Supervisory Spotlight

A Regulator's Perspective on Issues Facing Western Banks

Banking Supervision & Regulation
Federal Reserve Bank of San Francisco

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From the Director of Banking Supervision and Regulation

As 2013 draws to a close, it is important to note the condition of the industry is stronger today than it was a year ago. When we view trends on a quarterly basis, we're often too focused on the small, incremental changes and we forget to take a step back and look at the big picture. In this case, the big picture is an improving one.

Another big picture event that we're especially proud of in the 12th District is the nomination of Janet Yellen to be Chairman of the Board of Governors of the Federal Reserve System. Yellen, who is expected to be confirmed by the Senate early in 2014, is taking on these responsibilities at a time of recovery in the economy, but also in a context of ongoing and dramatic change in the regulatory environment. All of you who know her from her time as president of this Reserve Bank know that she is no stranger to community banks and the issues they face. I hope you also share my confidence that this perspective will remain important to her in her new role as Chairman.

As always, we welcome your feedback on the topics presented here, so if you'd like to share anything, please do so. And finally, I wish you and your staff a happy and successful 2014.

Best regards,

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Loan Growth is Accelerating in the 12th District

Keeping with the theme noted over the last several quarters, District banking conditions continue to improve at a slow and steady pace. An exception is the accelerating loan growth across the District. According to the latest edition of [First Glance 12L](), average loan growth in the District climbed nearly 7.0 percent (year-over-year), double the national average. For community banks with total assets below $1 billion, average annual loan growth has picked up to 5.8 percent. For community banks with total assets of $1 to $10 billion, average annual loan growth now stands at a very healthy 12.1 percent. Leading the way is Nevada; average annual loan growth for Nevada banks is a strong 11.4 percent.

It is also encouraging to see how widespread the pick-up in lending is across various product types. Although District banks are still reducing their Home Equity and Junior Lien Mortgage portfolios, we're seeing very good growth in Multifamily (+19.0 percent year-over-year), Commercial & Industrial (+12.0 percent), and Agricultural (+11.0 percent) loans. Meanwhile, credit quality is improving. We know that classified assets are declining at commercial banks across the District, loan loss rates have returned to pre-crisis levels, noncurrent loan rates are at the lowest level since late 2008, and the volume of Troubled Debt Restructurings (TDRs) continues to decline and is now at the lowest level since mid-2010. These positive credit quality trends, coupled with improving loan growth, sound capital and liquidity levels, and improving earnings, provide good evidence that banking conditions in the District are well on their way to recovery from the recent financial crisis and economic recession. Although there are still some headwinds, we expect conditions will continue to improve in the coming quarters.

For Loan Growth, How Strong is Too Strong?

We are very happy to see improving loan growth across the District. Multifamily loan growth rates were in excess of 20.0 percent at nearly half of the banks in the District, while more than a quarter of institutions in the District reported Agricultural, Construction & Land Development, Residential Mortgage, and Commercial & Industrial portfolios increase more than 20.0 percent over the last four quarters. However, in several loan categories today's growth rates exceed what we saw in the years leading up to the recent financial crisis. In fact, extremely strong loan growth was one contributor to many recent bank failures.

With this in mind, the Federal Reserve is focusing more attention on underwriting and pricing decisions at banks with significant loan growth. Management teams and Boards of Directors should ensure that prudent underwriting standards are maintained and that District banks are not booking new loans at the expense of prudent underwriting. We have heard from many in the industry that competition for good, well-qualified borrowers is fierce; nevertheless, it is important to maintain prudent lending standards to ensure the long-term viability of the industry. One way to accomplish this is to monitor the volume of policy and underwriting exceptions. From time-to-time, it may be acceptable to fund a loan that contains terms outside of the bank's approved criteria; however this should be appropriately approved and documented, and it should not be done frequently. If policy exceptions are not watched closely, the bank may find that it is actually underwriting to terms that are far more liberal than the Board of Directors may desire.

Guidance on Managing Outsourcing Risk Issued

On December 5, the Federal Reserve issued long-awaited guidance discussing risk management expectations for managing outsourcing risk. This guidance, which is also referred to as vendor management guidance, is applicable to institutions of all sizes, including community banks. We've noted over the years that institutions are increasingly reliant on third parties to conduct a variety of activities and operations on their behalf. While many of these activities don't present much risk, this isn't always the case. In some instances, operational, compliance, reputation, and legal risks could actually increase when an institution outsources an activity.

With this in mind, the guidance addresses the characteristics, governance, and operational effectiveness of an institution's service provider risk management program for outsourced activities beyond traditional core bank processing and information technology services. The guidance discusses three key areas: Risks from the Use of Service Providers; Board of Directors and Senior Management Responsibilities; and Service Provider Risk Management Programs. We encourage you and your staff to become familiar with this guidance (SR Letter 13-19), which can be accessed on the Federal Reserve's Supervision and Regulation Letters page (here).

Federal Reserve Hosts Community Banking Conferences

In October, the Federal Reserve System hosted two conferences on community banking. The first was on October 2 and 3, 2013, hosted by the Federal Reserve Bank of St. Louis and the Conference of State Banking Supervisors. The second was a week later at the Denver Branch of the Federal Reserve Bank of Kansas City. Both conferences included community bankers, academics and researchers, and state, Federal Reserve, and other federal bank regulators.

In St. Louis, the primary focus was on the presentation of research papers related to community banking and the results of a series of community bank town hall meetings. Panels addressed topics related to the role of community banks, community banks' performance, the supervision and regulation of community banks, and the challenges and opportunities in their markets. The theme of the Denver conference was "Responding to Economic and Regulatory Uncertainty." A key part of the agenda was focused on how the regulatory framework has changed and how these changes affect community banks. Several panelists addressed state and national issues for community banks, the future of real estate lending at community banks, and opportunities to increase earnings.

Bankers used the conferences to share thoughtful comments about the changing regulatory environment and increasing burden of understanding and complying with new rules and regulations. We too have also heard similar comments from many bankers in this District, and while it is true that most of the significant regulatory changes affect only the largest institutions, there are still many regulatory changes, particularly in the consumer compliance area, that even community bankers must be aware of and understand.

For those of you that might be interested in more detail on the speakers and presentations from these conferences, please visit these webpages:

St. Louis conference: http://www.stlouisfed.org/banking/community-banking-conference/

Kansas City conference:http://www.kansascityfed.org/events/eventdetail.cfm?event=6940F079662D17157CEC65C570F65D2C

Consumer Compliance Hot Topics – Year in Review

Recognizing the challenges presented by a changing regulatory landscape, the Federal Reserve also recently held a nationwide *Outlook Live* Webinar that provided participants with a recap of recent consumer compliance regulatory changes and recently issued regulatory guidance. Senior Federal Reserve staff also covered several hot topics that should be of interest to consumer banking staff at District institutions. An archive of this presentation can be accessed here. From this link, you can access archived *Outlook Live* Webinars on Small Creditor Qualified Mortgages, Conducting Consumer Compliance Risk Assessments, Indirect Auto Lending, and Unfair or Deceptive Acts or Practices (UDAP).

Resources

Call the Fed Webinar: Managing Interest Rate Risk in a Rising Rate Environment (December 5, 2013) with San Francisco Fed experts Wallace Young and Jeffrey Plaskett.

Outlook Live Webinar: Consumer Compliance Hot Topics—2013 Year in Review (December 12, 2013) Our annual review of this fast changing regulatory environment with senior Federal Reserve staff

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

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

FedViews (November 14, 2013) Fed economists' views on the current economy and the outlook.

Economic Letter: Why Do Measures of Inflation Disagree? (December 9, 2013) San Francisco Fed economists' latest research paper

Rebalancing the Economy: A Tale of Two Countries (November 8, 2013) Speech by John C. Williams, President and CEO, Federal Reserve Bank of San Francisco, to Community Leaders, Los Angeles, CA

Federal Reserve System Centennial Commemoration Visit the gateway to the history of the Federal Reserve System

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.