Supervisory Spotlight

A Regulator's Perspective on Issues Facing Western Banks

Banking Supervision & Regulation
Federal Reserve Bank of San Francisco

June 2013

From the Director of Banking Supervision and Regulation

Our theme this quarter is the ongoing earnings challenges facing banks in our District and the need to pay attention to risk management in this environment. As I noted in a recent piece in the *Community Banking Connections* newsletter, community banks are looking to a wide range of new products and services—such as the deposit advance products we highlight below—to build and maintain earnings. Management's skill in analyzing and mitigating risk is the critical factor in ensuring that the new product or service successfully addresses the bank's needs and the needs of its customers.

If you're not familiar with *Community Banking Connections*, I encourage you to learn more about it by clicking the link above. This newsletter began publication in 2012, and it is now really hitting its stride. In the latest issue, readers will find commentary on several important topics, including Asset/Liability Management, Negative Provisions and the ALLL, and the Confidential Supervisory Information Disclosure Rules.

I welcome your thoughts on the topics discussed in this newsletter or in *Community Banking Connections*.

Best regards,

Teresa Curran

Teresa.Curran@sf.frb.org

Banking Conditions Continue to Recover but Earnings Challenges are Real

Our latest quarterly review of bank financial results continues to characterize the condition of the industry as "still improving." Asset quality metrics are improving, capital ratios are strengthening, and loan growth continues to pick-up. However, in the first quarter of 2013, earnings growth stalled.

On a year-over-year basis, the average return on average assets (ROAA) for banks located in the 12th District increased from 0.59% to 0.72%. However, the average ROAA has been nearly flat over the last three quarters, and during the latest quarter, core profitability and net interest margins (NIMs) edged down from earlier quarters. Not surprisingly, in this low interest rate environment, NIM compression remains the most obvious theme. While in earlier quarters, District banks were able to aggressively lower their provisions for loan and lease losses, this option has mostly run its course as provision expenses in the latest quarter were near zero on average.

On a more positive note, many indicators suggest that the economic recovery continues to take hold, and the housing markets in most regions have improved significantly. These positive developments are pushing down past due loan rates, helping banks move problem assets off their books, and stimulating loan originations. On this latter point, year-over-year loan growth in the District is now 4.8% on average. In aggregate, Commercial & Industrial loan volume is up 6%, Consumer loan volume is up 9%, and 1-4 Family First Lien volume is up 14% over the last 12 months. While these growth rates are far from strong, overall loan growth in this District is more than double that of the nation, and loan growth has steadily picked up in each of the last four quarters. This is a trend that we expect will continue.

For a more complete snapshot of District financial conditions, economic highlights, and regulatory "hot topics," please review our latest First Glance 12L.

Third Party Outsourcing Risk

One emerging issue receiving attention is third-party outsourcing risk, often referred to as vendor management. Financial institutions are increasingly turning to third-parties to outsource various activities and functions. The practice of outsourcing itself is not a concern, as there are many legitimate reasons for an institution to use vendors and service providers to help it conduct its operations. However, the use of third-party vendors and service providers presents various risks, including (but certainly not limited to) compliance risk, reputational risk, and operational risk.

We believe this is a significant issue that warrants attention from management teams and boards of directors. Although outsourcing is a much more significant activity at larger institutions, even community banks rely on an extensive network of third-parties. In fact, we recently surveyed a number of community banks in this District and found that they used approximately 50 vendors and service providers, on average. Some of the activities conducted by the third-parties are low risk, while other activities clearly expose the institution to higher risk, particularly those third-party activities that are subject to consumer laws and regulations.

With this in mind, it is important for an institution to have a comprehensive risk management program that incorporates risk assessment, due diligence, and risk monitoring procedures. These important risk management functions should be appropriately scaled to the risk presented by the activity, so that higher-risk activities are subject to more rigorous documentation, review, and monitoring. In recent years, a number of banks were assessed Civil Money Penalties or were otherwise subject to regulatory action due to inappropriate activities of third-parties engaged by the institutions. In many cases, these problems were largely the result of inadequate monitoring and oversight.

In the coming months, the Federal Reserve will issue comprehensive guidance on this issue. In the meantime, examiners are beginning to explore this issue with bank management to build awareness, and to document and quantify the extent of outsourcing activities and the corresponding risks that need to be managed.

Deposit Advance Products

Following April's issuance of the CFPB's White Paper on Payday Loans and Deposit Advance Products, the Federal Reserve issued its own Statement on Deposit Advance Products. In this document, the Federal Reserve encourages institutions to respond to their customers' needs for small-dollar credit, but it also reminds state member banks that they should take into consideration the significant risks associated with deposit advance products, including the potential of consumer harm.

The Federal Reserve's Statement includes a list of many of the rules and regulations with which institutions should be familiar as they design and offer deposit advance products. In particular, institutions that offer these products must act in accordance with section 5 of the FTC Act, which prohibits unfair or deceptive acts and practices (UDAP), and section 1036 of the Dodd-Frank Act, which prohibits unfair, deceptive, or abusive acts or practices. And to further highlight the concerns with managing third-party outsourcing risk, the Statement also reminds institutions of the importance of having sound risk management and oversight practices in place when institutions rely on outside vendors to offer deposit advance products.

If your institution offers, or is considering offering, payday, deposit advance, or other small dollar loan products, we encourage you to read the CFPB's White Paper and the Federal Reserve's Statement. You may also find similar announcements released by the OCC and the FDIC to be of help.

Risk Management Considerations for New Products and Services

The latest issue of the Federal Reserve's Community Banking Connections includes tips on how successful bank management teams can rethink business strategies and develop new products and services to strengthen earnings. In a period characterized by low interest rates and limited loan demand, this is a natural reaction, and the Federal Reserve is supportive of community banks' efforts to strengthen earnings and overall financial viability. Furthermore, if these efforts lead to more diversified earnings streams, this would certainly be a positive for the industry.

However, there are a number of factors and issues that management teams should consider before introducing a new product or service. If your organization is planning to roll out any new products or services, we encourage you to review the entire article. In the meantime, we'll draw your attention to two of the more important considerations.

First, it is extremely important for the board of directors and management team to ensure the new product or service is a good strategic fit for the institution and its customers. Typically, the launch of a new product will be much more successful if it is based on thoughtful research, diligence, and analysis by bank management. Second, it is crucial that a wide variety of personnel are involved in the development of the new product or service. This includes staff from the operational, compliance, audit, and legal functions of the organization, each of whom will bring a different, but necessary perspective to the due diligence process.

Financial Stability Oversight Council's Annual Report

On April 23, 2013, the Financial Stability Oversight Council (FSOC) issued its latest Annual Report, in which the Council presents its latest views on the most significant risks to financial stability. While most of these are quite broad and are not directly related to community banking, the report goes into some detail on many operational risks that apply to all financial institutions, regardless of size.

For example, cyberattacks at financial institutions are happening with increased frequency, and at progressively smaller institutions. As the FSOC Annual Report notes, these attacks disrupt online access to customer websites, causing inconvenience and annoyance to customers, increased costs, and significantly elevated demand for mitigation service providers. Even community bankers need to be mindful of the increasing costs and challenges associated with keeping confidential information secure in this increasingly digital world.

Resources

FedViews (May 9, 2013) Fed economists' views on the current economy and the outlook.

The Economic Outlook and Monetary Policy: Moving in the Right Direction (May 16, 2013) Speech by John C. Williams, President and CEO, Federal Reserve Bank of San Francisco, to the Portland Business Journal CFO of the Year Awards Luncheon, Portland, Oregon

Fiscal Headwinds: Is the Other Shoe About to Drop? (June 3, 2013) The latest in the Economic Letter research series.

Consumer Compliance Outlook (First Quarter 2013) A Federal Reserve System publication dedicated to consumer compliance issues.

Bank Director's Desktop providing online training, a downloadable book, *Basics for Bank Directors*, and links to web based resources for bank directors to develop an understanding of their role in performing bank oversight responsibilities.