Supervisory Spotlight

A Regulator's Perspective on Issues Facing Western Banks

Financial Institution Supervision and Credit
FEDERAL RESERVE BANK
OF SAN FRANCISCO

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Greetings!

In this issue of *Supervisory Spotlight*, I'd like to highlight a variety of articles and analyses that might be of interest to Twelfth District bankers. Unlike prior *Spotlight* issues, where a "theme" was fairly apparent—emerging risks, communication, or change, to name a few—the variety of topics in this issue should ensure there is something that is relevant to every reader.

Over the holiday shopping season, I got to thinking about the new credit card that I had received, which had an embedded chip on the front of the card as well as the magnetic stripe on the back. In some stores, it was business as usual: swipe, sign, and go. In others, I was asked to insert my card into a reader and leave it there until the transaction was complete. A lot of my unasked questions about the new chip card technology were recently answered in an article, The U.S. EMV Chip Card Migration: Considerations for Card Issuers, in the current issue of *Community Banking Connections*. This article was written by Mary Hughes, a guest author from the Minneapolis Fed's Payments Information and Outreach Office. In it, she discusses the evolution of chip technology; why and how the U.S. is moving toward chip credit, debit, and prepaid cards; and how community bankers can prepare themselves, their merchants, and their cardholders for the migration. The article closes by providing links to additional sources of useful information about the EMV migration. Although most community bankers are aware of the chip card migration, I think you still will find some good information here about opportunities to reduce operational risk and fraud losses on your debit and credit card portfolios.

Speaking of losses, the allowance for loan and lease losses, or ALLL, is receiving a lot of attention lately. Fortunately, unlike during the financial crisis, the attention isn't due to the high level of provisioning. In fact, our recent quarterly report on banking conditions, First Glance 12L, shows that almost half of the District's banks recorded zero or negative provisions for loan losses in 2015. (See a first quarter 2013 article in *Community Banking Connections* for more on the supervisory perspectives about negative provisions.) Rather, the attention today is on the Financial Accounting Standards Board's (FASB) proposal to fundamentally change the ALLL model from one that focuses on "probable and incurred" losses to one that focuses on "expected" losses. FASB expects to finalize the Current Expected Credit Loss (CECL) model in the first half of 2016, with an effective date in 2019 or later. To help bankers understand FASB's proposed standard, an article in the current issue of *Community Banking Connections* compares the proposed CECL model to the current model and suggests how institutions can begin to prepare today. Given the significant philosophical shift from the "probable and incurred" loss model to the "expected" loss model, I encourage you to start discussing the potential implications with your management team, board of directors, external auditors, peers, and regulators. Once the standard is final, the agencies plan to offer additional information for bankers through Ask the Fed and other programs, and we will definitely highlight those opportunities in future issues of *Supervisory Spotlight* and through other FISC communication channels.

Related to the ALLL is a concern I discussed in the last issue of *Supervisory Spotlight* about the quality of loan growth and commercial real estate (CRE) lending concentrations. After that issue was published, the Federal Reserve, OCC, and FDIC issued an interagency *Statement on Prudent Risk Management for Commercial Real Estate Lending*. This statement doesn't create new guidance or policy, but it reminds banks to maintain underwriting discipline and to exercise prudent risk management practices that are commensurate with the level and nature of the bank's CRE lending risk. A helpful attachment provides a listing of interagency regulations and guidance documents related to CRE. You can access the statement and the attachment through the Federal Reserve's SR letter 15-17.

Finally, I'd like to draw your attention to the third/fourth quarter 2015 issue of *Consumer Compliance Outlook,* which is dedicated to the new and legacy flood insurance rules. Focus on this topic was particularly timely for our district given the potential impacts of El Niño and the recent storms in the Pacific Northwest. While the flood insurance rules have been around for over 40 years, our examiners have found that flood insurance compliance continues to be a challenge and flood insurance violations regularly appear among the top-cited consumer compliance exam findings. I encourage you to review this issue, which addresses the July 2015 interagency final rule and republishes and updates a comprehensive article on flood insurance requirements from 2011 titled "Flood Insurance Compliance Requirements," and ensure that you are complying with the most recent changes in this important area.

As always, I appreciate feedback and suggestions for topics that are of particular concern to your institutions. As always, I appreciate feedback and suggestions for topics that are of particular concern to your institutions.

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