Supervisory Spotlight

A Regulator's Perspective on Issues Facing Western Banks

Banking Supervision & Regulation
Federal Reserve Bank of San Francisco

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Loan Growth is Accelerating

Banking conditions in the 12th Federal Reserve District continue to slowly strengthen, but one of the areas in which we're seeing faster improvement is loan growth. For the 12 months ending September 30, 2012, loans increased an average 2.8% for all District institutions. This growth rate is still rather low, but it is substantially better than what we were seeing at September 30, 2011 when total loans in the District were contracting at an average rate of 4.8%. And, behind the current 2.8% average growth rate are some other encouraging trends. For example, growth in several loan categories is quite strong and improvement is widespread. In aggregate, Commercial & Industrial loans are up 16%, and 1-4 Family First Liens are up 11% over the last 12 months. Meanwhile, all other loan categories - with the exception of Construction & Land Development (down 16%) and Home Equity & Junior Liens (down 7%) - also have positive loan growth rates, ranging from 2% to 6%.

Importantly, community banks are contributing to the accelerating loan growth in the District. Aggregate multifamily loans at community banks have increased 8% over the last 12 months, while aggregate consumer lending at community banks has increased 12%. And, most interesting, community banks are making a lot more 1-4 Family First Lien loans; this category increased 20% over the last 12 months. Many community banks are actually generating some very strong growth in the 1-4 Family First Lien category. At September 30, 2012, 18% of community banks had 1-4 Family First Lien growth rates of 40% or higher. While community banks overall are still struggling to generate some meaningful loan growth, these developments point to strengthening conditions for community banks. Moreover, the broader accelerating loan growth trends that we're now seeing are welcomed, as these should contribute to stronger net interest margins and improving economic conditions in the District.

Want more details and information on loan growth and banking conditions in the District? Our latest edition of First Glance 12L is now available.

From the Director of Banking Supervision and Regulation

The message in this issue of Supervisory Spotlight is a continuation of what has now become a familiar theme -- the economy and banking sector are improving and we are cautiously optimistic about the future, yet we are realistic about the challenges ahead.

The most significant challenge – for both bankers and regulators – is continued uncertainty. We have been living with economic and regulatory ambiguity throughout 2012 and there is every reason to expect it to continue well into next year. Some issues will be clarified, such as the resolution of the fiscal cliff (one way or another) and a myriad of regulations that will be finalized in 2013. Yet many other issues are likely to remain unclear, including the pace of the recovery, the implications of continued low interest rates, and key regulatory matters. Moreover, it is not clear to many banks how they will develop stable earnings and strong profitability.

Operating in an extended period of uncertainty is at best difficult, and at worst overwhelming. It can definitely bring out the worst in all of us. I want to make yet another plug for regular and robust communication between regulators and financial institutions. By now, you are surely aware of the many ways that we are reaching out to depository institutions and holding companies to share information and perspectives. However, as I repeatedly tell my staff, communication is a shared responsibility. I strongly encourage you to engage with regulators outside the examination context to discuss strategic issues and potential risks and establish strong relationships. I especially value informal dialogue with Boards of Directors and always make time on my calendar for these meetings. We can't over communicate during these unprecedented times.

Fortunately, our collective efforts to restore a stronger and more robust banking system have taken root due, in no small measure, to the extraordinary efforts of you and your staff. I wish you all a peaceful holiday season and look forward to working with you in the New Year.

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Commercial Real Estate Concentrations

With the improving real estate market and declining commercial real estate (CRE) concentrations in this District, we are less concerned with CRE concentrations today than we were in the years leading into the recent financial crisis. Nevertheless, this topic drew a lot of interest and attention at a recent Regional Bankers Forum that we hosted. Several attendees at this event raised concern with what they characterized as regulatory "caps" on CRE lending.

Let's be clear on this. There are no regulatory "caps" on CRE lending. At institutions that have elevated levels of CRE concentrations, our examiners will continue to assess the institutions' CRE risk management framework, leveraging the guidance and expectations discussed in SR 07-01 (Interagency Guidance on Concentrations in Commercial Real Estate). In an effort to be transparent, the regulatory agencies collectively determined that a total CRE concentration greater than 300% (excluding owner occupied), or a Construction & Land Development concentration greater than 100%, represent elevated concentrations that warrant strong risk management practices. In fact, high CRE concentrations were a key contributor to many recent bank failures. In a study conducted last year, we learned that median CRE concentrations at failed banks were three times the level at surviving banks. Construction & Land Development concentrations were nearly six times that for surviving banks.

Accordingly, the CRE risk management framework at institutions that exceed the thresholds in the guidance should incorporate appropriate board and management oversight, prudent and active portfolio management, strong management information systems, appropriate and timely market analysis, clear and measurable underwriting standards, periodic portfolio-level stress tests or sensitivity analysis, and strong credit review processes.

Troubled Debt Restructurings

Troubled debt restructurings (TDRs) continue to slowly decline. At September 30, 2012, TDRs at District institutions represented 2.3% of total loans, which is off slightly from the peak of 2.5% at September 30, 2011. The continuing decline in TDRs is one reason why asset quality at District institutions continues to improve, and it implies that fewer borrowers are experiencing financial difficulties. That said, TDR accounting issues often still surface during bank examinations. In many of these instances, it is clear that bank managers are reluctant to report a restructured loan as a TDR. There are likely several reasons for this, but this appears to largely be due to concerns that TDRs are viewed unfavorably.

Now is a good time to provide some additional perspective on TDRs. First, this is an accounting issue more than it is a regulatory issue. Examiners are certainly interested in making sure institutions follow the accounting rules and that financial statements conform to GAAP; however, when assessing asset quality, examiners focus mostly on the volume of classified loans and the trend in past dues and charge offs. Second, TDRs illustrate how well – and to what extent – banks are working with their problem borrowers, which is something that has certainly been encouraged by the regulatory agencies in recent years.

Last, when trying to determine if a certain restructured loan should be reported as a TDR, it might be helpful to remember why institutions are required to report TDRs in the first place. Institutions must report TDRs appropriately so that readers of the financial statements can make informed decisions about the quality of the loan portfolio and the institution's financial statements. If not disclosed in some manner, loans that are paying current only because of concessions granted by the institution would appear to be of equal quality as all other loans in the current category. In other words, the reader of the financial statements should know that a certain percentage of what appear to be high quality loans are actually weaker credits to borrowers that were or are experiencing some financial difficulty.

Revised Guidance on Technology Service Providers

The Federal Financial Institutions Examination Council (FFIEC) recently issued an updated "Supervision of Technology Service Providers Booklet" that provides updated guidance on the supervision of technology service providers (SR 12-14). This guidance is primarily applicable to field examiners and supervisory staff; nevertheless, banking organizations that have relationships with technology service providers may find the guidance to be useful. You may also be interested to know that the FFIEC maintains an online Information Technology Examination Handbook InfoBase that is a great source for current regulatory guidance and resources covering a wide range of information technology topics and issues.

Call-the-Fed Webinars

We recently hosted two successful Call-the-Fed webinars. On September 13, 2012 our Call-the-Fed, "Commercial and Industrial Lending: Pitfalls and Risk Mitigants," focused on problems and best practices our examiners have observed with C&I lending. Specific topics included loan underwriting, administration strategies, cash flow calculations, covenants, and collateral inspections. Our November 20, 2012 webinar on "The U.S. Economy and 12th District Banking: Conditions and Outlook" included comments by a Senior Economist and a Senior Banking Analyst on District banking and economic conditions.

The Call-the-Fed webinars are just one way that we continue to engage and strengthen our ongoing dialogue with financial institutions in this District. These events are held several times each year and they are intended to focus on current banking topics or emerging risks to the financial industry. To learn more about the Call-the-Fed series and to access presentation materials and recorded audio of previous Call-the-Fed events, please visit our Call-the-Fed webpage.

Community Banking Connections

Speaking of communicating with community bankers, we encourage you to visit the Federal Reserve's new Community Banking Connections website. Community Banking Connections is a new quarterly publication with commentary focused solely on community bank issues. In the Third Quarter 2012 issue, the newsletter included information on The Importance of Community Banking, Interest Rate Risk Management at Community Banks, the Community Depository Institutions Advisory Council, the mysteries of appraisals, and the recent regulatory capital proposals.

You can access these articles at the Community Banking Connections website, which also serves as a portal for information on other matters and resources that should be of interest to community bankers. For example, the portal includes links to the Federal Reserve's Consumer Compliance Outlook newsletter, a quarterly publication focused on consumer compliance matters, and Outlook Live, the Federal Reserve's webinar program for emerging consumer compliance issues and topics. In coming months, community bankers will also be able to access FedLinks, short bulletins and updates on specific topics. Lastly, we encourage you to take advantage of the subscription service also available at the Community Banking Connections website. By clicking on the Subscribe Now link, you can subscribe to receive electronic or hard copies of these publications.

Resources

FedViews (November 8, 2012) Fed economists' views on the current economy and the outlook.

The Role of Monetary Policy in Bolstering Economic Growth (November 14, 2012) Speech by John C. Williams, President and CEO, Federal Reserve Bank of San Francisco, at the University of San Francisco Center for the Pacific Rim.

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.