Statement of
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On
Enhancing Safety and Soundness: Lessons Learned
and
Opportunities for Continued Improvement
before the
Subcommittee on Financial Institutions
and
Consumer Protection, Senate Committee on
Banking, Housing, and Urban Affairs
Washington, D.C.
June 15, 2011

Chairman Brown, Ranking Member Corker, and members of the Subcommittee, thank you for the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) about our supervisory process, how it has changed based on lessons we learned from the crisis, and what we see as opportunities for continued improvement.

Congress created the FDIC in 1933 in response to the most serious financial crisis in U.S. history. Our mission is to promote financial stability and public confidence in individual banks and in our nation's banking system through bank supervision, deposit insurance, consumer protection, and the orderly resolution of failed banking institutions. As the primary federal supervisor for the majority of U.S. community banks, the FDIC seeks to maintain a balanced approach to bank supervision, regardless of financial and economic conditions. In our unique role as deposit insurer, we have a vital interest in assessing risks to the Deposit Insurance Fund (DIF) posed by all FDIC-insured institutions.

My testimony today first provides some background information on the condition of the industry and the problems that led to the recent financial crisis. I will discuss our approaches to supervising large institutions and smaller community banks. Finally, I will discuss some provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) that we are incorporating into our supervisory process.

Condition of the Industry

Leading up to the financial crisis, FDIC-insured institutions recorded six consecutive years of record earnings, culminating in $145.2 billion in 2006. However, this extended period of industry profitability masked the underlying weaknesses in credit quality that would emerge starting in 2007 as real estate markets weakened and the U.S. economy moved into recession. By 2008, annual industry earnings had fallen to just $4.5 billion and, in 2009, the industry recorded a net loss of $9.8 billion – the largest loss in its history. Quarterly provisions for loan losses taken by FDIC-insured institutions since the end of 2007 now total just under $645 billion, equal to over 8 percent of the book value of loans outstanding at the beginning of 2008.

During the first quarter of 2011, FDIC-insured institutions recorded annual net income of $29 billion, the highest level since before the recession, but still well below the all-time highs of the mid-2000s. The main driver of earnings improvement has been steadily reduced provisions for loan losses. This reflects general improvement in asset quality indicators, including declining levels of noncurrent loans and net charge-offs for all major loan types. However, the ratio of noncurrent loans1 to total loans, at 4.7 percent, is still relatively high and remains above the levels seen in the late 1980s and early 1990s. While the reduced provisions for loan losses are encouraging, it is important to note that net operating revenue fell by $5.5 billion in the first quarter of 2011 compared to one year ago. Lower revenues, in part, reflect reduced loan balances, which have declined in ten of the past eleven quarters. Growth in well-underwritten loans is essential not only for banks to build revenues but also to provide a stronger foundation for economic recovery. Recent surveys, such as the Federal Reserve Senior Loan Officers' Opinion Survey and the National Federation of Independent Businesses' Survey on Small Business Economic Trends, also indicate that borrower demand remains sluggish.

Despite the economic challenges, community banks, which comprise the vast majority of banks that we supervise, continue to play a vital role in credit creation across the country, especially for small businesses. This has been borne out by loan originations over the past several years. On a merger-adjusted basis, community bank loan balances have increased by about one percent since the second quarter of 2008.2 However, over the same period, overall industry loan balances fell by about 9 percent.

While commercial property fundamentals point to stabilization, recent weakness in both residential and commercial property price trends highlight continued concerns. The S&P/Case-Shiller National Housing Index is down 5.1 percent year-over-year through first quarter 2011 and the Moody's/REAL Commercial Property Price Index has decreased by 8.5 percent in the year ending in March 2011. In both cases, distressed properties are weighing down prices.

Overall, we are cautiously optimistic regarding the current condition and trends in the banking industry. The number of institutions on the FDIC's "Problem List" is leveling off and the number of institution failures appears to have peaked in 2010. During the first quarter of 2011, the number of institutions on the FDIC's "Problem List" increased slightly from 884 to 888. Similarly, the current pace of failures is lower than the 157 failures in 2010. Nevertheless, the number of troubled institutions remains high at 12 percent of all insured institutions, indicating that a portion of the industry continues to struggle with lingering credit-quality issues. These issues adversely impact the ability of many institutions to grow their lending activity.

Factors that Led to the Recent Financial Crisis

Factors that led to the crisis of 2008 and motivated the legislative reforms were in four broad areas: excessive reliance on debt and financial leverage, misaligned incentives in financial markets, failures and gaps in financial regulation, and the erosion of market discipline due to regulatory arbitrage and "Too Big to Fail."

With regard to financial regulation, the regulatory reforms put in place for federally-insured depository institutions following the banking crisis of the 1980s and early 1990s helped to constrain risk-taking on bank balance sheets. However, opportunities for regulatory arbitrage allowed risks to grow in the so-called shadow banking system—a network of large-bank affiliates, special-purpose vehicles, and non-bank financial companies that existed largely outside of the prudential supervision, capital requirements, and FDIC receivership powers that apply to federally insured depository institutions in the U.S. The migration of financial activities outside of regulated financial institutions to the shadow banking system ultimately lessened the effectiveness of regulation and made the financial markets more vulnerable to a breakdown.

Many of the structured finance activities that generated the largest losses were complex and opaque transactions undertaken at the intersection of the lightly regulated shadow banking system and the more heavily regulated traditional banking system. For instance, private-label mortgage backed securities (MBS) and associated derivatives were originated through mortgage companies and brokers and facilitated by banks that were securitizers. As became evident, many of the underlying mortgage loans were poorly underwritten and contained a host of layered risks.

The housing bubble ensued, fueled with poorly underwritten loans originated for sale into the securitization market. The MBS were subject to minimum securities disclosure rules that are not designed to evaluate loan underwriting quality. For banks, once these loans were securitized, they were off the balance sheet and no longer on the radar of many banks and bank regulators. The mortgage loans began to default in high numbers undermining the MBS market. Eventually, the housing bubble collapsed, construction and development slowed, unemployment rose, and the economy went into recession. In addition, home prices continue to be depressed due to several factors including flawed mortgage servicing practices, which are not yet fully corrected, the overhang of foreclosure inventory, and the potential for litigation exposure.

One of the most powerful inducements toward excess leverage and institutional risk-taking in the period leading up to the crisis was the lack of effective market discipline. Several large, complex U.S. financial companies at the center of the 2008 crisis could not be wound down in an orderly manner when they became nonviable. With the exception of any insured depository institutions that they owned, their operations were subject to the commercial bankruptcy code, as opposed to FDIC receivership laws. In addition, some major important segments of their operations were located abroad and therefore outside of U.S. jurisdiction. In the heat of the crisis, policymakers in several instances resorted to bailouts instead of letting these firms collapse into bankruptcy because they feared that the losses generated in a failure would create a cascade of defaults through the financial system, freezing financial markets and seriously damaging our economic system.

Community banks were generally not involved in the mortgage-related issues at the first stages of the financial crisis, but were impacted as the recession took hold. Community banks tend to focus on local markets and loans for which local knowledge and personal service provide a competitive advantage, such as residential construction loans and other smaller commercial real estate projects. Construction and development (C&D) lending in areas that had experienced the steepest increase in home prices during the boom was hit first. Credit losses rose and subsequently spread across all loan types and rose as borrowers were caught in the recession and then slow recovery. At the same time, community banks' other sources of revenue used to offset credit losses from real estate portfolios was limited.

FDIC Supervisory Responsibilities

Despite the recent economic disruptions and subsequent stabilization, the FDIC's supervisory programs, while responsive to intensified problems in the industry, remain balanced. To accomplish this goal, the FDIC continuously enhances its examination and other supervisory approaches and maintains dialogue with institutions throughout the examination cycle.

The FDIC serves as the primary federal regulator for state-chartered institutions that are not members of the Federal Reserve System. The FDIC currently supervises 4,664 institutions, 4,358 of which have total assets of less than $1 billion. Regardless of size, as deposit insurer, the FDIC has an important interest in the condition of all insured institutions and their individual and aggregate impact on the DIF. As a result, the FDIC also has back-up authority to participate in examinations, with the primary federal regulator, at any insured institution.

The FDIC has, for a number of years, had different approaches to its supervision of larger, complex institutions from that of community banks. The larger, more complex institutions, and some mid-tier institutions, are subject to continuous on-site examination by teams of examiners and to extensive reporting. The smaller community banks have an annual or 18-month exam cycle and are also monitored off-site using quarterly Call Report information. The differences in the supervision of large and small banks are discussed in more detail below.

Supervision of Large Banks and Financial Firms

Supervisory programs, particularly for the larger institutions, have evolved to address the issues that led to the financial crisis, and to reflect the important protections and changes added by the Dodd-Frank Act. The Act requires that the FDIC and the Federal Reserve Board jointly issue regulations to implement new resolution planning and reporting requirements. These rules will apply to bank holding companies with total assets of $50 billion or more and non-bank financial companies designated by the

Financial Stability Oversight Council (FSOC) as "Systemically Important Financial Institutions" (SIFIs).

In addition, covered companies would be required to submit a resolution plan. Resolution plans should identify and map covered companies' business lines to legal entities and provide integrated analyses of their corporate structure; credit and other exposures; funding, capital, and cash flows; domestic and foreign jurisdictions in which they operate; their supporting information systems and other essential services; and other key components of their business operations. The resolution plan requirement in the Dodd-Frank Act appropriately places the responsibility on financial companies to develop their own plans "for rapid and orderly resolution in the event of material financial distress or failure" with review by the FDIC and the Federal Reserve Board.

The agencies are also working to develop a substantive process for reviewing resolution plans to determine whether a plan is both credible and would facilitate an orderly resolution of the company under the Bankruptcy Code. If a resolution plan is found to be "not credible," then the FDIC and the Federal Reserve Board may impose more stringent standards and take other action. If, after two years, the company's plan is still "not credible," the FDIC and the Federal Reserve Board may, in consultation with the FSOC, direct a company to divest certain assets or operations.

To focus the FDIC's expanded responsibilities to monitor and, potentially, resolve SIFIs, we established an Office of Complex Financial Institutions (OCFI). The OCFI will be responsible for the FDIC's role in the oversight of large bank holding companies and their corresponding insured depository institutions as well as for non-bank financial companies designated as systemically important by the FSOC. The OCFI will handle the FDIC's responsibilities, in concert with the Federal Reserve Board, for reviewing resolution plans and credit exposure reports developed by the SIFIs. Also, the OCFI will be responsible for implementing and administering the FDIC's SIFI resolution authority and for conducting special examinations of SIFIs under the FDIC's back-up examination and enforcement authority.

Supervision of Community Banks

Supervision of community banks consists of regular on-site examinations along with quarterly off-site monitoring of financial performance. Where conditions dictate closer supervision, we conduct on-site visits and collect supplemental information. As the supervisor of 4,358 community banks,3 the FDIC has a keen appreciation for the important role community banks play in the national economy. Community banks have branches in nearly all towns and urban areas, and about two-thirds of all branches in rural areas belong to community banks.

The FDIC's supervisory activities are carried out by examiners working from field offices located in 85 communities across the country. These examiners know the community banks in their areas and are familiar with the local conditions facing those banks. Many have seen more than one previous economic down cycle and recognize the critical role that community banks play in credit availability.

As discussed earlier, community banks still face lingering problems in their real estate loan portfolios and spillover effects caused by the collapsed housing bubble and the slow economy. Asset quality is not deteriorating as before, but volumes of troubled assets and charge-offs remain high, especially in the most affected geographic areas. The FDIC supervisory responses are scaled according to the severity of the weaknesses that a bank may exhibit. Banks with significant loan problems require close supervisory attention.

Supervisory Action to Encourage Real Estate Recovery and Lending

Throughout the real estate and economic downturn, the FDIC has advocated for policies that will help community banks and their customers navigate this challenging period and mitigate unnecessary losses. We share community banks' desire to restore profitability, strengthen asset quality, and serve the credit needs of local markets. The FDIC has worked closely with banks as they have taken steps to raise capital, enhance their loan workout functions, and revise strategic plans to remain competitive in the financial services industry. Through our regional and field offices located throughout the country, the FDIC actively communicates with the community banks we supervise and provides recommendations for addressing operational and financial weaknesses as appropriate.

In addition, the FDIC has joined several interagency efforts that encourage banks to originate and restructure loans to creditworthy borrowers, and to clarify outstanding guidance. For example, the federal bank regulatory agencies issued the Interagency Statement on Meeting the Needs of Creditworthy Borrowers on November 12, 2008, which encouraged banks to prudently make loans available in their markets. The agencies also issued the Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers on February 12, 2010, to encourage prudent small business lending and emphasize that examiners will apply a balanced approach in evaluating loans. This guidance was issued subsequent to the October 30, 2009, Policy Statement on Prudent Commercial Real Estate Workouts that encourages banks to restructure loans for commercial real estate mortgage customers experiencing difficulties making payments. The CRE Workouts Guidance reinforces long-standing supervisory principles in a manner that recognizes pragmatic actions by lenders and small business borrowers are necessary to weather this difficult economic period.

The FDIC also joined the other banking agencies in issuing the Interagency Appraisal and Evaluation Guidelines on December 2, 2010, to clarify expectations for real estate appraisals. Clarification of these guidelines was important for the industry given changes in property values over the past several years. We do not require banks to recognize losses on loans solely because of collateral depreciation or require appraisals on performing loans unless an advance of new funds is being contemplated. Moreover, the interagency guidance recognizes that borrowers' ability to repay real estate loans according to reasonable terms remains the primary consideration in a lending decision.

We also actively engage with community banks at the state level and nationally through various trade associations, which helps our agency articulate its supervisory expectations on important issues through a variety of forums. For example, the FDIC established an Advisory Committee on Community Banking to provide us with advice and guidance on a broad range of policy issues impacting small community banks, as well as the local communities they serve, with a focus on rural areas. The Advisory Committee has provided valuable input on examination policies and procedures, credit and lending practices, deposit insurance assessments, insurance coverage issues, regulatory compliance matters, and obstacles to the continued growth and ability to extend financial services in their local markets. We also sponsor training events for community banks including regional and national teleconferences on risk management and consumer protection matters, as well as Directors Colleges to help bank directors better understand the supervisory process.

The FDIC conducts more than 2,500 on-site examinations annually, and we recognize that questions and even disagreements with individual examination findings may sometimes arise, especially in difficult economic times. The FDIC has a number of outlets for bankers to express their concerns when this occurs. On March 1, we issued guidance reiterating that FDIC-supervised institutions can voice their concerns about an examination or other supervisory determination through informal and formal channels. The FDIC takes pride in the professionalism of its examination force but also strongly encourages banks to provide feedback on FDIC examinations. The guidance highlights that often the most effective method for understanding why the FDIC reached a particular conclusion during its examination is for the bankers to discuss the issue with the examiner-in-charge, field office supervisor, or the appropriate official in the Regional Office.

Addressing Regulatory Burden

The FDIC is interested in finding ways to eliminate unnecessary regulatory burden on community banks, whose balance sheets are much less complicated than those of the larger banks. We continuously pursue methods to streamline our supervisory process through the use of technology and other means to reduce disruption associated with examination activity. While maintaining an effective examination process is paramount, we are sensitive to banks' business priorities and strive to be efficient in our work.

Certain supervisory programs are designed to be less burdensome on small banks compared to the larger, more complex institutions. For example, statutorily mandated examinations are less frequent for certain well-managed, well-capitalized institutions under $500 million in size. There are also fewer reporting requirements for smaller institutions, including Call Report line items and requirements for other reporting. In addition, to make it easier for smaller institutions to understand the impact of new regulatory changes or guidance, we specifically note upfront in our Financial Institution

Letters (the vehicle used to alert banks to any regulatory changes or guidance) whether the change applies to institutions under $1 billion. Finally, there are less burdensome requirements for smaller institutions in their implementation of the Community Reinvestment Act.

As we testified before this Subcommittee in April, much of the Dodd-Frank Act should have no direct impact on community banks, and certain changes in the Act provide benefits. For example, the Act permanently increased deposit insurance coverage to $250,000 and made changes in the assessment base that will result in significantly lower premiums for most banks under $10 billion in assets. Further, provisions of the Act that impose additional capital and other heightened prudential requirements on the largest financial institutions are aimed at reducing systemic risks. Those and other provisions of the Act should do much to return competitive balance to the marketplace by restoring market discipline and ensuring appropriate regulatory oversight of systemically important financial companies.

Finally, the Dodd-Frank Act should help level the playing field with non-banks as they will now be required to meet the same standards as banking institutions, especially in the mortgage finance arena. However, it is clear that consumers have come to expect, and depend greatly on, insured institutions to design and offer fair and equitable financial products and services. We believe the public's significant trust in community banks has been fostered by their diligence in maintaining effective consumer protection programs.

Much of the regulatory cost of the Dodd-Frank Act will fall, as it should, directly on the large institutions that create systemic risk. The leveling of the competitive playing field will help preserve the essential diversity of our financial system, and prevent any institution from taking undue risks at the expense of the public.

Conclusion

The FDIC understands the significant challenges faced by banks and their borrowers as the real estate markets and the financial sector recover from the dislocations that precipitated the crisis. The FDIC has made supervisory enhancements that address the lessons learned from the recent crisis and organizational changes to implement our new responsibilities from the Dodd-Frank Act. The FDIC has joined with other federal financial regulators in encouraging lenders to continue making prudent loans and working with borrowers experiencing financial difficulties. As the primary federal regulator for most community banks, the FDIC recognizes their critical role in helping local businesses fuel economic growth and we support their efforts to make good loans in this challenging environment.

Thank you and I would be pleased to answer any questions.

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1 Noncurrent loans are those that are 90 or more days past due or are on nonaccrual.

2 In merger-adjusted growth analysis, loan balances reported by banks with assets less than $1 billion in the current quarter are compared with these same institutions' loan balances in a prior period. Prior-period loan balances include those of any institutions merged or acquired in intervening periods.

3 Throughout this testimony, for purposes of data analysis, community banks are defined as banks and thrifts with total assets of less than $1 billion.

Last Updated 6/15/2011