Supervisory Spotlight

A Regulator's Perspective on Issues Facing Western Banks

Banking Supervision & Regulation
Federal Reserve Bank of San Francisco

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Has the Liquidity Build-Up Ended?

Overall, financial conditions continue to improve. While bank earnings in the District remain relatively weak, improving earnings trends continue, and an increasing number of District banks are again posting satisfactory earnings. Meanwhile, loan growth is picking up, credit quality continues to improve, and liquidity and capital levels remain at historic highs.

However, as highlighted in the Federal Reserve Bank of San Francisco's most recent edition of [First Glance 12L](), the rising liquidity levels that were evident over the last five years have reversed. For the first time since 2007, short-term investments as a percent of assets declined at commercial banks in the second quarter. Similarly, we saw the first uptick since 2007 in the average loans/assets ratio in the latest quarter. Together, these trends suggest that the build-up in liquidity at District banks has ended. As loan growth continues to improve and as the economic and business environments strengthen, we expect that we'll continue to see declining liquidity metrics in the District. While many institutions currently enjoy healthy liquidity positions, this trend nonetheless warrants close attention from management teams and the regulatory agencies.

The latest First Glance 12L provides further information on liquidity trends and banking conditions in the District, as well as the hot topics that are currently capturing the regulatory agencies' attention. We encourage you to review the report and to share it with colleagues in your organization.

From the Director of Banking Supervision and Regulation

Regular readers of the Supervisory Spotlight know that keeping track of the changing regulatory landscape requires constant monitoring and attention by boards of directors, executive management, and even line-level staff at all institutions. Of course the same is true of the economic and banking environment, with new risks emerging as conditions improve. Among the issues we examine this quarter are rising liquidity levels, the new capital rule that was issued in July, and increasing interest rate risk.

On Tuesday September 24, we are hosting a *Call the Fed* webcast on "The U.S. Economy and 12th District Banking: Conditions and Outlook," which will be an opportunity to look at these and other issues in greater detail. Later in the year, another *Call the Fed* webinar will focus in on managing interest rate risk at community banking institutions. Please stay tuned for the invitation to that event. In the meantime, if you have any questions about the new capital rule, or any of the other issues we've covered in this letter, please reach out to me or to your regular contacts here at the Reserve Bank.

Best regards,

Teresa Curran

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Capital Reform is Now Here

One of the more notable regulatory reform initiatives was completed in July when the agencies finalized their respective rules to implement Basel III in the United States. As noted in this Federal Reserve press release, the revisions to the capital rules are designed to strengthen resiliency in the banking industry and contribute to the overall health of the U.S. economy.

The new capital rule introduces many notable changes to the current capital requirements. The final rule applies to all banks, top-tier bank holding companies that are not subject to the Board's Small BHC Policy Statement, savings associations, and top-tier Savings and Loan Holding Companies (SLHCs) that are not substantially engaged in insurance or commercial activities. For most institutions the rule becomes effective January 1, 2015.

Of particular interest to community banks, the final capital rule reflects some changes from the 2012 capital proposal that are intended to minimize the impact and burden on smaller, less complex financial institutions. For example, the final rule includes a one-time opt-out provision that many banking organizations can use if they do not want to include the unrealized gains and losses in accumulated other comprehensive income (AOCI) in common equity tier 1 capital. Additionally, the final rule permanently grandfathers the tier 1 capital treatment of non-qualifying tier 1 capital instruments (including trust preferred securities) issued prior to May 19, 2010 for banking organizations with less than $15 billion in assets. The agencies also decided not to adopt the proposed changes to the treatment of residential mortgages; the final rule retains the current 50% or 100% risk weights for exposures secured by one-to-four family residential properties.

The main elements of the final capital rule affecting community banks include the following:

- The final rule includes revisions to the minimum capital ratios and introduces a new common equity tier 1 capital ratio. The rule requires all banking organizations to maintain a common equity tier 1 capital ratio of at least 4.5 percent, a tier 1 capital ratio of at least 6.0 percent, and a total risk based capital ratio of 8.0 percent. Additionally, banking organizations will need to maintain a tier 1 leverage ratio of at least 4.0 percent. To put these new requirements in context, current District average Tier 1, Leverage and Total RBC ratios are well above these thresholds.
- The final rule implements a capital conservation buffer in addition to the minimum capital ratios. Banking organizations will need to hold common equity tier 1 capital greater than 2.5 percent of risk-weighted assets, on top of the minimum risk-based capital requirements in order to avoid restrictions on capital distributions and certain discretionary bonus payments to executive officers. This new requirement begins to phase in on January 1, 2016.

- The final rule makes several changes to the definition of capital. It strengthens the eligibility criteria for regulatory capital instruments and it limits the inclusion of minority interests, mortgage servicing assets, and deferred tax assets in regulatory capital.
- The final rule includes several changes to risk-weights, including increases for past-due loans and certain commercial real estate loans.
- The final rule makes revisions to the Prompt Corrective Action (PCA) Framework to align with the new minimum capital ratios.

An excellent resource for community bankers who want to learn more about the final capital rule and how it will impact their institution is the New Capital Rule Community Bank Guide that was released by the regulatory agencies with the Final Rule. This guide provides a great summary of the new rule and the changes to the regulatory capital framework, and it summarizes important information regarding transition periods.

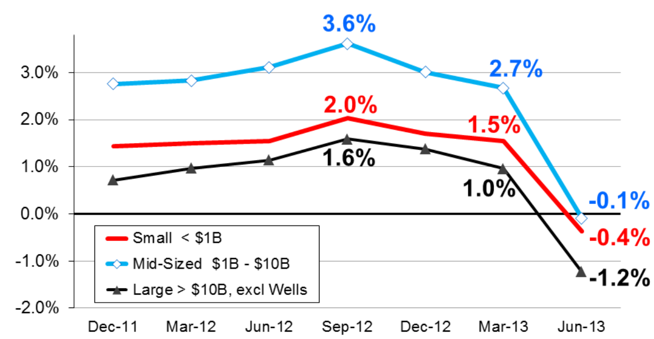
Interest Rate Risk is Still Building

We remain concerned with the increasing level of interest rate risk at 12th District institutions. Clearly, it is difficult for community banks to strengthen net income in this low rate environment. Net interest margins continue to compress, and net income remains relatively low at community banks across the District.

With that in mind, it is not too surprising to hear that many management teams are seeking other ways to improve net income. Absent the strong loan growth that many of us are anxiously awaiting, management teams are purchasing longer-dated securities that carry slightly more yield than securities of shorter terms. This is driving an overall lengthening of assets on bank balance sheets. The additional yields being captured do help to limit the extent of net interest margin compression. However, going longer term often presents more interest rate risk.

District institutions may now be experiencing evidence of this additional interest rate risk. In the second quarter, the market value of investments at District banks declined notably. At March 31, 2013, community banks in the District reported unrealized **gains** on investment securities that on average represented 1.5% of equity. This shifted in the 2nd quarter; at June 30, 2013, community banks in the District reported unrealized **losses** on investment securities that on average represented 0.4% of equity (see the chart below).

Net Unrealized Securities Gains Turn to Losses Across Small, Mid-Sized, and Large Banks



Based on a panel of commercial banks active over this period, excluding De Novos; preliminary 6/30/13 data;

While there could be many reasons for this shift, it corresponds with the recent uptick in interest rates, and it is the first time since 2011 that institutions are reporting unrealized losses in the investment portfolio (on average).

Given this, we strongly encourage bank management teams to review their risk model assumptions in light of these evolving market conditions. Quarterly, or at least annual, review of key asset and liability assumptions should be standard procedure—and all the more important now. In addition, please take a look at two particularly good resources for community bankers: SR 10-1 (Interagency Advisory on Interest Rate Risk) and SR 12-2 (Questions and Answers on Interagency Advisory on Interest Rate Risk Management). Once again, if you have questions or concerns regarding supervisory expectations on interest rate risk management, please feel free to talk with us.

Resources

Call the Fed Webinar: Economic Conditions and 12th District Banking Outlook (2:00pm Pacific time, September 24, 2013) with San Francisco Fed experts Gary Zimmerman and Gary Palmer.

FedViews (August 8, 2013) Fed economists' views on the current economy and the outlook.

The Economic Outlook, Unemployment, and Monetary Policy (September 4, 2013) Speech by John C. Williams, President and CEO, Federal Reserve Bank of San Francisco, to Portland Community Leaders, Portland, OR

Community Banking Connections (Second Quarter 2013) A Federal Reserve System resource for community banks.

Consumer Compliance Outlook (Second 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.