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Statement of

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Chairman Dodd, Ranking Member Shelby and members of the Committee, it is my pleasure to appear today to discuss the condition of the U.S. banking system. In my remarks, I will summarize briefly the role of the Federal Reserve in banking supervision, provide an overall view of the health of the U.S. banking system, and then discuss some key areas of supervisory focus.

The U.S. banking system is facing some challenges, but remains in sound overall condition, having entered the period of recent financial turmoil with solid capital and strong earnings. The problems in the mortgage and housing markets have been highly unusual and clearly some banking organizations have failed to manage their exposures well and have suffered losses as a result. But in general these losses should not threaten their viability. We, along with the other banking agencies, have been working with banking organizations to identify and rectify those shortcomings in risk management and to ensure that the banking system continues to be safe and sound.

Role of the Federal Reserve in Banking Supervision

The Federal Reserve has supervisory and regulatory authority over a wide range of financial institutions and activities. It works with other federal and state supervisory authorities to ensure the safety and soundness of the banking industry, the stability of the financial system, and fair and equitable treatment of consumers in their financial transactions.

While the Federal Reserve is not the primary federal supervisor for the majority of commercial bank assets, it plays an important role as the "umbrella supervisor" of bank holding companies. The bank holding companies supervised by the Federal Reserve number approximately 5,000 and have consolidated assets of about $14.2 trillion. The Federal Reserve conducts inspections of all large, regional, and complex bank holding companies and maintains inspection teams on-site at the largest bank holding companies. For smaller less complex organizations, supervision is conducted through a combination of off-site monitoring and on-site inspections. These inspections, which are conducted using established procedures, manuals, and techniques, allow the Federal Reserve to review the organization's systems for identifying and managing risk across the organization and its various legal entities and to evaluate the overall financial strength of the organization. The primary purpose of these inspections is to ensure that the holding company and its nonbank subsidiaries do not pose a threat to the soundness of the company's depository institutions. In fulfilling this role, the Federal Reserve relies to the fullest extent possible on information and analysis provided by the appropriate supervisory authority of the company's bank, securities, or insurance subsidiaries.

The Federal Reserve is also the primary federal supervisor of state-member banks, sharing supervisory responsibilities with state supervisory agencies. In this role, Federal Reserve supervisory staff regularly conduct on-site examinations and off-site monitoring to ensure the soundness of supervised state member banks. There are over 870 state member banks whose assets total more than $1.5 trillion, representing about 12 percent of all commercial banks by number and about 14 percent of all commercial bank assets.

Consumer protection within the financial services industry is another important responsibility of the Federal Reserve. Among the Federal Reserve's responsibilities in this area are: writing and interpreting regulations to carry out many of the major consumer protection laws; reviewing bank compliance with regulations; investigating complaints from the public about compliance with consumer protection laws; and conducting community development activities.

Recent Performance of the U.S. Banking System

I would now like to address the condition of banking organizations supervised by the Federal Reserve. I will start by discussing bank holding companies, providing a brief overview of their recent performance, condition, and outlook. I will then do the same for state member banks.

Bank holding companies

Over the second half of 2007, bank holding companies (BHCs) experienced a substantial deterioration in asset quality and earnings, largely attributable to the effects of the slowing residential housing market on the quality of mortgage and construction loans. The sharp rise in subprime delinquencies, moreover, adversely affected the securitization market and placed strains on the liquidity and capital of some of the largest BHCs as these institutions brought off-balance sheet exposures onto their books. Many of these institutions also recognized significant valuation write-downs on assets affected by this market volatility.

The combination of sizable write-downs and substantially higher provisions for loan losses in response to deteriorating loan quality resulted in weaker profitability at BHCs in the third quarter of 2007 and overall losses of more than $8 billion in the fourth quarter based on preliminary regulatory report data. Nonperforming assets also increased notably as the quality of mortgages, home equity lines of credit, and loans to real estate developers weakened. However, despite these adverse developments, bank holding companies still reported total net income exceeding $90 billion for the full year of 2007. In addition, the overall nonperforming assets ratio remained below levels reached earlier in this decade.

The earnings performance of the fifty largest U.S. based bank holding companies as a group, which together represent more than three-fourths of all assets at bank holding companies, has clearly been subpar over the past two quarters and accounts for the industry's overall weak performance. In aggregate, these companies generated overall losses of over $9 billion for the fourth quarter, incorporating asset write-downs of more than $31 billion and loan loss provisions that exceeded loan charge-offs by $14 billion. Nonperforming assets also swelled at these companies during 2007, doubling from $33 to $67 billion, and raising the nonperforming assets ratio from a historically low 0.70 percent at December 31, 2006, to 1.25 percent at the end of 2007.

Liquidity has also been under pressure at some of the fifty largest bank holding companies. In many cases, these pressures reflect difficulties securitizing some assets and the need to bring on balance sheet some assets that had previously been securitized. As a result, banking companies have experienced a moderate overall decline in liquid assets as a portion of total assets, and strains have emerged in term interbank funding markets. Bank holding companies are actively responding to these pressures and some have sought to increase more stable sources of funding to bolster their liquidity positions. In addition, as noted in last week's *Monetary Policy Report*, the Federal Reserve has taken a number of steps to address the difficulties in term funding markets.

Asset write-downs and unplanned increases in assets have placed pressure on capital ratios and caused some banking organizations to take a more cautious approach to extending credit. However, large bank holding companies in aggregate and individually continued to maintain regulatory capital ratios in excess of minimum regulatory requirements. As of December 31, 2007, the fifty largest bank holding companies reported aggregate tier 1 leverage, tier 1 risk-based, and total risk-based capital ratios of 5.3, 7.5, and 11.1 percent, respectively. In part, these capital ratios reflect steps taken by several large BHCs to replenish depleted equity positions by curtailing share repurchases, reducing dividends, and raising additional capital in order to maintain desired capital levels relative to regulatory norms. Indeed, in recent months, large bank holding companies have raised more than $50 billion in capital.

Looking ahead, bank holding companies will continue to face challenging market conditions and persistent pressure on earnings. More asset write-downs are likely as the market continues to adjust risk premiums and valuations change. Adverse trends in loan quality will almost certainly continue and will require close monitoring by banking institutions and supervisory agencies alike. Liquidity positions will need to continue to be actively managed and banking organizations will need to implement risk management improvements to remedy the deficiencies that have been noted by companies and supervisors over the past year.

State member banks

Most state member banks entered the recent financial disturbance in sound condition, reporting strong earnings through the first half of 2007 and maintaining high capital ratios. As of December 31, 2007, more than 99 percent of these banks reported risk-based capital ratios consistent with a "well-capitalized" designation under Prompt Corrective Action standards. However, profitability suffered in the second half of 2007 as state member banks increased loan loss provisions, reducing the aggregate return on average assets from 1.4 percent for the full year 2006 to 1.1 percent for 2007. In addition, although still below the most recent peak in 2002, the nonperforming assets ratio moved up sharply over the past year. In large part, this increase reflected deterioration in residential mortgages and loans to builders and has contributed to an increase in the portion of state member banks with less-than-satisfactory supervisory ratings from 4.5 percent at year-end 2006 to 6.3 percent at the end of 2007. Indeed, half of the state member banks that were downgraded to less-than-satisfactory CAMELS ratings since mid-2007 have evidenced significant financial or risk management weaknesses related to commercial real estate lending activities.

State member banks entered 2007 relatively well-positioned to confront and withstand more adverse conditions. However, like bank holding companies, these banks face deteriorating credit conditions in 2008 and we anticipate further increases in their loan delinquencies and charge-offs. We also foresee more difficult liquidity conditions for some of these banks, and we expect to see the number with less than satisfactory CAMELS ratings of 3, 4, or 5 grow from the low level that has prevailed over the last several years.

Key Areas of Supervisory Focus

As the nation's central bank, the Federal Reserve is acutely aware of conditions in the economy and financial markets and the challenges those conditions pose to the safety and soundness of banking organizations. Accordingly, we have been focusing supervisory efforts on those institutions most exposed to residential and commercial real estate or other sectors that have come under pressure. We are also attentive to those institutions that would suffer most from a prolonged period of deterioration in economic conditions. We continue to focus our examinations on the financial condition of banking organizations--including the adequacy of their liquidity, capital, and loan loss reserves and their consequent ability to recognize additional losses. We are also evaluating risk management practices very closely, including scrutinizing governance and controls, given some of the risk management lapses in those areas revealed by recent events.

At this point, I would like to provide a summary of the key areas of supervisory focus, including residential mortgage lending, consumer protection, bank liquidity and capital positions, consumer (nonmortgage) lending, commercial real estate, and commercial lending.

Residential mortgages

Among the challenges currently facing the U.S. banking system, residential mortgage lending has presented the largest problems so far. In addition to the economic and social distress created for many homeowners and communities, the sharp increases in subprime mortgage loan delinquencies and foreclosures over the past year have affected the banking industry significantly.

Delinquency rates on subprime adjustable-rate mortgages (ARMs) began to increase in 2006, and by December 2007, more than one-fifth of these loans were seriously delinquent (that is, ninety days or more delinquent or in foreclosure). For subprime mortgages with fixed interest rates, delinquency rates have moved up significantly in recent months, to the upper end of their historical range. For prime and near-prime mortgages, performance weakened somewhat in 2007, but generally remained fairly solid. The continued erosion in the quality of mortgage credit has led to an increase in initial foreclosure filings, with foreclosures rising the most in areas where home prices have fallen after an earlier period of rapid increase.

Some banking organizations in particular have been adversely affected by problems with residential mortgages. A number of large organizations have suffered substantial write-downs on subprime mortgages. The effect of the problems in subprime mortgages, however, extends beyond the mortgage accounts themselves. Securities backed in part or full by subprime assets have also declined in value as investors factored in estimates of potential losses. Where the securities had been heavily structured or leveraged, these losses have in some cases been severe. Further, many banks financed nonbank firms that originated these assets through "mortgage warehouse" lines of credit or through repurchase agreements. As the banks saw the values of the financed mortgages falling last year, their margin calls put a number of originators out of business.

Most recently, home equity lending has emerged as a more challenging area. As banking organizations report increased delinquencies and losses in home equity lines of credit (HELOCs), especially in light of falling housing prices in some markets, we continue to monitor current and potential exposures, and are reviewing the industry's collateral valuation methods.

Federal Reserve supervisors have focused very intensely on problems with residential mortgages and are taking appropriate action. In reaction to the immediate problems facing homeowners struggling to meet payment obligations, the Federal Reserve and other banking agencies have encouraged mortgage lenders and mortgage servicers to pursue prudent loan workouts through such measures as modification of loans, deferral of payments, extension of loan maturities, capitalization of delinquent amounts, and conversion of ARMs into fixed-rate mortgages or fully indexed, fully amortizing ARMs. The Federal Reserve has also collaborated with community groups to help homeowners avoid foreclosure.

In addition, the Federal Reserve has taken steps aimed at avoiding future problems in subprime mortgage markets while still preserving responsible subprime lending and sustainable homeownership. Through examinations and other supervisory activities, we are taking our knowledge of the root causes of bank-related mortgage lending problems and using it to work with institutions to improve risk management practices in this area. Some of this work builds on the guidance on subprime mortgages issued last summer by the U.S. banking agencies. The guidance is designed to help ensure that borrowers obtain adjustable-rate mortgages that they can afford to repay and can refinance without prepayment penalty for a reasonable period before the first interest rate reset. The Federal Reserve, along with the other banking agencies, issued similar guidance on nontraditional mortgages in 2006.

Given significant growth in banks' HELOC portfolios over the past several years, the agencies have been concerned for some time that banks' HELOC underwriting placed insufficient emphasis on the creditworthiness of borrowers and placed too much weight on the value of the collateral during a booming housing market. In 2005, the agencies issued joint guidance that outlined these concerns and set forth supervisory expectations for risk management of home equity lending activities. The guidance emphasized the importance of active portfolio management, particularly for those institutions pursuing significant growth in HELOC balances and underwriting HELOCs with high loan-to-value limits and limited documentation on borrowers' asset and income.

Consumer protection

As the Committee is aware, problems associated with residential mortgages stem in part from lax lending standards. In some cases, improper practices vis-à-vis consumers contributed to the defaults we have seen in the subprime mortgage market. To address these practices, under the authority given to it by the Congress, the Federal Reserve has taken action to protect consumers in their mortgage transactions. In December, the Board issued for public comment a comprehensive set of new regulations to prohibit unfair or deceptive practices in the mortgage market, under the authority granted us by the Home Ownership and Equity Protection Act of 1994 (HOEPA). The proposed rules would apply to all mortgage lenders and would establish lending standards to help ensure that consumers who seek mortgage credit receive loans whose terms are clearly disclosed and that can reasonably be expected to be repaid. Accordingly, the rules would prohibit lenders from engaging in a pattern or practice of making higher-priced mortgage loans without due regard to consumers' ability to make the scheduled payments. In addition, for all mortgage loans, our proposal addresses misleading and deceptive advertising practices, requires borrowers and brokers to agree in advance on the maximum fee that the broker may receive, bans certain practices by loan servicers that harm borrowers, and prohibits coercion of appraisers by lenders. We expect substantial public comment on our proposal, and we will carefully consider all information and viewpoints while moving expeditiously to adopt final rules.

The effectiveness of the new regulations, however, will depend critically on strong enforcement. To that end, in conjunction with other federal and state agencies, we are conducting compliance reviews of a range of mortgage lenders, including nondepository lenders. The agencies will collaborate in determining the lessons learned and in seeking ways to better cooperate in ensuring effective and consistent examinations and improved enforcement of all categories of mortgage lenders.

We are also working toward finalizing rules under the Truth in Lending Act that will require new, more informative, and consumer-tested disclosures by credit card issuers. Separately, we are actively reviewing potentially unfair and deceptive practices by issuers of credit cards. Using the Board's authority under the Federal Trade Commission Act, we expect to issue proposed rules regarding these practices this spring.

Liquidity and capital issues

As noted earlier, liquidity disruptions in certain financial markets have created challenges for banking organizations. During times of systemwide stress, such as the one we are currently experiencing, significant liquidity demands can emanate from both the asset and the liability side of a bank's balance sheet. For example, we have recently seen how unanticipated draws on liquidity facilities by structured investment vehicles, commercial paper conduits, and others can lead to significant growth in bank assets. Moreover, some organizations have also encountered difficulty in selling whole loans or securitizing assets as planned. There were also cases in which reputational concerns have prompted banks or their affiliates to provide liquidity support to a vehicle or to incorporate some of the vehicle's assets onto the bank's balance sheet, even when the bank had no legal obligation to do so. In a few cases, these unexpected increases in the balance sheet created some pressures on capital ratios, even when capital levels remained unchanged. Further instances of unplanned asset expansion could continue.

Reduced liquidity in the markets for certain structured credit products continue to create valuation challenges and concerns about these products have spread to other sectors. Illiquidity in some credit markets may make it difficult for some market participants, including banking organizations, to hedge positions effectively.

From a supervisory perspective, it has become clear that some bankers did not adequately explore scenarios in which market liquidity could be disrupted, or in which there could be sudden demands for the institution's own liquidity. We are working very closely with banking organizations to ensure that they improve liquidity risk management practices, including contingency funding plans and improved information systems, and ensure that these practices are integrated with other aspects of risk management. Banking organizations must employ more comprehensive stress testing and scenario analysis--exercises that capture both bank-specific problems and broader market disruptions--to assess the impact that problems in market liquidity, as well as funding liquidity, can have on capital adequacy.

Credit cards and other consumer lending

Of course the Federal Reserve is focused on the possibility that troubles in the residential mortgage sector could adversely affect other types of consumer lending, such as credit cards or auto loans. Banking organizations' consumer loans excluding mortgages--which include credit cards and auto loans--grew somewhat faster in 2007 than in 2006, suggesting some substitution of nonmortgage credit for mortgage credit. The pickup in consumer debt was mostly attributable to faster growth in revolving credit, a pattern consistent with the results of the Federal Reserve's Senior Loan Officer Opinion Survey. Banks, on net, reported easing lending standards on credit cards over the first half of 2007 and reported little change in those standards on net over the second half of the year. In contrast, significant portions of respondents in the second half of 2007 reported that they had tightened standards and terms on other consumer loans, a change that may have contributed to a slowing in the growth of nonrevolving loans over the final months of 2007.

Thus far, the quality of other consumer loans has remained satisfactory. However, the delinquency rates on credit cards and consumer installment loans at banking organizations increased over the second half of the year. Moreover, although household bankruptcy filings remained below the levels seen before the changes in bankruptcy law implemented in late 2005, the bankruptcy rate rose modestly over the first nine months of 2007 and could be a harbinger of increasing delinquency rates on other consumer loans. In view of this risk, Federal Reserve supervisors are monitoring these consumer loan segments for signs of spillover from residential mortgage problems, particularly in regions showing homeowner distress, and are paying particular attention to the securitization market for credit card loans.

Commercial real estate

Commercial real estate is another area that requires close supervisory attention. The delinquency rate on commercial mortgages held by banking organizations almost doubled over the course of 2007 to over two percent. The loan performance problems were the most striking for construction and land development loans--especially for those that finance residential development--but some increase in delinquency rates was also apparent for loans backed by nonfarm, nonresidential properties and multifamily properties.

In the most recent Senior Loan Officer Opinion Survey, a number of banking organizations reported having tightened standards and terms on commercial real estate (CRE) loans. Among the most common reasons cited by those that tightened credit conditions were a less favorable or more uncertain economic outlook, a worsening of CRE market conditions in the areas where the banks operate, and a reduced tolerance for risk. Notably, a number of small and medium-sized institutions continue to have sizable exposure to CRE, with some having CRE concentrations equal to several multiples of their capital.

Despite the generally satisfactory performance of commercial mortgages in securitized pools, spreads of yields on BBB-rated commercial mortgage-backed securities over comparable-maturity swap rates soared, and spreads on AAA-rated tranches of those securities have risen to unprecedented levels. The widening of spreads reportedly reflected heightened concerns regarding the underwriting standards for commercial mortgages over the past few years, but it also may be the result of increased investor wariness regarding structured finance products. CRE borrowers that require refinancing in 2008, particularly those with short-term mezzanine loans, will face difficulty in locating new financing under tighter underwriting standards and reduced demand for CRE securitizations.

In those geographic regions exhibiting particular signs of weakness in real estate markets, for several years we have been focusing our reviews of state member banks and bank holding companies on evaluating growing concentrations in CRE. Building on this experience, we took a leadership role in the development of interagency guidance addressing CRE concentrations, which was issued in 2006. More recently, because weaker housing markets have clearly started to adversely affect the quality of CRE loans at the banking organizations that we supervise, we have heightened our supervisory efforts in this segment even more. These efforts include monitoring carefully the impact that lower valuations could have on CRE exposures, as well as evaluating the implementation of the interagency guidance on concentrations in CRE, particularly at those institutions with exceptionally high CRE concentrations or with riskier portfolios.

Recently, we surveyed our examiners about their assessments of real estate lending practices at a group of state member banks with high concentrations in CRE lending. We had two main objectives for this effort. First, we wanted to evaluate the Federal Reserve's implementation of the interagency CRE lending guidance and to determine whether there were any areas in which additional clarification of the guidance would be helpful to our examiners. Second, we wanted to assess the degree to which banks were complying with the guidance and gain further information on the degree of deterioration in real estate lending conditions. Through this effort, we confirmed that many banks have taken prudent steps to manage their CRE concentrations, such as considering their exposures in their capital planning efforts and conducting stress tests of their portfolios. Others, however, have not been as effective in their efforts and we have uncovered cases in which interest reserves and extensions of maturities were used to mask problem credits, appraisals had not been updated despite substantial recent changes in local real estate values, and analysis of guarantor support for real estate transactions was inadequate. Based on these findings, we are currently planning a further series of targeted reviews to identify those banks most at risk to further weakening in real estate market conditions and to promptly require remedial actions. We have also developed and started to deliver targeted examiner training so that our supervisory staff is equipped to deal with more serious CRE problems at banking organizations as they arise.

Commercial and industrial loans

While there are some pockets of poor performance in commercial and industrial lending, for the most part the sector continues to perform fairly well. Commercial and industrial (C&I) loans surged in 2007 because of extremely rapid growth in the second half of the year resulting, in part, from large banks' inability to syndicate leveraged loans that they had underwritten. Finally, after the issuance of an unprecedented amount of leveraged syndicated loans over the first half of 2007, issuance declined considerably in the second half of the year, when demand by nonbank investors for those loans diminished.

In the Senior Loan Officer Opinion Survey of October 2007 and January 2008, many banks reported charging wider spreads on C&I loans--the loan rate less the bank's cost of funds--representing the first such tightening in several years. A large proportion of banks also indicated that they had tightened lending standards. Most of the banks that tightened terms and standards indicated that they had done so in response to a less favorable or more uncertain economic outlook and a reduced tolerance for risk. However, about one-fourth of the banks cited concerns about their own liquidity or capital position as reasons for tightening.

The delinquency rate on C&I loans at commercial banks trended higher throughout 2007, but remained near the bottom of its historical range at the end of the year. Charge-offs on C&I

loans at commercial banks also increased in 2007, particularly in the fourth quarter when the charge-off rate moved up from 0.48 to 0.85 percent of average C&I loans. In addition, examiners continue to note early signs of credit deterioration at some banks where delinquencies have not yet increased significantly.

Here, too, supervisors are responding to ensure that banks' commercial and industrial (C&I) lending activities remain safe and sound. Examiners are focusing on underwriting standards, evaluating both the methodology and results of banks' stress tests of credit portfolios and the impact of potential shocks on credit and asset quality. Credit administration--that is, banks' activities to monitor their loans and maintain their credit operations--are also being watched carefully. Examiners are looking for signs of imprudent renewals, excessive waivers of terms without compensation, or other activities which might mask recognition of poorly performing credits. We are emphasizing that banks employ appropriate internal controls that will ensure that borrowers meet their obligations under credit agreements--not only obligations for payments, but also obligations to furnish up-to-date information such as financial statements--which allow the bank to properly assess credit risk. We also continue to regularly review internal bank reports and meet with bank management to discuss underwriting and credit performance in order to identify problem areas early and while they are still manageable.

Supervisory Strategies for Going Forward

The U.S. banking industry is facing serious challenges; the Federal Reserve, working with the other U.S. banking agencies has acted--and will continue to act--to ensure that the banking system continues to be safe and sound and able to meet the credit needs of a growing economy. Our initial assessment of the weaknesses at individual firms indicates that risk management systems and senior management oversight at some institutions were not sufficiently robust. As supervisors, we must redouble our efforts to ensure risk management practices and controls keep pace with changes in financial markets and business models, providing both positive incentives and clear consequences.

Supervisors have emphasized for several years the concept of enterprise-wide risk management. However, problems stemming from recent events indicate that bank management in many cases was not fully aware of the latent risks contained in various structures and financial instruments, and how those risks could manifest themselves. Supervisors, therefore, will be enhancing their focus on the capacity of a firm as a whole to manage risk and to integrate risk assessments into the overall decision-making by senior management. Additional emphasis on enhancing stress-testing is also appropriate to focus more bank attention on risks that have a low probability of occurrence but unacceptably high potential costs. As part of an international effort, we have also been developing a set of preliminary "lessons learned" from banking organizations' experiences with recent market events, containing examples of both stronger and weaker practices, to share with the banking industry as well as our own examination staff.

Finally, as part of a responsible and proactive supervisory approach, and as we have done in the past, we are conducting critical assessments of our own supervisory programs, policies, and practices. This is a prudent step and is consistent with long-standing Federal Reserve practice. In the same vein as the "lessons learned" analysis for banking institutions mentioned above, our intent is to identify opportunities for improving our own supervisory processes both within the current environment and as preparation for future supervisory challenges. These assessments will be specific to our supervisory programs as well as their execution over the past several years, will be conducted across a broad portfolio of institutions and supervisory programs, and should help to further strengthen our supervisory objectives and procedures.

It will take some time for the banking industry to work through this current set of challenges and for financial markets to recover from recent strains. The Federal Reserve will continue to work with other U.S. banking agencies and the Congress to help ensure that bank safety and soundness is maintained.