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The Condition of the Banking Industry

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Summary

After six years of continuous record-breaking profits, the effects of the deepening subprime mortgage are showing their negative impact on the U.S. banking industry's profits. On a quarterly basis, net income of Federal Deposit Insurance Corporation (FDIC)-insured commercial and savings institutions declined by $9.4 billion (24.7%) from the third quarter of 2006. In the first three quarters of 2006, these institutions earned $112.404 billion as compared to $100.732 billion in 2007, a decline of more than 10%. Last year, FDIC-insured banks earned a record $146 billion (see **Table 2**, column 4). With expected significantly poorer earnings for the rest of the year, profitability for 2007 is expected to fall short of 2006 due mainly to subprime mortgage foreclosures.

The industry, however, continues to be more concentrated with fewer small banking institutions, which could lead to higher prices for bank services. Smaller banks are less able to garner cheaper funds for lending from wholesale markets and are less able to mitigate their credit and interest rate risks through participation in securitization and syndication markets. Even though the subprime crisis has limited large institutions' access to funding, smaller banks remain more vulnerable to the increased indebtedness of borrowers and stricter lending requirements. The three largest banking institutions have assets in the range of $1 trillion each. Their combined assets represent 30% of FDIC-insured banks. The next four banks hold another 13% of these assets, and the top 25 banks hold more than 50% of the assets of FDIC-insured banks. As a result of mergers and acquisitions, at the end of the third quarter of 2007, on net, there were 183 fewer commercial and savings institutions than there were at the end of the third quarter of 2006.

Since many smaller institutions were not active in the subprime and the derivatives markets, the data show that noncurrent assets on smaller institutions' books are higher than those of larger institutions (**Table 1,** column 8). Furthermore, despite the overall growth in deposits in the banking system, deposits at smaller banks continue to decline as deposits at the larger banks continue to grow. Between September 30, 2006, and September 30, 2007, deposits at large commercial banks grew 12.0%, and those for small commercial banks declined 4.2%. Similarly, in the same period while deposits grew at large savings institutions, they declined for the smaller savings institutions. In the first three quarters of 2007, the data (not shown in the Tables) suggest that deposits at larger institutions are growing at a slower rate than the first half of 2006, while deposits continue to decline at smaller institutions.

This report is a brief assessment of the condition of the U.S. banking industry using selected FDIC data for the three quarters of 2006, year-end of 2006, as well as the first three quarters of 2007. The assessment suggests that there are signs of weakening profitability, particularly among larger institutions. At the same time, even though equity capital remained strong in both small and large banks, smaller banks continue to remain less profitable and therefore at great risk of failure or takeovers.

This report will be updated as developments warrant.

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The Bottom Line

For the sixth year in a row, profits in the U.S. banking industry have been breaking records. However, this year the streak seems to be coming to an end. For the first three quarters of 2007 (**Table 1,** column 4), the industry reported net income of $100.7 billion. The industry earned $11.7 billion (10%) less than it earned in the first three quarters of 2006 (**Table 3,** column 4), a significant sign of the beginning of a profit slowdown. For the second quarter in a row, fewer than half the banks reported an increase in net income. The average return on assets for the first three quarters of 2007 was 0.92%, down considerably from the 1.33% in the first three quarters of 2006 and 1.28% for December 31, 2006. The decline in earnings was due primarily to increased provisions for loan losses and increased non-interest expenses partly related to the subprime mortgage crisis.[1]

Even though bank profits were strong for the first three quarters of 2007, in the third quarter profits declined. The historically high profits were attributable to the low-interest-rate environment that has held since 2001, despite the Federal Reserve Board's (Fed's) policy of raising and lowering interest rates recently. Specifically, mortgage lending and non-interest income were the major contributors to the profitability of banking, mainly because of application and servicing fees. However, by the third quarter of 2007, net income of FDIC-insured commercial banks and savings institutions declined $9.4 billion (24.7%) from the third quarter of 2006. Residential real estate accounts for more than half the increase in noncurrent loans rising by $7.5 billion (27%), while noncurrent home equity loans rose by $783 million (27%). Noncurrent loans are growing in other real estate-related sectors such as real estate construction and development loans, real estate loans secured by nonfarm nonresidential properties, and commercial and industrial loans. Consequently, the return on assets declined from 1.33% at the end of the first three quarters of 2006 to 0.92% at the end of the first three quarters of 2007.

Like profitability at the end of 2001, a period of slow growth, which had a greater impact on larger banking institutions, the current weaker profitability in the first three quarters of 2007 seems to be having a greater impact on the larger banks more than on the smaller ones. **Table 1,** column 5, shows that return on assets for banks with assets greater than $10 billion was 1.16%. For commercial banks with assets less than $100 million it was 0.92%. For 2006, **(Table 2,** column 5) shows the

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[1] For detailed analyses of the subprime crisis, see CRS Report RL34182, *Financial Crisis? The Liquidity Crunch of August 2007,*by Darryl E. Getter, Edward Vincent Murphy, Marc Labonte, and Mark Jickling, September 21, 2007, and CRS Report RS22722, *Securitization and Federal Regulation of Mortgages for Safety and Soundness,* by Edward Vincent Murphy, September 17, 2007.

respective figures of 1.39% and 1.03%. The negative change in the return on assets in 2007 is greater for the larger institutions (0.23%) than for the smaller ones (0.11%), which could be explained by smaller banks not participating as heavily in the asset-backed securities and derivatives markets. These tables also show that larger savings institutions are experiencing a greater decline in their return on assets than the smaller savings institutions, with the exception of the 20 very small savings institutions with less than $100 million in assets. Like the commercial banks, the large savings institutions were heavily involved in subprime lending and asset-backed securities.

Table 1. First Three Quarters of 2007, FDIC-Insured Institutions' Numbers, Assets, Profits, Equity Capital Ratios, and Noncurrent Assets (2001 and 2007)

Institutions	# of Inst. 2007	Total Assets (bil. $) 2007	Total Profits (mil. $) 2007	Return on Assets, % 2007	Equity Capital Ratios, % 2007	Non-current Assets to Total Assets 2001	Non-current Assets to Total Assets 2007
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Commercial Banks	**7,303**	**10,793**	**90,184**	**1.17**	**10.20**	**0.97**	**0.67**
Greater than $10 billion	84	8476	70,859	1.16	9.93	1.00	0.62
$1 billion to $10 billion	415	1,100	9,429	1.17	11.56	0.73	0.82
$100 million to $1 billion	3,673	1,050	8,777	1.15	10.39	0.73	0.92
Less than $100 million	3,131	167	1118	0.92	13.37	0.81	0.87
Savings Institutions	**1,257**	**1,914**	**10,549**	**0.77**	**11.86**	**0.66**	**1.06**
Greater than $5 billion	32	1,340	8068	0.79	12.06	0.53	1.12
$1 billion to $5 billion	124	308	1138	0.74	10.66	0.79	1.02
$100 million to $1 billion	719	246	1301	0.71	11.34	0.60	0.76
Less than $100 million	382	20	42	0.29	16.42	0.78	0.91
Total/Weighted Averages	**8,560**	**12,707**	**100,732**	**.92**	**10.45**	**0.77**	**0.73**

Source: FDIC *Quarterly Banking Profile*, Tables II-A, II-B, IV-A, IV-B, for the Full Year 2001 and 2007. Available at [http://www2.fdic.gov/qbp/2007sep/all2a.html], [http://www2.fdic.gov/qbp/2001dec/all2.html], and [http://www2.fdic.gov/qbp/2007sep/sav3.html]. Visited on December 18, 2007

On the positive side, the safety and soundness of the industry as measured by bank equity capital — the owners' money that is the first line of defense against

bank failure — has also been strong. Equity capital, however, has declined slightly in the most recent quarters as a result of declining profits and the necessity of building reserves against future defaulting assets and foreclosures. **Table 1** shows the equity capital ratio for all FDIC-insured institutions is 10.45%, which was 0.01% less than it was at the end of the first three quarters of 2006, but 0.07% less than it was at the end of 2006. Still, these levels of equity capital are near record levels. For example, on December 31, 2001, the equity capital was 9.09, which was high then.

Table 2. December 31, 2006, FDIC-Insured Institutions' Numbers, Assets, Profits, Equity Capital Ratios, and Noncurrent Assets (2001 and 2006)

Institutions	# of Inst. 2006	Total Assets (bil. $) 2006	Total Profits (mil. $) 2006	Return on Assets, % 2006	Equity Capital Ratios, % 2006	Non-current Assets to Total Assets 2001	Non-current Assets to Total Assets 2006
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Commercial Banks	**7,402**	**10,090**	**128,640**	**1.33**	**10.21**	**0.97**	**0.51**
Greater than $10 billion	88	7,804	101,011	1.35	10.05	1.00	0.50
$1 billion to $10 billion	406	1,076	13,741	1.35	10.99	0.73	0.51
$100 million to $1 billion	3,662	1,040	12,328	1.24	10.21	0.73	0.60
Less than $100 million	3246	170	1,560	0.95	12.74	0.81	0.72
Savings Institutions	**1,279**	**1,770**	**17,071**	**1.00**	**12.31**	**0.66**	**0.63**
Greater than $5 billion	46	1,283	13,045	1.06	12.75	0.53	0.63
$1 billion to 5 billion	109	217	1,650	0.79	10.74	0.79	0.65
$100 million to $1 billion	737	250	2,227	0.88	11.15	0.60	0.57
Less than $100 million	387	20	149	0.78	15.58	0.78	0.79
Total/Weighted Averages	**8,681**	**11,860**	**145,711**	**1.28**	**10.52**	**0.77**	**0.53**

Source: FDIC *Quarterly Banking Profile*, Tables II-A, II-B, IV-A, IV-B, for the Full Year 2001 and 2006. Available at [http://www2.fdic.gov/qbp/2006dec/all2a.html], [http://www2.fdic.gov/qbp/2001dec/all2.html], and [http://www2.fdic.gov/qbp/2006dec/sav3.html]. Visited on December 18, 2007.

The Risk Considerations

The appropriate level of equity capital depends on the total risk, including credit and interest rate risk, in the banking institutions' asset portfolios. Meeting

and even exceeding capital requirements are easier when the industry is making record profits. Today, bank capital is higher than it was in 2004. That level was the highest since 1938.[2] As some analysts argue, regulatory capital compliance gets cheaper as profits grow. But, the combination of the subprime liquidity crisis and the deterioration in macroeconomic conditions exposes the banking industry to increased portfolio risks.

Table 3. First Three Quarters of 2006, FDIC-Insured Institutions' Numbers, Assets, Profits, Equity Capital Ratios, and Noncurrent Assets (2001 and 2006)

Institutions	# of Inst. 2006	Total Assets (bil. $) 2006	Total Profits (mil. $) 2006	Return on Assets, % 2006	Equity Capital Ratios, % 2006	Non-current Assets to Total Assets 2001	Non-current Assets to Total Assets 2006
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Commercial Banks	**7,450**	**9,765**	**96,748**	**1.37**	**10.36**	**0.97**	**0.48**
Greater than $10 billion	87	7,464	75,121	1.39	10.15	1.00	0.46
$1 billion to $10 billion	401	1,095	10,751	1.35	11.52	0.73	0.45
$100 million to $1 billion	3,631	1,032	9,563	1.28	10.29	0.73	0.58
Less than $100 million	3,331	174	1,313	1.03	12.75	0.81	0.72
Savings Institutions	**1,293**	**1,992**	**15,658**	**1.10**	**11.91**	**0.66**	**0.58**
Greater than $5 billion	33	1,387	12,645	1.19	10.89	0.53	.59
$1 billion to $5 billion	123	333	1,278	0.83	10.51	0.79	0.59
$100 million to $1 billion	738	252	1,606	0.87	11.14	0.60	0.46
Less than $100 million	399	20	129	0.86	15.41	0.78	0.72
Total/Weighted Averages	**8,743**	**11,758**	**112,406**	**1.33**	**10.46**	**0.77**	**0.49**

Source: FDIC *Quarterly Banking Profile*, Tables II-A, II-B, IV-A, IV-B, for the Full Year 2001 and 2006. Available at [http://www2.fdic.gov/qbp/2007sep/all2a.html], [http://www2.fdic.gov/qbp/2001dec/all2.html], and [http://www2.fdic.gov/qbp/2007sep/sav3.html]. Visited on December 18, 2007.

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[2] The Comptroller of the Currency speaking about nationally chartered banks said, "Today, all national banks, with the exception of a few small banks under special supervision, have risk-based capital ratios [capital divided by total assets] above 8 percent [the regulatory requirement] and more than 90 percent of national banks have risk-based capital ratios above 10 percent." Testimony of the Comptroller of the Currency, John D. Hawke, in U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *An Examination of the Condition of the Banking and Credit Union Industry*, April 20, 2004, p. 9, at [http://banking.senate.gov/_files/ACF23F.pdf]. Visited May 20, 2005.

The rapid growth in bank profits was generated as a result of the healthy growth of the economy in the beginning of 2006 (real GDP grew 5.6% in the first quarter but only 3.4% year-over-year). The slower rate of economic growth (the consensus forecast is for about 2.5% growth in 2008) may increase the industry's exposure to credit risk.

Credit Risk

Credit risk is the risk that borrowers may fail to fully make the obligated payments of their loans. In short, credit risk is the probability of default. Credit risk is highly correlated with interest rate risk because higher interest rates tend to reduce borrowers' available income and increase the probability of default as borrowers take on new loans with higher required payouts.[3] The level of consumer indebtedness is a major credit risk factor. Total household indebtedness is at an historic high. Total outstanding household liabilities have reached almost $12 trillion. Mortgage debt accounted for 73.1% of total outstanding debt in 2006.[4] In 1990, it accounted for 67.3% of total household debt. In the mid-1980s, total household debt was roughly 70% of household annual after-tax income. In 2006, that proportion had risen to more than 120%.[5] Rising household indebtedness has raised concerns about the sustainability of the growth in consumer spending, which accounts for 70% of the gross domestic product (GDP). Since interest rates are beginning to rise, banks have been seeing a rise in noncurrent loans because households now have a greater exposure to rising variable-rate consumer loans and adjustable mortgages. In the three Tables, column 8, noncurrent assets to total assets went from 0.49% to 0.73% between the first three quarters of 2006 to the first three quarters of 2007. It is now almost as high as the 0.77% that was reached in the 2001 recession (**Table 1**, column 7). Some borrowers with weaker credit histories and balance sheets are clearly experiencing problems meeting their obligations.

Interest Rate Risk

Rising market interest rates is the main source of bank losses due to interest rate risk. The following example illustrates the problem. Suppose a bank makes a two-year, $1 million loan for which it charges 10% interest per annum. And, the bank faces the choice of market financing of the loan with a two-year time deposit at 9% per annum or with a one-year time deposit at 8% per annum.[6] The 9% choice would result in $10,000 in certain interest earnings for each of the two years for a total of $20,000. However, if the bank chooses the one-year financing, it will earn

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[3] See Stuart I. Greenbaum and Anjan V. Thakor, *Contemporary Financial Intermediation* (New York: Dryden Press, 1995), p. 361.

[4] See CRS Report RL30965, *Rising Household Debt: Background and Analysis*, by Brian W. Cashell.

[5] Ibid., p. 6.

[6] Market financing a loan means that the bank borrows the funds it uses for the loan from lenders in the financial market. The bank charges its borrower a higher interest than it pays for those funds in the market.

$20,000 in year one. But its earnings in year two will depend on the currently unknown one-year interest rate that will prevail a year from now. Should the one-year interest rate remain unchanged at 8%, the bank will earn a second year of $20,000 for a total of $40,000. If in the second year the one-year interest rate falls to 5%, the bank would do even better and record a second-year earning of $50,000 for a total of $70,000. But if the market interest rate rises to 13%, the bank would suffer a loss of $30,000 in year two, wiping out all profits plus $10,000, or 50% of the earnings it made in the first year, and it would take an overall loss. This risk could be avoided by choosing the two-year financing of the loan.

The Subprime Credit Crunch

The example above explains a significant part of the cause of the subprime crisis. Banks were taking advantage of the low-interest environment by using short-term funds to finance higher-earning, long-term loans and mortgages. As short-term interest rates move higher, these depository institutions' profits declined. To be more specific, some analysts argue that banks and other financial firms financed their mortgage-backed securities with short-term commercial paper. When the availability of credit became more difficult, drying up the commercial paper market, banking institutions were forced to start writing off their losses in mortgage-backed securities due to a significant drop in purchasers of these securities. With rising short-term rates, the shortage of purchasers made the banks increasingly vulnerable to more loan losses and defaults.

FDIC Chairman, Sheila Bair, in announcing third quarter earnings of FDIC-insured banks and thrifts on November 28, 2007, said that "with more than 1.5 million adjustable rate mortgages scheduled to reset in 2008 and another 375,000 set for 2009, the immediate priority for banks and thrifts is to make it easier for homeowners to refinance, and to prevent as many foreclosures as possible . . . "[7] In their efforts to prevent foreclosures, many institutions have limited new lending in order to build up their loan loss reserves and capital. As a result, some analysts argued that the subprime mortgage crisis has turned into a credit crunch where banks and thrifts cannot afford to expand lending because of the rising expense of preventing foreclosures. For example, the banks have seen their interest income fall in order to allow borrowers to pay lower interest to prevent foreclosures. Since banks try to maintain or increase their capital asset ratio when faced with increasing non-current assets as shown in the tables, banks tend to reduce their mortgage lending to slow the deterioration of their capital positions.

A number of bills that would prevent foreclosures due to the subprime crisis are being debated in Congress. The ones that have been most noted in the press are the Mortgage Forgiveness Debt Relief Act of 2007 (H.R. 3648), the Mortgage Reform and Anti-Predatory Lending Act of 2007 (H.R. 3915), and the Emergency Mortgage Loan Modification Act of 2007 (H.R. 4178). Among other things, H.R. 3648 would exclude forgiven mortgage debt from taxable income. It would allow canceled debt from home equity loans and lines of credit to be excluded as taxable

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[7] Thecla Fabian, "' No Surprises,' But FDIC Q3 Earnings Report Again Highlight Subprime Meltdown Fallout," *BNA Banking Daily,* November 29, 2007, p. 1.

income. H.R. 3915 would require a licensing and registration system for participants in the mortgage finance industry, set new mortgage origination standards, establish rules governing liability for loan assignees and securitizers, lower the points and fee triggers for loans defined as high-cost, and establish a new Office of Housing Counseling at the Department of Housing and Urban Development. H.R. 4178 would offer participants in mortgage debt restructuring a form of "safe harbor" from investors law suits for six months.

The Paulson plan for subprime mortgages modifications is the Bush Administration's subprime mortgage relief plan. Details of this plan were not fully worked out at the time of announcement. But, as outlined by the Secretary of the Treasury at the December 3, 2007 National Housing Forum in Washington, D.C., it would assist subprime borrowers by freezing their mortgage payments at the pre-reset level. These borrowers would have to be current with their adjustable rate mortgages (ARM) but facing substantial rate resets.[8] While the plan would require major subprime lenders, servicers, and investors to buy-into it, critical issues such as how long the frozen payment would last, and what role legislation in Congress would play in preventing investor law suits.

Competition in the Industry

If the subprime crisis were to have an impact on the banking industry competitiveness, it would be to slow the rate of bank concentration. In terms of priorities, the mortgage crisis has moved managing loan losses ahead of mergers and acquisitions. Over the last two decades, the banking industry has been rapidly consolidating through mergers and acquisitions, which means that there are fewer but larger banks. Since the former chairman of the FDIC made the following statement, there are even fewer banks.

> Once the recently announced mergers are complete, there will be three banking companies whose assets are in the range of one trillion dollars each. Their combined assets will account for approximately 30 percent of the assets of FDIC-insured institutions. The next four largest holding companies will have assets in the range of $200 billion to $400 billion, and they will account for another 13% of industry assets. The top 25 banking companies hold over one-half of the industry's assets, while the top 100 hold almost three-quarters.[9]

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[8] Richard Cowden, "The Paulson Suprime Loan Modification Plan Would Extend Resets on Systemic Basis," *BNA Banking Report*, December 3, 2007, p. 1. [http://ippubs.bna.com/NWSSTND/IP/BNA/bar.nsf/SearchAllView/08CD9B5DB62FBC47852573A40015597D?Open&highlight=THE,PAULSON,PLAN]. Visited December 5, 2007.

[9] Testimony of Chairman Federal Deposit Insurance Corporation Donald E. Powell, in U.S. Congress, Senate Committee on Banking, Housing and Urban Affairs, *An Examination of the Condition of the Banking and Credit Union Industry*, April 20, 2004, p. 8, at [http://banking.senate.gov/_files/powell.pdf]. Visited May 20, 2005.

As a result of bank consolidation, between the end of the third quarter of 2006 and the end of the third quarter of 2007, there were 148 fewer commercial banks and 35 fewer thrifts.[10]

Cost of Funds Is Lower for Large Banks

In the low-interest-rate environment, larger banks clearly have an advantage over smaller banks in raising deposits that fund loans. The subprime crisis suggests that the suppliers of these funds overpriced the assets they received for these funds. Consumers have been taking advantage of declining mortgage rates to extract funds from the increased value of their homes. A sizeable part of these funds from refinancing and home equity loans has been used to pay off higher credit card and installment debts.[11] Smaller banks have a greater reliance on retail funding, which mainly comes from their customers' deposits. The interest rate difference between the lower mortgage loan rates and the rates banks pay for deposits has narrowed. Bankers call this an erosion in smaller banks' net interest margins. In a low-interest-rate environment, deposits continue to flow into banks, particularly to larger banks because the rate of return on alternative money market instruments is lower. Consequently, deposits at commercial banks grew at 9.1% and at 1.5% at savings institutions between September 30, 2006, and September 30, 2007. However, for all FDIC-insured institutions with less than $100 million in assets, deposits declined by 4.3%, while deposits grew 12.0% at institutions with greater than $10 billion in assets. The 116 largest depository institutions of the 8,560 institutions in America hold 74% of all deposits in the third quarter of 2007.[12]

The high liquidity and profits in the banking system are being reduced rapidly by the subprime crisis due to lending constraints being imposed by regulators and the resulting overall rise in short term interest rates. In the recession of 2001, smaller banks had not heavily lent to nonfinancial, high-tech companies, which became financially troubled during the recession. Large banks were doing most of that lending, but they were better prepared because of their broader sources of funding. In that recession, the noncurrent loan ratio for all FDIC-insured institutions (loans at least 90 days past due) went up to 1.00% for commercial banks with assets greater than $10 billion (see **Table 1,** column 7). After falling for almost seven years, **Table 1**, column 8, shows that for the first three quarters of 2007, these same large banks' noncurrent asset ratio has declined to 0.62%, which is still significantly below what it was in the 2001 recession. However, it was 16 basis points above what it was a year ago, 0.46% (**Table 3**, column 8). It is a different story for the other large and small commercial banks shown in these tables. For these

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[10] See *Quarterly Banking Profile*, September 30, 2007, [http://www2.fdic.gov/qbp/2007sep/cb1.html], and [http://www2.fdic.gov/qbp/2006sep/sav1.html]. Visited December 18, 2007.

[11] Testimony of John D. Hawke, Jr. before the Committee on Banking, Housing, and Urban Affairs, *An Examination of the Condition of the Banking and Credit Union Industry*, April 20, 2004, p. 6 [http://banking.senate.gov/_files/ACF23F.pdf]. Visited May 11, 2005.

[12] *FDIC Quarterly Banking Profile*, Table III A, September 30, 2006, and September 30, 2007. [http://www2.fdic.gov/qbp/2006sep/all4a2.html], and [http://www2.fdic.gov/qbp/2007sep/all4a2.html]. Visited December 18, 2007.

institutions, noncurrent assets are now higher than they were during the 2001 recession. For example, in the third quarter of 2007, smaller savings institutions' noncurrent assets were higher than they were in the 2001 recession. Their noncurrent asset ratios went from 0.66% in 2001 to 1.06 at the end of the first three quarters of 2007. That is up from the low of 0.48% at the end of the first three quarters of 2006. In short, large banks' noncurrent assets are now increasing along with those of smaller banks and thrifts.

Risk Management

Bank regulators have been encouraging banks to take specific steps to ensure the safety and soundness of the banking system. Banks and thrifts overall have maintained high levels of equity capital (see **Tables 1-3**, column 6). The regulators are now placing great emphasis on improving credit-risk management, developing and improving their methods of measuring risk on a transaction-by-transaction basis and holding the appropriate level of capital for that risk. These new methods are to better quantify risk and establish more formal and disciplined processes to recognize, price, and manage risk. To ensure compliance, bank regulators have been moving from the traditional regime of periodic examinations to in-house examiners. The Office of the Comptroller of the Currency, for example, has placed resident examiners in the 24 largest national banks. These examiners and specialists in areas such as commercial and retail credit, capital markets, bank technology, and asset management, provide the regulators with real-time risk management information. Despite these measures, the institutions and their regulators were unable to foresee the subprime crisis.

Even though the subprime crisis has called into question the effectiveness of these new approaches to risk management, large banks are still expected to take a holistic, portfolio view of management using advances in technology to garner information to help them underwrite and manage their credit risk. Regulators claimed that larger institutions have reduced their credit risk exposure to concentration by using the syndicated loan markets which broadly distribute credit exposure within the U.S. banking system as well as to foreign bank and non-banking organizations.[13] Similarly, the greater use of securitization markets has provided another way to manage risk concentration and to diversify funding sources to provide greater access to under served markets. Moreover, the growth of derivatives markets has provided larger banks tools to manage their interest risk exposures. For example, because residential real estate lending is typically associated with low credit risk because of diversification, solid collateral, and borrowers' vested interest, banks are able to reduce this exposure by using hedges like interest rate swaps and options, which then enable banks to manage future shifts in interest rates while expanding lending. The apparent failure of these sophisticated instruments has brought these larger institutions' profitability closer to those of smaller institutions,

[13] Ibid. Hawke, pp. 9-11; Greenspan, pp.6-8.

which are unable to take advantage of these tools because of the higher cost of these instruments.[14]

The use of these risk-mitigating instruments to protect against risks poses two challenges for regulators. First, risk-mitigating tools are complicated contingency instruments whose hedge value is extremely difficult to determine or to price beforehand. Regulators as well as bankers often rely on judgment to estimate their protective value against risks. The subprime crisis suggests that these assets were less valuable that the institutions and banking institutions thought they were. Second, if these derivative instruments are truly effective protection against rate risk, smaller banks are disadvantaged by their availability almost exclusively to larger banks. On the other hand, if they are not effective, smaller banks might be better off without using them. Some analysts have argued that most smaller banks do not have enough assets to enter these markets, or their management is not sophisticated enough to understand how to use them successfully. Evidently, the same may be said for some larger banks.

Compliance with Basel II

With the historically high level of capital for the last few years, U.S. banks in general have adequate levels of capital to comply with the new Basel accord. However, the expected decline in profits and the need for more loan loss reserves could cause a dramatic decline in capital. Regulators are in the process of implementing the capital rules under Basel II. Federal banking regulators will require some U.S. banks to use new methods of calculating their regulatory capital requirements. Both houses of Congress have held hearings on the Basel II Capital Accord. Basel II sets a more comprehensive framework for judging and containing bank risk than the existing framework, and it is more closely tuned to changes in risks that affect capital adequacy. Basel I, the existing capital framework under which most countries' banks are currently operating, is less sophisticated in calculating the appropriate minimum capital requirement given the riskiness of a bank's assets. Mainly for this reason, federal banking regulators are in the process of writing a Notice of Proposed Rulemaking (NPR) for Basel I as they did for Basel II. With this NPR, federal regulated banking institutions could have three methods of calculating their capital requirements: the Basel II advanced approach for large international banks, all other banks may have to choose between the Basel II standardized approach or remaining on Basel I method.

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[14] Both commercial and saving institutions borrow through advances from the Federal Home Loan Banks (FHLBs) at very low interest rates to make mortgage loans. In 2003, FDIC-insured commercial banks borrowed $245.3 billion from the FHLBs; thrift institutions borrowed $234.3 billion, but thrift institutions' advances from the FHLBs grew 8.3% between 2002 and 2003, while the commercial banks' advances grew about half as fast, or 4.8%, according to FDIC data. This suggests that the larger commercial banking institutions have been more successful at garnering funding from more competitive non-FHLB sources than the generally smaller institutions.

Basel II is slated for implementation in January 2009, which will apply to the largest 10 to 20 U.S. international banks, but more banks may voluntarily participate. Basel II is of interest to Congress for several reasons. It would change the safety and soundness standards for U.S. banks, and it may receive direct legislative action as well as require new regulatory oversight. Moreover, it has serious implications for the world's financial system in ways that would affect the U.S. economy. For such reasons, the United States Financial Policy Committee for Fair Capital Standards Act (H.R.1226) was introduced in the 109th Congress and could be reintroduced in the second session of 110th Congress. It would establish a mechanism for developing U.S. positions on Basel Committee issues. The Basel II standardized approach seeks to enhance the risk sensitivity of Basel I, while avoiding the complexity of Basel II advanced approach, and eliminate competitive distortions between adopting and non-adopting Basel II banks.

Conclusion

The banking industry had record-breaking profits in 2006 as it has for the previous five years. However, there are clear signs that profit growth is slowing and has turned negative for some institutions. At the same time, the industry's safety and soundness in terms of capital is still better than it has been since the late 1930s. However, this soundness comes from an industry becoming more concentrated. Larger banks clearly have advantages over smaller banks in funding assets and also mitigating credit and interest rate risks. Recent developments in the subprime lending crisis have brought these advantages in to question. These processes have left large banking institutions vulnerable to increased credit and interest rate risks now that short-term interest rates have risen and the rate of growth in the economy has slowed. Consumers are spending a larger portion of their disposable income on financial obligations, which exposes the banks to credit risk. Credit risk is the risk of default. Banks are also vulnerable to interest rate risk because of the declining interest rate margin between the interest the banks pay for funds they lend out and the interest they receive from their borrowers. Rising interest rates could result in accelerating reduced profitability. Larger banks that used these advanced methods of funding mortgages are beginning to see their profitability approaching those of the smaller banks that rely heavily on retail funding.