

California Bar Association

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Commissioner

California Department of Financial Institutions
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Topics for Today

- Observations on the crisis – How did we get in this mess?
- Impact on CA banks
- Economic and financial outlook
- Assessing the policy response (macro and proposed regulatory)

Observations on the financial crisis and its impact on the economy

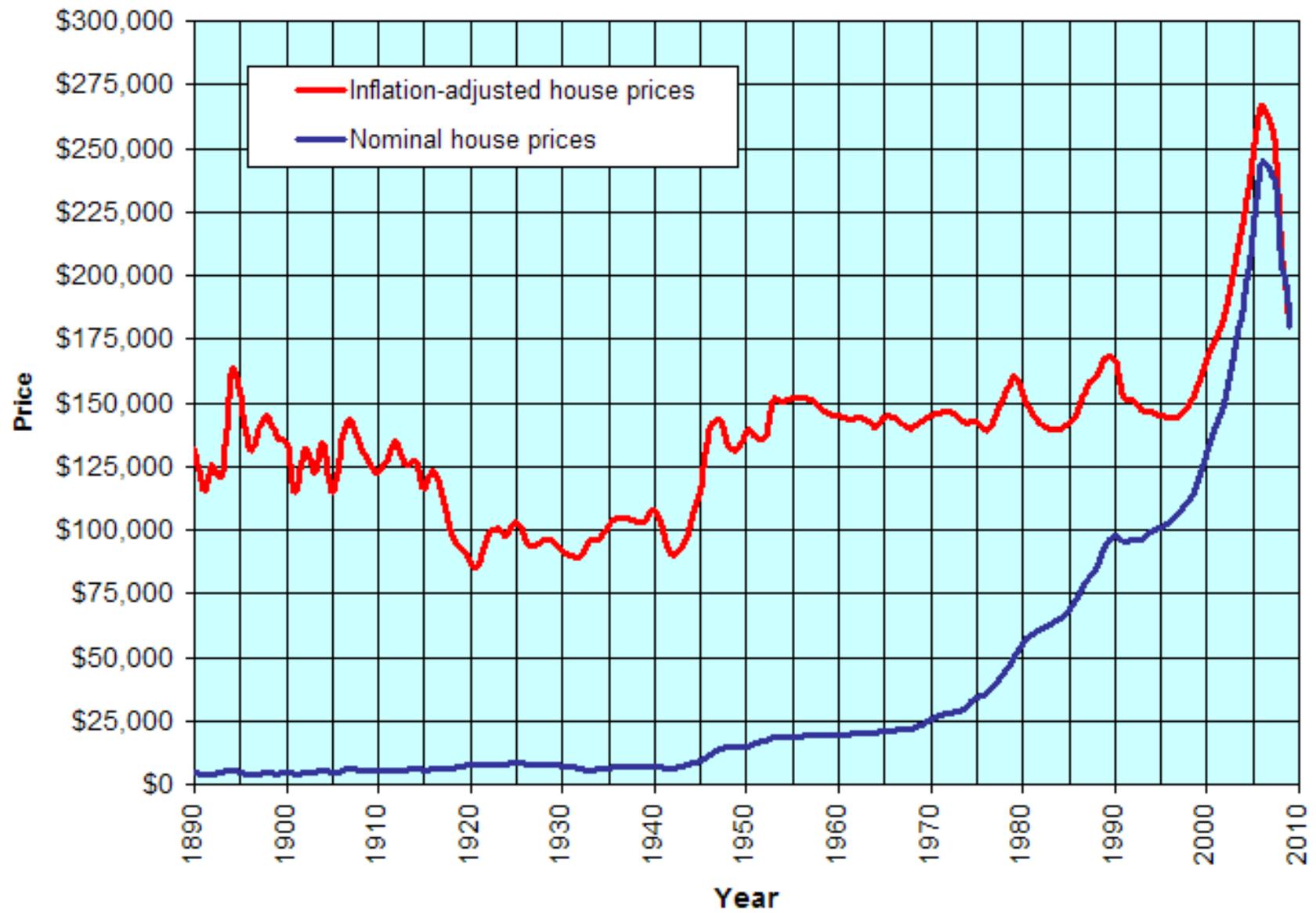
- Recap the causes...
 - Easy money fueled a boom in home prices
 - Households stopped saving and got overextended on mortgages and other forms of consumer credit
 - Corporate governance and risk management failed at too many FIs, notably the largest
 - Regulators missed the build-up of leverage & the concentration in mortgage finance in the system

Case Shiller Composite Indices SA (Nominal)

— Composite 10 — Composite 20



U.S. House Prices, 1890-2008



The Frugality Trap

Economists expect Americans to begin saving more at a time when the economy is increasingly dependent on them to spend.

Personal saving rate



Personal consumption as percentage of GDP



Source: Bureau of Economic Analysis

Chart 10: Household debt-to income ratio (%)

Source: Thomson Datastream

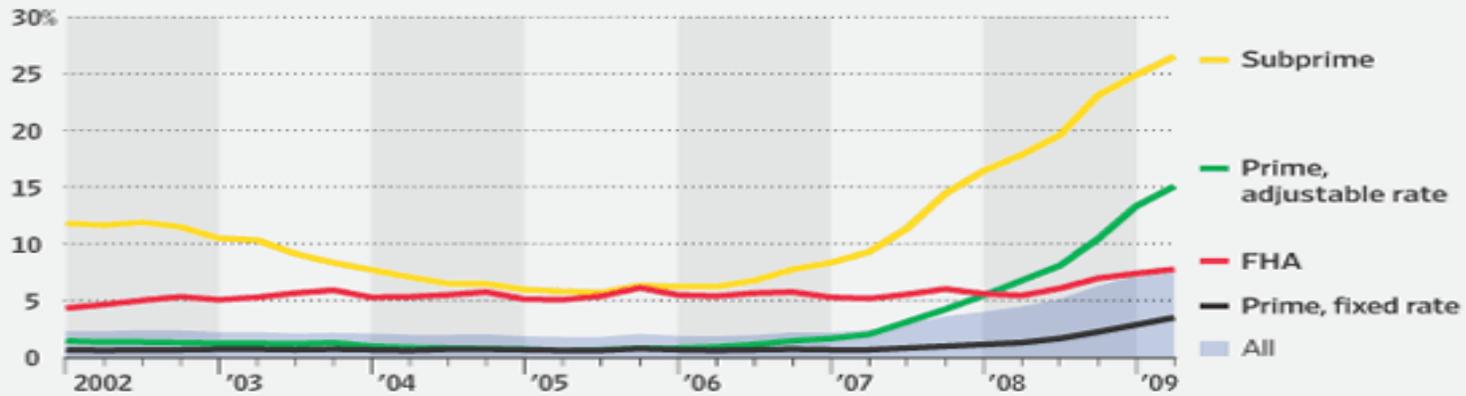


Prime Time

As mortgage delinquencies continue to rise, more borrowers with the prime loans that make up the bulk of the market are falling behind or into foreclosure.

Seriously delinquent mortgages by type of loan

Percentage of loans that are 90 days or more delinquent or in foreclosure



Foreclosures and foreclosure starts in the second quarter of 2009

FORECLOSURES BY STATE

Highest percentage of loans outstanding



Biggest increase over the first quarter, in percentage points



FORECLOSURE STARTS BY LOAN TYPE

Distribution of foreclosure starts by type of loan

Loan Type	Time Period	Percentage of total loans outstanding	Percentage of U.S. foreclosures started
PRIME, FIXED RATE	2009 2nd qtr.	65.5%	32.4%
	First qtr.	65.3	28.9
	Year ago	65.2	20.4
PRIME, ADJUSTABLE RATE	2009 2nd qtr.	12.4%	25.1%
	First qtr.	13.1	23.8
	Year ago	14.2	23.8
SUBPRIME FIXED RATE	2009 2nd qtr.	6.3%	13.2%
	First qtr.	6.4	12.7
	Year ago	6.5	12.3
SUBPRIME, ADJUSTABLE RATE	2009 2nd qtr.	5.0%	20.2%
	First qtr.	5.3	26.6
	Year ago	6.0	36.3
FHA	2009 2nd qtr.	10.7%	9.1%
	First qtr.	9.9	8.0
	Year ago	8.2	7.1

Source: Mortgage Bankers Association

Governance and Regulatory Failures

- Governance and regulatory failures at large, supposedly sophisticated financial institutions (FIs)
 - Concentrations in mortgage products
 - Staggering use of leverage
 - “Shadow banking system” grew up without much regulatory scrutiny
 - Supervision of large FIs (bank and nonbank) was inadequate
 - Failure to act on build-up of risk in the system as a whole

BIS Report: “Bank Failures in Mature Economies”

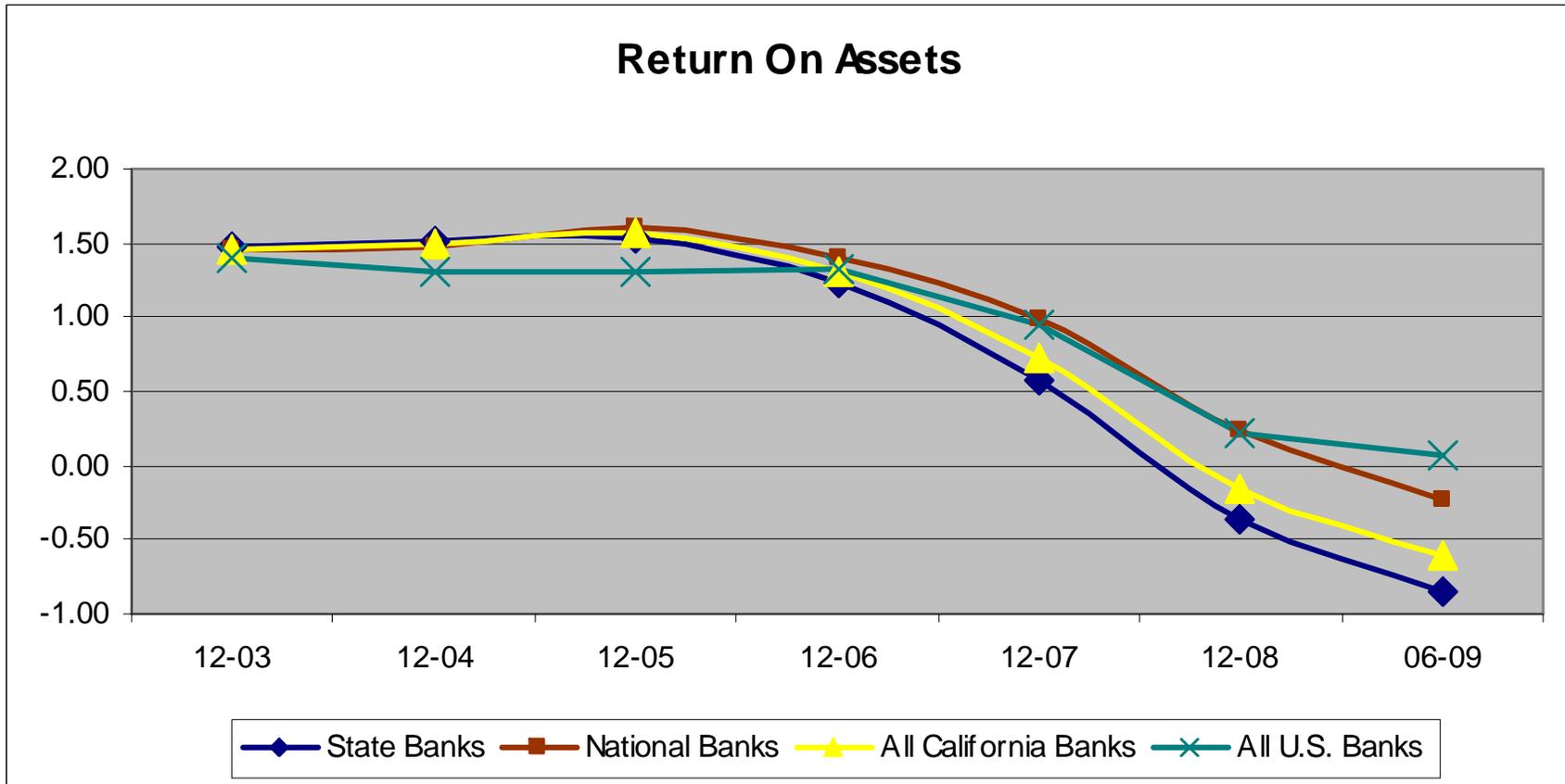
- “The widespread banking crises that involved credit risk were remarkably similar. A period of financial deregulation resulted in rapid growth in lending, particularly in real estate lending. Rapidly rising real estate prices encouraged more lending, abetted by lax regulatory systems in many cases. When economic recessions occurred, inflated real estate prices collapsed, leading directly to the failures.”

Published in 2004

California-Headquartered Banks

Assessing the Impact

Return on Assets



Return on Assets by Quintile*

State Chartered Commercial and Industrial Banks

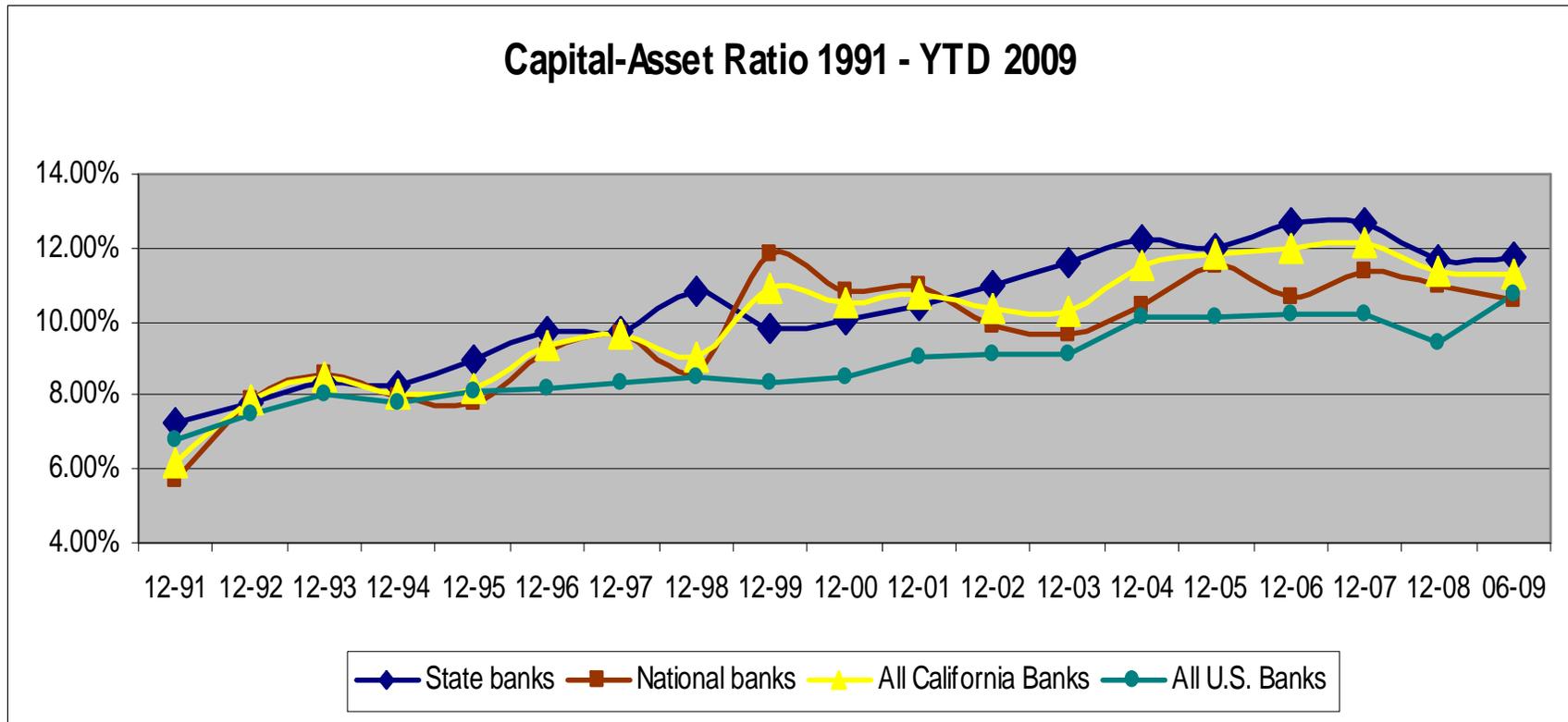


Annualized year-to-date through As of June 30, 2009

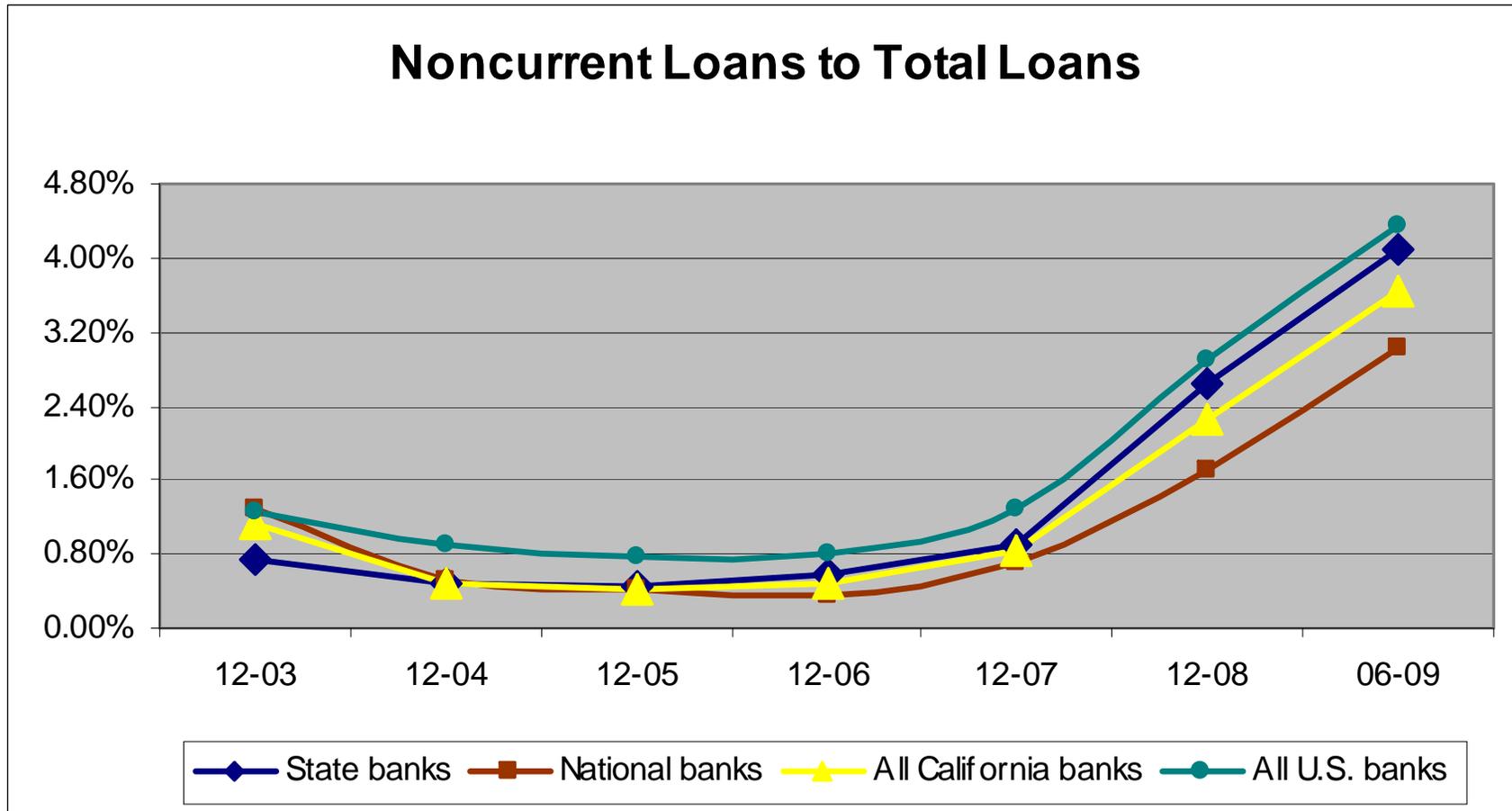
Asset Size	Over 3 years of operation				< 3 yrs ops.	Total
	Less than \$100MM	\$100 to \$500MM	\$500MM to \$2 Billion	\$2 Billion and More	All asset sizes	
Number of Banks	21	100	39	21	43	224
First Quintile	0.6	1.2	0.8	1.0	-0.4	0.9
Second Quintile	0.1	0.4	0.3	0.6	-1.6	0.3
Third Quintile	-0.9	-0.1	0.1	0.0	-2.8	-0.3
Fourth Quintile	-1.7	-0.6	-0.8	-1.2	-4.4	-1.4
Fifth Quintile	-5.1	-4.1	-1.8	-4.9	-6.5	-4.9
Total	-1.1	-0.5	-0.4	-0.8	-2.5	-0.8

* Quintiles of equal sizes are created by dropping off first the highest then the lowest ratio in each group until the number of institutions is divisible by 5.

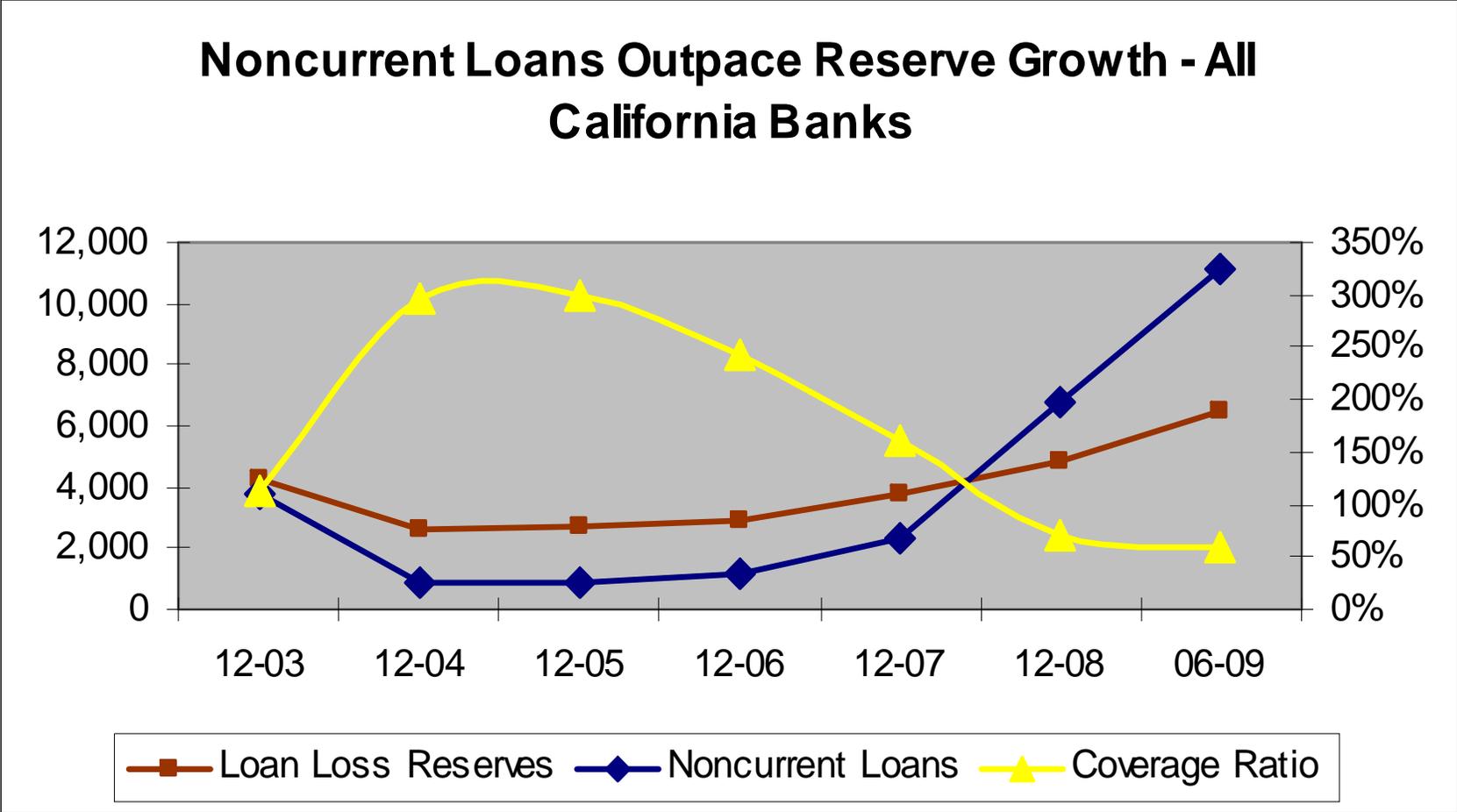
Capital Adequacy



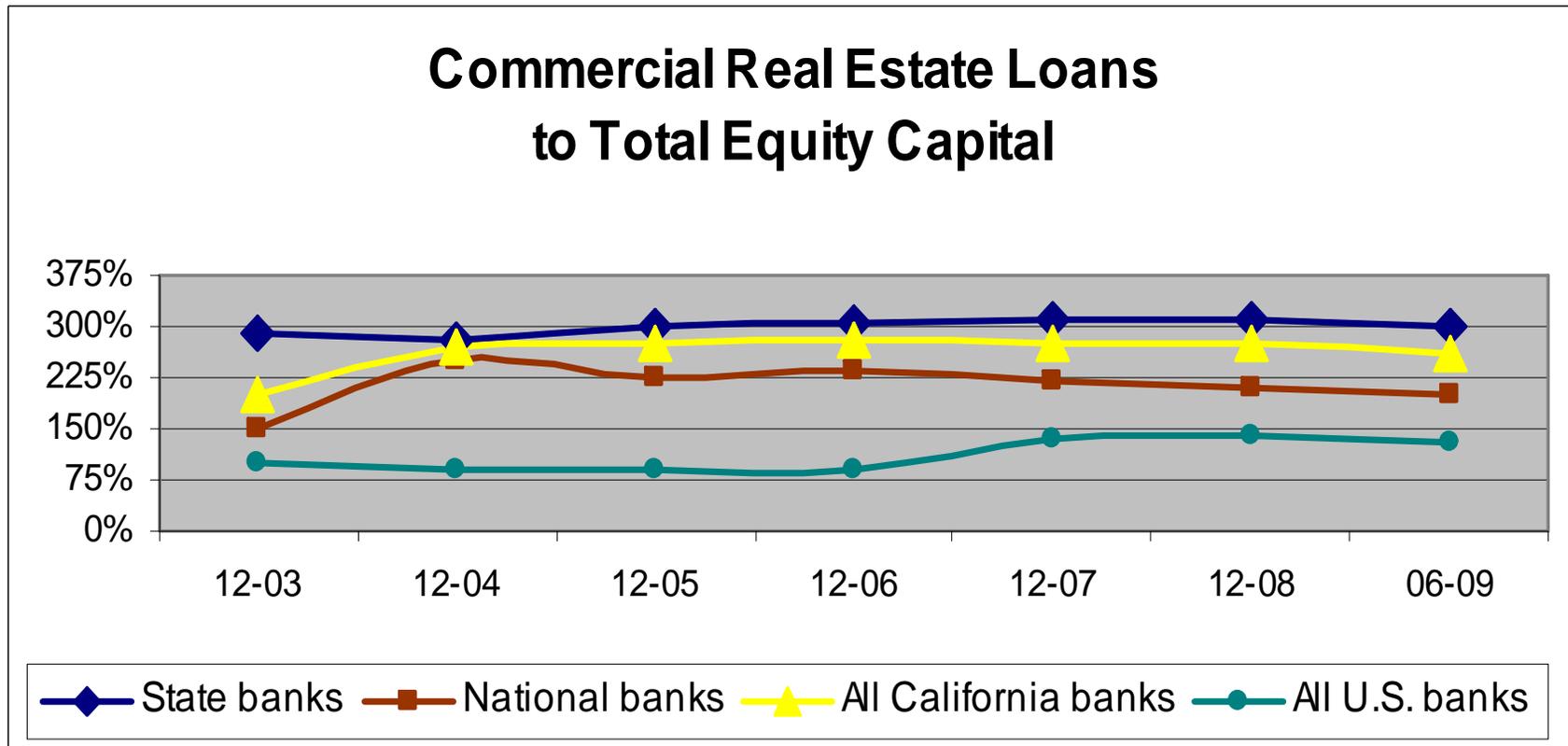
Noncurrent Loans and Leases to Total Loans and Leases



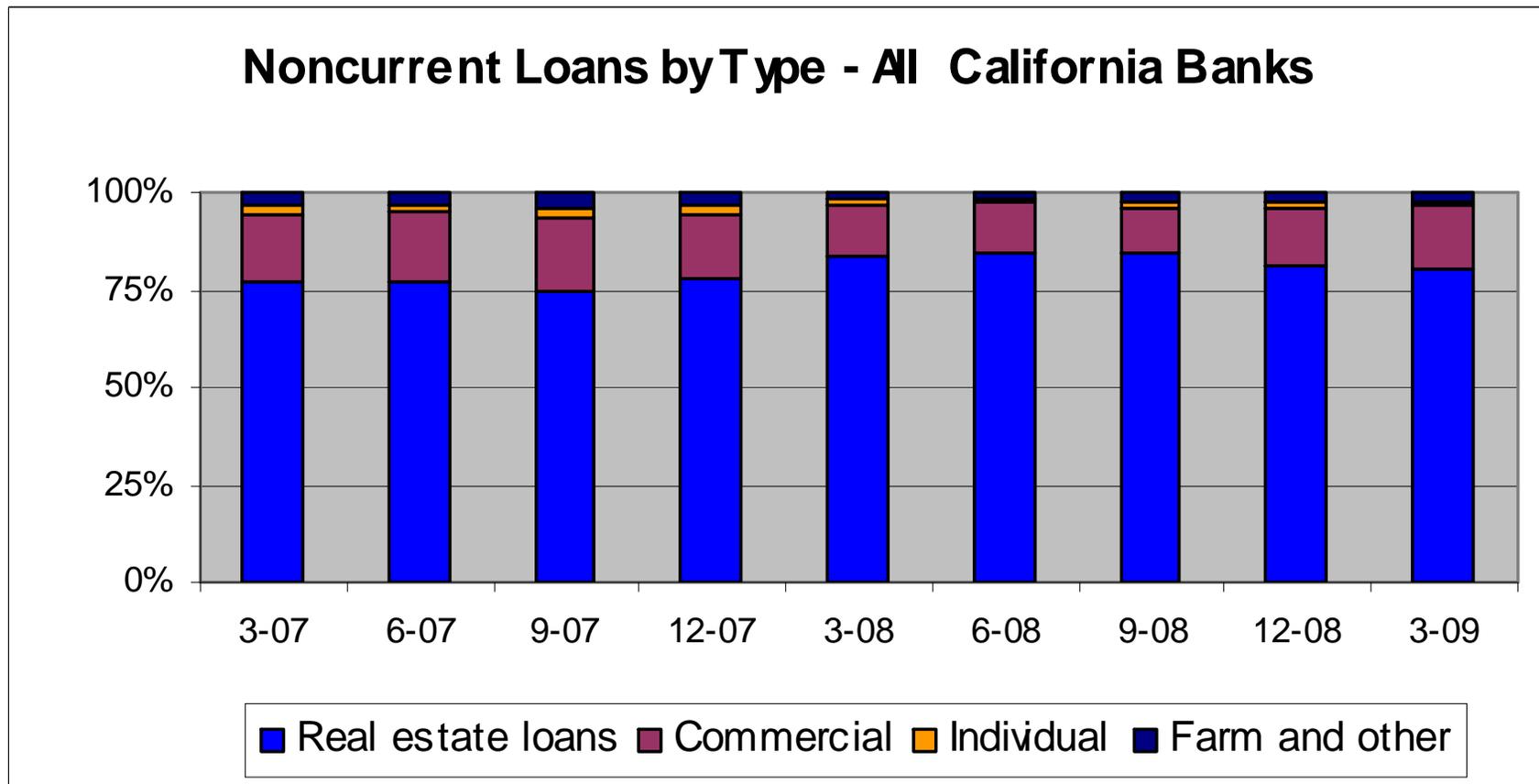
Loan Loss Reserves vs. Noncurrent Loans and Leases



Commercial Real Estate Loans to Total Equity Capital

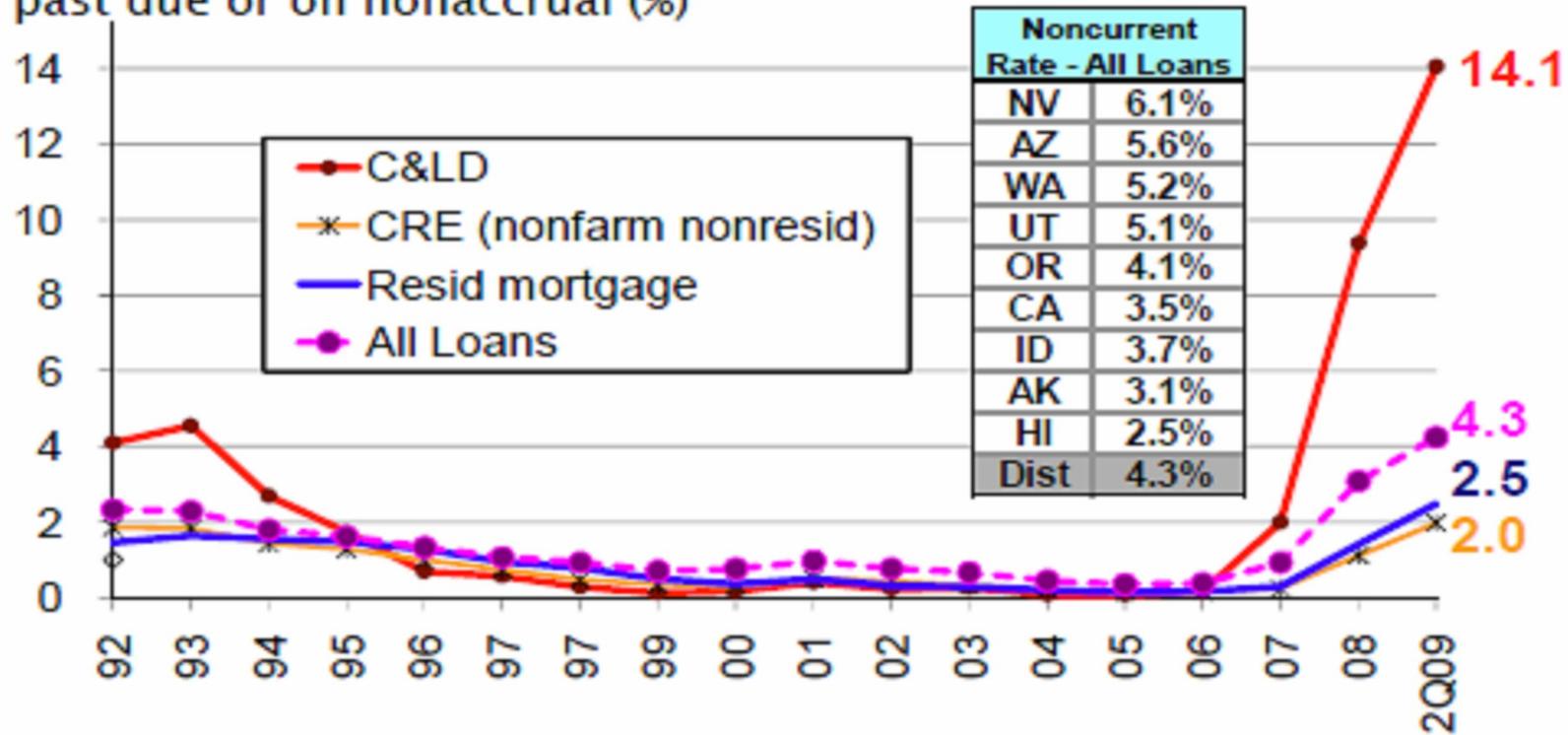


Noncurrent Loans by Type – All California Banks



5) District Bank Avg. Noncurrent Rate at Record High, Driven by C&LD Loan Deterioration

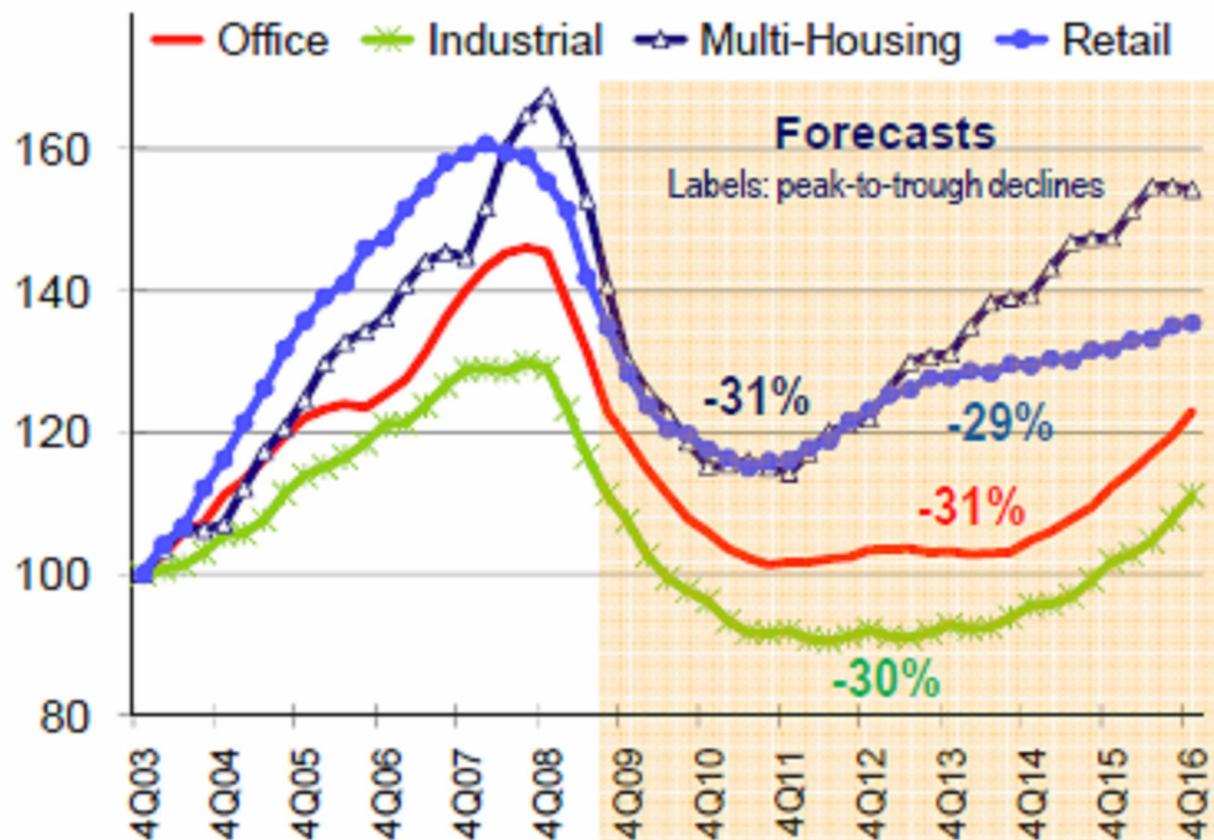
12th District Bank Noncurrent Loan Rates - Pct 90+ days past due or on nonaccrual (%)



Adj. avgs. (10% trim) for all 12th District commercial & industrial banks, excluding De Novo banks; 2Q09 data is based on preliminary reports

4) CRE Property Values Declining as Fundamentals Deteriorate & Risk is Repriced

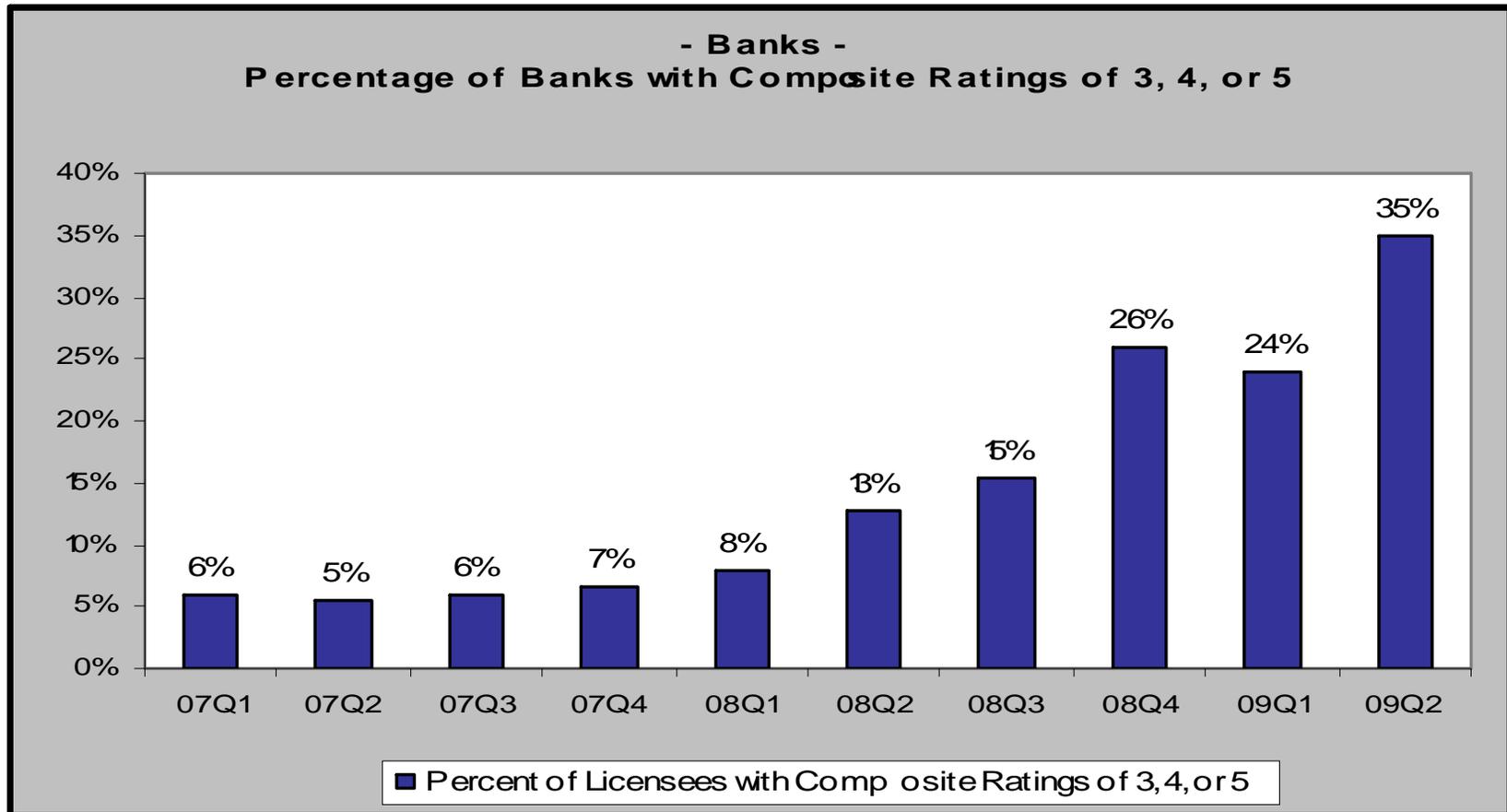
National Data - Index 2003 = 100



Largest Projected 12D Peak to Trough Declines			
Sector	MSA	Btm	Decl %
Off	SD	2Q 14	-60%
Ind	PHX	2Q 15	-57%
Ret	OAK	3Q 11	-54%
MH	PHX	4Q 11	-59%

Based on Torto Wheaton Research Investment Outlook, Summer 2009 Base Case Forecast

Increase in Problem Banks



How are we responding?

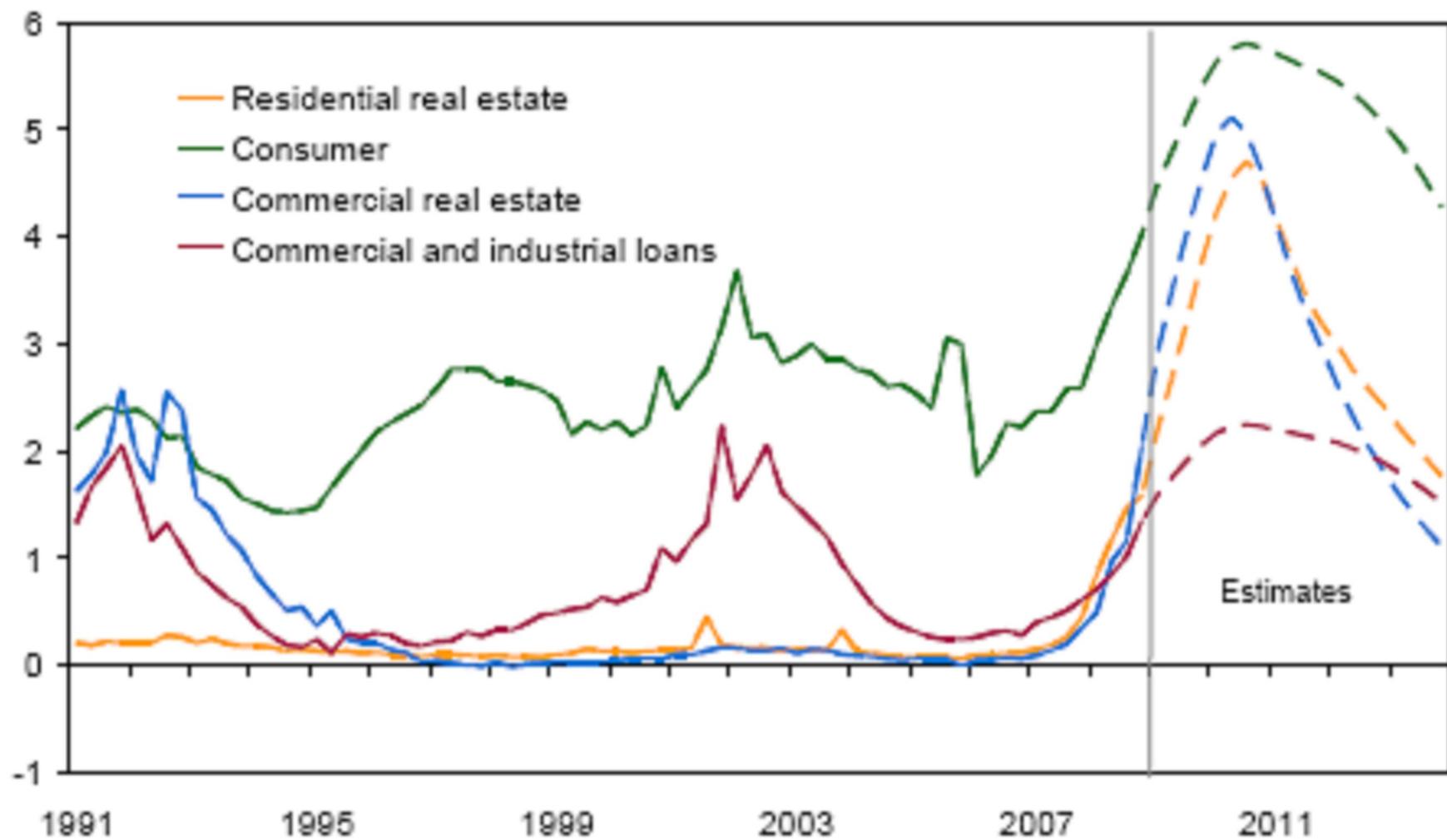
- Risk Based Exam Scheduling
- Longer Exam Duration When Needed
- More Enforcement Actions
- Liquidity Issues Loom Large As Troubles Mount
- More Failures -- When Failures Occur, “Whole Bank with Loss Share” Is a DFI Goal
- Thinking About Lessons Learned

Economic/Financial Outlook

- CA unemployment rate in July '09 was 11.9% -- up from 7.1% a year ago.
- House prices may have bottomed out in worst markets. Outlook is darker for other areas.
- Deleveraging is going on everywhere except in government sector.
- Credit losses, especially on commercial real estate, will continue
- History shows that economies behave far worse in the aftermath of a financial crisis – a protracted workout (i.e., slow recovery) is likely.
- “Hope for the best. Plan for the worst.”

Figure 1.20. U.S. Loan Charge-Off Rates: Baseline

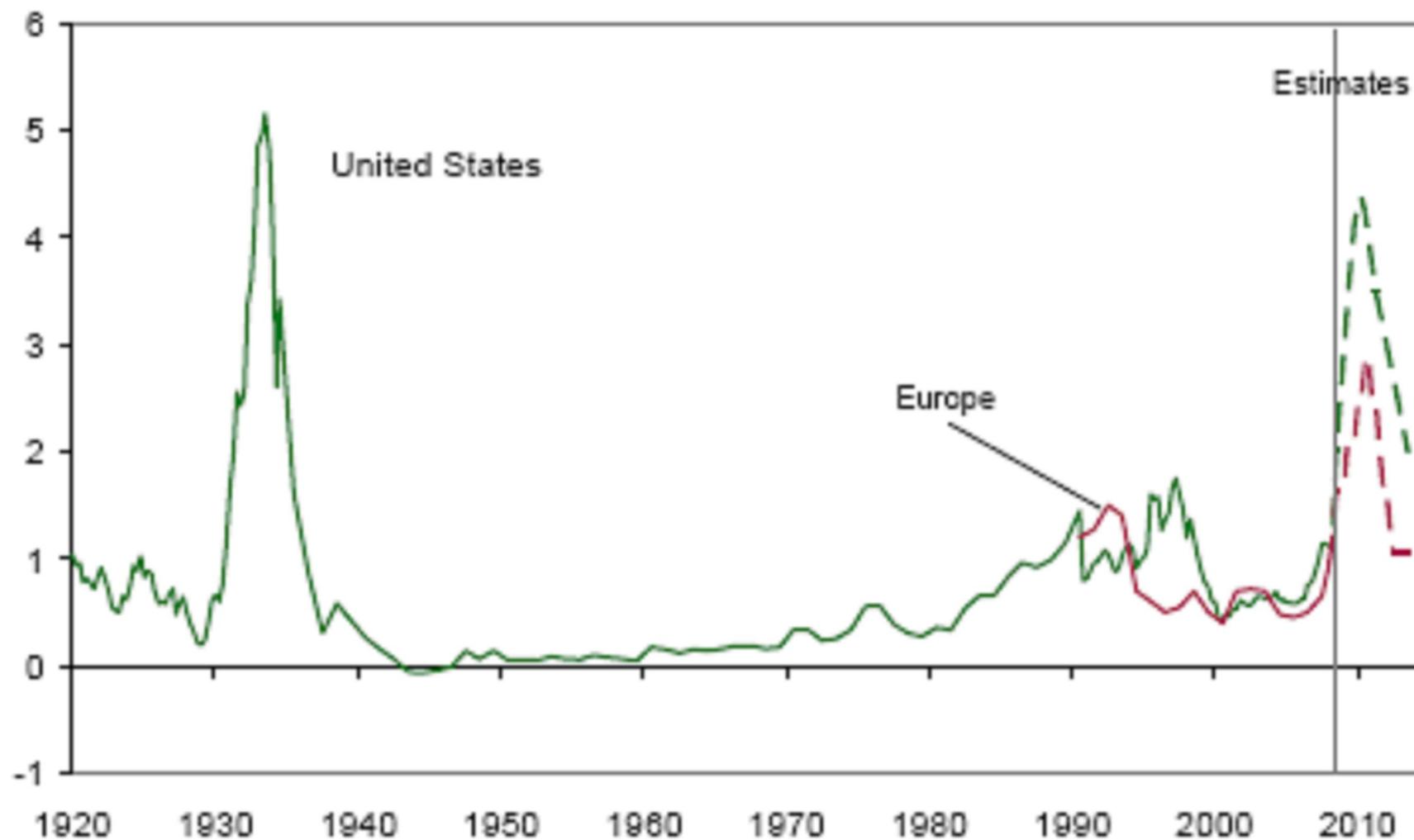
(In percent)



Sources: Federal Reserve; and IMF staff estimates.

Figure 1.30 Commercial Bank Loan Charge-Offs

(In percent of total loans)



Source: IMF staff estimates.

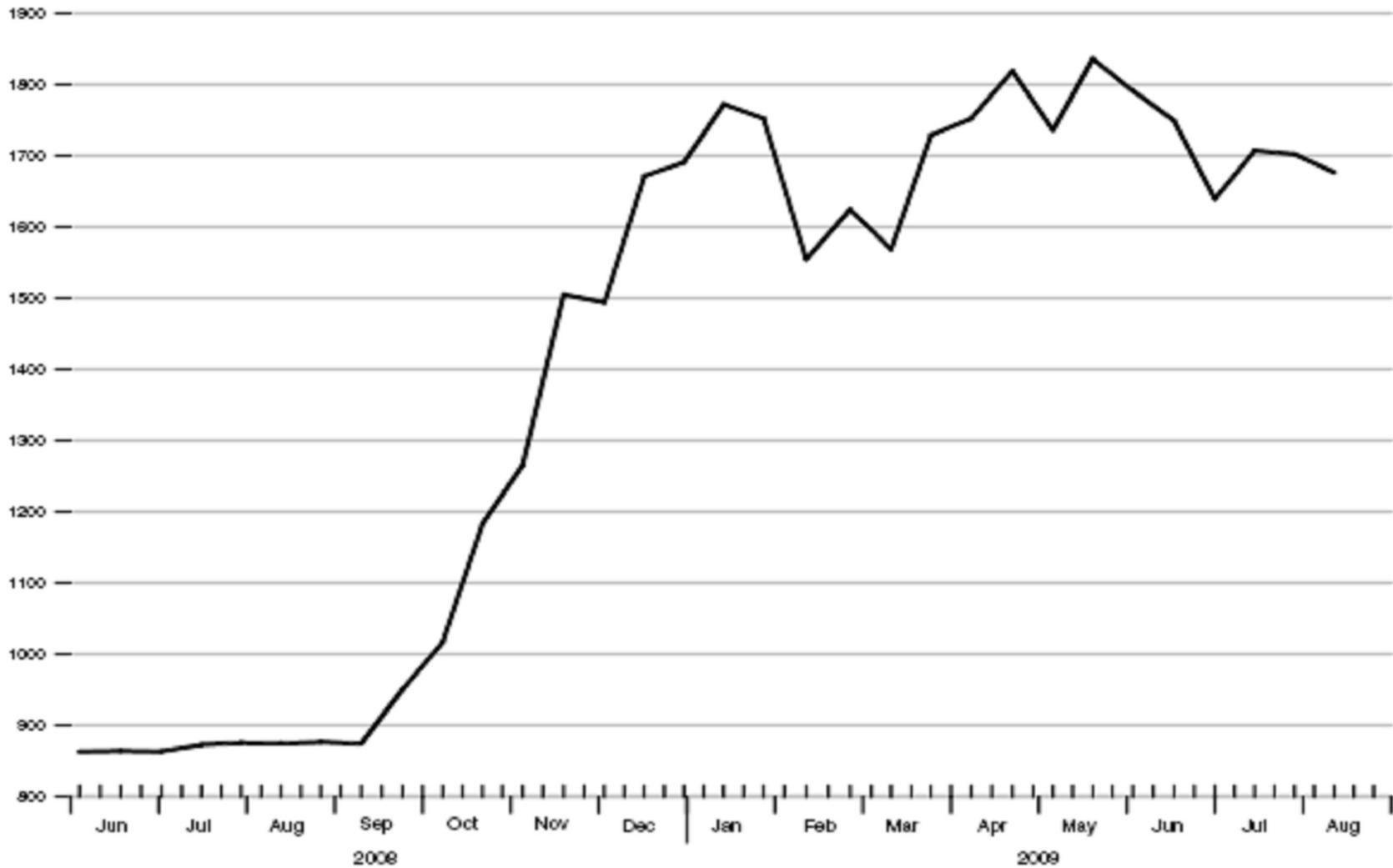
Policy Responses

- Massive monetary stimulus is being applied to counteract private sector deleveraging and the freeze-up of ABS market
- Fiscal stimulus package slow to get going, but deficit will still reach record peace time levels as a share of GDP
- Bailouts and assisted mergers of large FIs helped avert a financial meltdown, but exacerbated the TBTF problem
- Mortgage market is on government life support

Adjusted Monetary Base

Averages of Daily Figures, Seasonally Adjusted

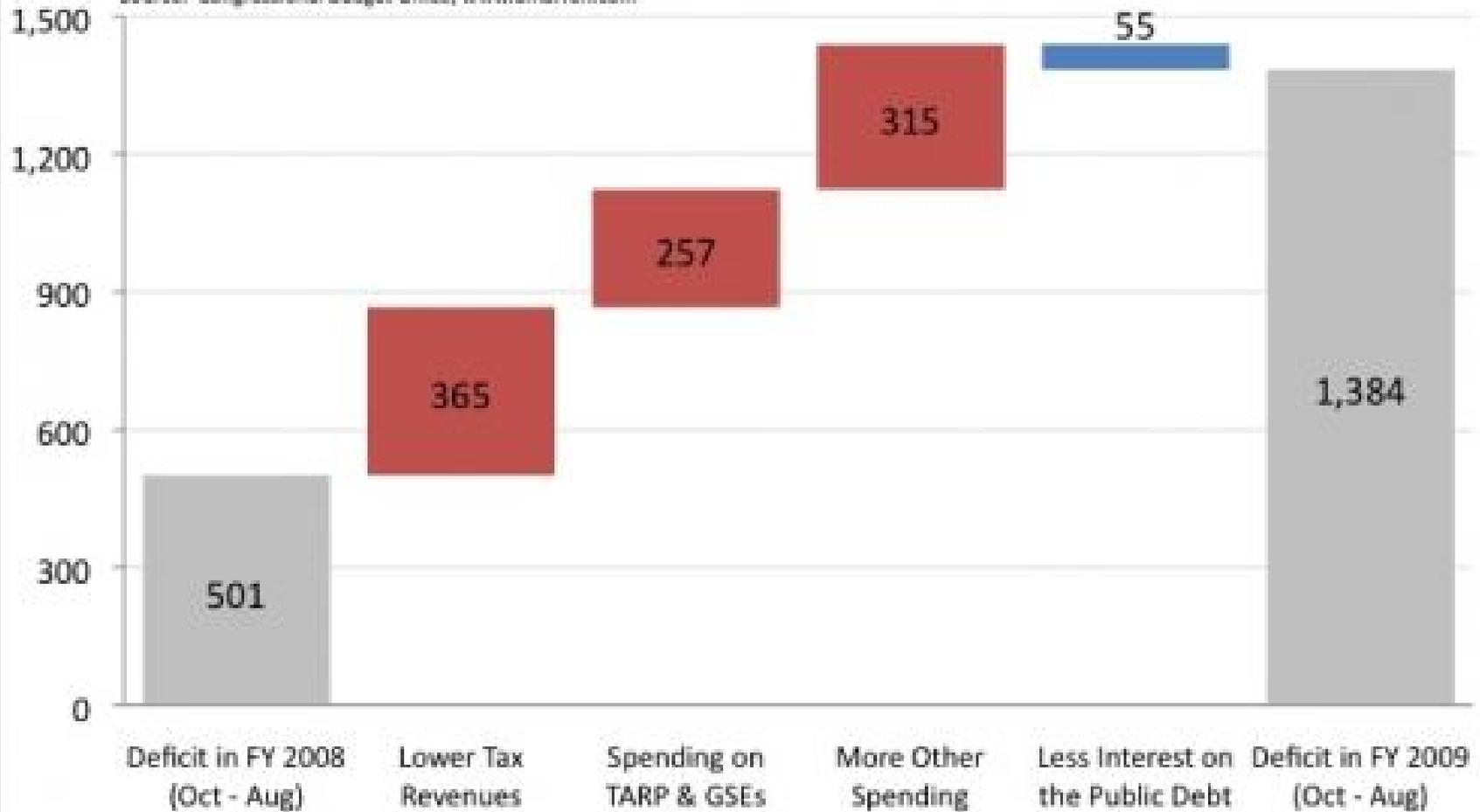
Billions of dollars



Why is the Budget Deficit Exploding?

Deficits, Revenues, and Outlays through August for FY 2008 and FY 2009 (Billions of Dollars)

Source: Congressional Budget Office; www.dmarron.com



Short Run vs. Long Run Issues

- Unwinding monetary & fiscal stimulus without cratering the economy or reigniting inflation will be a challenge
- Future of housing finance is, so far TBD
- Getting regulatory reform right will be a challenge
- What will Congress do about TBTF? The Obama plan doesn't fix this problem.
- Future of the dual chartering system and state vs. federal balance of regulation is unclear