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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, as a follow-up to the testimony I gave at a hearing held by your Committee in early March. In my remarks today, I will provide an updated view of the health of the U.S. banking system, discuss some key lessons learned from recent events, and then outline a few important areas in which the Federal Reserve is responding in its role as banking supervisor.

Within the past year, we have seen a number of banking institutions suffer losses, some quite substantial. These and other institutions have been facing a range of risk management challenges, some of them relatively fundamental in nature and others associated with the increased use of complex and relatively new products. Fortunately, bank managers are acting on lessons learned from recent events and taking steps to rectify identified problems. Supervisors are also taking steps to respond to lessons being learned from recent events and, where appropriate, enhancing supervisory processes. Some of these steps include enhancing our understanding of the adverse implications of greater complexity in financial products and markets, stepping up our continuing efforts to address the challenges associated with supervising large, complex consolidated entities by multiple regulatory agencies, and ensuring that we continue to send strong supervisory messages, in good times and bad.

Condition of the Banking System

As you know, the Federal Reserve is responsible for supervising bank holding companies, working together with the primary supervisors of the banks and their affiliates. We ourselves are the primary supervisors of state-chartered banks that choose to join the Federal Reserve System. My update on banking conditions will focus on these two groups of banking organizations.

As the U.S. housing market has weakened and the economy has slowed over the past year, banking organizations have recognized significant losses stemming both from higher credit charges against residential mortgage-related loans held on their books and sharp asset value write-downs of securitized mortgage-related positions and leveraged loans. Indeed, the 50 largest bank holding companies, which represent more than three-fourths of all bank holding company assets, reported losses of more than $9 billion in the fourth quarter of 2007. Overall, bank holding companies in aggregate generated a loss of more than $8 billion during the difficult fourth quarter of 2007.

The largest 50 bank holding companies performed better in the first quarter of 2008, reporting profits of $5.2 billion and reduced trading losses. Consequently, bank holding companies overall reported net income of nearly $10 billion for the quarter, down substantially from the $36.5 billion in income they reported for the first quarter of 2007 but a considerable improvement over the prior quarter’s losses. Nonetheless, the headwinds of heavy trading book losses proved difficult to overcome for some firms and seven of the fifty largest bank holding companies still recorded net losses for the quarter. Moreover, as economic conditions have softened, these large companies have reported increasing problems in mortgage loan portfolios, particularly home equity lines of credit, and in loans to residential real estate developers. In some cases, broker-dealer subsidiaries of bank holding companies have suffered valuation losses on their holdings of mortgage-related assets. Reflecting this deterioration in mortgage-related exposures, nonperforming assets more than doubled over the past year from $37 billion to $81 billion and, as of March 31, 2008, nonperforming assets as a share of overall assets reached the highest level since 2002.

Loan loss provisions rose sharply during the first quarter to $32 billion, exceeding net charge-offs by more than $14 billion, as the institutions were building their loan loss reserves in advance of expected further deterioration in loan quality. Increased concern over the potential for more losses from traditional lending activities has also been evident in the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices, which in recent quarters has shown banks tightening their lending standards and terms.

The 50 largest bank holding companies continue to work at improving their liquidity positions in the wake of recent market turmoil. Several of these companies had brought on balance sheet substantial assets that were originally securitized or otherwise held off balance sheet, forcing alterations in funding strategies and increasing pressures in the term funding market. As the Committee is aware, the Federal Reserve has taken a number of steps with its liquidity facilities to address the difficulties in term funding markets.

In order to bolster equity positions diminished by recent writedowns, U.S. bank holding companies--some at the urging of supervisors--have raised more than $80 billion in capital so far in 2008. In addition, some have reduced dividends to further shore up their capital base. Reflecting these steps, aggregate tier 1 leverage, tier 1 risk-based, and total risk-based capital ratios for the largest 50 bank holding companies increased over the first quarter, expanding the margins above regulatory minimums. We expect bank holding companies to continue to report weak earnings and further asset valuation writedowns and/or significant credit costs in coming quarters. Indeed, despite higher provisioning during the past several quarters, coverage of nonperforming loans by loan loss reserves has not kept pace with growth in problem assets and bank holding companies may likely face the need to further bolster loan loss reserves. In view of this uncertain outlook, additional capital injections and the consideration of dividend cuts are still warranted for some of these companies and we have strongly encouraged supervised bank holding companies to enhance their capital positions. Stronger capital positions also will allow banking institutions to participate in and support the rebound in lending that will accompany the strengthening of the U.S. economy.

Consistent with trends in commercial banks overall, conditions at state member banks have weakened over the past year. Problems in residential mortgage, home equity, and loans to home builders have pushed the nonperforming assets ratio at these banks to 1.57 percent, more than twice the level of one year ago and the highest rate since 1993. Loan loss provisions have also accelerated, rising to a high of 1.14 percent of average loans during the first quarter of 2008 in large part reflecting the deterioration in residential real estate-related loan portfolios. Despite this deterioration, state member banks still reported aggregate net income of $3.7 billion and a return on assets of about one percent for the first quarter of 2008. Moreover, more than 98 percent of these banks reported risk-based capital ratios consistent with a “well-capitalized” designation under prompt corrective action standards.

Over the coming months, we expect banking institutions to continue to face deteriorating loan quality. House prices are still declining sharply in many localities and losses related to residential real estate--including loans to builders and developers--are bound to increase further. In addition, weak economic conditions could well extend problems to other segments of lending portfolios including consumer installment or credit card loans, as well as corporate loan portfolios. Moreover, banking organizations must be prepared for the possibility that liquidity conditions become tighter if uncertainties in the capital markets fail to subside or if credit conditions deteriorate significantly. Accordingly, we anticipate that the number of banks with less than satisfactory supervisory ratings will continue to increase from the relatively low levels that have existed in recent years and we are monitoring developments at all supervised institutions closely.

Risk Management Lessons for Financial Institutions

Recent market events point to a number of risk management lessons for financial institutions. I will highlight just a few key points; many of these lessons have been documented more fully by recent public reports and discussed in speeches by Chairman Bernanke, myself, and other Federal Reserve officials.[1]

The period leading up to the recent market turbulence was an unusually good one for the banking system, characterized by high profits, strong balance sheets, rapid innovation, business growth, and relatively few bank failures. Unfortunately, the extended period of good times in the banking system bred a sense of overconfidence among many bankers and other market participants, causing them to underestimate risks and not fully consider the potential for those good times to end. Most notably, many market participants expected housing prices to continue their upward trend and did not properly consider what might happen if prices leveled off or fell. In order to be good risk managers, bankers need to understand that overconfidence and complacency must be continually battled, especially during an extended period of good times.

Another key lesson is that if risks are to be successfully managed, they must first be properly identified, measured and understood. Unfortunately, recent events have revealed significant deficiencies in these areas. Notable examples are the underestimation by many firms of the credit risk of subprime mortgages and certain tranches of structured products, as well as

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[1] President's Working Group on Financial Markets (2008), "Policy Statement on Financial Market Developments," March 13, www.treas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf
Financial Stability Forum (2008), "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience," April 7, www.fsforum.org/publications/FSF_Report_to_G7_11_April.pdf;
Senior Supervisors Group (2008). "Observations on Risk Management Practices during the Recent Market Turbulence" March 6, www.newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf .

poor understanding of particular market risk characteristics of structured credit products. In a number of cases, bank managers did not exercise proper due diligence in valuing their positions and assessing their risks, relying solely on third-party assessments of risk that turned out to be overly optimistic. Other firms did not fully consider the linkages and correlations between credit risk and market risk, leading to mismeasurement of their overall exposure.

Some institutions took an excessively narrow perspective on risk with insufficient appreciation of the need for a range of risk measures, including both quantitative and qualitative metrics. For example, some firms placed too much emphasis on the mechanical application of value-at-risk or similar model-based indicators. Sophisticated quantitative tools and models play an important role in good risk management, and they will continue to do so. But no model, regardless of sophistication, can capture all of the risks that an institution might face. Those institutions faring better during the recent turmoil generally placed relatively more emphasis on validation, independent review, and other controls for models and similar quantitative techniques. They also continually refined their models and applied a healthy dose of skepticism to model output. Stress tests and scenario analysis are tools through which institutions can gain perspective on risks that fall outside those typically captured by statistical models.

Another crucial lesson from recent events is that financial institutions must understand their liquidity needs at an enterprise-wide level and be prepared for the possibility that market liquidity may erode quickly and unexpectedly. As is now widely recognized, many contingency funding plans did not adequately prepare for the possibility that certain off-balance-sheet exposures might have to be brought onto the firm’s balance sheet. Nor did they adequately account for the possibility of widespread and protracted declines in asset market liquidity.

Unexpected balance sheet expansions subsequently added to funding pressures as well as to pressures on capital ratios.

Effective oversight of an organization as a whole is one of the most fundamental requirements of prudent risk management. Senior managers at successful firms are actively involved in risk management, which includes determining the firm's overall risk preferences and creating the incentives and controls to induce employees to abide by those preferences. Often those incentives and controls must provide a counterweight to the incentives to seek short-run profits that can be inherent in prevailing compensation practices. Strong oversight requires access to a variety of high-quality information on a timely basis. Successful senior managers also work to ensure that critical information is transmitted horizontally as well as vertically; during recent events, some firms' business lines did not share vital information relevant to risk positions and business tactics, with adverse implications for profitability.

The leaders of well-managed institutions of all sizes generally seek to have strong and independent risk functions. Such functions support clear, dispassionate thinking about the entire firm's risk profile. In addition, the institution benefits when senior managers encourage risk managers to dig deep to uncover latent risks and to point out cases in which individual business lines appear to be assuming too much risk. The lessons I just noted emphasize the importance of risk management fundamentals, which means that they apply not only to those institutions suffering substantial losses recently, but also to institutions faring better during recent events.

Supervisory Consideration of Lessons Learned

Risk management shortcomings at financial institutions highlighted by recent events also present policy and operational challenges for supervisors. The primary responsibility for risk management appropriately rests with the management of each institution, and our supervisory efforts are not aiming to prevent individual banks from suffering losses, which is part of the banking business. However, we are working to make sure that financial institutions have a better understanding of their potential for loss and that there are not broader breakdowns in risk management that can affect the financial system and the economy. While events continue to unfold, some key lessons for supervisors, in addition to bankers, are coming into focus. I would first like to highlight a few key lessons, and then in the next section will describe corresponding supervisory actions.

For one, the increased complexity and linkage within and among increasingly globalized markets presents greater challenges not just for bankers but also for supervisors. Supervisors need to enhance their understanding of the direct and indirect relationships among markets and market participants, and the associated impact on the banking system. Supervisors must also be even more keenly aware of the manner in which those relationships within and among markets and market participants can change over time and how those relationships behave in times of stress--not just at banking institutions, but also at other financial firms that play prominent roles in financial markets and whose actions and condition can have an impact on financial stability.

Before the recent market turbulence, the Federal Reserve--in many cases along with the other U.S. banking agencies--acted on a number of fronts to alert financial institutions about emerging risks, for example by issuing supervisory guidance on nontraditional mortgages, home equity lending, commercial real estate, and subprime lending. We must continue to be vigilant about emerging risks, not just in these more turbulent times, but also when good times return--and we must be insistent that banking organizations factor these risks into their own risk management practices. It is also clear that supervisors need to enhance their focus on consumer compliance issues at the point of contact between lenders and households and on the linkages between weaknesses in consumer lending practices and safety and soundness, such as occurred with subprime mortgages.

The current U.S. regulatory structure, with multiple supervisory agencies, has a number of strengths and benefits, but challenges can arise in assessing risk profiles of large, complex financial institutions operating across financial sectors, particularly given the growth in the use of sophisticated financial products that can generate risks across various legal entities. Congress established a consolidated supervisory framework for bank holding companies in recognition that some risks cross legal entities and are managed on a consolidated basis. Accordingly, monitoring those properly requires a supervisory approach directed at more than one, or even several, of the legal entity subdivisions within the overall organization. Recent events have highlighted the fundamental importance of enterprise-wide risk management; both supervisors and bankers need to understand risks across a consolidated entity and assess the risk management tools being applied across the firm.

The implementation of consolidated supervision in the United States generally works well, with strong, cooperative relationships between the Federal Reserve and other relevant bank supervisors and functional regulators. Information sharing among relevant supervisors and regulators is essential to ensure that a banking organization's global activities are effectively supervised on a consolidated basis, and we have worked over the years to develop and enhance interagency coordination and information sharing. But as institutions grow larger and more complex, we need to ensure that our system of consolidated supervision keeps pace.

Supervisory Actions Going Forward

We are acting in response to lessons from recent events to ensure the continuing safety and soundness of the U.S. banking system. Of course, we also continue to study recent and ongoing events to gain additional information and insights.

As a first step, supervisors are redoubling their efforts to help organizations improve their risk-management practices, given the challenges some banks are facing today. Accordingly, we have increased supervisory attention to this issue. For instance, supervisors are reinforcing and strengthening their focus on assessments and testing of fundamental risk management processes, requiring vigorous corrective action when weaknesses are identified. We are also ensuring that institutions take a more forward-looking approach to risk management; for example, our examiners are reviewing due diligence around commercial real estate valuations and ensuring that bankers make appropriate adjustments based on market conditions. This approach is consistent with recent lessons we have all learned from residential real estate. Additionally, we are more intensely verifying assertions made by bank management about the robustness of their risk management capabilities. Naturally, we have focused first on the institutions in most need of improvement, but we will continue to remind stronger institutions of the need to remain vigilant against potential weaknesses.

Supervisors are also enhancing their understanding of the full spectrum and the scale of the risks inherent in increasingly complex banking activities and the potential for risks to crystallize in times of stress. In particular, we are focusing on the inter-relationships among risk types, not just with respect to those areas that precipitated recent events, but more broadly. These forward-looking risk identification processes include a more comprehensive understanding of institutions’ main and emerging business lines and the full range of risks they generate. We are also counseling institutions to improve their own risk identification processes and to emphasize the importance of stress testing and scenario analyses.

Better risk management at banking organizations must be accompanied by more robust liquidity and capital cushions. As developments of the past months clearly demonstrate, the difficulty in identifying complexity and linkages--and their potential impact during times of stress--requires institutions to maintain sizable and more reliable liquidity and capital cushions, given the inherent uncertainty in financial markets. This is a key point supervisors are reinforcing strongly.

The Federal Reserve is nearing completion of enhancements to its supervisory guidance to clarify our role as consolidated supervisor of bank and financial holding companies--often known as our “umbrella supervisor” role. The updated guidance is primarily intended to provide greater clarification to our own examination staff. For example, it provides for more consistent Federal Reserve supervisory practices and assessments across institutions with similar activities and risks, detailing expectations for understanding and assessing primary governance functions and risk controls, material business lines, nonbank operations, funding and liquidity management, consumer compliance, and other key activities and risks. Again, from a financial stability perspective the Federal Reserve has an interest not just in identifying the risks within an individual organization, but also understanding the broader set of risks affecting all key market participants.

The updated consolidated supervision guidance, which will be made publicly available, naturally reiterates the importance of coordination with, and reliance on, the work of other relevant supervisors and functional regulators. The consolidated supervision guidance under development is being updated based on the lessons from recent events noted above. We need to continue to work closely with other supervisors and regulators as we implement the enhanced consolidated supervision guidance, with focus on improving interagency coordination of supervisory activities across all bank holding companies, particularly the largest and most complex organizations.

We are also considering new or augmented supervisory guidance on other aspects of risk management, including further emphasis on the need for an enterprise-wide perspective when assessing and managing risk. For example, we are developing supervisory guidance to clarify expectations surrounding compliance risk, focusing particularly on firm-wide compliance risk management for large, complex organizations. Another example is our participation in the development of enhanced guidance on the management of liquidity risks, which is being developed by the Basel Committee on Banking Supervision.

As you know, the U.S. federal banking agencies are also in the process of implementing the Basel II framework, which is intended to enhance the quality of risk management by tying regulatory capital more closely to institutions' underlying risks and by requiring strong internal systems for evaluating credit and other risks. We understand that Basel II must be implemented carefully and so have established an extended transition process with multiple safeguards. Indeed, findings from recent supervisory reviews on the use of economic capital have direct application to the evaluations we will make under Pillar 2, where banks are required to have their own robust internal process to ensure that they have adequate capital for their entire risk profile. Importantly, Pillar 2 underscores the current supervisory authority to require institutions to hold additional capital if the agencies are not satisfied with the levels chosen by bank management. We are also working with the Basel Committee to ensure that the Basel II framework appropriately reflects the lessons of recent events, such as by strengthening the capital treatment of off-balance-sheet vehicles and assessing the use of external credit ratings to determine capital charges.

Conclusion

The Federal Reserve plays an important role in the strong supervisory structure we have here in the United States. And we are committed to making our supervisory and regulatory processes as strong as possible, improving them when necessary. Going forward, we must continue to send strong supervisory messages to senior management at financial institutions--perhaps with more force and frequency than in the recent past--particularly since during extended periods of good times institutions can lose their focus on the importance of sound risk management fundamentals. We continue to review our supervision practices to identify and act on potential areas for improvement in light of recent events.