Supervisory Spotlight

A Regulator's Perspective on Issues Facing Western Banks

Banking Supervision & Regulation
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From the Director of Banking Supervision and Regulation

The year started off well, with first quarter banking conditions continuing the gradual improving trend that began in 2010. Financial performance overall remains subdued as many banks continue to deal with the aftereffects of the financial crisis and recession, but the steady progress we're seeing is encouraging.

This issue concludes by highlighting two forums where the Federal Reserve is engaging with bankers outside of the supervisory process. The recent ***Ask the Fed*** session included a robust dialogue on real estate conditions and the lending environment, and our ***Community Depository Institutions Advisory Council*** meeting provided a good opportunity to consider the various facets of interest rate risk.

I'm committed to participating in the Fed's open dialogue with the industry. My senior officers and I are attending all of the District's banking association meetings this summer and we remain available to meet with bankers outside the examination setting. We'd like to hear about any concerns or perspectives that you, your boards of directors, or your management teams would like to share.

Best Regards,

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Western Banking Conditions Continue Recovery

Banks in the 12th Federal Reserve District continued to show signs of gradual improvement through the first quarter of 2012. Stronger earnings, asset quality, liquidity, and capital measures are encouraging. These trends, along with concerted efforts by bank management teams to address weaknesses, support the growing number of CAMELS rating upgrades we're seeing across the West. Among all District banks examined in the first quarter, nearly one in four received a composite CAMELS upgrade. But we still have a long way to go before full recovery, as just under half of District banks still have a less-than-satisfactory rating.

Although core earnings momentum remains challenging given low interest rates and subdued loan demand, profitability continues to recover. 12th District banks reported an average annualized ROAA of 0.60% for the first quarter, up sharply from 0.35% a year ago. Lower loan loss provisions continue to explain the better bottom line results.

District asset quality also continued to improve steadily. Banks of all sizes and across all states posted declining noncurrent loan rates through the first quarter, although smaller banks lagged somewhat. The District average noncurrent rate of 3.3% is down 150 basis points from the March 2010 peak but remains significantly higher than the national average rate of 2.0%. We're seeing noncurrent rates edge down across all major loan types as well as declines in troubled debt restructurings and foreclosed real estate.

For further details on District banking conditions, check out the recently issued First Glance 12L report.

Federal Reserve Issues Statement on Rental of Other Real Estate Owned ("OREO") Properties

The large volume of distressed residential properties, coupled with rising demand for rental housing in many markets, means some banks are temporarily renting OREO to improve the eventual recovery on the loan. In early April, the Federal Reserve issued a policy statement (SR 12-5/CA 12-3) addressing this trend. The guidance and related Q&A cover a wide range of topics including: reporting and classification of OREO assets; appraisal requirements; accounting treatments for sale and transfer of OREO assets; operational issues for the management of OREO assets; and community development and consumer protection issues.

The statement reiterates earlier guidance that allows banks to use rentals of residential OREO properties as part of an orderly disposition strategy. The policy also describes supervisory expectations, including the importance of compliance with laws & regulations (e.g., landlord-tenant requirements and selling properties within required timeframes) and the management of third-party vendors. Finally, it's important for bankers to remember that the policy does not rule out other immediate disposition strategies, such as sales to private investors or purchasers intending to occupy the property.

Agencies Issue New Guidance and Proposals on Mortgage Lending

The Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act) mandates a nationwide licensing and registration system for residential mortgage loan originators (MLOs). In late April, the Federal Reserve issued a circular letter as a reminder that by July 29, 2012, institutions must conduct an initial independent test for SAFE Act compliance. The circular letter provides key reference information including new interagency SAFE Act examination procedures and the Federal Reserve's supervisory expectations regarding MLOs.

In other developments related to mortgage lending, the Consumer Financial Protection Bureau recently issued CFPB Bulletin 2012-02 regarding loan originator compensation rules. The Bulletin clarifies that financial institutions may make contributions to qualified profit sharing, 401(k), and employee stock ownership plans for MLOs. In addition, the Bureau recently announced proposals for rules pursuant to

Dodd-Frank Act provisions relating to mortgage servicing and simplifying mortgage points and fees. As these rules may apply to all institutions, we encourage you to review and understand their potential impact.

Federal Reserve Hosts Call on Real Estate Conditions

Many of you are familiar with the Federal Reserve's *Ask the Fed* conference call series which was launched in 2008. The program gives bankers a chance to learn about industry risks and supervisory policy initiatives and to hear directly from examiners about sound practices and red flags they're seeing in the field.

One of our officers presented at a recent *Ask the Fed* session on commercial and residential real estate which was conducted in front of a live audience of 200+ attending a conference hosted by the Kentucky Department of Financial Institutions in Lexington, KY, with more than 1,000 additional participants on the conference call. The speakers noted that the multi-family segment of commercial real estate continues to perform very well, but they highlighted the acceleration of new multi-family construction in many major markets that might serve as a warning sign for bankers looking to jump into this lending area. On the residential side, the speakers addressed many of the lingering weaknesses in the housing market, but they also pointed to several encouraging developments. For example, home prices are stabilizing across the nation and are increasing in certain areas, market participants are noting an uptick in showings and buyer interest, and home affordability is at an all-time high.

The *Ask the Fed* session held in Kentucky is just one of many ways the Federal Reserve strives to maintain a meaningful dialogue with the banking industry. At the San Francisco Fed, we host regional *Call the Fed* webinars on important safety and soundness issues and we administer the nationwide *Outlook Live* webinars as part of the Federal Reserve System's *"Consumer Compliance Outlook"* newsletter. Most recently, an *Outlook Live* webinar on "2010 Census Data - What it Means for CRA, HMDA, and Fair Lending Compliance" was held on June 21, 2012. Late last year, we held a *Call the Fed* session on Responding to the Cyber Threat: Interagency Supplement to Authentication in an Internet Banking Environment.

Enhanced Dialogue with Community Bankers

In 2010, the Fed launched the Community Depository Institutions Advisory Council ("CDIAC") to more closely consider community bank perspectives in policy deliberations. Each of the twelve Reserve Banks has a local council, with membership drawn from smaller banks, credit unions, and savings associations. One representative from each local council serves on the national council that meets with the Board of Governors twice a year. Many of you may be familiar with this program—eleven 12th District bankers are members of the San Francisco Fed's CDIAC. This process gives us a direct line to community bankers' thinking about regulatory issues and local economic trends.

We recently concluded the third meeting of our CDIAC, where there was an engaging discussion of lending conditions. Council members made clear that the competition for strong borrowers is fierce and in some cases causing aggressive underwriting. They also shared their concerns that the unusually high deposit balances in the industry are not sustainable, especially as alternative investment opportunities increase along with economic growth. I hope all of you feel free to discuss your concerns with the council members, who can then raise those issues at a council meeting. CDIAC members serve three year terms, so there will be opportunities for other institutions to participate directly on the council.

Resources

First Glance 12L— First Quarter 2012 (May 2012) A first look at financial performance of 12th District banks for the 1st quarter of 2012.

Economic Trends and Conditions (May 2012) Monthly review & analysis of key trends in the 12th District economy.

Bank Regulation in the Post-Crisis World (May 4, 2012) Speech by John C. Williams, President and CEO, Federal Reserve Bank of San Francisco at the California Bankers Assocation, 121st Annual Convention at Dana Point, California. For other speeches by President Williams, please visit the Federal Reserve Bank of San Francisco's News and Events page.

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

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.