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Statement of

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Introduction

Chairman Moore, ranking member Biggert, and members of the committee, I appreciate the opportunity to appear before you today to discuss trends in the commercial real estate (CRE) sector and other issues related to the condition of the banking system. First, I will discuss the condition of financial markets generally and of the banking system. I will then describe current conditions in commercial real estate markets (and the Chicago area specifically). Next I will outline Federal Reserve activities to enhance liquidity and improve conditions in financial markets to support the flow of credit to households and businesses, including certain activities that have a direct impact on CRE markets. Finally, I will discuss the ongoing efforts of the Federal Reserve to promote credit availability and ensure a balanced approach is taken when reviewing banks' credit activities.

Background

The Federal Reserve has supervisory and regulatory authority for bank holding companies (BHCs), state-chartered banks that are members of the Federal Reserve System (state member banks), and certain other financial institutions and activities. We work with other federal and state supervisory authorities to ensure the safety and soundness of the banking industry, foster stability of the financial system, and provide for the fair and equitable treatment of consumers in financial transactions. While the Federal Reserve is not the primary federal supervisor for the majority of commercial banks, it is the consolidated supervisor of BHCs, including financial holding companies, and conducts inspections of those institutions.

Under existing law, the primary purpose of inspections is to ensure that the holding company and its nonbank subsidiaries do not pose a threat to the BHC's depository subsidiaries. In fulfilling this role, the Federal Reserve is required to rely to the fullest extent possible on information and analysis provided by the appropriate supervisory authority of the BHC's depository, securities, or insurance subsidiaries. The Federal Reserve is also the primary federal supervisor of state member banks, sharing supervisory responsibilities with state agencies. In this role, Federal Reserve supervisory staff regularly conduct on-site examinations and off-site monitoring to ensure the safety and soundness of supervised state member banks.

The Federal Reserve is involved in both regulation, establishing the rules within which banking organizations must operate, and supervision, ensuring that banking organizations abide by those rules and remain safe and sound. Because rules and regulations in many cases cannot reasonably prescribe the exact practices each individual bank should use for risk management, supervisors set out policies and guidance that expand upon requirements set in rules and regulations and establish expectations for the range of acceptable practices. Supervisors rely extensively on these policies and guidance as they conduct examinations and assign supervisory ratings.

Beginning in the summer of 2007, the U.S. and global economies entered a period of intense financial turmoil that has presented significant challenges for the financial services industry. These challenges intensified in the latter part of 2008 as the global economic environment weakened further. As a result, parts of the U.S. banking system have come under severe strain, with some banking institutions suffering sizable losses. The number of bank failures continues to rise, with some 140 banks having failed in 2009, and 67 more in the first four months of 2010.

Conditions in Financial Markets and the Economy

Supported by stimulative monetary and fiscal policies and the concerted efforts of policymakers to stabilize the financial system, a recovery in economic activity appears to have begun in the second half of last year. However, significant restraints on the pace of the recovery remain, including weakness in both residential and nonresidential construction and the poor fiscal condition of many state and local governments. In addition, the labor market has been particularly hard hit by the recession.

Financial markets have improved considerably in recent months. Conditions in short-term credit markets have continued to normalize, and spreads in bank funding markets and the commercial paper market have returned to near pre-crisis levels. However, recent developments in Europe have introduced a new element of uncertainty. In light of the many improvements noted, the Federal Reserve has largely wound down the extraordinary liquidity programs that it created to support financial markets during the crisis.

Despite stronger financial positions, banks' lending to both households and businesses has continued to fall. The decline in large part reflects sluggish loan demand and the fact that many potential borrowers no longer qualify for credit, both results of a weak economy. The high rate of write-downs has also reduced the quantity of loans on banks' books. Banks have also been conservative in their lending policies, imposing tough lending standards and terms; this caution reflects bankers' concerns about the economic outlook and uncertainty about their own future losses and capital positions.

Although bank credit remains tight, there are some positive signs. Economic activity has continued to strengthen. In addition, senior loan officers have indicated that, at least outside of CRE, they anticipate a modest reduction in their troubled loans over the coming year. As a result, bank attitudes toward lending may be shifting. In the Senior Loan Officer Opinion Survey conducted in April, most banks reported unchanged lending standards over the previous three months. For the first time since the crisis began in the summer of 2007, banks reported no net tightening of lending standards for small businesses.[1]

Performance of the Banking System

By some measures, the financial condition of banking firms has strengthened markedly during recent quarters. Last spring, the Federal Reserve and other banking regulators evaluated the nation's largest bank holding companies under the Supervisory Capital Assessment Program, popularly known as the stress test. The release of the stress test results significantly increased market confidence in the

[1] See Board of Governors of the Federal Reserve System (2010), April 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices, www.federalreserve.gov/boarddocs/SnLoanSurvey/201005/default.htm.

banking system. Greater investor confidence in turn allowed the banks to raise substantial amounts of new equity capital and, in most cases, to repay government capital.

On the other hand, loan quality has continued to deteriorate at banking institutions. For example, during the fourth quarter of 2009 (the most recent period for which data are available), nonperforming assets at the 50 largest U.S. bank holding companies continued to climb. This raised the ratio of nonperforming assets to 5.1 percent of loans and other real estate owned on bank balance sheets. The most rapid deterioration in asset quality occurred in first-lien mortgages due to higher loan modifications and a backlog in foreclosures. Small and mid-size banks are experiencing similar difficulties.

Credit losses at U.S. banking organizations also continue to rise, and banks face risks of sizable additional credit losses given the likelihood that employment will take some time to recover. In addition, while housing prices appear to have stabilized in recent months, foreclosures and mortgage loss severities are likely to remain elevated. Moreover, the values of both existing commercial properties and land have declined almost 40% on average but are showing some preliminary signs of stabilization. Thus, while the largest portion of the value decline may be behind us, it is not certain that values will begin to rise again sharply in the foreseeable future. CRE values tend to lag the overall economy on both the up and down sides.

In the aggregate, Illinois banks experienced net losses for most of 2009, even though declining interest margins stabilized in the second half. (Interest margins are particularly important for small and mid-size institutions, as they are an important source of retained earnings that add to a bank's capital and can be used to offset credit losses.) In recent quarters, nonperforming loans and loan-loss provision expenses rose rapidly at Illinois institutions. While Illinois banks did make significant additions to their loan-loss reserves, the gains were outpaced by the increase in nonperforming loans. Capital ratios have been declining for the past three years, due largely to continued net losses. Since the financial crisis began, 35 Illinois institutions have failed, accounting for nearly 14 percent of the U.S. total. At present, just over eight percent of U.S. commercial banks are located in Illinois. Most of the failed banks held much larger-than-average concentrations in CRE, which, when the economy slowed, had a quick and adverse impact on bank earnings and capital. Today, Illinois loan portfolios remain concentrated in CRE, with commercial and industrial lending a distant second.

Current Conditions in Commercial Real Estate Markets

Demand for commercial property in the U.S., which is sensitive to trends in the labor market, has declined significantly and vacancy rates have increased. Hit hard by the loss of businesses and employment, an increasing amount of retail, office, and industrial space is standing vacant. In addition, many businesses have cut expenses by renegotiating existing leases. The combination of reduced cash flows and higher rates of return required by investors has lowered valuations, and many existing buildings are selling at a loss. As a result, credit conditions in CRE markets are particularly strained and commercial mortgage delinquency rates have increased rapidly.

The higher vacancy levels and significant decline in the value of existing properties have placed particularly heavy pressure on construction and development projects that do not generate income until after completion. As a result, developers, which typically depend on the sales of completed projects to repay their outstanding loans, are finding their ability to service existing construction loans strained.

Sharp price declines and tighter underwriting standards have frustrated borrowers seeking to refinance the balloon payments on maturing commercial mortgages. As a result many lenders have either extended or re-structured maturing loans; the Federal Reserve has been working with banks to encourage this restructuring where feasible.

In Chicago, CRE conditions are largely dependent on employment trends. With the onset of the financial crisis, job losses in Chicago have been concentrated in professional and business services. As of fourth quarter 2009, metro Chicago's total employment declined 4.3% over the last 12 months, significantly worse than the national decline of 3.5%.[2] By most measures, Chicago's CRE markets have shown adverse trends and performed significantly worse than national averages. Chicago's multifamily market has been adversely affected by contracting employment and additions to supply. For example, during the 2007-09 time period, 30,560 rentable units were added, while net absorption during this period was only 4,978. As a result, the vacancy rate doubled, from 3.7 percent in 2006 to 7.4 percent in 2009. Unsold condominiums reverting to rentals are a particular concern, as Chicago has led the U.S. in condominium construction.

Chicago's hotel sector is also a concern, with significant new supply added at the same time as convention business has declined. From 2006 to 2009, Revenue per Available Room declined from \$85.45 to \$64.90, due in part to 6,622 rooms being added while demand fell sharply. Office, warehouse, and retail space have also experienced declining occupancy and rental rates. For example, from 2006 to 2009, the office vacancy rate rose from 15.4 percent to 18.4 percent (14.8 percent downtown and 23.0 percent suburban). Over the same time period, warehouse vacancy rates rose from 11.6 percent to 14.9 percent. Also over the same time period, retail vacancy rates rose from 8.4 percent to 13.7 percent and average rents fell from \$19.91 to \$15.36.

(It should be noted that the regulatory definition of CRE includes all construction loans, loans secured by nonfarm nonresidential properties, and loans secured by multifamily properties. Therefore it includes 1- to 4-family residential construction loans, which have been severely affected by the housing slump.)

Many community and smaller regional banking firms have built up unprecedented concentrations in CRE loans and will be particularly affected by conditions in real estate markets. For example, these loans make up more than 30 percent of community bank assets and have deteriorated sharply as fundamentals in property markets have weakened. Performance problems have been most striking in

[2] All Chicago market data are from CBRE Econometric Advisors, Spring 2010 reports covering Chicago CRE submarkets.

construction and development loans, especially for those that finance residential development, but have been significant in other loan segments as well. Problem CRE loans represent a significant proportion of total CRE loans and of capital at a number of smaller banking organizations.

The Federal Reserve has been focused on CRE exposures at supervised institutions for some time. In response to rising CRE concentrations (especially in some regional and community banking firms in the early part of this decade) and in light of the central role CRE loans played in the banking problems of the late 1980s and early 1990s, we led an interagency effort to develop supervisory guidance on CRE concentrations. The guidance was proposed and finalized in 2006 and published as final in the Federal Register in early December 2006.[3] In that guidance, we emphasized our concern that some institutions' strategic- and capital-planning processes did not adequately recognize the risks arising from their CRE concentrations. We also outlined our expectations that institutions with concentrations in CRE lending needed to perform ongoing assessments to identify and manage concentrations through stress testing and similar exercises to identify the impact of adverse market conditions on earnings and capital.

As weaker housing markets and deteriorating economic conditions have impaired the quality of CRE loans at supervised banking organizations, the Federal Reserve has devoted increasing resources to assessing the quality of CRE portfolios at regulated institutions. These efforts include monitoring the impact of declining cash flows and collateral values on CRE portfolios. Federal Reserve examiners in Districts most adversely affected have been particularly focused on evaluating exposures arising from CRE lending.

Federal Reserve examiners are reporting a sharp deterioration in the credit performance of loans in banks' portfolios and loans in commercial mortgage-backed securities (CMBS). Of the approximately $3.5 trillion of outstanding debt associated with CRE, including loans for multifamily housing developments, about $1.8 trillion was held on the books of banks and thrifts, and an additional $900

[3] See Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation (2007), "Interagency Guidance on Concentrations in Commercial Real Estate," Supervision and Regulation Letter SR 07-1 (January 4), www.federalreserve.gov/boarddocs/srletters/2007/SR0701.htm.

billion represented collateral for CMBS, with other investors holding the remaining balance of $800 billion. Of note, more than $600 billion of CRE loans will mature each year over the next few years. In addition to losses caused by declining property cash flows and deteriorating conditions for construction loans, losses will also be boosted by the depreciating collateral values underlying those maturing loans, although supervisors, when assessing creditworthiness, are focusing on the cash-generating capacity of the properties and not just on collateral values. Nevertheless, these losses will place continued pressure on banks' earnings, especially those of smaller regional and community banks that have high concentrations of CRE loans.

Federal Reserve Activities to Help Revitalize Credit Markets

The Federal Reserve has taken a number of actions to strengthen the financial sector and to promote the availability of credit to businesses and households. In addition to aggressively lowering short-term interest rates, the Federal Reserve has established a number of facilities to improve liquidity in financial markets. One such program is the Term Asset-Backed Securities Loan Facility (TALF), a joint Federal Reserve – Treasury program that was begun in November 2008 to facilitate the extension of credit to households and small businesses.

Before the crisis, securitization markets were an important conduit of credit to the household and business sectors. Securitization markets (other than those for mortgages guaranteed by the government) essentially shut down in mid-2008, and the TALF was developed to promote renewed issuance. Under the TALF, eligible investors may borrow to finance purchases of the AAA-rated tranches of various classes of asset-backed securities. The program originally focused on credit for households and small businesses, including auto loans, credit card loans, student loans, and loans guaranteed by the Small Business Administration. The program was broadened to allow investors to use the TALF to purchase both existing and newly issued CMBS, which were included to help mitigate the refinancing problem in that sector.

The TALF has been successful in helping restart securitization markets. Issuance has resumed, and rate spreads for asset-backed securities have declined substantially, an indication that risk premiums are compressing. In addition, a substantial fraction of Asset Backed Securities (ABS) is now being purchased by investors that do not seek TALF financing, and ABS-issuers have begun to bring non-TALF-eligible deals to market.

The current fundamental weakness in CRE markets is exacerbated by the fact that the CMBS market, which previously had financed about 30 percent of originations and completed construction projects, completely shut down for more than a year. Until mid-November 2009, when the first CMBS issuance came to market with financing provided by the Federal Reserve's TALF, essentially no CMBS had been issued since mid-2008. Investor demand for the new issuance was high, in part because of the improved investor protections put in place so that securities would be eligible collateral for TALF loans. In the end, non-TALF investors purchased almost 80 percent of the TALF-eligible securities. Two additional CMBS deals without TALF support came to market shortly after the TALF-finance deal was issued. The first multi-borrower CMBS deal in a year and a half, which also did not apply for TALF financing, was issued in April. All three of these deals were very well received by investors, and several major banks have started warehousing CRE loans for future CMBS issuance, though volumes remain low. Irrespective of these positive developments, market participants anticipate that CMBS delinquency rates on legacy securities will climb higher in the near term and issuance of new securities will be minimal, driven not only by negative fundamentals but also by borrowers' difficulty in rolling over maturing debt.

The TALF program terminated on March 31, 2010, except for loans collateralized by newly issued CMBS, which are authorized until June 30, 2010.

Availability of Credit

In an effort to encourage prudent CRE loan workouts, the Federal Reserve led the development of interagency guidance issued in October 2009 regarding CRE loan restructurings and workouts.[4] This policy statement provides guidance for examiners and for financial institutions that are working with CRE borrowers who are experiencing diminished operating cash flows, depreciated collateral values, or prolonged delays in selling or renting commercial properties, particularly as the loans on those properties mature and need to be refinanced. The statement is especially relevant to small businesses because owner-occupied CRE often serves as collateral for many small business loans.

The Federal Reserve recognizes that prudent loan workouts are often in the best interest of both financial institutions and borrowers, particularly during difficult economic conditions. There has been a significant increase in the use of such loan modifications in non-bank CRE lenders, such as life insurance companies and servicers of CMBS pools. Accordingly, the policy statement details risk-management practices for loan workouts that support prudent and pragmatic credit and business decision-making within the framework of financial accuracy, transparency, and timely loss recognition.

Importantly, at the Federal Reserve we have complemented the guidance with training programs for examiners and outreach to the banking industry to underscore the importance of sound lending practices. From January to April 2010, Federal Reserve staff conducted a System-wide examiner training initiative that reached Federal Reserve and state examiners across the United States. Additionally, an interagency training program was conducted specifically for examiners reviewing CRE loans as part of the interagency Shared National Credit Program, which includes the largest commercial real estate loans in the nation.

We are working hard to track the progress and effectiveness of this guidance. Before issuing the guidance, Federal Reserve staff surveyed examiners to gain a better understanding of the banks' workout

[4] See Interagency Policy Statement on CRE Loan Restructurings and Workouts (November 2009), www.federalreserve.gov/newsevents/press/bcreg/20091030a.htm.

practices. We also are asking examiners to capture, where possible, information on troubled debt restructurings and other types of loan workouts and dispositions as part of the ongoing examination process. In addition, we are exploring the feasibility of more formal statistical approaches for measuring and evaluating the effectiveness of the guidance. We continue to receive and evaluate comments and feedback from supervised banks, and we will consider the need for adjustments if feedback suggests they are needed.

Prudent real estate lending depends upon reliable and timely information on the market value of the real estate collateral. This has been a cornerstone of the regulatory requirements for real estate lending and is reflected in the agencies' appraisal regulations. In that regard, the Federal Reserve requires a regulated institution to have real estate appraisals that meet minimum appraisal standards, including the Uniform Standards of Professional Appraisal Practice, and contain sufficient information to support the institution's credit decision. Over the past several years, the Federal Reserve has issued several appraisal-related guidance documents to emphasize the importance of a bank's appraisal function and the need for independent and reliable appraisals. Most recently, the Federal Reserve and the other federal agencies issued a proposal to revise the Interagency Appraisal and Evaluation Guidelines, which is expected to be finalized in the coming months. These guidelines reinforce the importance of sound appraisal practices.

Given the lack of sales in many real estate markets and the predominant number of distressed sales in the current environment, regulated institutions face significant challenges today in assessing the value of real estate. We expect institutions to have policies and procedures for obtaining new or updated appraisals as part of their ongoing credit review. An institution should have appraisals or other market information that provide appropriate analysis of the market value of the real estate collateral and reflect relevant market conditions, the property's current "as is" condition, and reasonable assumptions and conclusions.

The Federal Reserve has directed examiners to be mindful of the effects of excessive credit tightening in the broader economy, and we have taken steps, including additional examiner training and industry outreach, to underscore these intentions. We are aware that bankers may become overly conservative in an attempt to ameliorate past weaknesses in lending practices, and we are working to emphasize that it is in all parties' best interests to continue making loans to creditworthy borrowers.

As part of our effort to help stimulate appropriate bank lending, the Federal Reserve and the other federal banking agencies issued regulatory guidance in November 2008 to encourage banks to meet the needs of creditworthy borrowers, including small businesses.[5] The guidance was issued to encourage bank lending in a manner consistent with safety and soundness -- specifically, by taking a balanced approach in assessing borrowers' abilities to repay and making realistic assessments of collateral valuations.

On February 5 of this year, the banking agencies issued guidance to examiners that reinforced the points that institutions should strive to meet the credit needs of creditworthy small business borrowers and that the supervisory agencies will not hinder those efforts.[6] For the reasons noted earlier, we recognize that the ongoing financial and economic stress has resulted in a decrease in credit availability, including loans to small businesses, and has prompted institutions to review their lending practices. Although current loss rates would indicate that a measure of tightening was appropriate and necessary, some institutions may have become overly cautious in their lending practices. Thus, while prudence must remain the watchword for both banks and their supervisors, we do not want our examiners to take an overly mechanistic approach to evaluating small business lending. So far, we have not seen evidence that this is a widespread problem among our examiners.

[5] See Board of Governors of the Federal Reserve System, FDIC, Office of the Comptroller of the Currency, and Office of Thrift Supervision (2008), “Interagency Statement on Meeting the Needs of Creditworthy Borrowers,” joint press release, November 12, www.federalreserve.gov/newsevents/press/bcreg/20081112a.htm.

[6] See Board of Governors of the Federal Reserve System (2010), “Regulators Issue Statement on Lending to Creditworthy Small Businesses,” press release, February 5, www.federalreserve.gov/newsevents/press/bcreg/20100205a.htm.

Conclusion

While financial market conditions have improved in the United States, the overall environment remains under stress, and some geographic areas (including Chicago) are experiencing more difficulty than others. The Federal Reserve, working with the other banking agencies, has taken strong action to ensure that the banking system remains safe and sound and is able to meet the credit needs of our economy. We also have aggressively pursued monetary policy actions and have provided liquidity to help restore stability to the financial system and support the flow of credit to households and businesses. In our supervisory efforts, we are mindful of the risk-management deficiencies at banking institutions revealed by the financial crisis and are ensuring that institutions develop appropriate corrective actions.

It will take some time for the banking industry to work through this current set of challenges and for the financial markets to fully recover. In order to promote credit availability, the Federal Reserve is encouraging banks to deploy capital and liquidity in a responsible way that avoids past mistakes and does not create new ones. The Federal Reserve is committed to working with other banking agencies and the Congress to promote the concurrent goals of fostering credit availability and a safe and sound banking system.