

A Tough Year for the Banking Industry



Banking Supervision and Regulation

Banking Supervision and Regulation staff assess the impact of the economic and financial environment on the banking industry and, since the crisis began, have been facilitating institutions' access to government and Federal Reserve relief programs. Supervisory staff's perspectives on banking conditions and the industry's risk management capabilities help Credit and Risk Management staff manage the increased activity at the discount window and contribute to monetary policy decisions and policy responses to the crisis.

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The year 2008 was the most challenging one in decades for the nation's banking industry. As a whole, the industry's \$16.1 billion annual profit was the lowest since 1990, mostly because of sharply higher expenses for bad loans. Some banks didn't survive the year. In fact, failures and assistance transactions among institutions insured by the Federal Deposit Insurance Corporation (FDIC) nationwide reached a 15-year high of 30, with the assets of these institutions totaling \$1.7 trillion. In addition, by year-end 2008, 252 institutions were on the FDIC's "problem list"—those with the worst supervisory ratings—up dramatically from 76 at year-end 2007.

Banking organizations with significant exposure to the housing sector—typically through residential mortgages, home construction loans, or investments in related securities—experienced the greatest deterioration in financial performance. Asset quality and profits at these institutions suffered severely when home mortgage borrowers, building contractors, and land developers couldn't make loan payments and when the value of mortgage-related securities plummeted.

Moreover, turmoil in financial markets and shaken confidence among depositors created funding problems across a broad range of banking organizations, even for those without investments in the housing sector. Some banking companies couldn't maintain the stable deposit base they needed to sustain their operations, and the breakdown in financial markets forced institutions that relied on those markets to scramble for alternative funding, which sometimes was available only at a very high price.

Banking Performance in the Twelfth District

While several of the Twelfth District's banking organizations have significant mortgage lending operations, many more provided construction financing to support the housing boom that occurred over the past several

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years. In fact, quite a few of the District's community banks are concentrated in lending or other activities related to the housing sector. When residential real estate markets started to sour in 2007, the performance of those banks began to suffer. With the broader weakening of the economy and financial market turmoil in 2008, loan quality and earnings deterioration escalated, and some banks faced a liquidity crisis when nervous customers started to draw down deposits or close their accounts altogether.

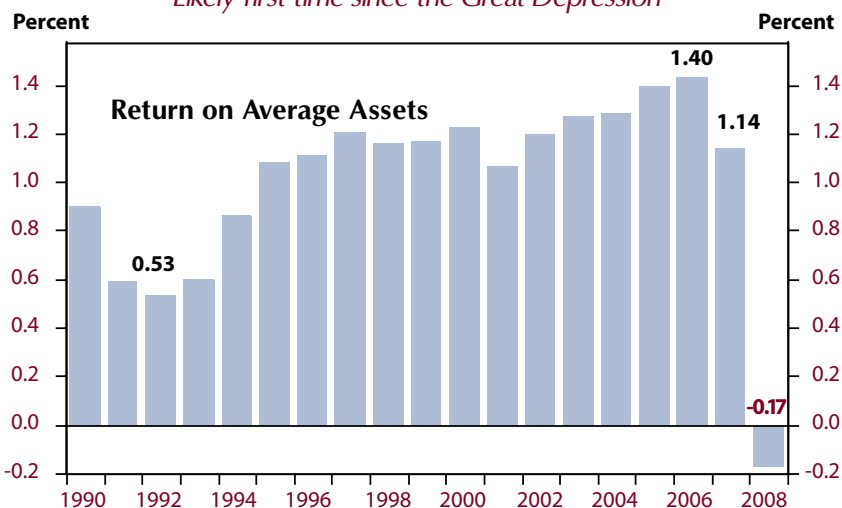
Adjusting Supervisory Programs

The Federal Reserve Bank of San Francisco's Division of Banking Supervision and Regulation promotes the safety and soundness of the banking system and upholds compliance with regulations. The Division's risk-focused supervision program emphasizes credit, market, liquidity, operational, reputational, and legal risks in the region's banking organizations. At year-end 2008, the Division's portfolio of institutions included 240 bank holding companies, 45 state-chartered banks that are members of the Federal Reserve, and the U.S. operations of foreign banking organizations from 24 different countries. Division staff supervise these institutions through a combination of on-site examinations (conducted in the institutions' offices) and off-site work (conducted at the Reserve Bank). Examples of activities include evaluating risk management processes and internal controls, monitoring financial performance and relevant market conditions, reviewing loan documentation and internal management reports, meeting with an institution's management to discuss identified issues, evaluating applications to expand operations, and initiating supervisory enforcement actions for troubled institutions. The Division closely coordinates its supervisory activity with the appropriate banking agencies and other regulatory bodies.

Starting in late 2007, faced with sharply deteriorating banking conditions in the

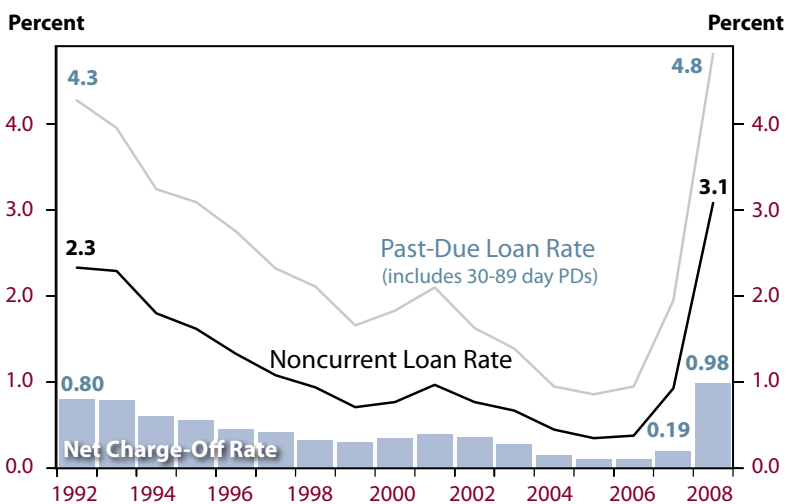
On Average, District Banks Slipped into the Red in 2008

Likely first time since the Great Depression



All commercial banks excluding those less than 3 years old; averages adjusted for outliers

District Loan Quality Metrics Are Worse Than Peaks of Prior Downturn in 1992



All commercial banks excluding those less than 3 years old; averages adjusted for outliers

region, the Division made several adjustments to the supervisory program. Most significantly, many bank examinations were accelerated or extended where problems were developing rapidly. Additionally, supervisory staff intensified activities to complement examinations including enhancing off-site monitoring and real-time on-site funding and liquidity monitoring. Staff also worked closely with the FDIC to monitor and develop resolutions for troubled banks. In addition, the Division communicated to the banking industry the critical importance of strong funding and liquidity risk management and capital planning in the current environment. Industry consolidation resulted in another significant program change, as the largest banking organization in the District's portfolio completed a major acquisition that substantially expanded its presence across the country.

Implementing Governmental Programs to Combat the Financial Crisis

As a supervisor of banking organizations, the Division is playing a critical role helping financial institutions take advantage of Federal Reserve and governmental support programs during the financial crisis. Such programs include not only the Federal Reserve's various lending facilities, but also the U.S. Treasury's Troubled Asset Relief Program (TARP), the FDIC's Temporary Liquidity Guarantee Program (TLGP), and elements of the Treasury's Financial Stability Plan.

For TARP, which offers infusions of capital to qualified institutions, the Division worked on the U.S. Treasury's behalf to guide many District banking companies through the application process. Some received capital in 2008, while processing continued for others into

2009. For TLGP, which provides the FDIC's guarantee on certain debt instruments and non-interest-bearing transaction accounts, the Division counseled institutions about participation in the program and consulted with the FDIC as it reviewed requests for exceptions to rules and guarantee limits.

For the U.S. Treasury's Financial Stability Plan, announced in February 2009, Division staff are participating in the comprehensive stress test of the country's largest banking organizations. The stress test is intended to enhance overall financial stability by ensuring that these institutions have enough capital to withstand a more severe decline in the economy than projected. In addition, the Division will support the Treasury's Capital Assistance Program, which is expected to be similar to the TARP process discussed earlier.

Looking Ahead

As problems that began in the housing sector spilled over into the broader economy, so have banking performance weaknesses related to housing spread into other lines of bank business including commercial real estate, corporate, and consumer lending. Commercial real estate weakness is a particular concern for the Twelfth District because most banks have lending concentrations in that sector. Recessionary effects normally take some time to work their way through loan portfolios—and because financial markets are not yet fully functioning, the lag this time around could be even longer. Going forward, the Division will continue to support the banking industry's recovery by working with individual organizations to address governance and risk management challenges and by facilitating use of policy tools designed to repair the financial system. ■