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!

We recently held our semi-annual Risk Assessment Session (RAS), where many of our staff gathered to discuss the risks that are or will be challenging 12th District institutions. I always enjoy these discussions as they allow us to combine the current thinking of our risk specialists with insights from exam staff on what they are seeing in and hearing from supervised institutions. The interplay of these discussions ultimately allows us to make better informed supervisory decisions that reflect the combined wisdom of our diverse teams.

The general consensus from the recent RAS was that 12th District banking risks are stable: loan growth at District institutions has rebounded, current credit quality is strong, and liquidity and capital are sound. Our top three concerns remain the same as in April 2015: Bank Secrecy Act/Anti-Money Laundering compliance, cybersecurity, and readiness for an increase in interest rates. I have already shared my thoughts and sources for additional information about these three risks in recent issues of Supervisory Spotlight, but I thought it was important to let you know that these risks remain near the center of our radar.

We identified one emerging concern that is steadily moving toward the center of our risk radar and bears additional discussion: the quality of loan growth and commercial real estate (CRE) lending concentrations. Data in the Third Quarter 2015 issue of First Glance 12L highlight building CRE concentrations and support our growing concern. Past experience reminds all of us that rapid growth and poorly managed CRE concentrations are strongly correlated with bank failures. As we learned during the financial crisis, it can be very easy to overlook increasing credit risk when asset quality metrics are strong, as they are today. However, it's important to remember that today's delinquency statistics reflect decisions made when the current book of loans was first underwritten, and they do not reflect the quality of the loans being underwritten today. I encourage you to review the *Interagency Guidance on Concentrations in Commercial Real Estate* that the Federal Reserve released as SR letter 07-1 in January 2007 to refresh your memories about the expectations for effective risk management in this emerging risk area.

Numerous sources suggest that underwriting concessions are again becoming the norm. This isn't surprising, as we are at a point in the business cycle where we customarily see banks drop or weaken protective covenants, extend maturities, and take other steps to build market share. Given the inherent risks of late-cycle lending, which typically do not manifest themselves until the economic downturn is upon us, the latter part of a business cycle is also a time when supervisors and bank risk officers need to be most alert. The current issue of *Community Banking Connections* features an article, "Asset Concentrations Present Deep Tradeoffs for Community Banks and Bank Supervisors," which offers a good discussion of the tradeoffs that a community bank has to consider as it balances the desire to lend within its community against the inherent risk of geographic and loan-type concentrations. This article, combined with the third article in the series "Development and Maintenance of an Effective Loan Policy," should provide valuable insight for community bankers with rapidly growing loan portfolios.

The importance of timely and effective risk management isn't limited to credit risk. The seventh anniversary edition of *Consumer Compliance Outlook* is dedicated to product risk management, the process by which a financial institution identifies, controls, and mitigates risks for its products and services. This issue and its feature article, "Managing Risk Throughout the Product Life Cycle," is particularly timely as we are seeing many banks expand their product and service offerings in response to competitive and earnings pressure. However, the article provides equally relevant reminders for the effective risk management of legacy products and services. The format of the article is particularly helpful as it is divided into chapters that relate to the various life cycle stages—strategic considerations, with particular focus on board and senior management involvement; product design, with a focus on fairness; marketing; product delivery; origination or consummation; product use and duration; and product termination—providing points relevant to almost all members of the management team.

In closing, I'd like to draw your attention to the agenda and materials from the Federal Reserve and CSBS third annual Community Banking in the 21st Century conference, held in September. I was fortunate enough to attend this conference, and I found the speakers and topics discussed to be very relevant to our District. The primary research centered around three areas: small business and farm lending, community bank performance, and community banking pre- and post-crisis. The website provides links to the papers, videos of all sessions, and the popular summary from the National Survey and Town Hall meetings.

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

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