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Thoughts on the Economy and the Banking Sector

Thank you, John, for that kind introduction. I'm delighted to be with you today. As John said, I'm new to the San Francisco Fed. I'm still in my first year as President. But I'm not new to the Federal Reserve System. Nor am I completely new to banking issues. When I was a Governor at the Board some ten years ago, I served on the Committee on Markets and Regulation, where we focused on risk management and systemic risk, including supervising risk-taking at banks.

That period—the mid-1990s—was a fascinating time to work on banking issues. With the industry getting back on its feet after the dismal days of the early part of the decade, there was renewed energy for change. The legislative groundwork for Gramm-Leach-Bliley was being laid. Consolidation and expansion of interstate banking were moving ahead. Securitization was having a profound impact on the role of banks in funding credit. In derivatives markets, large banking organizations were both users and market makers.

Today, ten years later, these trends are still changing banking. The challenge for the Fed and the other agencies has been to figure out the appropriate responses of bank supervision and capital regulation. For example, with banks competing in the broader financial services arena, it has been important in adapting supervision and regulation to limit the attendant burdens on banks. Indeed, when I was at the Board, one of the first things I learned—in a very graphic way—is just how heavily regulated the banking industry is. Here's what happened. When I first joined the committee, I wanted to get up to speed on the issues, so I asked for a copy of the Fed's regulations to review. What I *expected* was a couple of thick binders. What I *got* was something else altogether. Some poor research assistant came into my office rolling what looked like a grocery store shopping cart, and it was *filled* with volumes of regulations!

Needless to say, that image has stuck with me, and it has made me very supportive of efforts to reduce those regulatory burdens wherever feasible. At the same time, there are clear public policy concerns that justify bank supervision of risk and capital regulation. For example, even with all the changes in banking, the potential for moral hazard that's related to the federal safety net for banks remains a concern. In addition, supervision addresses concerns about systemic risk—something that banks don't fully factor into their own risk-management decisions. That's why it makes sense for bank supervisors to have a role in ensuring that banks make careful and prudent decisions about the degree of risk they bear and hold capital commensurate with that degree of risk.

In my remarks today, I want to start by exploring a key construct underpinning the changes in supervision and regulation of risk that has helped make them less intrusive to the operations of banking. I'll argue that the advances in risk management at banks and the changes in the supervision and regulation of banks have occurred through a mutually reinforcing process—where sometimes the private sector has taken the lead, and sometimes regulation and supervision have helped push risk management forward. Then I'll turn to the impact of the economy on banking in recent years. I'll conclude with some issues that are on our supervisory radar screen.

Supervision, Regulation, and Risk Management in Banking

The idea that advances in risk management at banks and changes in capital regulation and risk supervision can be mutually reinforcing processes is not terribly surprising. Although banks and bank supervisors have different motives—which certainly can lead to differing views about what the appropriate level of risk is—they also have a common interest in having accurate measures of risk and in focusing on the processes and techniques for managing risk. For banks, good risk management is key to creating value for shareholders—that is, profits. For bank supervisors, good risk management and capital regulation are key to ensuring the safety and soundness of the banking system.

A good example of how this common interest led to the mutually reinforcing process is the focus on capital as a fundamental part of risk management. In the early 1980s, bank supervisors had good reason to be concerned about banks' declining capital positions. They took the initiative by instituting explicit capital requirements. Then came the first Basel Accord, which took effect in the early 1990s. It broke new ground by tying the level of capital to the riskiness of assets. Admittedly, this risk-based framework was crude, but it was a start. More importantly, though, Basel I was about increasing capital in banking and putting capital on the front line in risk management, both for supervisors and for banks.

Basel I did succeed in increasing capital in banking. Today, ninety-seven percent of U.S. banks are considered not just adequately capitalized, but actually well capitalized, and the average risk-based total capital ratio sits at close to thirteen percent. Market capitalization ratios for many banking organizations are even more impressive.

Despite this success in raising capital ratios, it was apparent early on that the first Basel Accord's approach had flaws, especially for large, complex banking organizations. One serious concern was that some institutions were able to use securitization to reduce their funding requirements without commensurately reducing their risk. While the regulators were able to come up with ways to set capital requirements for such retained risk, it was a bit like writing software patches for an out-of-date operating system. By the mid-1990s, it was clear that we needed a new operating system.

The path to the new system, Basel II, provides another illustration of the mutually reinforcing process. This time, the innovations originated not with the supervisors, but with the bankers. They had developed models that encompass their processes, procedures, and techniques, including statistical models for assessing portfolio risk. Regulators saw that these "state of the art" risk-management tools also provided the makings of a framework that they themselves could use to address the shortfalls of Basel I. Clearly, leveraging the risk-management techniques banks were already using represented a significant intellectual step forward in bank supervision.

I realize that when it comes to Basel II, some of you may be thinking, "Why should I care about that?" After all, in the United States, only about ten large, complex, internationally active banks will be required to use internal risk models to determine their capital requirements, and another ten or so may qualify to opt-in to do so. But even if you're not among those 20 or so institutions, my answer still would be that, indeed, you should care and be knowledgeable about Basel II—perhaps not in terms of the detail, but in terms of the risk-management principles underlying the framework. The key principles are: striving to assess your overall portfolio risk and having confidence in the reliability of your risk assessment process.

The latter goal is actually one that supervision helped to push forward long before Basel II. Ten years ago, when I was at the Board of Governors, we rolled out our "risk-focused supervision." Since then, although we still engage in so-called transactions testing, we have shifted our attention to assessing internal systems and controls for evaluating and managing risk. I think this approach has been effective and that it has helped promote better risk management in the banking industry.

The economy and banking

As I've described, risk management at banks and bank supervision were moving in the right direction in the second half of the 1990s. But the industry had yet to be tested by adverse economic shocks. Well, beginning in 2000, we started to get those shocks: the dot-com bust, the investment bust, then 9/11, the wars in Afghanistan and Iraq, and the corporate governance scandals. Not surprisingly, these shocks led to serious erosion in confidence and a pullback in spending by the business sector.

Both monetary policy and fiscal policy responded aggressively to these shocks. The Fed slashed short-term interest rates starting in 2001 to their lowest levels in forty years. And the Congress passed tax-cut packages to stimulate spending. But because these macro policies, especially monetary policy, affect the economy with a lag, we still had substantial job losses and clear signs of stress in the corporate sector. For example, bond downgrades and defaults rose sharply in the recession, matching levels reached in the previous recession. And risk spreads on high-risk corporate bonds spiked, exceeding previous peaks.

In the face of these shocks, both large banks and community banks proved to be far more resilient than in the previous recession. And it would appear that the developments I've been discussing—stronger capital positions in conjunction with improvements in supervision and banks' advances in risk-management—deserve much of the credit for this resilience. For example, in terms of bank supervision, research indicates that supervisory ratings were stiffer for a given set of performance measures going into the last recession than they were earlier in the 1990s. This is consistent with the shift to risk-focused supervision that I mentioned earlier.

In terms of good management, it appears that, even where there were potential risk exposures, banks took relatively safe positions. That is illustrated in the experience with syndicated loans, where the data show increases in risk over the cycle, but with non-banks holding more of the riskier loans than banks. Prudence on the part of banks clearly came into play in other respects, as well. Federal Reserve surveys show that banks tightened credit standards and required that loans have lower loan-to-value ratios before the downturn, and our examiners have confirmed that during on-site reviews.

Before we pat ourselves on the back for such great supervision and such great management, let me point out that some things about the economic environment itself turned out to be favorable for the banking industry in this cycle. For one thing, banks were less exposed to the sectors under the most stress, such as telecommunications and energy. Probably the most significant favorable factor was the remarkable strength of consumer spending, especially on durables and housing, which was spurred in part by the low interest rate environment. This gave a boost to bank earnings through growth in lending, especially mortgage refinancing.   Also, commercial real estate loan quality at banks held up relatively well, even with the rise in vacancies and declines in rents, in part because of the decline in mortgage rates and the rise in refinancing that lowered debt burdens for businesses.

The economic environment during the current cycle also affected the makeup of bank portfolios. With low interest rates and high profits in the recovery, nonfinancial businesses restructured their balance sheets. They moved to longer-term financing and also tapped internal funding. For large banks this meant a sharp decline in C&I loans and credit enhancements on commercial paper—though they have shared in the rise in bond underwriting. For community banks the restructuring meant a slowdown in C&I lending, though business loan growth was still positive.

The restructuring by businesses also reinforced the growth in commercial real estate lending at banks, including community banks. Here in the West, the share of commercial real estate loans for banks with under one billion dollars in assets exceeds the national average of twenty-eight percent in most states. Concentration is especially high in California, where commercial real estate loans account for forty-six percent of loans among community banks.

As you know, when residential mortgages are added, total real estate loans account for the lion's share of the lending among community banks. The average share for the West as a whole is about the same as for the nation—at seventy percent—with Hawaii at the top with seventy-eight percent, followed by California with seventy-seven percent.

This emphasis on real estate financing by banks is understandable, given developments in credit markets. First, residential real estate debt relative to the economy has grown substantially. Even with securitization, it is not surprising that banks would share in the growth, especially given the decline in the role of savings institutions. Also, banks as intermediaries have a comparative advantage in funding more idiosyncratic credit, such as commercial real estate. The commercial real estate mortgage-backed securities market is growing, but not fast enough to absorb the overall rise in commercial real estate credit. The bottom line is that among community banks there is a notable degree of specialization and the trend has been toward more concentration.

Outlook for the economy and banks

That brings me to the outlook. After the economic expansion stumbled in the spring of last year, it now looks to be on a firmer footing. A broad range of economic data suggests that real GDP is growing noticeably above trend. By most estimates, trend is around three and a quarter to three and a half percent. We've seen vigorous growth in business spending and solid growth in consumer spending. Employment hasn't been quite as strong as expected, especially given all the monetary and fiscal stimulus out there. Even so, the economy generated an average of nearly 200,000 new jobs a month over the past twelve months.

As the economic expansion has firmed over the past few months, the Fed has removed some degree of accommodation, bringing the fed funds rate to two and a half percent. In its recent statements, the FOMC has indicated that the expansion seems likely to remain on track, with inflation pressures remaining well-contained. So long as this scenario holds up, the Committee has said that it expects to continue to remove the policy accommodation at a pace "that is likely to be measured."

At banks, the renewal of strong growth in C&I lending in recent months is consistent with the rise in business investment. We will probably see business demand for credit rise further with the trimming of profit growth among nonfinancial firms. The repatriation of profits from abroad this year, however, could affect businesses' demand for credit, at least at the larger banks. Nevertheless, in terms of the ability to borrow, business balance sheets overall look to be in good shape in terms of debt burdens. When it comes to households, we don't know for sure what levels of debt burden they feel comfortable with. Although the Federal Reserve's figures on financial obligations relative to income for households have come down some in recent quarters, they are still high. Nonetheless, the expectation is that consumer spending will continue to grow at a moderate pace.

For banks, an expanding economy should support loan growth and good asset quality. But there are some areas for caution in the banking outlook, and that brings me to what's on our supervisory radar screen at the San Francisco Fed.

Supervisory radar screen

I already mentioned growing commercial real estate concentrations. That's been prominent on our radar screen for some time because concentrations are especially high at western banks. Earlier this year, exam staff at the San Francisco Fed concluded a detailed review of some of the most highly concentrated banks that we supervise. They found that loan quality and underwriting is good overall, but concentration risk management practices are weak. For example, management and directors at most of these banks did not formally acknowledge their concentrations in their strategic or capital planning, nor did they have reports that give them a portfolio-wide view of their risk. The San Francisco Fed has communicated our expectations around high commercial real estate concentrations to the banks we supervise, and we're now at the early stages of developing potential interagency guidance.

Given the high concentrations at banks in the west—and California in particular—we give considerable attention to commercial real estate market conditions. The good news is that we've seen a decline in office vacancy rates around most western markets since last year's highs. But something we're keeping an eye on is the lagged response in net operating revenues for commercial office and industrial space. This could lead to rising bank loan delinquencies and charge-offs. On the plus side, lower mortgage rates help ease cash flow pressures, and gains in employment should support higher rental rates going forward.

Another issue on our radar screen is rapid growth at many western community banks. For example, total loan growth at California commercial banks averaged twenty-two percent in the past year, excluding new banks. High growth can outstrip a bank's capital and internal control structure, and we've seen banks offer new products and services without formally analyzing the risks and implementing required control and audit processes. Additional expansion in a stronger economy could add stress to the existing control environment and management capacity at some banks. Advances in technology and productivity certainly help support growth, but banks often tell us they're "doing more with less," and some may be tempted to cut corners imprudently. We've already seen this in some cases.

Another concern related to loan growth is the easing of credit standards and terms on loans. We expect to see this in an economic expansion, and recent Fed Surveys on bank lending confirm that this is occurring. But it's somewhat troubling that one of the reasons banks indicated they're easing credit conditions is increased competition from other banks and non-banks.

The rising interest rate environment is also on our radar screen. Even though banks have made considerable advances in managing interest rate risk, there are a few things we're watching. First, some borrowers may have difficulty meeting higher payments on variable-rate loans—especially consumers who already have built up a high level of debt burden. That said, the potential impact on banks should be limited because nonperforming loans are at such a low level right now, and because of offsets from a stronger economy. A more significant supervisory concern with the rate environment is that while many banks are understandably positioning their balance sheets for rising rates—by shortening asset durations, for example—some are not considering alternative scenarios with respect to the shape of the yield curve and the timing of rate changes, and we've already seen how the bond market and long rates have fluctuated in reaction to some of the economic uncertainties I mentioned earlier.

A related issue is the potential impact on liquidity. While deposit growth has held up reasonably well, funding may become more challenging as depositors seek higher returns. Banks have many more funding options available today than in the past. But rising rates will test banks' interest rate risk management and funding strategies, especially if loan demand jumps concurrently. And though most banks—even small community banks—are using sophisticated techniques such as Economic Value of Equity and earnings simulation, some banks fall short by not fully understanding their models, by failing to validate assumptions on a regular basis, or by using a model that doesn't support the size and complexity of operations.

The final issue I'd like to touch on is the compliance environment. As I said, I am sensitive to the regulatory burden, and I do appreciate the impact of heightened attention in several areas such as bank secrecy, anti-money laundering, the Sarbanes-Oxley Act, and various consumer regulations. Regulatory compliance—in a broad sense—is on our radar screen because we've seen some banks increase their focus on growth and efficiency so much that elements of their compliance programs slip. This has happened not only because the desire to reduce costs has made it tempting to cut corners, but also because some banks have not fully appreciated how growth in size and complexity requires a more robust compliance program.

As you know, the banking regulators have had a longstanding role in assessing compliance with various safety and soundness as well as consumer regulations. At the Federal Reserve, compliance is an essential component in our evaluation of a bank's internal controls and risk management framework. Some recent laws have expanded the focus in certain areas—for example, the Patriot Act and SOX 404. But our fundamental role hasn't changed. What has changed is the environment. Today, weaknesses in a banking organization's internal control structure and compliance programs translate not only to significant operational risks but also to considerable legal and reputational risks.

Conclusion

In closing, I want to emphasize that we don't think widespread problems are likely. Some banks will probably see fallout from the risks I mentioned as well as from others that I didn't discuss. But industry conditions in many respects are stronger now than they've ever been. That undeniable fact, together with the advances in risk management I talked about, put the industry overall in a solid position to deal with any challenges that may arise.

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