptcies, we are concerned that some small thrifts in particularly hard-hit areas may need additional capital to weather the potential downturn. Even though smaller thrifts typically maintain higher capital ratios than larger institutions, commercial real estate and business-related loans are generally larger than consumer-related loans. Hence, problems in even a few commercial real estate and business loans have the potential to impact

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capital levels. For these reasons, we continue to closely monitor commercial real estate and business trends, with a special focus on those local market areas in which thrifts are exposed.

Community banks and thrifts survive, in a large part, because their local presence and personal interactions give them an advantage in meeting the financial needs of families and small businesses. Their local knowledge often allows them to make better judgments about the creditworthiness of local borrowers. This ability to employ their local knowledge across a spectrum of lending products is the source of their strength and a key to their ultimate survival.

#### ***IV. Developing Trends***

##### ***A. Interest Rate Risk***

Currently short-term interest rates are considerably lower than long-term interest rates. In light of this factor and the continuing constriction within the credit markets, OTS is concerned that some institutions may be tempted to take on unsafe and unsound levels of interest rate risk in an attempt to bolster earnings. Historically, the thrift industry has had greater exposure to interest rate risk because of its heavy concentration of long-term, fixed-rate residential mortgages. As a result, OTS developed an off-site supervisory model in 1991 to measure and monitor interest rate risk exposure in the thrift industry and has issued advisory letters reminding institutions of our supervisory expectations regarding sound practices for managing interest rate risk. Reports from the OTS model are shared with both bank officials and OTS examiners on a quarterly basis. This supervisory approach is unique among the FBAs.

Our model suggests that the level of interest rate risk in the industry is still at manageable levels. However, we recognize that the economic environment could change quickly and, under certain scenarios, some institutions could experience severe downward pressure on both earnings and capital. To that end, OTS will continue to identify those institutions in an effort to ensure they take appropriate action to reduce their interest rate risk.

The OTS recognizes that banking institutions are in the business of taking and managing risk and the current environment offers attractive opportunities. Given this, our goal is to discourage unsafe and unsound practices without curtailing investment in residential mortgages.

#### *B. Continuing High Levels of Unemployment*

As mentioned earlier, the increase in the nation's unemployment rate from the beginning of the recession in December 2007 (unemployment rate of 4.9 percent) through September 2009 (9.8 percent) has been the greatest of any of the other ten recessions since 1945. Moreover, the nation's "underemployment" rate – a broader measure of the health of the nation's job markets that includes those unemployed, working part-time due to economic reasons, and not actively looking for work but would like to work – has increased to 17 percent in September 2009, the highest level on record since this statistic has been calculated (January 1999).

One small positive trend is that the rate of job loss appears to be slowing. According to the Bureau of Labor Statistics, total nonfarm payroll employment declined by

263,000 in September 2009. From May through September, job losses averaged 307,000 per month, compared with losses averaging 645,000 per month from November 2008 to April. Since the start of the recession in December 2007, payroll employment has fallen by 7.2 million.

These job losses have and will continue to put enormous financial pressure on struggling borrowers and will likely result in further economic challenges to those holding loan-related assets, as well as those attempting to operate in this sector of the economy.

#### *C. Liquidity*

As indicated earlier, thrifts have increased their liquidity. Cash, deposits and government securities rose to 9.1 percent of assets at the end of June 2009 from 8.5 percent at the end of 2008. Despite these encouraging trends, recent events illustrate that liquidity risk management at many banks needs improvement. Deficiencies include insufficient holdings of liquid assets, funding risky or illiquid asset portfolios with potentially volatile short-term liabilities, and a lack of meaningful cash flow projections and liquidity contingency plans.

As a result of these concerns, the OTS along with the other FBAs and the Conference of State Bank Supervisors, drafted guidance that reiterates the principles contained in existing guidance and, where appropriate, conforms these principles to the guidance issued by the Basel Committee on Banking Supervision in September 2008. More specifically, the guidance re-emphasizes the importance of cash flow projections, diversified funding sources, stress testing, a cushion of liquid assets and a formal well-developed contingency funding plan as primary tools for measuring and managing

liquidity risk. The guidance also puts the industry on notice that we expect all financial institutions (and affiliated holding companies) to manage liquidity risk in a manner consistent with their size, complexity and risk profile, and that failure to maintain an adequate liquidity risk management process is considered an unsafe and unsound practice.

The proposed guidance went out for comment on July 6, 2009. The 60-day comment period closed on September 4, 2009. In general, the industry feedback was supportive, but we received several suggestions for improving the document. The FBAs are currently weighing the merits of those suggestions. We expect to issue final guidance before year-end.

#### *D. Regulatory Restructuring*

Regarding concerns on the horizon for the thrift industry, the proposed consolidation of bank and thrift regulators certainly fits into that category. The Administration proposal to merge the OTS and the OCC, as well as the proposed consolidation of all federal bank regulatory functions under a single new super-regulator, would impose major costs and disruption for the thrift industry. The prospect of such consolidation has caused unease and uncertainty that has a chilling effect on new charter applications and institutions' planning for the future.

The OTS currently conducts consolidated supervision of thrifts and their holding companies. Although the OTS is not the proper regulator for systemically important conglomerates, the agency is well-suited to continue to supervise thrift holding

companies, particularly for the many local consumer and community lenders across America who should not be asked to bear the cost and inefficiency of separate holding company regulation. The overwhelming majority of thrifts are small, conservative lenders that offer home mortgages, car loans and other day-to-day financial services to consumers. Quite a few are community-based mutual institutions that have been integral parts of their communities for decades. The health of the financial services industry is improving, but by no means robust. The transition costs of thrifts converting to a different supervisor and a separate holding company regulator would be an unnecessary burden at a difficult time.

Another potential point of cost and disruption are the quarterly financial reports that banks and thrifts submit to their regulators. Thrifts report their financial status to the OTS through Thrift Financial Reports, while banks file Call Reports. Under consolidation proposals, either thrifts would need to overhaul their financial reporting systems, or the consolidated agency would need to operate and maintain two different reporting systems.

For smaller, community-based institutions, the specter of consolidation also brings unease because their operations are so different from the operations of large banks, particularly the trillion-dollar mega-banks. Under a single super-regulator, the needs of the community-oriented majority could be too often overlooked because of the need to focus attention and resources on institutions posing the greatest risk to the financial system. Consumer-and-community institutions would no longer have a regulator focused

on their traditional business model of knowing their customers and meeting the everyday financial needs of families and small businesses.

Consolidating agencies would take years, cost the industry millions of dollars and generate upheaval in the day-to-day supervision of financial institutions. All of this would be done with no efficiencies or other benefits for taxpayers, consumers or the industry.

#### *E. Overdraft Protection*

A number of measures indicate that while credit card usage is dropping, the use of debit cards is increasing. One of the reasons for increased debit card use may be that – given the current economic downturn - consumers are attempting to manage their finances more carefully by spending what they have, rather than borrowing to pay for purchases.

However, with the advent of fee-based overdraft protection, consumers who overdraw their debit accounts may face significant fees relative to the size of the overdrafts they incur. In fact, recent research indicates that because debit transactions are generally small – around \$20.00 – the typical \$27 overdraft fee often exceeds the value of the transaction.<sup>15</sup>

The OTS shares the concerns about overdraft programs that have been expressed by members of Congress. As a result, we are in the process of supplementing our existing

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<sup>15</sup> See FDIC Study of Bank Overdraft Programs at p 79 (Nov. 2008) (FDIC Overdraft Study), available at: [http://www.fdic.gov/bank/analytical/overdraft/FDIC138\\_Report\\_FinalTOC.pdf](http://www.fdic.gov/bank/analytical/overdraft/FDIC138_Report_FinalTOC.pdf).

overdraft guidance<sup>16</sup> for thrift institutions and examiners to clarify our supervisory expectations with respect to these programs. Our goal in doing so is to ensure that OTS supervised institutions are managing overdraft protection programs in a responsible way.

Beyond compliance with applicable rules, we plan to emphasize that failure to implement the best practices already advocated in OTS supervisory guidance can lead to violations of law. For example, existing OTS overdraft guidance warns against manipulating transaction clearing order to inflate fees.<sup>17</sup> Such an approach may violate the Federal Trade Commission (FTC) Act prohibition against unfair practices.

OTS also supports consumer choice in this area. Specifically, OTS supports requiring that a consumer affirmatively consent, or “opt-in,” before an institution may charge a fee for paying an overdraft, particularly for electronic transactions. Consistent with the increased use of debit cards noted above, recent research suggests that debit transactions account for the largest share of overdraft transactions-41 percent.<sup>18</sup> However, institutions often automatically enroll their customers in overdraft protection programs. Studies have shown that this strategy may lead to increased consumer participation in overdraft protection programs due to the power of inertia and lack of attention on the part of consumers.<sup>19</sup> Yet, consumer testing indicates that many people

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<sup>16</sup> See 70 FR 8428 (February 18, 2005).

<sup>17</sup> See 70 FR at 8431.

<sup>18</sup> See FDIC Overdraft Study at p.78.

<sup>19</sup> Madrian, Brigitte C., and Shea, Dennis F., The Power of Suggestion: Inertia in 401(K) Participation and Savings Behavior, Working Paper 7682, National Bureau of Economic Research, Cambridge, MA, May 2000 (available at: <http://www.nber.org/papers/w7682>).

would consider removing overdraft protection from their electronic transactions if they had the opportunity to do so.<sup>20</sup> These consumers should be given that choice up front.

#### *F. Reverse Mortgages*

Reverse mortgages present another set of emerging issues. Reverse mortgages are loans that convert home equity into payments from a lender. Available to homeowners age 62 and older, reverse mortgages typically do not require any payments from borrowers as long as they continue to live in their homes. Many of these loans are made under the Home Equity Conversion Mortgage program administered by the Department of Housing and Urban Development<sup>21</sup>, but institutions also offer reverse mortgages through their own proprietary programs.

Reverse mortgages present safety and soundness challenges because they rely primarily on the sale of the collateral property for repayment, and they have not been tested through the credit life cycle.<sup>22</sup> Although reverse mortgages are growing in popularity, they are complicated products for consumers. This, combined with the fact that they are offered to seniors who may be vulnerable to misleading marketing techniques, prompted the OTS to join other members of the Federal Financial Institutions Examination Council to develop reverse mortgage guidance for lenders. We expect to propose the guidance for comment soon.

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<sup>20</sup> See *Review and Testing of Overdraft Notices*, Macro International, December 8, 2008, available at: <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20081218a6.pdf>

<sup>21</sup> See 12 U.S.C. 1715z-20; 24 CFR 206.

<sup>22</sup> The OTS has already issued guidance on risk management issues presented by reverse mortgages. See *OTS Examination Handbook*, to One-to-Four Family Residential Real Estate Lending section, Appendix B available at: <http://files.ots.treas.gov/422041.pdf>.

### *G. Other Consumer Protection Issues*

The OTS is also taking a number of other steps to ensure that institutions under our supervision conduct business in a manner that is compliant with consumer protection laws, including the FTC Act prohibition against unfair and deceptive acts and practices. For example, we recently published rules prohibiting a range of unfair credit card practices, including increasing interest rates on existing balances when consumers are paying on time and charging credit card account opening fees that are so high that they erode most of the credit issued.<sup>23</sup> While OTS recognized that credit card issuers may have to commit significant resources to comply with the new rules, we strongly encouraged OTS supervised institutions to do so as soon as possible.<sup>24</sup> OTS also organized a conference call for financial institutions and other interested parties to ask implementation questions to help them prepare for the new rules as quickly and efficiently as possible. This effort to spur compliance reached more than 700 callers.

As you know, the Credit Card Accountability Responsibility and Disclosure Act of 2009 (Credit CARD Act) expands the prohibition against practices that the OTS found to be unfair and restricts additional practices. OTS shares the concerns that prompted Congress to enact the Credit CARD Act and we have taken prompt steps to ensure that institutions under OTS jurisdiction are aware of their new responsibilities under this legislation.<sup>25</sup> In particular, we have highlighted the requirement that institutions review accounts in which consumers' interest rates have been increased since January 1, 2009

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<sup>23</sup> See Unfair or Deceptive Acts or Practices (UDAP) Rule, 74 FR 5498, 5502-5504 (January 29, 2009).

<sup>24</sup> See Letter to Thrift Chief Executive Officers dated December 18, 2008, available at: <http://files.ots.treas.gov/25287.pdf>

<sup>25</sup> See Letter to Thrift Chief Executive Officers dated June 25, 2009, available at: <http://files.ots.treas.gov/25308.pdf>

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and develop a process for determining whether the rates applicable to such accounts should be reduced when the circumstances that warranted the rate increase are no longer present.<sup>26</sup> We are committed to enforcing this requirement. Moreover, we have encouraged OTS supervised institutions to go further than required under the implementing rules to ensure that consumers understand the effect of exercising the right to reject rate increases provided by the Credit CARD Act.<sup>27</sup>

The OTS also exercised its authority under the FTC Act earlier this year by taking formal enforcement actions that required two thrifts to cease engaging in unfair and deceptive acts and practices related to credit card and overdraft protection programs.<sup>28</sup> Through these actions, the OTS required the thrifts to reimburse consumers more than \$1.5 million and pay civil money penalties of \$250,000.

## **V. Conclusion**

Thank you again, Mr. Chairman, Ranking Member Crapo and members of the Subcommittee, for the opportunity to testify on behalf of the OTS on the current condition of the thrift industry. In summary, the OTS-regulated thrift industry is continuing to face imposing challenges from the financial crises. However, the industry is poised to return to thriving status once the housing market recovers and the economy again swings upward.

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<sup>26</sup> See Letter to Thrift Chief Executive Officers dated July 13, 2009, available at: <http://files.ots.treas.gov/25312.pdf>

<sup>27</sup> See Letter to Thrift Chief Executive Officers dated September 29, 2009, available at: <http://files.ots.treas.gov/25322.pdf>

<sup>28</sup> See In re Bank of Greene County (July 22, 2009), available at: <http://files.ots.treas.gov/enforcement/97159.pdf> and In re: American Express Bank, F.S.B. (June 29, 2009) available at <http://files.ots.treas.gov/enforcement/97146.pdf> and <http://files.ots.treas.gov/enforcement/97147.pdf>.

**PREPARED STATEMENT OF JOSEPH A. SMITH, JR.**  
NORTH CAROLINA COMMISSIONER OF BANKS,  
ON BEHALF OF THE CONFERENCE OF STATE BANK SUPERVISORS

OCTOBER 14, 2009

**INTRODUCTION**

Good afternoon, Chairman Johnson, Ranking Member Crapo, and distinguished members of the Subcommittee. My name is Joseph A. Smith, Jr. I am the North Carolina Commissioner of Banks and the Chairman of the Conference of State Bank Supervisors (CSBS).

Thank you for the opportunity to testify today on the condition of the banking industry. In the midst of a great deal of discussion about reform and recovery, it is very important to pause to assess the health of the industry and the factors affecting it, for good and ill.

My testimony today will present the views of state bank supervisors on the health of the banking industry generally and the banks we oversee in particular—the overwhelming majority of which are independent community banks. The states charter and regulate 73 percent of the nation’s banks (Exhibit A). These banks not only compete with the nation’s largest banks in the metropolitan areas, but many are the sole providers of credit to less populated and rural areas (Exhibit B). We must remember 91 percent of this country’s banks have less than \$1 billion in assets but share most of the same regulatory burdens and economic challenges of the largest banks which receive the greatest amount of attention from the Federal Government. Community and regional banks are a critical part of our economic fabric, providing an important channel for credit for consumers, farmers, and small businesses.

I will address: the key challenges that state-chartered banks face, regulatory policies that we are pursuing to improve supervision and the health of the industry, and recommendations to improve the regulation of our banks and ultimately the health of the industry.

**CONDITION OF THE BANKING INDUSTRY**

While the economy has begun to show signs of improvement, there are still many areas of concern. Consumer confidence and spending remains low, deficit spending has soared, and unemployment rates continue to slowly tick upward. The capital markets crisis, distress in the residential and commercial real estate markets, and the ensuing recession have greatly weakened our nation’s banking industry. And despite recent positive developments, the banking industry continues to operate under very difficult conditions. While there are pockets of strength in parts of the state bank system, the majority of my fellow state regulators have categorized general banking conditions in their states as “gradually declining.” Not surprisingly, the health of banks is directly affected by the economic conditions in which they operate. Times of economic growth will usually be fueled by a banking industry with sufficient levels of capital, a robust and increasing volume of performing loans, ample liquidity, and a number of new market entrants, in the form of *de novo* institutions. Conversely, this recession is characterized by a banking industry marred by evaporating capital levels, deteriorating and increasingly delinquent loans, liquidity crunches, and a steady stream of bank failures.

The Federal Deposit Insurance Corporation (FDIC) reports in its most recent *Quarterly Banking Profile* that the banking industry suffered an aggregate net loss of \$3.7 billion in the second quarter of 2009. These losses were largely caused by the increased contributions institutions made to their loan-loss provisions to counter the rising number of non-performing loans in their portfolios and realized losses. Further, additional writedowns in the asset-backed commercial paper portfolios and higher deposit insurance assessments impacted banks’ earnings significantly.<sup>1</sup>

Across the country, my colleagues are experiencing deteriorating credit quality in their banks, which is straining earnings and putting extreme pressure on capital. Deterioration in credit quality is requiring greater examination resources as regulators evaluate a higher volume of loans. Concentrations in commercial real estate (CRE) loans in general, and acquisition, development, and construction (ADC) loans in particular, are posing the greatest challenge for a significant portion of the industry. This is an important line of business for community and regional banks. Banks with less than \$10 billion in assets comprise 23 percent of total bank assets, but originate and hold 52 percent of CRE loans and 49 percent of ADC loans by volume. Reducing the concentrations that many of our institutions have in CRE lending is

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<sup>1</sup> FDIC *Quarterly Banking Profile*, Second Quarter 2009: <http://www2.fdic.gov/qbp/2009jun/qbp.pdf>.

an important factor in restoring them to health; however, it is our view that this reduction needs to be done in a way that does not remove so much credit from the real estate market that it inhibits economic recovery. Striking an appropriate balance should be our goal.

Deteriorating credit quality has a direct and destructive effect on bank capital. Reduction in capital, in turn, has a direct and destructive effect on a bank's liquidity, drying up its sources of funding from secondary sources, including capital markets, brokered deposits, home loan and bankers' banks and the Federal Reserve. This drying up of liquidity has been a significant challenge for a substantial number of the failures.

#### **CAPITAL IS KING**

As we entered the financial crisis, we touted the overall strong capital base of the industry, especially compared to previous periods of economic stress. While this was true, banks are highly leveraged operations, and when losses materialize, capital erodes quickly. While this is true for all institutions, it is more pronounced in our largest banks. According to the FDIC, as of December 31, 2007, banks over \$10 billion in assets had an average leverage capital ratio of 7.41 percent. This was 200 basis points (b.p.) less than banks with assets between \$1 billion and \$10 billion; 256 b.p. less than banks with assets between \$100 million and \$1 billion; and an astonishing 610 b.p. less than banks with assets less than \$100 million. As the financial crisis was unfolding and the serious economic recession began, these numbers show our largest institutions were poorly positioned, leading to the extraordinary assistance by the Federal Government to protect the financial system. Even with this assistance, this differential continues today with the largest institutions holding considerably less capital than the overwhelming majority of the industry.

Last year, the Federal Government took unprecedented steps to protect the financial system by providing capital investments and liquidity facilities to our largest institutions. Financial holding company status was conferred on a number of major investment banks and other financial concerns with an alacrity that was jaw-dropping. We trust the officials responsible took the action they believed necessary at that critical time. However, Federal policy has not treated the rest of the industry with the same expediency, creativity, or fundamental fairness. Over the last year, we have seen nearly 300 community banks fail or be merged out of existence, while our largest institutions, largely considered too big to fail, have only gotten bigger. State officials expect this trend to continue, with an estimated 125 additional unassisted, privately negotiated mergers due to poor banking conditions.

Additional capital, both public and private, must be the building block for success for community and regional banks. While TARP has provided a source of capital for some of these institutions, the process has been cumbersome and expensive for the community and regional banks, whether they actually received the investment of funds or not. There has been a lack of transparency associated with denial of a TARP application, which comes in the form of an institution being asked to withdraw. This should be of deep concern to Congress. If TARP is to be an effective tool to strengthen community and regional banks, the Treasury must change the viability standard. We should provide capital to institutions which are viable after the TARP investment. Expanded and appropriate access to TARP capital will go a long way to saving the FDIC and the rest of the banking industry a lot of money. To date, this has been a lost opportunity for the Federal Government to support community and regional banks and provide economic stimulus.

There are positive signs private capital may be flowing into the system. For the 6 months ending June 30, 2009, over 2,200 banks have injected \$96 billion in capital. While capital injections were achieved for all sizes of institutions, banks with assets under \$1 billion in assets had the smallest percentage of banks raising capital at 25 percent.

There has been and, to our knowledge, there still is a concern among our Federal colleagues with regard to strategic investments in and acquisitions of banks, both through the FDIC resolution process and in negotiated transactions. While these concerns are understandable, we believe they must be measured against the consequence of denying our banks this source of capital. It is our view that Federal policy should not unnecessarily discourage private capital from coming off the sidelines to support this industry and in turn, the broader economy.

#### **SUPERVISION DURING THE CRISIS**

There are very serious challenges facing the industry and us as financial regulators. State regulators have increased their outreach with the industry to develop a common understanding of these challenges. Banks are a core financial intermediary, providing a safe haven for depositors' money while providing the necessary

fuel for economic growth and opportunity. While some banks will create and have created their own problems by miscalculating their risks, it is no surprise that there are widespread problems in banks when the national economy goes through a serious economic recession.

We will never be able, nor should we desire, to eliminate all problems in banks; that is, to have risk-free banking. While they are regulated and hold the public trust, financial firms are largely private enterprises. As such, they should be allowed to take risks, generate a return for shareholders, and suffer the consequences when they miscalculate. Over the last year, we have watched a steady stream of bank failures. While unfortunate and expensive, this does provide a dose of reality to the market and should increase the industry's self-discipline and the regulators' focus on key risk issues. In contrast to institutions deemed too big to fail, market discipline and enhanced supervisory oversight can result in community and regional banks that are restructured and strengthened.

#### *Recognizing the Challenges*

The current environment, while providing terrific challenges with credit quality and capital adequacy, has also brought an opportunity for us to reassess the financial regulatory process to best benefit our local and national economies. To achieve this objective, it is vital to step back and make an honest assessment of our regulated institutions, their lines of business, management ability, and capacity to deal with economic challenges. This assessment provides the basis for focusing resources to address the many challenges we face.

With regard to financial institutions, as regulators we must do a horizontal review and engage in a process of "triage" that divides our supervised entities into three categories:

- I. Strong
- II. Tarnished
- III. Weak

**Strong** institutions have the balance sheets and management capacity to survive, and even thrive, through the current crisis. These institutions will maintain stability and provide continued access to credit for consumers. Further, these institutions will be well-positioned to purchase failing institutions, which is an outcome that is better for all stakeholders than outright bank failure. We need to ensure these institutions maintain their positions of strength.

**Tarnished** institutions are under stress, but are capable of surviving the current crisis. These institutions are where our efforts as regulators can make the biggest difference. Accordingly, these institutions will require the lion's share of regulatory resources. A regulator's primary objective with these institutions should be to fully and accurately identify their risks, require generous reserves for losses, and develop the management capacity to work through their problems. We have found that strong and early intervention by regulators, coupled with strong action by management, has resulted in the strengthening of our banks and the prevention of further decline or failure. By coordinating their efforts, state and Federal regulators can give these banks a good chance to survive by setting appropriate standards of performance and avoiding our understandable tendencies to over-regulate during a crisis.

**Weak** institutions are likely headed for failure or sale. While this outcome may not be imminent, our experience has shown that the sooner we identify these institutions, the more options we will have to seek a resolution which does not involve closing the bank. It simply is not in our collective best interest to allow an institution to exhaust its capital and to be resolved through an FDIC receivership, if such an action can be avoided. Institutions we believe are headed toward almost certain failure deserve our immediate attention. This is not the same as bailing out, or propping up failing institutions with government subsidies. Instead, as regulators our goal is an early sale of the bank, or at least a "soft landing" with minimal economic disruption to the local communities they serve and minimal loss to the Deposit Insurance Fund.

#### **AREAS REQUIRING ATTENTION**

This is the time for us to be looking forward, not backwards. We need to be working to proactively resolve the problems in the banking industry. To do this, we need to ensure our supervisory approach is fair and balanced and gives those banks which deserve it the chance to improve their financial positions and results of operations. The industry and regulators must work together to fully identify the scope of the problems. However, I believe we need to consider the response which follows the identification. We should be tough and demanding, but the response does not

need to send so many banks toward receivership. A responsive, yet reasonable approach, will take a great deal of time and effort, but it will result in less cost to the Deposit Insurance Fund and benefit communities and the broader economy in the long-run. I would like to highlight a few areas where I have concerns.

#### *Increase Access to Capital*

First, as discussed earlier, we need to allow capital to flow into the system. There is a significant amount of capital which is seeking opportunities in this market. We need to encourage this inflow through direct investments in existing institutions and the formation of new banks. To the extent that private investors do not themselves have bank operating experience or intend to dismantle institutions without consideration of the social and economic consequences, such shortcomings can and should be addressed by denial of holding company or bank applications or through operating restrictions in charters or regulatory orders. Where private equity groups have employed seasoned management teams and proposed acceptable business plans, such groups should be granted the necessary regulatory approvals to invest or acquire. While we cannot directly fix the capital problem, we should ensure the regulatory environment does not discourage private capital.

#### *Expedite Mergers*

Second, we need to allow for banks to merge, especially if it allows us to resolve a problem institution. Unfortunately, we have experienced too many roadblocks in the approval process. We need more transparency and certainty from the Federal Reserve on the process and parameters for approving mergers. To be clear, I am not talking about a merger of two failing institutions. Facilitating the timely merger of a weak institution with a stronger one is good for the system, good for local communities, and is absolutely the least cost resolution for the FDIC.

#### *Brokered Deposits*

Third, over the last several years the industry has explored more diversified funding, including the use of brokered deposits. Following the last banking crisis, there are restrictions for banks using brokered deposits when they fall below "well capitalized." I appreciate the efforts of FDIC Chairman Bair in working to provide more consistency and clarity in the application of this rule. However, I am afraid the current approach is unnecessarily leading banks to fail. We allowed these banks to increase their reliance on this funding in the first place, and I believe we have a responsibility to assist them in gradually unwinding their dependency as they work to clean up their balance sheet. My colleagues have numerous institutions that could have benefited from a brokered deposit waiver granted by the FDIC. As noted above, many of the recent failures of community and regional banks have been the result of a sudden and precipitous loss of liquidity.

#### *Open Bank Assistance*

Fourth, the FDIC is seriously constrained in providing any institution with open bank assistance. We are concerned that this may be being too strictly interpreted. We believe there are opportunities to provide this assistance which do not benefit the existing shareholders and allows for the removal of bank management. This is a much less disruptive approach and I believe will prove to be much less costly for the FDIC. The approach we suggest was essentially provided to Citibank and Bank of America through loan guarantees without removing management or eliminating the stockholders. As discussed previously, we believe that the Capital Purchase Program under TARP can be a source of capital for transactions that restructure banks or assist in mergers to the same effect. We are not suggesting that such support be without conditions necessary to cause the banks to return to health.

#### *Prompt Corrective Action*

Finally, Congress should also investigate the effectiveness of the Prompt Corrective Action (PCA) provisions of the Federal Deposit Insurance Corporation Improvement Act in dealing with problem banks. We believe there is sufficient evidence that the requirements of PCA have caused unnecessary failures and more costly resolutions and that allowing regulators some discretion in dealing with problem banks can assist an orderly restructuring of the industry.

### **LOOKING FORWARD**

There will be numerous legacy items which will emerge from this crisis designed to address both real and perceived risks to the financial system. They deserve our deliberate thought to ensure a balanced and reasoned approach which provides a solid foundation for economic growth and stability.

The discussions around regulatory reform are well underway. We would do well to remember the instability of certain firms a year ago which put the U.S. financial system and economy at the cliff's edge. We must not let the bank failures we are seeing today cloud the real and substantial risk facing our financial system—firms which are too big to fail, requiring extraordinary government assistance when they miscalculate their risk.

We need to consider the optimal economic model for community banks, one that embraces their proximity to communities and their ability to engage in high-touch lending. However, we must ensure lower concentrations, better risk diversification, and improved risk management. We need to find a way to ensure banks are viable competitors for consumer finance and ensure they are positioned to lead in establishing high standards for consumer protection and financial literacy.

We must develop better tools for offsite monitoring. The banking industry has a well established and robust system of quarterly data reporting through the Federal Financial Institutions Examination Council's Report of Condition and Income (Call Report). This provides excellent data for use by all regulators and the public. We need to explore greater standardization and enhanced technology to improve the timeliness of the data, especially during times of economic stress.

Over the last several years, the industry has attracted more diversified sources of funding. This diversification has improved interest rate risk and liquidity management. Unfortunately, secured borrowings and brokered deposits increase the cost of resolution to the FDIC and create significant conflicts as an institution reaches a troubled condition. We need to encourage diversified sources of funding, but ensure it is compatible with a deposit insurance regime.

We need to consider how the Deposit Insurance Fund can help to provide a countercyclical approach to supervision. We believe Congress should authorize the FDIC to assess premiums based on an institution's total assets, which is a more accurate measure of the total risk to the system. Congress should revisit the cap on the Fund and require the FDIC to build the Fund during strong economic times and reduce assessments during period of economic stress. This type of structure will help the entire industry when it is most needed.

#### **CONCLUSION**

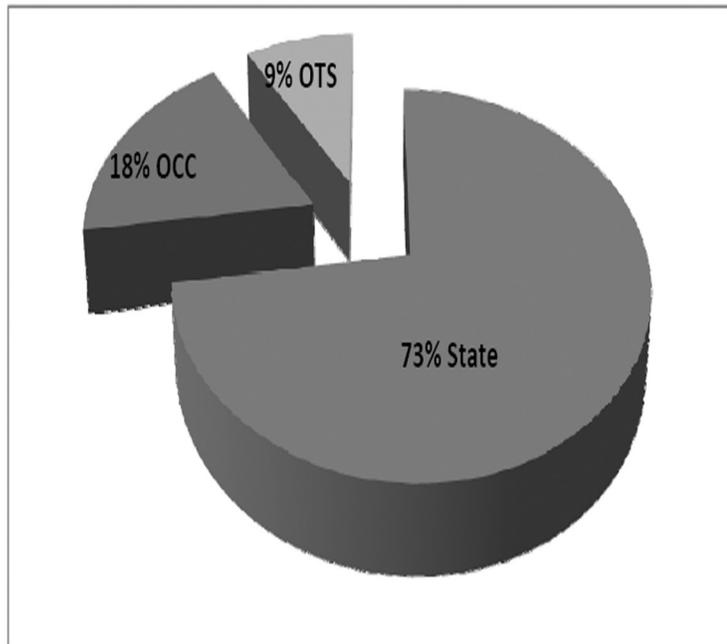
The banking industry continues to face tremendous challenges caused by the poor economic conditions in the United States. To move through this crisis and achieve economic stability and growth, Members of Congress, state and Federal regulators, and members of the industry must coordinate efforts to maintain effective supervision, while exercising the flexibility and ingenuity necessary to guide our industry to recovery.

Thank you for the opportunity to testify today, and I look forward to any questions you may have.

Exhibit A

## Charters By Type

As of 6/30/2009

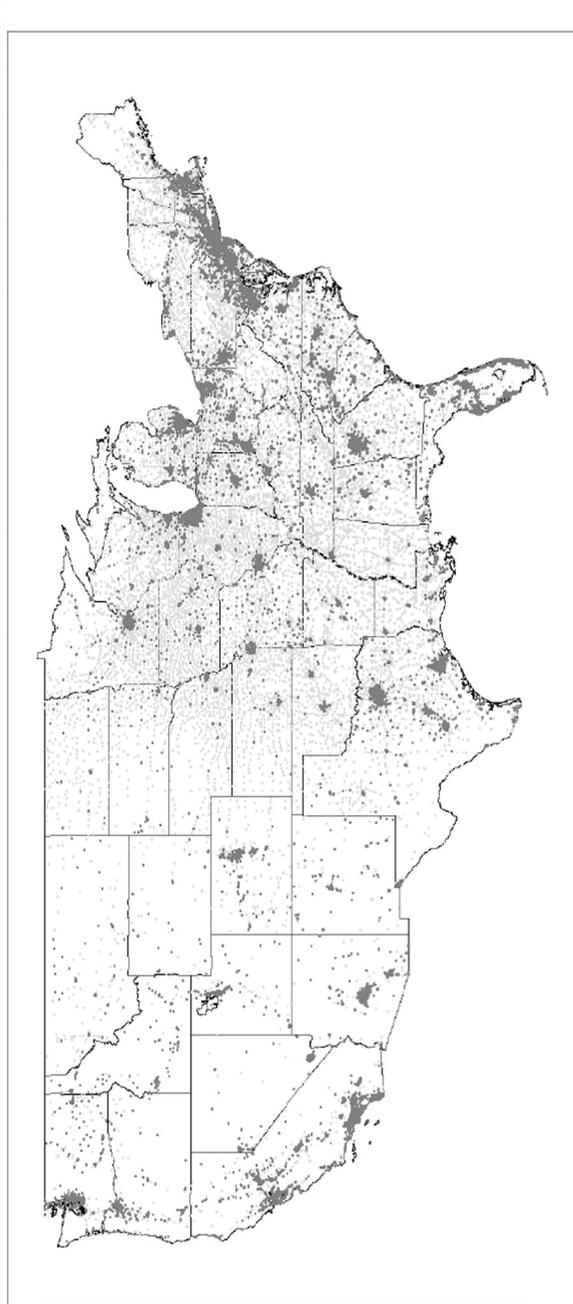


## Numbers of Charters by Authority

	STATE	OCC	OTS	TOTALS
6/30/2009	5,968	1,508	728	8,204
12/31/2008	6,034	1,540	740	8,314
12/31/2006	6,216	1,723	768	8,707
12/31/2000	6,607	2,231	915	9,753
12/31/1995	7,676	2,858	1,171	11,705
12/31/1992	8,388	3,593	1,386	13,367

Exhibit B

Branch locations of Top 7 (red) overlaid on all others (green) as of March 16, 2009



**PREPARED STATEMENT OF THOMAS J. CANDON**  
 DEPUTY COMMISSIONER, VERMONT DEPARTMENT OF BANKING, INSURANCE,  
 SECURITIES, AND HEALTH CARE ADMINISTRATION  
 ON BEHALF OF THE NATIONAL ASSOCIATION OF STATE CREDIT UNION SUPERVISORS  
 OCTOBER 14, 2009

***Introduction***

Honorable Chairman Johnson, Ranking Member Crapo and the distinguished members of the Financial Institutions Subcommittee of the Senate Banking, Housing and Urban Affairs Committee, thank you for the opportunity to testify before this Subcommittee on the State of the Banking Industry. I am Thomas J. Candon, Deputy Commissioner of Banking and Securities for the Vermont Department of Banking, Insurance, Securities and Health Care Administration. I am pleased to be here on behalf of state credit union regulators as Chairman of the National Association of State Credit Union Supervisors<sup>1</sup> (NASCUS). In this prepared testimony, I will share state credit union regulators' perspectives on the condition of state-chartered credit unions and areas for reform.

NASCUS has been committed to enhancing state credit union supervision and advocating for a safe and sound state credit union system since its inception in 1965. NASCUS is the sole organization dedicated exclusively to the promotion of the dual chartering system and advancing the autonomy and expertise of state credit union regulatory agencies.

The state credit union system is 100 years old. Today, there are 3,065 state-chartered credit unions with a combined \$404 billion in assets.<sup>2</sup> State-chartered credit unions represent 40 percent of the nation's nearly 7,700 credit unions.

At this hearing, the Subcommittee is assessing the state of financial institutions, areas of concern as well as capital and lending needs. In this testimony, I will detail information from state regulators on the following:

- Condition of state-chartered credit unions
- Corporate credit union impact
- Credit union capital needs
- Regulatory considerations for member business lending
- Trends and regulatory response
- Value and strength of state supervision

***Condition of state-chartered credit unions***

Like all financial institutions, state credit unions have been adversely affected by the economic downturn. However, at this point, state natural person credit unions remain generally healthy and continue to serve the needs of their members and their communities. For the most part, natural person credit unions did not engage in many of the practices that have precipitated the current market downturn.

Nationally, the average credit union net worth is down to 10.03 percent, with 96 percent of all federally insured credit unions having more than 7 percent in capital as of June 30, 2009. Further, the percentage of delinquent loans is 1.58 percent for all credit union loans.

State-chartered credit unions in my state of Vermont have the capability to lend due to an increase in deposits that we attribute to a flight to safety. Consumer loans are available to members although underwriting continues to be based on a member's ability to repay. At this time, Vermont credit unions do not make many member business loans and have nominal commercial real estate loans on their balance sheets. Our regulatory focus is on the amount of capital held by some of our credit unions and the impact of the growing unemployment picture on delinquencies.

The capital of Vermont credit unions is affected by the growth of deposits which were up 24.73 percent in Vermont as of June 30, 2009, and the impact of the corporate credit union losses (which I will discuss later). Income is also being reduced as margins are squeezed and credit union members are struggling to make loan payments.

In Vermont, our small credit unions like many around the country are not only affected by a downturn in the economy but also by increasing regulatory burden. We continue to see mergers as long-time managers retire and volunteer boards cannot keep up with the increased demands. As state regulators we monitor our credit

<sup>1</sup>NASCUS is the professional association of the 48 state credit union regulatory and territorial agencies that charter and supervise the nation's 3,100 state-chartered credit unions.

<sup>2</sup>As of June 30, 2009.

unions closely. If there is any sign of distress, we have an examiner communicating with the credit union to make sure we understand what needs to be done to correct the problems.

As the Subcommittee knows, the effect of the economy on financial institutions varies from region to region. Some regions are weathering significant impacts from the destabilized real estate market, while others are addressing more localized economic issues. In many cases, state regulators are concerned about unemployment and its impact on members' ability to meet their obligations. State regulators are also concerned about the growing number of delinquencies, charge-offs and pressures on earnings, especially in smaller state-chartered credit unions. While loan delinquency and net charge-offs have generally increased for state-chartered credit unions, state regulators indicate that the levels remain manageable.

State regulators also report increased scrutiny on consumer credit products, including auto loans, credit cards and other consumer credit portfolios given the nation's economic condition. State credit union regulators are cognizant of credit unions' future financial performance as commercial credit problems begin to affect consumer credits. The weak economy creates a tightening of commercial credit, an issue being closely monitored by state regulators.

Some states, including my home state of Vermont, have not experienced the fallout from commercial or subprime lending as our state-chartered credit unions did not engage in those activities. State regulators continue to encourage their credit unions to exercise sound underwriting, proper risk management and due diligence, the elements that have kept credit unions in a better position throughout this economic downturn. Further, state regulators are monitoring red flags closely, fully utilizing offsite monitoring and using early warning systems to detect risk.

The growing trend toward consolidation is also on the minds of state regulators as credit union mergers continue to occur, both voluntarily and for regulatory purposes. As economic pressures persist, finding suitable merger partners may become more difficult. State regulators recognize this dilemma and see merger issues as an ongoing concern in 2010.

In addition, growth is an issue state regulators are paying close attention to in today's environment. The National Credit Union Administration (NCUA) reported in its Financial Trends in Federally Insured Credit Unions for January–June 2009 an annualized asset growth rate of 14.53 percent. This growth gives rise to concerns about interest rate risk and the need to ensure quality asset/liability and balance sheet management among credit unions.

#### ***Corporate Credit Union Impact***

As I noted earlier, one of the issues affecting both state and Federal credit unions is the impact of problems in the corporate credit union network. Allow me to elaborate. In addition to direct economic pressures, credit unions are addressing indirect economic pressures by way of the impact of losses from corporate credit unions. The deterioration of asset-backed securities held by two Federal corporate credit unions (U.S. Central Corporate Federal Credit Union and Western Corporate Federal Credit Union) and their consequent conservatorship by the NCUA have resulted in considerable balance sheet impact on natural person credit unions.

For the first time in nearly 20 years, the NCUA Board approved a credit union premium in September 2009 with the assessment of 0.15 percent of insured shares. The premium will both restore the National Credit Union Share Insurance Fund (NCUSIF) equity to 1.30 percent and begin to repay a portion of the Temporary Corporate Credit Union Stabilization Fund borrowings from the U.S. Treasury.

State regulators, in consultation with Federal regulators, are working to address the impact of corporate losses and to make regulatory improvements to mitigate recurrence. As the NCUA develops its proposed rule for regulation of corporate credit unions, state regulators continue to stress the following principles:

- Enhance supervision and tighten regulatory standards
- Properly assess risk problems
- Preserve equal opportunity for all corporates to compete as long as they remain safe and sound and retain the support of their members
- Guard against preemption of state authority and homogenization of the corporate system

State regulators have also cautioned the NCUA against regulation that would unnecessarily or adversely impact safe and sound corporate credit unions that have properly managed their investments and remain fully supported by their members.

NCUA has been working cooperatively with state regulators to institute revisions to the agency's Part 704 corporate credit union regulations to strengthen the safety

and soundness of the corporate system. Regulators should continue to focus on ensuring any credit union, natural person or corporate, has robust risk management and mitigation policies in place to balance its investment portfolios. Such policies should include adequate reserves, requisite expertise, meaningful shock testing and valuation mechanisms as well as concentration limits. NASCUS believes there is no question that after recent events corporate credit unions must retain higher capital reserves. NCUA should work with NASCUS and state regulators to develop more comprehensive capital requirements, including risk-based capital.

The regulatory capital program for corporate credit unions should consider an institution's status as a wholesale or retail corporate, its mix of products and services (investment, payment systems, pass through, *etc.*) and establish parameters of actions for state and Federal regulators if capital falls below defined thresholds.

Capital is important to both the corporate credit union system and the natural person credit unions that support the corporate credit unions. During the corporate stabilization process, supplemental capital may have mitigated some of the unintended consequences to net worth categories at natural person credit unions. Further, access to a risk-based capital system would foster safety and soundness for the entire credit union system.

#### ***Credit Union Capital Needs***

The majority of credit unions are weathering conditions today; however, as stated previously, credit unions' earnings are suffering and credit unions are losing money. We need to act now to ensure credit unions remain as safe and sound as possible. NASCUS has long supported comprehensive capital reform for credit unions and believes that given the current economic climate, reform in this area is critical and timely. Credit unions need more ways to raise capital, notably access to supplemental capital. NASCUS continues to encourage the Senate Banking Committee to consider credit union capital reform as part of its financial reform efforts.

Unlike other financial institutions, credit union access to capital is limited to reserves and retained earnings from net income. Since net income is not easily increased in a fast-changing environment, state regulators recommend additional capital-raising capabilities for credit unions. Access to supplemental capital will enable credit unions to respond proactively to changing market conditions, enhancing their future viability and strengthening their safety and soundness. Supplemental capital would serve as an extra layer of protection for the credit union deposit insurance fund as well.

Allowing credit unions access to supplemental capital with regulatory approval and robust oversight will improve their ability to react to market conditions, grow safely into the future and serve their members in this challenged economy. It would also provide a tool for credit unions to use if they face declining net worth or liquidity needs. We feel strongly that now is the time to permit this important change.

NASCUS follows several guiding principles in our quest for supplemental capital for credit unions. First, a capital instrument must preserve the not-for-profit, mutual, member-owned and cooperative structure of credit unions. Next, it must provide for full disclosures, investor protection and robust safeguards. Prudential safety and soundness requirements must be maintained for these investments and supplemental capital must preserve credit unions' tax-exempt status. Finally, regulatory approval would be required before a credit union could access supplemental capital.

It is NASCUS' studied belief that a change to the Federal Credit Union Act could provide this valuable tool to the credit union system without altering the not-for-profit, mutual, cooperative structure of credit unions as tax exempt member owned financial institutions. We realize that supplemental capital will not be appropriate for every credit union, nor would every credit union need access to supplemental capital. This is why NASCUS supports regulator approval as a pre-condition for credit unions issuing supplemental capital.

A task force of NASCUS state regulators is currently studying supplemental capital for credit unions with the NCUA. This regulatory group is researching the appropriate regulatory parameters for supplemental capital for credit unions.

As this Subcommittee addresses regulatory reform and other legislation this fall, NASCUS encourages favorable consideration of access to supplemental capital for credit unions.

#### ***Regulatory Considerations for Member Business Lending***

Credit union member business lending, when conducted within proper regulatory controls, has proved beneficial for credit unions, their members, and their communities. However, while some credit unions are actively engaged in member business lending, many are not. As Congress considers changes to credit unions' member business lending capabilities, state regulators will work with the NCUA in its capac-

ity as the insurer to build regulatory parameters for proper oversight through the examination and supervision process. Further, credit unions must have a thorough understanding of member business lending and be diligent in their written policies, underwriting and controls for the practice to be conducted in a safe and sound manner. From a prudential regulator view, an arbitrary cap on member business lending is less important than proper underwriting and thorough reporting of all business loans.

***Trends and Regulatory Response***

I would like to respond to the Subcommittee's request for information regarding developing trends, concerns and state regulatory responses to today's challenges. Rising unemployment continues to be a concern and we expect that it will continue to negatively impact state credit unions well into 2010 as delinquencies and bankruptcies continue to increase.

Some state regulators have seen a marked increase in loan delinquencies and net charge-offs at June 2009; however, the levels remain manageable. Earnings pressures continue so credit unions are seeking ways to reduce overhead expenses. Loan demand has slowed somewhat in the mid-to smaller credit unions; a contrast to the increased indirect lending activities experienced in the larger credit unions. State regulators are closely monitoring both lending and investment activities within their credit unions and continue to stress the importance of sound underwriting and due diligence at the board level. State regulators also continue to supervise their institutions closely through offsite monitoring and onsite examinations and visitations. Credit unions need to understand their portfolio makeup and the impact that an increasing rate environment will have on their institutions.

Another economic stressor affecting small credit unions is the uncertainty of losing their core field of membership if comprised of select employee groups. Because some small credit unions still rely on one or two employers for their members, if those businesses do not survive, the credit union will not survive either.

***Value and Strength of State Supervision***

In this challenged economic environment, state regulators have demonstrated the importance of local supervision of state-chartered institutions and the value of a dual regulatory regime. State regulators are properly tuned into both their institutions and the specific needs of local consumers. Further, state regulators have the expertise to identify risk areas and take enforcement actions where necessary. With respect to consumer protection, state regulators are directly accountable to Governors and state legislatures, who in turn are directly accountable to their consumer citizens. It is for this reason that many states have always emphasized consumer protection along with safety and soundness in financial services oversight. As regulatory modernization efforts are considered by the Senate Banking Committee, we encourage you to retain state supervision and uphold state authority. Further, we ask you to recognize the essential value of dual chartering to financial institution's ability to innovate.

Finally, as we talk about dual chartering, I wanted to note our regulatory partners, the National Credit Union Administration. In my state of Vermont, all of my credit unions are federally insured, and therefore subject to share insurance oversight from NCUA in addition to state safety and soundness and compliance regulation and supervision. We work extremely well with NCUA, and I believe our strong cooperative relationship has contributed substantially to the stability of the credit union system in my region. Indeed, this cooperative relationship between state regulators and the NCUA exists throughout the Nation as well.

NASCUS would be pleased to provide any additional information you deem appropriate as you work through these matters. While the current economic climate has an unquestionable adverse impact on the state credit union system, I remain confident that the generally sound management of credit unions combined with ongoing vigilant state regulatory oversight has enabled the credit union system to prudently meet their members' needs. Thank you for your attention.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO  
FROM SHEILA C. BAIR**

**Q.1.** According to a recent New York Times article, about \$870 billion, or roughly half of the industry's \$1.8 trillion of commercial real estate loans, now sit on the balance sheet of small and medium sized banks. To what extent has TALF encouraged capital to enter the commercial real estate market and what other step should regulators be taking to address this problem?

**A.1.** Small and medium-sized financial institutions hold a significant dollar amount of commercial real estate loans on their balance sheets. Many of these smaller institutions were not active in the commercial real estate mortgage securitization market because of the comparatively small dollar amount of the loans and the nature of customer-focused relationships in community banking. Therefore, we do not believe the TALF has had a significant effect on the availability of credit for smaller commercial real estate loans.

In terms of encouraging commercial real estate lending, the Federal banking agencies issued a policy statement on October 30, 2009, titled *Prudent Commercial Real Estate Loan Workouts*. The Statement encourages banks to continue making good loans to commercial real estate borrowers and work with borrowers experiencing difficulties in their repayment capacity because of the economic downturn.

The TALF was designed to increase credit availability for businesses and consumers by facilitating renewed issuance of securities backed by loans to consumers and businesses at more normal interest rate spreads. Based on recent TALF transactions involving commercial real estate mortgage loans, the program appears to have encouraged capital to enter the securitization market. As the Federal Reserve Bank of New York is facilitating the TALF program, the Senator may want to consult with the Reserve Bank on the program's performance and success in encouraging capital to return to the commercial real estate market.

**Q.2.** How will FASB's new rules on off-balance sheet accounting impact financial institution's ability to lend and how do you intend to implement the changes?

**A.2.** Following publication of the Notice of Proposed Rulemaking on September 15, 2009, the bank regulatory agencies received 41 comments from banks, bank holding companies, banking industry associations, mortgage companies, investment and asset management firms, and individuals. A number of commenters indicated that implementation of FAS 166 and FAS 167 without changes to the Agencies' risk-based capital rules would negatively impact financial markets and curtail lending due to higher regulatory capital requirements resulting from the consolidation of significant amounts of assets onto banking organizations' balance sheets. Commenters also argued that such implementation would inappropriately align capital requirements with GAAP's control-based approach to consolidation, in contrast to the credit risk focus of the Agencies' risk-based capital rules. The commenters overwhelmingly supported a delay or phase-in of the regulatory capital requirements resulting from the implementation of FAS 166 and FAS 167.

In response the FDIC, working with the other Federal bank regulatory agencies, developed a final rule to better align regulatory capital requirements with the actual risks of certain exposures. Banks affected by the new accounting standards generally will be subject to higher minimum regulatory capital requirements. The final rule provides an optional delay and phase-in for a maximum of 1 year for the effect on risk-based capital and the allowance for loan and lease losses related to the assets that must be consolidated as a result of the accounting change. The final rule also eliminates the risk-based capital exemption for asset-backed commercial paper assets. The transitional relief does not apply to the leverage ratio or to assets in conduits to which a bank provides or has provided implicit support.

The Final Rule was passed by the FDIC Board of Directors on December 15, 2009. The rule provides temporary relief from risk-based measures in order to avoid abrupt adjustments that could undermine or complicate government actions to support the provision of credit to U.S. households and businesses in the current economic environment. Banks will be required to rebuild capital and repair balance sheets to accommodate the new accounting standards by the beginning of 2011. The optional delay and phase-in provides capital relief to ease the impact of the accounting change on bank's regulatory capital requirements, and enable banks to maintain consumer lending and credit availability as they adjust their business practices to the new accounting rules.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO  
FROM JOHN DUGAN**

**Q.I.** According to a recent New York Times article, about \$870 billion, or roughly half of the industry's \$1.8 trillion of commercial real estate loans, now sit on the balance sheet of small and medium sized banks. To what extent has TALF encouraged capital to enter the commercial real estate market and what other steps should regulators be taking to address this problem?

**A.I.** The Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF) is intended to help make credit available to consumers and businesses by facilitating the issuance of asset-backed securities (ABS) and by improving the conditions for ABS more generally. Until recently, most of the financing conducted with TALF facilities has been concentrated in automobile and credit card ABS securities. The use of TALF to help restart the commercial mortgage-backed securities (CMBS) markets has lagged due to the complexity and level of due diligence required for these types of transactions.

The use of the TALF program to assist the CMBS market took a positive step forward on November 16, 2009, when U.S. mall owner Developers Diversified Realty Corp sold \$400 million of securities with the help of TALF financing. The \$323 million TALF eligible AAA-rated portion was priced at under 4 percent, a much better rate than originally anticipated. This issuance is indicative of a key potential benefit of CMBS TALF: it provides a reasonable cost for senior debt, allowing liquidity to flow back into the market. However, it does not by itself solve the problem of overleveraged

borrowers. Since TALF financing is only available for AAA-rated debt, it would likely not directly benefit many of the problem borrowers sitting on the books of the banks today. However, there is an indirect benefit in that it provides market liquidity. Investors will likely use this initial deal as a benchmark, which could encourage other capital into the commercial real estate market. Because of this potential benefit, many market participants would like to see the current deadlines for the TALF program extended beyond the current deadlines of June 30, 2010, for newly issued CMBS and March 31, 2010, for legacy CMBS (*i.e.*, deals issued before 1/1/09).

Although there has been some modest improvement in liquidity within the CMBS market, the underlying fundamentals for many commercial real estate segments are still weak with delinquency, nonaccrual, and loss levels still increasing. Ultimately, the credit fundamentals of the industry need to stabilize in order for investors, bankers, and borrowers to fully understand pricing of commercial real estate assets.

Banking regulators have a limited ability to directly encourage capital investment into the commercial real estate industry. We are mindful, however, that our actions must not put up unreasonable barriers to take flow of capital. At the OCC, we are encouraging bankers to work with their borrowers, and we continue to stress to examiners the need to take a measured, balanced approach when evaluating loan and borrower performance in this economic environment. We have stressed that we expect and encourage bankers to work with borrowers who may be facing financial difficulty, and to extend new credit to creditworthy borrowers when these actions are done in a prudent and safe and sound manner. In an effort to promote clarity and consistency in the industry, the OCC, in conjunction with the other Federal banking agencies and the FFIEC's State Liaison Committee, recently issued a Policy Statement on Prudent Commercial Real Estate (CRE) Loan Workouts. The policy statement reiterates the agencies' view that prudent CRE loan workouts are often in the best interest of the financial institution and the borrower, and establishes clear regulatory expectations for the industry when working with borrowers. The statement notes that examiners should not criticize banks for engaging in an effective workout program even if the restructured loan has a weakness that results in an adverse credit classification. The statement also reiterates our policy that loans should not be classified simply because the underlying values have declined to amounts that are less than the current loan balance. Instead, classifications must be based on an analysis of the borrower's ability and capacity to repay. To help promote greater consistency both within and across the agencies in making such determinations, the policy statement provides real world examples that our examiners are seeing, and provides guidance on when classification and write-downs are and are not warranted.

**Q.2.** How will FASB's new rules on off-balance sheet accounting impact financial institution's ability to lend, and how do you intend to implement the changes?

**A.2.** Upon implementing FAS 166 and FAS 167, banking organizations will be required to consolidate certain assets and liabilities

that are currently held in variable interest entities (VIEs)<sup>1</sup> that these organizations do not consolidate under current generally accepted accounting principles (GAAP) standards. Certain banking organizations have reported that the consolidation of variable interest entities will result in a significant increase in assets reported on-balance sheet at the time the new accounting standards become effective, which will be January 1, 2010, for banking organizations with a calendar year end. Moreover, except for VIEs that a banking organization consolidates at fair value, consolidation will require the banking organization to recognize an allowance for loan and lease losses for loans held in consolidated VIEs.

On September 16, 2009, the Federal banking agencies (Agencies) published in the *Federal Register* a notice of proposed rulemaking (NPR) regarding the effect of the accounting changes under FAS 166 and FAS 167 would have on capital requirements under the regulatory capital rules. The NPR noted that banking organizations had provided non-contractual support to VIEs that they sponsored in order to prevent senior securities in the structure from being downgraded, thereby mitigating reputational risk and the associated alienation of investors, and preserving access to cost-effective funding. In light of these actions taken by banking organizations, the NPR stated that the Agencies believe that the broader accounting consolidation requirements of FAS 166 and FAS 167 will result in a regulatory capital treatment that more appropriately reflects the risks to which banking organizations are exposed. For these and other reasons, the NPR did not propose changing the regulatory capital rules to mitigate the effect of FAS 166 and FAS 167 on banking organizations' minimum regulatory capital requirements.<sup>2</sup>

Before issuing the NPR, the Agencies carefully considered the probable effect on banking organizations' financial regulatory capital ratios and financial condition that will result from implementing FAS 166 and FAS 167. Among other sources, the Agencies considered information obtained through the Supervisory Capital Assessment Program (SCAP)—the recent stress test of the nineteen largest U.S. banking organizations. The SCAP directly considered the likely on-boarding of assets resulting from changes in accounting standards in the assessment of risk-weighted assets and the associated ALLL needs of the stress-tested banks. Moreover, the NPR sought information and comments on a number of questions, including the effect of the accounting changes on banking organizations' financial position and lending, as well as the effect on finan-

<sup>1</sup>A VIE is a business structure that allows an investor to hold a controlling interest in the entity, without that interest translating into possessing enough voting privileges to result in a majority. VIEs generally are thinly capitalized entities and include many "special purpose entities", or "SPEs."

<sup>2</sup>The NPR proposed the following three changes to the agencies regulatory capital rules: (1) eliminate provisions in the agencies' risk-based capital rules that allow banking organizations to exclude consolidated asset-backed commercial paper (ABCP) program assets from risk-weighted assets and instead assess a risk-based capital requirement against contractual exposures of the organization to such ABCP programs (ABCP exclusion); (2) eliminate a provision in the risk-based capital rules that excludes from tier 1 capital the minority interest in a consolidated ABCP programs subject to the ABCP exclusion; and (3) add a new reservation of authority for the agencies' risk-based capital rules to permit a banking organization's primary Federal supervisor to treat entities not consolidated under GAAP as if they were consolidated for risk-based capital purposes, commensurate with the risk relationship of the banking organization to the entity.

cial markets. The NPR also solicited comments on whether there are significant costs or burdens associated with implementing FAS 166 and FAS 167, and whether the Agencies should consider a phase-in of the capital requirements that would result from the GAAP changes.

Based on an analysis of available information, including comments received on the NPR, the Agencies have finalized work on this rulemaking and expect to publish a final rule in the Federal Register shortly. The Agencies have long maintained that banking organizations should hold capital commensurate with the level and nature of the risks to which they are exposed. The Agencies use risk-based capital rules, supplemented by a leverage capital rule (collectively, regulatory capital rules) to evaluate capital adequacy of banking organizations. In the regulatory capital rules, the Agencies use GAAP as the initial basis for determining whether an exposure is treated as an on- or off-balance sheet asset. In the final rule, the Agencies continue to make use of GAAP concepts within the regulatory capital regime by recognizing VIEs consolidated under FAS 167, and the risks associated with those assets, in their risk-based capital ratios. However, in order to avoid abrupt adjustments that could undermine or complicate government actions to support the provision of credit to U.S. households and businesses in the current economic environment, the Agencies are providing banking organizations with an optional two-quarter implementation delay followed by an optional two-quarter partial implementation of the effect of FAS 167 on risk-weighted assets and ALLL includable in tier 2 capital.

During this rulemaking process, the Agencies have determined that while regulatory capital ratios at banking organizations most effected by implementation of FAS 166 and FAS 167 would decline, those ratios would remain significantly above regulatory minimums subsequent to the implementation of FAS 166 and FAS 167. In addition, the Agencies continue to believe that the new GAAP consolidation standards of FAS 167 more closely align the risk banking organizations face with respect to VIEs with which they are involved than current GAAP standards.<sup>3</sup> The Agencies are aware, however, that several government programs supporting the securitization market are scheduled to terminate in the first quarter of 2010. In addition, Congress and the regulatory agencies are considering a number of legislative and regulatory changes that would affect the securitization activities. Given that the Agencies cannot precisely assess the combined effect of these changes on the securitization market, and because securitization activities remain an important source of funding for banking organizations, the Agencies are providing banking organizations a delay or phase-in period in the final rule.

**Q.3.** What is the impact of the proposed action by the Office of the Comptroller of the Currency and the Office of Thrift Supervision to

<sup>3</sup>Determining whether a company is required to consolidate a VIE under FAS 167 depends on a qualitative analysis of whether the company has a "controlling financial interest" in the VIE. A company has a controlling financial interest if it has (1) the ability to direct matters that most significantly impact the activities of a VIE and (2) either the obligation to absorb losses of the VIE that could be significant to the VIE, or the right to receive benefits from the VIE that potentially could be significant to the VIE, or both.

end “no payment” deferred interest financing promotions on consumers and businesses? I understand the impact to be very large and I would appreciate the agencies working to clarify that “no payment” deferred interest financing promotions can be used in the future albeit perhaps with revised disclosures and marketing.

**A.3.** In January 2003, the OCC, the Office of Thrift Supervision, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (the Agencies), issued the Credit Card Account Management and Loss Allowance Guidance (AMG). This guidance addressed regulatory concerns with the easing of minimum payment requirements as well as concerns with other account management practices. The AMG states, in part, that the Agencies expect lenders to require minimum payments that will amortize the current balance of the account over a reasonable period. The guidance does not differentiate between general purpose and private label card programs.

The receipt of regular monthly payments is important in consumer lending for several reasons. For borrowers, well designed payment structures promote a fundamental understanding of their debt burden in terms of monthly cash-flow and total income. Regular, budgeted payments help avoid the potential pitfalls associated with payment shock when payments begin or significantly increase under the loan amortization schedule. Regular payments also allow borrowers to demonstrate to existing and prospective lenders the willingness and capacity to repay their debts while systematically reducing those debts.

For lenders, regular payments are an efficient way to monitor borrowers’ willingness and ability to repay without the operational expense associated with requiring ongoing payment capacity information. Regular payment streams also allow the identification of early warning measurements such as delinquencies, roll rates, payment rates, and credit scores to be effective. Furthermore, they help lenders manage Portfolio risk by providing important inputs into the determination of adequate capital and reserve levels.

On June 18, 2009, the OCC issued a Supervisory Memorandum to remind our examiners that the increased use of “No Payment” programs being offered by banks, and their retail partners, are not consistent with the AMG. We asked our examiners to ensure that national banks cease any “No Payment” programs by February 22, 2010. This gives national banks, and their retail partners, time to make necessary changes and coincides with the implementation date for other changes dictated by the Credit CARD Act.

As a matter of clarification, the OCC does not object to “No Interest” programs. These promotions are very attractive to consumers and often provide real, tangible benefits. However, the OCC believes that any benefits associated with “No Payment” programs are outweighed by the negative impacts, including the loss of discipline associated with a regular payment stream, potential payment shock, a prolonged repayment schedule, and bank safety and soundness concerns.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO  
FROM DANIEL K. TARULLO**

**Q.1.** According to a recent New York Times article, about \$870 billion, or roughly half of the industry's \$1.8 trillion of commercial real estate loans, now sit on the balance sheet of small and medium sized banks. To what extent has TALF encouraged capital to enter the commercial real estate market and what other step should regulators be taking to address this problem?

**Q.2.** How will FASB's new rules on off-balance sheet accounting impact financial institution's ability to lend and how do you intend to implement the changes?

**A.1.-A.2.** At the end of the second quarter of 2009, approximately \$3.5 trillion of outstanding debt was associated with commercial real estate (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 commercial mortgage-backed securities (CMBS), with other investors holding the remaining balance of \$900 billion.

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 (ABS). 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 2.5 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 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 TALF program provided financing to investors in the first new CMBS deal, totaling \$400 million, since June 2008 on November 16. Significant investor demand drove down the spread on the AAA-rated TALF-eligible portion, with demand for the non-TALF eligible AA and A-rated tranches also higher than anticipated. The strong demand from cash investors and resulting low yield discouraged some TALF investors, resulting in the request for only \$72.2 million in TALF loans for the purchase of \$85.0 million of the \$323.4 million AAA-rated TALF-eligible portion of the deal. However, without the availability of TALF financing, it is unlikely that the deal would have come to market. Since then, we have seen another CMBS deal come to market, totaling \$460 million, which did

not apply for TALF support. There are reports of a third deal, which would also not apply for TALF financing, totaling \$600 million, due to be priced in December. We believe that the demonstration of investor demand for the DDR deal has encourage other lenders to bring similar conservatively underwritten single-borrower deals to market irrespective of the availability of TALF financing. Both non-TALF deals reportedly declined TALF financing in order to structure the securities with terms that are longer than the TALF loans.

The Federal Reserve continues to inject liquidity into the commercial real estate market through the TALF program, and is working with market participants to increase transparency and investor protections in this market. We have issued guidance to banks to encourage modifications of maturing CRE loans on properties with sufficient rental income to continue to service the debt payments, but due to the continuing credit crunch are unable to obtain refinancing. And we continue to support broad economic growth that would improve the fundamentals of commercial real estate.

As part of the lessons learned process, the President's Working Group on Financial Markets and the Securities and Exchange Commission encouraged the FASB to re-assess its accounting standards for off-balance sheet vehicles. In response, and following a period of public comment on the proposal, FASB recently modified FAS 166 and 167.

Under these modifications, an enterprise (*e.g.*, company, individual, or group of bond holders) is required to consolidate certain special purpose entities (SPEs) whenever it has a "controlling financial interest" in the SPE, that is, the enterprise has the power to direct the SPE's most significant activities and the right to receive benefits from, or obligation to bear losses of, the SPE. The accounting standards also require disclosure of the enterprise's involvement with such SPEs and any significant changes in risk exposure that result.

Whether an enterprise will be required to consolidate an SPE will depend on the specific facts and circumstances of each transaction. Beginning in 2010, many banking organizations that sponsor securitizations will be required to consolidate the associated SPEs. Certain asset-backed commercial paper conduits, revolving securitizations structured as master trusts (such as credit card securitizations), mortgage loan securitizations not guaranteed by the U.S. Government or a U.S. Government-sponsored agency, and term loan securitizations (such as auto and student loan securitizations), are among the types of securitization SPEs that will likely require consolidation by their sponsoring banking organization. In almost all cases, the SPE consolidation requirements will not apply to investors in the asset-backed securities, because such investors generally do not have power to direct the SPE's most significant activities.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER  
FROM DANIEL K. TARULLO**

**Q.I.** Mr. Tarullo, I am concerned about the Federal Reserve overstepping the authority Congress has granted. News reports about the Federal Reserve giving itself the authority to veto pay packages is beyond the pale.

- Can you please submit for the record, where in the Federal Reserve Act the Fed [is] given the authority to regulate compensation agreements?
- Why should the Federal Reserve be allowed to veto pay agreements that are approved by a company's board of directors?
- How involved has Chairman Bernanke been in drafting this illegal rulemaking?
- Which Federal Reserve Governor has been pushing the Federal Reserve's policy on this issue?

**A.I.** The Federal Reserve's proposed supervisory guidance and related supervisory initiatives regarding incentive compensation practices derive from our statutory mandate to protect the safety and soundness of the banking organizations we supervise. The proposed guidance was developed in consultation with all Board members and all Board members voted in favor of issuing the proposed guidance for public comment.

Recent events have highlighted that improper compensation practices can contribute to safety and soundness problems at financial institutions and to financial instability. Compensation practices were not the sole cause of the crisis, but they certainly were a contributing cause—a fact recognized by 98 percent of the respondents to a 2009 survey conducted by the Institute of International Finance of banking organizations engaged in wholesale banking activities.<sup>1</sup> The Federal Reserve and the other Federal banking agencies regularly issue supervisory guidance to identify practices that the agencies believe would ordinarily constitute an unsafe or unsound practice, or to identify risk management systems, controls, or other practices that the agencies believe would ordinarily assist banking organizations in ensuring that they operate in a safe and sound manner.

The proposed supervisory guidance, which currently is out for public comment,<sup>2</sup> is based on three key principles: (1) incentive compensation arrangements at a banking organization should not provide employees incentives to take risks that are beyond the organization's ability to effectively identify and manage; (2) they should be compatible with effective controls and risk management; and (3) they should be supported by strong corporate governance, including active and effective oversight by the organization's board of directors. Consistent with these principles, the Federal Reserve's efforts are focused on ensuring that the way in which banking organizations structure their incentive compensation arrangements do not—intentionally or unintentionally encourage excessive risk-taking, and that banking organizations have the types of policies,

<sup>1</sup> See The Institute of International Finance, Inc. (2009), *Compensation in Financial Services: Industry Progress and the Agenda for Change* (Washington: IIF, March).

<sup>2</sup> Board of Governors of the Federal Reserve System (2009), "Federal Reserve Issues Proposed Guidance on Incentive Compensation," press release, October 22, 2009.

procedures, internal controls, and corporate governance structures to promote and maintain sound incentive compensation arrangements.

Importantly, the proposed guidance does not mandate that banking organizations follow any particular method for achieving appropriately risk-sensitive incentive compensation arrangements. In fact, the guidance expressly recognizes that the methods used to achieve risk-sensitive compensation arrangements likely will differ across and within firms, and that use of a single, formulaic approach is unlikely to consistently promote safety and soundness.

**Q.2.** Is it the Federal Reserve's official position that executive compensation is a cause of systemic risk?

- If so, can you please provide this Committee with documentation to support this position?

**A.2.** Pay practices for risk-taking employees at many levels in banking organizations, not just top executive pay practices, were one among many contributors to the crisis. The role of compensation practices in the crisis has been widely recognized by both industry and supervisors, both here and overseas. For example, in their responses to a survey conducted by the Institute of International Finance, a global association of major financial institutions, 36 of 37 large banking organizations engaged in wholesale activities agreed that compensation practices were a factor underlying the crisis.<sup>3</sup> The Senior Supervisors Group, which is composed of senior financial supervisors from seven major industrialized countries (the United States, Canada, France, Germany, Japan, Switzerland, and the United Kingdom), also reported that many firms and their supervisors had determined that failures of incentives and controls throughout the industry, including those related to compensation, contributed to systemic vulnerability during the crisis.<sup>4</sup> Moreover, the Financial Stability Board, a group composed of senior representatives of national financial authorities, international financial institutions, standard setting bodies, and committees of central bank experts, has identified compensation practices as a factor contributing to the crisis.<sup>5</sup>

**Q.3.** What comments has the Federal Reserve received on this proposal from the banks it regulates?

**A.3.** The comment period closed on November 27, 2009. The Board has received 29 comments on the proposed guidance, four of which were submitted on behalf of individual banking organizations, five of which were submitted on behalf of groups representing multiple banking organizations, and two of which were submitted on behalf of groups representing both banking and nonbanking organizations. Public comments on the proposal are made available on the Board's website at [http://www.federalreserve.gov/generalinfo/foia/index.cfm?doc\\_id=OPpercent2D1374&doc\\_ver=l](http://www.federalreserve.gov/generalinfo/foia/index.cfm?doc_id=OPpercent2D1374&doc_ver=l).

**Q.4.** Mr. Tarullo, regarding the specifics of the proposal:

<sup>3</sup>See The Institute of International Finance, Inc. (2009), *Compensation in Financial Services: Industry Progress and the Agenda for Change* (Washington: IFF, March).

<sup>4</sup>See Senior Supervisors Group (2009), *Risk Management Lessons from the Global Banking Crisis of 2008*.

<sup>5</sup>See Financial Stability Board (2009), *Principles for Sound Incentive Compensation Practices*.

- Would the Federal Reserve require companies to “clawback” money that’s already been paid to employees?
- Is there a threshold a bank must meet to qualify for a review of executive compensation arrangements?

**A.4.** The proposed guidance provides that incentive compensation arrangements should not encourage excessive risk-taking, and describes several methods that are currently used by banking organizations to make compensation more sensitive to risk. These methods can be broadly described as risk adjustment of awards, deferral of payment, longer performance periods, and reduced sensitivity to short-term risk. As noted in the proposed guidance, the deferral of payment method is sometimes referred to in the industry as a “clawback.” The term “clawback” also may refer specifically to an arrangement under which an employee must return incentive compensation payments previously received by the employee (and not just deferred) if certain risk outcomes occur.

Importantly, the proposed guidance does not require a banking organization to use any particular method, including those described in the guidance, to ensure that its incentive compensation arrangements do not encourage employees to take excessive risks. In fact, the proposed guidance expressly recognizes that the methods discussed in the guidance have their own advantages and disadvantages, and that banking organizations will need flexibility in determining how best to achieve balanced incentive compensation arrangements in light of the particular activities, structure, and other characteristics of the organization.

The proposed supervisory guidance would apply to all banking organizations that are supervised by the Federal Reserve. These organizations are primarily responsible for ensuring that their incentive compensation arrangements do not encourage excessive risk-taking or pose a threat to the safety and soundness of the organization. To help promote and monitor the development of safe and sound incentive compensation arrangements, the Federal Reserve also has announced two, separate supervisory initiatives. These two separate programs are designed to reflect the differences among the universe of banking organizations supervised by the Federal Reserve. The first initiative involves a special, horizontal review of incentive compensation practices at large, complex banking organizations (LCBOs). LCBOs warrant special supervisory attention because they are significant users of incentive compensation arrangements and because flawed practices at these institutions are more likely to have adverse effects on the broader financial system.

A separate program will apply to the thousands of other organizations supervised by the Federal Reserve, including community and regional banking organizations. Supervisory staff will review incentive compensation arrangements at these organizations as part of the regular risk-focused examination process. These reviews, as well as our supervisory expectations for these organizations, will be tailored to reflect the more limited scope and complexity of these organizations’ activities—a fact also recognized in various aspects of our guidance.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO  
FROM DEBORAH K. MATZ**

**Q.1.** According to a recent New York Times article, about \$870 billion, or roughly half of the industry's \$1.8 trillion of commercial real estate loans, now sit on the balance sheet of small and medium sized banks. To what extent has TALF encouraged capital to enter the commercial real estate market and what other step should regulators be taking to address this problem?

**A.2.** For the most part, credit unions have not participated in TALF. As cooperatives, many credit unions maintain a whole membership philosophy and seek to retain all of their members' financial business in-house. While federally insured credit unions hold less than 1.5 percent of all commercial real estate loans, the credit union industry's involvement in commercial lending has increased. Loans to members for business purposes have more than quintupled from December 2002 to June 2009, rising from \$6.7 billion to \$33.7 billion. Of the \$33.7 billion member business loan portfolio, 76 percent are secured by real estate.

The credit union industry has continued to grant member business loans even when most other financial service providers are contracting. For the first half of 2009, member business loans experienced 11.9 percent growth.

NCUA is encouraging the flow of credit in these difficult economic times. Below are some examples of recent actions taken to promote balancing safety and soundness issues with the credit unions' desire to meet their members' financial needs. This month, NCUA hosted a webcast for credit unions and examiners entitled "Member Business Lending: Regulators' Perspective," which provided guidance, best practices, and insight into the underwriting and examination of member business lending. This webcast provided a balanced view of the needs of the industry with safety and soundness considerations.

Additionally, NCUA recently released a joint policy statement with the Federal Financial Institutions Examination Council (FFIEC) supporting prudent commercial real estate (CRE) loan workouts. This statement provides guidance for examiners and 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. This guidance discusses another component of the current lending environment that the financial industry is currently facing.

In order to further encourage credit union involvement in commercial lending, Congress could consider raising or removing the current statutory limitation on member business lending. The Federal Credit Union Act currently limits federally insured credit unions to 1.75 times the actual net worth of the credit union or 1.75 times the minimum net worth required for the credit union to be considered well capitalized. Raising or eliminating this limitation on member business loans will increase credit unions' ability to generate and hold more loans to small businesses served by those credit unions, while providing NCUA with the ability and obligation to set standards and benchmarks for this activity based on the needs of the industry. NCUA understands an increase or elimi-

nation of this limitation without prudent regulatory oversight could pose significant risk to individual credit unions, and is prepared to provide the necessary oversight.

NCUA is also aware of the importance of increasing lending in the commercial real estate market in order to stimulate the economy, while ensuring the safety and soundness of the institutions the NCUA regulates and insures. There is a fine balance between these two objectives that the NCUA is encouraging the credit union industry to find. In fact, a Letter to Credit Unions that promotes best practices of member business lending is currently in process. NCUA will continue to issue guidance to examiners and the credit union industry to address issues related to the current financial and economical environment.

**Q.2.** How will FASB's new rules on off-balance sheet accounting impact financial institution's ability to lend and how do you intend to implement the changes?

**A.2.** The FASB's new rules will make it more difficult for credit unions to sell loans or portions of loans and gain the benefit of removing those assets from their books through sales treatment. For a small number of credit unions who engage in securitization transactions, the new rules will make it difficult to avoid consolidation accounting with the securitization trust. In either case, the net worth ratio will be diluted by the "transferred" financial assets that must remain on the credit unions' books even though "sold". In the former case, NCUA anticipates that credit unions will restructure legal transfer agreements to conform loans sales and partial loan sales to the "participating interest" rules of the new standard and proceed with business as usual. In the latter case, the small number of credit unions that engage in securitization structures will most likely cease and desist from this activity.

The larger and more onerous impact of the new accounting rules will fall on the NCUA Board and the Funds it oversees. The NCUA Board oversees the National Credit Union Share Insurance Fund ("NCUSIF"), the Corporate Credit Union Stabilization Fund ("Stabilization Fund"), the Central Liquidity Facility ("CLF"), the NCUA Operating Fund, and the Community Development Revolving Loan Fund. NCUA prepares its financial statement under U.S. generally accepted accounting principles ("GAAP") for commercial enterprises.

As the NCUA Board acts under its statutory authorities to "workout" troubled credit unions with the least cost to the NCUSIF and the Stabilization Fund, the new accounting rules will most likely require NCUSIF to consolidate with the Stabilization Fund as well as conserved, troubled credit unions under the NCUA Board oversight. Financial statement consolidation of the NCUSIF, the Stabilization Fund, and troubled, conserved credit unions solely due to the NCUA Board exercising its statutory powers as it acts within its mission under moral obligation to protect credit union and taxpayer resources is not a plausible outcome of applying accounting rules. The new rules assume a "profit making" incentive behind NCUA's actions when, in fact, its actions are statutory in nature—supervision and Federal deposit insurance.

The primary readers of the NCUSIF financial statements—credit union members, the public, and the U.S. Treasury Department—are not better served by the consolidated presentation of governmental with non-governmental entities. A scope exception for government entities from consolidating with the entities it supervises and insures would be the optimal outcome. The FASB has not been receptive to such a scope exception primarily because it would not have wide applicability and there is an existing scope exception within the standard for non-profit entities.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO  
FROM TIMOTHY WARD**

**Q.1.** According to a recent New York Times article, about \$870 billion, or roughly half of the industry's \$1.8 trillion of commercial real estate loans, now sit on the balance sheet of small- and medium-sized banks. To what extent has TALF encouraged capital to enter the commercial real estate market and what other step should regulators be taking to address this problem?

**A.1.** The Term Asset-Backed Securities Loan Facility (TALF) program was primarily created to help restore liquidity in the asset-backed securities markets. Since the Federal Reserve Board (the FRB) announced an expansion of the TALF to include commercial mortgage-backed securities (CMBS), the Federal Reserve Bank of New York (FRBNY) has received loan requests totaling \$6.5 billion to help fund the purchase of legacy CMBS (those created prior to January 1, 2009).

Improvements in CMBS market liquidity and confidence have occurred since the severe dislocations in these markets during late summer/early fall of 2008. Most notably, the yield spreads between CMBS and 10-year Treasury securities have narrowed significantly from over 10 percent in late summer/early fall 2008 to about 4.5 percent in November 2009. Though still wider than typical spreads of about 1.5 percent, the narrowing of spreads is evidence of normalization of the CMBS markets. And it is likely the TALF program contributed to these improvements.

It is important to note that only a small percentage of commercial real estate loans are in CMBS. According to estimates from the Commercial Mortgage Securities Association, only about 25 percent of total commercial real estate loans are held in CMBS. This may point to the need to expand TALF, or similar programs, beyond the CMBS markets to help address rising problems in commercial real estate. And this is especially true for small- and medium-sized banks and thrifts.

**Q.2.** How will FASB's new rules on off-balance sheet accounting impact financial institution's ability to lend and how do you intend to implement the changes?

**A.2.** As a result of the FASB accounting changes, generally effective the beginning of 2010 for most institutions, many securitizations previously off-balance sheet will come on-balance sheet and many new securitizations will stay on-balance sheet. Consequently, higher regulatory capital requirements will result from the larger balance sheets and some institutions may need to

raise additional capital or shrink their balance sheet size, which could result in a downward pressure on lending activity and increase the costs of borrowing.

The Federal banking agencies require that regulatory reports comply with Generally Accepted Accounting Principles (GAAP). By law, reports filed with the Federal banking agencies must be uniform and consistent with and no less stringent than GAAP (as required by Section 37 of the FDI Act). Consequently, securitization accounting must be reported by financial institutions in accordance with GAAP. GAAP serves as the starting point for regulatory capital treatment.

Due to these GAAP accounting changes, an Interagency Notice of Proposed Rulemaking (NPR) for the regulatory capital treatment of securitizations was issued. The comment period for the NPR closed on October 15, 2009. The NPR proposed to follow the new GAAP treatment for regulatory capital purposes as, unless determined otherwise based upon information provided through the comment process, the agencies believe the new GAAP more appropriately reflects the securitization risks to which financial institutions are exposed. The comments are currently being evaluated by the banking agencies with the expectation of issuing a final rule before the regulatory reporting of these accounting changes.

**Q.3.** What is the impact of the proposed action by the Office of the Comptroller of the Currency and the Office of Thrift Supervision to end “no payment” deferred interest financing promotions on consumers and businesses? I understand the impact to be very large and I would appreciate the agencies working to clarify that “no payment” deferred interest financing promotions can be used in the future albeit perhaps with revised disclosures and marketing.

**A.3.** Over the past year, OTS and OCC have worked closely to develop their respective policy statements, which are substantially identical. On September 24, 2009, OTS issued CEO Letter 321—“No Interest, No Payment” Credit Card Programs to remind savings associations of certain requirements contained in the 2003 interagency “Account Management and Loss Allowance Guidance for Credit Card Lending.” That guidance articulated sound account management, risk management, and loss allowance practices for all institutions engaged in credit card lending.

CEO Letter 321 reminds savings associations of OTS’s long-standing position that minimum monthly payments are a key tenet of safe and sound retail lending and should be required on credit card accounts. It states that regular monthly payments add structure and discipline to the lending arrangement, provide regular and ongoing contact with the borrower, and allow the borrower to demonstrate and the bank to assess continued willingness and ability to repay the obligation over time. Conversely, the absence of a regular payment stream may result in protracted repayment and mask true portfolio performance and quality. Further, in accordance with the OTS Examination Handbook, it indicates that the minimum monthly payment should cover at least a 1-percent principal reduction plus all assessed monthly interest and finance charges. CEO Letter 321 neither prohibits nor discourages the practice of “no interest” credit card promotions.

Finally, the CEO Letter states that savings associations will be given a reasonable time to implement any changes to their existing programs as a result of the policy clarification. All savings associations are expected to be in full compliance for all new credit card transactions no later than February 22, 2010.

OTS has no precise data on the expected impact of the OTS and OCC ending the no payment programs offered by banks and savings associations. Because of the increased delinquencies associated with certain customers of no-pay accounts, we expect a decline in loan delinquencies and chargeoffs. While there may be a curtailment in the number of purchases that these programs facilitate, OTS believes that the primary affect will be for borrowers who cannot afford the purchases.

In arriving at the decision to issue a letter on these programs, OTS considered, among other things, that recent examinations of OTS-supervised savings associations that offer “no interest, no payment” credit card programs revealed increasing past due and losses related to these accounts. OTS examination staff noted that:

No payment promotions present substantially higher credit risk (unexpected loss) to banks than regular revolving accounts. This is not necessarily because the accounts/customers themselves are riskier; but because the structure of the promotion results in an inability to adequately monitor and assess risk. These promotions also present problems for customers who are less adept at managing their finances. The best way to address these problems is to require some level of minimum monthly payments.

No payment promotions are most prevalent on big ticket purchases such as furniture, or big screen televisions. These types of purchases often result in balances of \$5,000 or more. Many view promotional programs that offer no payments until next year as being designed to entice customers into making a large purchase that they may not otherwise have considered or thought they couldn't afford. It allows customers to acquire these items without worrying about paying for them for a long period of time. For those customers who are not as adept at managing their finances, it may be very difficult to make a \$5,000 payment at the end of the promotion—at which time they will incur high financing costs, in some cases (back-billing) all of the costs they thought they were avoiding.


**Office of Thrift Supervision**

Department of the Treasury

Deputy Director, Examinations, Supervision, and Consumer Protection

Timothy T. Ward

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September 24, 2009

**MEMORANDUM FOR: CHIEF EXECUTIVE OFFICERS**
**FROM:** Timothy T. Ward *Timothy T. Ward*  
 Deputy Director  
 Examinations, Supervision, and Consumer Protection

**SUBJECT:** "No Interest, No Payment" Credit Card Programs

On January 8, 2003, the Office of Thrift Supervision, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation jointly issued the "Account Management and Loss Allowance Guidance for Credit Card Lending ("AMG"). That guidance articulated sound account management, risk management, and loss allowance practices for all institutions engaged in credit card lending. This memorandum reminds savings associations of some of the specific requirements of that guidance.

One key tenet of safe and sound retail lending is the monthly minimum payment requirement. Regular monthly payments add structure and discipline to the lending arrangement, provide regular and ongoing contact with the borrower, and allow the borrower to demonstrate and the bank to assess continued willingness and ability to repay the obligation over time. Conversely, the absence of a regular payment stream may result in protracted repayment and mask true portfolio performance and quality.

Recent examinations have identified increasing use of "no interest, no payment" programs that allow borrowers to defer making payments for extended periods. These deferral periods often range from three- to twelve-months or longer, and are most commonly associated with private label marketing agreements for retailers such as electronics and furniture companies.

The AMG states that OTS expects lenders to require minimum payments that will amortize the current balance over a reasonable period of time consistent with the unsecured, consumer-oriented nature of the underlying debt and the borrower's documented creditworthiness. As indicated in the OTS Examination Handbook Section 218, as revised in May 2006, the minimum monthly payment should cover at least a one percent principal balance reduction plus all

assessed monthly interest and finance charges. Savings associations are thus reminded they should require a minimum payment from the borrower each month for all credit card programs, including private label arrangements with retailers. While savings associations (or their retail partners) may offer "no interest" promotions, they should have a policy of a minimum monthly payment even during the promotional period. The minimum payment should be consistent with the issuer's standard principal reduction for the product or program, but in no event less than one percent of the principal balance owed.

In recognition of the time needed to revise marketing campaigns and materials, savings associations will be allowed a reasonable amount of time to comply with the minimum payment expectations described in this memorandum for all new credit transactions. Nonetheless, full compliance should be no later than February 22, 2010, which is also the implementation deadline for most of the new requirements contained in the Credit Card Act of 2009. (See OTS CEO Memorandum #308, issued June 25, 2009, "Credit Card Act of 2009: Effective Dates.")

For further information, contact William Magrini, Senior Project Manager, Credit Policy, at (202) 906-5744.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO  
FROM JOSEPH A. SMITH**

**Q.1.** According to a recent New York Times article, about \$870 billion, or roughly half of the industry's \$1.8 trillion of commercial real estate loans, now sit on the balance sheet of small and medium sized banks. To what extent has TALF encouraged capital to enter the commercial real estate market and what other step should regulators be taking to address this problem?

**A.1.** Did not respond by printing deadline.

**Q.2.** How will FASB's new rules on off-balance sheet accounting impact financial institution's ability to lend and how do you intend to implement the changes?

**A.2.** Did not respond by printing deadline.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO  
FROM THOMAS J. CANDON**

**Q.1.** According to a recent New York Times article, about \$870 billion, or roughly half of the industry's \$1.8 trillion of commercial real estate loans, now sit on the balance sheet of small and medium sized banks. To what extent has TALF encouraged capital to enter the commercial real estate market and what other step should regulators be taking to address this problem?

**A.1.** The financial institutions supervised by NASCUS members—state-chartered credit unions—do not have access to TALF.

**Q.2.** How will FASB's new rules on off-balance sheet accounting impact financial institution's ability to lend and how do you intend to implement the changes?

**A.2.** State-chartered credit unions have not made substantive use of the new FASB provisions related to off-balance sheet accounting and accordingly, it is not anticipated that these changes by FASB will have a material impact on the ability of credit unions to lend to their members. Credit unions will be minimally impacted, if at all. The two areas of primary structural constraint regarding credit union lending continue to be field of membership restrictions and the limitations imposed by Federal restrictions on member business lending. FASB's new rules regarding off-balance sheet accounting are likely to have a more substantial impact on large commercial banks which may have utilized off-balance sheet structures to mitigate on-balance sheet risk.