

THE STATE OF THE BANKING INDUSTRY

By William M. Isaac*

The financial markets have been in turmoil in recent months, due in large part to concerns about subprime mortgages. I am convinced that the problems are not nearly as severe as many fear and that the biggest problem is fear itself.

In times past, most financial problems were reflected in bank balance sheets. Banks made loans and for the most part kept them on their books.

When things got overheated, the Federal Reserve tightened money, which raised the cost of borrowing. Typically, banks cut back on lending, a recession ensued, and banks took their lumps.

We were able to get a pretty good handle on the dimensions of the problems because banks were examined regularly and were required to recognize their likely losses. Moreover, because most of the larger banks were public companies, they were required to publicly disclose their problems.

One interesting thing about the subprime mortgage problem is that it is not being driven by an economic downturn. In the wake of the stock market collapse and the turmoil caused by 9/11, interest rates fell precipitously and real estate seemed a safe haven. As the real estate market heated up, loans were made to investors and other borrowers who had little margin for error, particularly those who decided to take out adjustable rate mortgages.

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The overheated real estate market, fueled by speculators, had to cool, and it did. The Fed raised interest rates, and the rapid escalation in real estate prices came to a halt in many markets. Speculators ran for the exits creating an inventory of housing in some markets that will take time to work off.

It is difficult for the financial markets to assess the dimensions of the subprime mortgage problems, and the uncertainties are creating a lot of volatility in the markets. Mortgages are originated by thrifts, mortgage companies, banks, and others. These days, the mortgages are placed into trusts, and securities representing ownership of those trusts are sold to investors such as pension funds, hedge funds, and insurance companies.

We are not sure who owns the bulk of the subprime mortgages, but they appear to be spread widely across the globe. The really good news is that the problems do not appear to have infected the banking system to a significant degree. A strong banking system is essential to a strong economy, and we have a very strong banking system by every measure.

It is estimated by Inside Mortgage Finance that total subprime mortgage loans outstanding at year-end 2006 stood at \$1.24 trillion. Subprime mortgages are not a separately reported item for banks so we do not know precisely how much they hold. A reasonable estimate is \$200-\$300 billion.

Let's use \$250 billion and put it into perspective. While \$250 billion is nothing to sneeze at, it is not a lot of money in a banking system that holds \$12.3 trillion of assets and has total equity capital and reserves of nearly \$1.4 trillion.

Keep in mind that a high rate of loss on \$250 billion of mortgage loans would be 15% pre-tax, or about \$23 billion after taxes, and the losses would be incurred over time. Losses of

this magnitude could be absorbed relatively easily by an industry that earned \$146 billion in 2006 – after reserving \$29 billion for losses – and has \$81 billion in loss reserves.

A 15% pre-tax loss on the entire \$1.24 trillion in subprime loans would be \$186 billion spread out over time among investors throughout the world. A loss of this magnitude is a roughly equivalent to the impact of a 1% decline in the U.S. stock market.

We have all read reports in the press about increasing numbers of problem banks and rising charge off levels for loans. Some note that the some of the problems are the most serious experienced by the industry since 1991.

It's really important that we understand that the ability of the industry to handle today's problems is night and day when compared to 1990. For example, non-current loans in June 2007 totaled approximately \$67 billion compared to \$103 billion in 1990. However, total non-current loans in 2007 amounted to less than 5% of equity capital and reserves compared to nearly 30% in 1990.

Net loan and lease charge offs totaled \$27 billion in 2006 compared to roughly \$35 billion in 1990. However, chargeoffs as a percentage of net income were only 18% in 2006 compared to 309% in 1990.

Let's turn to problem banks – those rated 4 or 5 by regulators on a scale of 1 to 5. They total 61 institutions currently, holding just \$23 billion of assets (well under 1% of the industry's assets), compared to 1,426 institutions in 1991, holding \$819 billion in assets (18% of the industry's assets).

While we experienced hundreds of bank failures (including the ten largest failures in history) during the 1980s and early 1990s, we have had but one failure in the last three years with assets of just \$15 million.

This is not to say that things will not get worse, particularly if the economy falters. But it is inconceivable to me that we will experience a banking downturn remotely resembling the downturn in the 1980s.

There have been vast structural changes in banking with the advent of interstate banking and the elimination of thousands of marginal firms through acquisitions and failures. Banks are more diversified, better managed, and much stronger financially, and the competition among them is more rational. Moreover, banks have been proficient in reducing their risks by moving assets off their balance sheets and into the hands of investors.

The Federal Reserve has had three successive outstanding chairmen over the past 30 years who have implemented monetary policy with a great deal of skill and discipline. That, coupled with the strength of the banks, creates a degree of stability in the financial system that should enable us to steer through much greater turbulence than I can see on the horizon.