Supervisory Spotlight
A Regulator's Perspective on Issues Facing Western Banks

Banking Supervision & Regulation
Federal Reserve Bank of San Francisco

March 2013

From the Director of Banking Supervision and Regulation

As we approach the 2nd quarter of 2013, two things remain clear. First, the financial condition of institutions in this District continues to slowly improve. While the progress remains steady overall, we are encouraged by the accelerated improvement in community banks, a sector that had significantly lagged District averages. We hope the trend continues.

Second, regulatory changes continue to require both Management and Board attention. In this issue we address two of the many new mortgage lending rules recently issued by the CFPB, as well as recent changes that will force many management teams to rethink how they utilize and rely upon the ratings assigned to investment securities by the credit rating firms. I recognize the burden that your management teams face as they absorb the continuing flow of new rules, regulations, and guidance, and reiterate my invitation to discuss any issues or questions about how these changes might affect your institution. Please feel free to reach out to me or your regulatory contact if we can provide any assistance or clarity.

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Banking Conditions: Solid Improvement, but Further to Go

Although banking conditions in the 12th District continue to steadily improve, the industry still has not fully recovered from the financial crisis. What will it take to get to full recovery? Among other things, the industry needs to see stronger loan growth, healthier net interest margins, and fewer problem and non-performing assets.

Loan growth continues to accelerate, but the growth rate remained relatively low at 3.9% at year-end 2012. Much of this growth was in the Commercial & Industrial and 1-4 Family First Lien portfolios, which increased 11% and 10%, respectively, in 2012. However, overall growth still lags historic norms. Similarly, asset quality indicators continue to improve, but noncurrent loans in the District remained relatively high at 2.4% on average. Unfortunately and not surprisingly, net interest margins (NIM) remained under pressure in the District. The average NIM was flat in 2012 at 4.1%, roughly 110 basis points lower than the NIM at year-end 2006. This is a function of the still-low interest rate environment, coupled with limited loan growth opportunities. For additional information on banking conditions, please read the 4Q 2012 First Glance 12L.

New Mortgage Rules Issued

Much of the remaining discussion in this edition of Supervisory Spotlight will be devoted to the mortgage lending rules recently issued primarily by the CFPB. The seven sets of rules are quite expansive, covering Ability to Repay and Qualified Mortgages; High-Cost Mortgages; Escrow Requirements; Mortgage Servicing; Appraisals; and Loan Originator Compensation. In the following sections, we focus on Ability to Repay and Qualified Mortgage Standards under the Truth in Lending Act (TILA), and the rules affecting appraisals under both the Equal Credit Opportunity Act (ECOA) and TILA. We'll cover other mortgage topics in future editions.

- **Ability to Repay (ATR) and Qualified Mortgages.** On January 10, 2013, the CFPB adopted a new rule to implement laws requiring mortgage lenders to consider consumers' ability to repay home loans before extending them credit. The rule also establishes a new category of loans called "qualified mortgages," that offer lenders special protection from liability. The rule becomes effective January 10, 2014. Concurrently, the Bureau released a proposal seeking comment on whether to adjust the final rule for, among others, certain community-based lenders and small portfolio creditors. That comment period has ended, and the final adjusted rule should be issued later this spring.

  Under the general ability to repay standards, mortgage lenders are required to assess consumers' ability to repay mortgage loans before extending them credit. The rule details eight underwriting factors regarding consumer-specific information that must be considered and verified. Under these standards, there are no restrictions on loan features, loan terms, or points and fees; but, due to the verification requirements, the rule does essentially eliminate the ability of lenders to offer no-document or low-document loans.

  Lenders can also comply with the ATR rules by originating qualified mortgages. So-called QMs are considered "safer" since they are free from features that are considered more risky, have restrictions on upfront points and fees, and are generally underwritten to a maximum debt-to-income ratio of 43 percent. Because they are considered less risky, QMs offer lenders special protection from liability. The rule also includes a QM balloon exemption for lenders in rural or underserved areas and a temporary category of qualified mortgages that have more flexible underwriting as long as they satisfy the general product feature prerequisites for a QM and also satisfy the underwriting requirements of an applicable government loan program.

- **Appraisal Requirements.** On January 18, 2013, two rules affecting appraisals were issued. The first, issued by the CFPB, implements ECOA requirements affecting disclosures and appraisal delivery. The second, an interagency rule, implements TILA requirements for higher priced mortgage loans. Both rules become effective January 18, 2014.

  These rules are designed to improve consumer access to appraisals and other written valuations (appraisal reports).

The new rule requires creditors to provide applicants with an early notice of their right to receive appraisal reports and a free copy of the report. The rule also establishes timing requirements for when appraisal reports must be provided. As noted in the rules, the creditor may provide one disclosure for the overlapping ECOA and TILA early disclosure requirements.

The TILA rule also requires, for higher priced mortgage loans, the use of a licensed or certified appraiser who prepares a written appraisal based on a physical inspection of the interior of the property. To discourage fraudulent property "flipping," the rule also contains a requirement for additional analysis in certain cases (for example if a borrower had obtained the property for a lower price within the previous six months).

For further information on each of the new mortgage rules, a District Circular letter issued February 8, 2013 provides a summary of the key elements of each rule and includes relevant links to other available resources.

Safe Act Reminder

On August 10, 2010, the Federal Reserve issued guidance (SR 10-14) related to registration requirements for federal mortgage loan originators (MLOs) that were contained in the Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act). Under the SAFE Act, an individual generally is prohibited from engaging in the business of mortgage loan origination without first obtaining and maintaining a unique identifier, and either a license and registration as a state-licensed MLO or a registration as a federally registered MLO.

In recent conversations with bank management teams, examiners learned that some bankers are not fully aware of the MLO registration requirements or are unfamiliar with the process to ensure MLOs obtain the proper registration. With this in mind, we encourage bank management teams to revisit SR 10-14 and subsequent guidance. An excellent resource is the Federal Registry Resource Center, which provides loan originators with information that they will need to make sure applicable staff are appropriately registered.

New Guidance on Credit Ratings

On November 15, 2012, the Federal Reserve issued guidance entitled Investing in Securities without Reliance on Nationally Recognized Statistical Rating Organization Ratings (SR 12-15). This guidance advised state member banks that effective January 1, 2013 they may no longer rely solely on credit ratings when determining if an investment security is a permissible investment.

Going forward, an investment security will meet the investment grade test only if the issuer has an adequate capacity to meet its financial commitments under the security for the projected life of the asset or exposure. While external ratings can complement an institution's assessment of the issuer's capacity, institutions can no longer make the decision based solely on an external credit rating.

This will likely present some challenges for many community banks. With that in mind, please note that with SR 12-15, the Federal Reserve distributed additional guidance developed by the OCC. This additional guidance was developed to assist institutions when determining what steps should be taken to demonstrate that they meet the new pre-purchase and due diligence requirements. Most notably, this document includes a list of key factors that management teams should consider when evaluating different types of investment securities.

Addressing the Future of Community Banking

In closing, Governor Elizabeth Duke recently gave a speech in which she shared her thoughts on the future of community banks. Her comments should be of particular interest to community bankers in this District. In the speech, she addressed the concern of "one size fits all" regulation, noting that regulators need to differentiate rules and regulations to community banks based on their risk profiles. Accordingly, community bankers should keep this in mind when providing comments to Notices of Proposed Rulemakings. Also in her comments, Governor Duke discussed some of the research now being conducted on the factors that influence the viability and performance of community banks. If you missed her comments, you can read her speech here.

Resources

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

The Economy and Monetary Policy: Follow the Demand (February 21, 2013) Speech by John C. Williams, President and CEO, Federal Reserve Bank of San Francisco, at The Forecasters Club, New York, New York.

Community Banking Connections (Fourth Quarter 2012) A Federal Reserve System website and publication providing additional insight on recent supervisory and regulatory developments related to community banking.

Consumer Compliance Outlook (Fourth Quarter 2012) 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.