Supervisory Spotlight

A Regulator's Perspective on Issues Facing Western Banks

Banking Supervision & Regulation
Federal Reserve Bank of San Francisco

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Banking Conditions Continue to Improve

The ongoing improvement in overall banking conditions remains tepid. However, we are pleased to see that 12th District financial institutions posted stronger earnings, asset quality, liquidity, and capital at year-end 2011. Of particular note, commercial banks in the 12th District reported an average ROAA of 0.35% for 2011. While this remains low by historical measures, it is the first time that commercial banks in the District posted positive full-year earnings on average since 2007. The average commercial bank ROAA in the District increased a healthy 58 basis points from 2010, and the improvement was widespread across all states. However, it is hard to ignore that the better profitability was entirely due to sharply lower provision expenses, and many institutions recorded negative provisions in the final quarter of 2011. Core earnings were actually flat compared to 2010, and bankers in the District continue to find it difficult to strengthen the NIM given persistently low interest rates and soft loan demand (although C&I and multi-family loan balances are up noticeably).

Asset quality in the District also improved notably. Although noncurrent loans and net charge offs remain at elevated levels, trends are quite positive. Noncurrent loan rates are declining in all states and the average net charge off rate for the District has declined to 1.0%, well below the peak of 2.1% seen in 2009. Meanwhile, the volume of Troubled Debt Restructurings (TDRs) and Other Real Estate Owned (OREO) appear to have peaked. For further information on District conditions, remember that we dissect banking conditions in the First Glance 12L report available here. The latest issue of this report includes sections on Commercial Banks, Savings Institutions and Industrial Banks, and Supervisory Hot Topics.

Fed Guidance on Problem Asset Exchanges

On December 21, 2011 the Federal Reserve Board of Governors issued SR 11-15 (Disposal of Problem Assets through Exchanges). The Board has seen an increase in the number of these so-called problem asset exchanges, as banks search for alternative ways to reduce problem assets and strengthen core earnings. These problem asset exchanges are marketed as a way for institutions to replace problem assets with performing assets; in a typical asset exchange, a bank acquires a portfolio of performing loans, in exchange for cash plus a portfolio of problem loans. While these transactions, if properly executed with reputable counterparties and subjected to the appropriate level of due diligence, could reduce nonperforming assets, Federal Reserve staff have been made aware of transactions that present significant risk to institutions and could compromise their safety and soundness.

If your bank has engaged in or is contemplating this type of transaction, we encourage you to review this new guidance. The guidance illustrates a problem asset exchange and it provides a list of issues that management should consider

From the Director of Banking Supervision and Regulation

We're pleased to see that banking conditions in this District continue to improve. As we briefly note in this letter, all aspects of financial performance for commercial banks in this District improved in the latest quarter. This improvement is tepid, but it continues the mostly positive trend from prior quarters and we anticipate that conditions will continue to slowly improve.

In this letter, we also address regulatory reform, credit availability, and the future of community banking, three interconnected topics that we can only touch upon in a brief newsletter like this. Nevertheless, we recognize that these are important topics for bankers and we hope that you'll find our comments and those of Governor Duke and Chairman Bernanke to be of interest.

As always, I look forward to hearing from you about the issues we raise in this letter, and any other concerns that you, your Directors, and your senior management care to share with me.

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when assessing the associated risks. These issues include: the economic costs and benefit of the transaction, the servicing responsibilities attached to the acquired assets, the transaction's compliance with the risk tolerance and risk mitigation policies of the institution, the appropriate accounting treatment, the marketing agent and the agent's relationship with the entity providing the performing assets, and the acquiring institution's experience, skills, personnel, and risk management capabilities to manage the newly acquired assets. Additionally, the institution should obtain an independent valuation of the assets being acquired.

Update on the Consumer Financial Protection Bureau

Since its launch, the Consumer Financial Protection Bureau (Bureau) has been actively assuming its core responsibilities. As part of this process, 17 consumer financial protection laws were republished as interim final rules with technical and conforming changes to reflect the transfer of authority and certain other changes made by the Dodd-Frank Act. The interim final rules also requested comment on technical issues raised by their republishing, and on notice 76 FR 75825 concerning the Bureau's efforts to identify priorities in streamlining regulations that it inherited from other Federal agencies. In addition, the January 4, 2012, recess appointment of Director Richard Cordray grants the Bureau full authority to exercise its powers, which include the full scope of its rulemaking authority and supervision of nonbank entities. With the expanded authority, the Bureau launched its nonbank supervision program, hosted payday lending field hearings, and published payday lending examination procedures (i.e., short-term, small-dollar lending examination procedures). The Bureau also began exercising its rulemaking authority by issuing a final remittance transfer rule that amends Regulation E and concurrent proposal and request for comment on additional changes, such as exemption for certain companies that do not routinely provide remittance transfer services.

There are a number of Dodd-Frank Act mandates due within the next 12 - 18 months, which suggests that the pace of consumer regulatory activity will likely increase. As a result, we encourage you to monitor the Bureau's proposals as they are issued and to fully utilize comment periods as an opportunity to influence the final rules and help prevent unintended consequences resulting from any new rules. For our part, we will continue to maintain a good dialogue and working relationship with Bureau staff in the Western District, and we'll continue to provide updates on important developments in the consumer regulatory environment.

Interest Rate Risk FAQs

On January 11, 2010, the Federal Reserve and the other financial regulators published an Advisory on Interest Rate Risk Management (SR 10-1, "Interagency Advisory on Interest Rate Risk"). Since its release, examiners and the industry have requested clarification on some specific recommendations in the advisory. In response to these questions, the financial regulators jointly developed a frequently asked questions (FAQs) document that provides interpretive guidance on some of these issues (SR 12-2). The advisory and the FAQs are intended for use by banking organizations and supervisors as they assess organizations' management of interest rate risk. While the questions and answers are applicable to all institutions, we note that many of these questions originated from community banking organizations and we encourage you to review them.

Regulatory Reform and Credit Availability

Federal Reserve Governor Elizabeth A. Duke spoke on the issue of regulatory burden at a recent event hosted by the California Bankers Association. We encourage you to read her prepared remarks on issues covering supervisory expectations, balancing safety and soundness with credit availability, encouraging creative supervisory approaches to emerging problems, regulatory burden and mortgage lending. Even more recently, Chairman Ben Bernanke addressed the "role of community banks in a challenging economy" in a speech at the FDIC's Future of Community Banking Conference. The Federal Reserve System is very aware of the concerns that many bankers have regarding regulatory reform, increasing regulatory requirements, and the future of community banking. Regulators certainly need to be very thoughtful and careful as we implement steps to strengthen financial stability without making it too costly to comply, and without impeding credit availability.

With this in mind, the Federal Reserve is now reviewing several aspects of its community bank supervisory program. Several projects are underway to improve or clarify guidance on topics such as CAMELS upgrades, formal enforcement actions, ALLL assessments, capital planning, and stress testing. We are also exploring ways to improve certain internal processes related to processing reports and reviewing applications, and we're considering enhancements to our industry training and outreach efforts. We'll provide more information on these initiatives as it becomes available.

By the Way...

John Williams, President of the Federal Reserve Bank of San Francisco has given a number of speeches on monetary policy and the economic recovery. His most recent speech, "The Federal Reserve's Mandate and Best Practice Monetary Policy" can be accessed here. In this speech, Mr. Williams presents his views on the current stance of monetary policy. Mr. Williams is a frequent speaker and is in very high demand, so many of you may be pleased to hear that Mr. Williams has agreed to speak at two upcoming industry events. He will be speaking at the California Bankers Association's annual convention on May 4, and at the Oregon, Idaho and Nevada Bankers' annual joint convention on July 9.

Also, did you know that you and your staff can subscribe to receive a wide variety of publications and announcements at the Federal Reserve Bank of San Francisco's website (www.frbsf.org)? These include the popular 12th District Banking Profile and First Glance 12L reports, as well as our circular letters that are used to announce new policies and guidance. If you haven't visited our website lately, you'll find that the look and feel of the site have been enhanced. You can access and subscribe to Banking Supervision and Regulation publications here.

Resources

First Glance 12L— Fourth Quarter 2011 (February 2012) A first look at financial performance of 12th District banks for the 4th quarter of 2011.
Economic Trends and Conditions (February 2012) Monthly review & analysis of key trends in the 12th District economy.

FedViews Fed economists' views on the current economy and the outlook.

The Federal Reserve's Mandate and Best Practice Monetary Policy (February 13, 2012) Speech by John C. Williams, President and CEO, Federal Reserve Bank of San Francisco at the Marian Miner Cook Athenaeum, Claremont McKenna College.

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.