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

It's September, that "back to school" time of year again. It's also the four year anniversary of the worst month of the financial crisis, when financial markets froze and there was a crisis of confidence in financial institutions. As memories can be short, I find it useful to recall those scary days in September 2008, particularly when considering the industry's recent progress. Additionally, it's helpful to reflect on the range of issues exposed during this time, including significant weaknesses in financial supervision. These lessons learned directly contributed to the new rules and regulations that we are all living with today.

The Q2 2012 financial data are available, and the news for banks in our District is good. The financial condition of institutions of all sizes and in all locations continues to improve. Obviously, economic headwinds remain, presenting challenges to sustained profitability. However, absent an unanticipated downturn, we feel bullish that banks in the West will continue to strengthen, grow, and, importantly, expand lending.

The regulatory environment remains challenging. In this Supervisory Spotlight, we highlight a few new rules and proposals and encourage you to take advantage of the comment periods. I can speak from personal experience that every comment is considered; many final rules are shaped by the comments received during these periods. Of great importance now are the capital proposals, which we highlight below. All the regulators are committed to calibrating the new rules for different types of banks, taking into account institutions' size, complexity, and risk profile. It is a dynamic time and, as always, we appreciate your comments and feedback.

Best Regards,

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Banking in an Evolving Regulatory Environment

The latest edition of the quarterly First Glance 12L provides a mid-year snapshot of banking conditions in the 12th District. We continue to see slow and steady improvement in several financial metrics, including loan growth, asset quality, profitability, and capital. Additionally, upgrades in bank CAMELS ratings continue to outpace downgrades (in fact, there were no downgrades in the second quarter). On the other hand, banking conditions have not fully recovered, many banks are still struggling, and several economic headwinds remain.

That said, the news is encouraging. Of note, loan growth continues to accelerate. For the first time in over three years, the average loan growth rate is positive for small, mid-sized, and large banks. The average loan growth rate for all District banks is now 1.3%, which far exceeds the negative loan growth rate (-6.2%) at mid-year 2011. Interestingly, residential mortgage production is driving much of the loan growth. First lien mortgages increased 14% and 16% at small and mid-sized banks, respectively, whereas residential mortgages increased 7% at large banks. Meanwhile, noncurrent rates have dropped broadly across the District and net charge-off rates are down sharply. Net income is also strengthening and the median ROAA is now positive in all states in the 12th District. The improvement in profitability continues to come mostly from falling provision expenses, however, as core profitability is up only slightly since mid-year 2011.

We believe that banking conditions will continue to steadily improve in the second half of 2012, especially if employment and the housing markets continue to strengthen. Speaking of the economy, you may be interested in a recent Economic Letter published by the Federal Reserve Bank of San Francisco that analyzes the relationship between household debt and credit availability.

Continued Legal and Regulatory Reforms

In this improving economic and banking environment, bankers still must pay close attention to new laws affecting banks' activities and new proposals to regulate bank behavior. Some recent highlights:

- **The Biggert-Waters Flood Insurance Reform Act of 2012** was signed into law on July 6, 2012. The law extends the National Flood Insurance Program (NFIP) until September 30, 2017 and makes significant changes to the National Flood Insurance Act of 1968 and the Flood Disaster Protection Act of 1973. Key changes include increased civil money penalties, elimination of key federal subsidies for flood insurance, and additional requirements relating to flood insurance premium escrow, force-placed insurance coverage, and refund of premiums. The law also provides additional guidance on accepting private flood insurance in place of NFIP coverage. As many of the changes require implementing regulations, we will keep you updated as amended guidance and regulations are issued.
- The Consumer Financial Protection Bureau (CFPB) recently issued a number of proposals related to **mortgage lending**. The proposals address a broad range of topics, including mortgage loan servicing rules, improved access to appraisal reports, appraisal requirements for "higher-risk mortgages," and loan originator rules that include restrictions on up-front points and fees, restrictions on loan originator compensation, and loan originator qualification requirements. Given the potential impact of these proposals, we encourage you to review and understand the proposals and submit your comments to influence the rulemaking process. You can access the recent CFPB proposals on the Bureau's Notice and Comment web page.
- On June 7, 2012, the Federal Regulatory Agencies issued a package of three Notices of Proposed Rulemaking

(NPRs) **designed to revise capital requirements** to make them consistent with the Basel III capital standards and certain provisions of the Dodd-Frank Act.

The following two NPRs would apply to all commercial banks, all BHCs domiciled in the United States and not subject to the Board's Small Bank Holding Company Policy Statement, and all SLHCs domiciled in the United States.

- The **Basel III NPR** focuses on proposed reforms that would improve the overall quality and quantity of banking organizations' capital. This NPR would revise the risk-based and leverage capital requirements and introduce a new common equity tier 1 minimum capital requirement.
- The **Standardized Approach NPR** would revise and harmonize rules for calculating risk-weighted assets to enhance their risk sensitivity and address weaknesses identified over recent years.

The third NPR, the **Advanced Approaches and Market Risk NPR**, would generally apply only to the largest, most complex organizations. This NPR would revise the advanced approaches risk-based capital rule and incorporate certain aspects of Basel III applicable only to advanced approaches banking organizations. Further, it would codify the Board's market risk capital rule and apply consolidated capital requirements to savings and loan holding companies.

The Federal Reserve recently hosted a series of nationwide calls on the capital NPRs that were oriented to institutions of different asset sizes. If you missed these events, you can access the presentations on the Ask the Fed website. Additionally, if you haven't already done so, we suggest that you review the proposals and submit comments, as appropriate. The comment period has been extended to October 22, 2012.

Managing the Risks Associated with Mobile Devices

The use of mobile devices will be getting greater attention by Federal Reserve examiners during upcoming Information Technology (IT) examinations, especially for those institutions that do not have an established mobile infrastructure and instead leverage employees' personally-owned devices—a practice often referred to as "Bring Your Own Device." On the one hand, mobile devices provide an efficient and convenient way for staff to conduct business, allowing work to get done from anywhere and at any time, greatly improving productivity and responsiveness. On the other hand, these devices introduce new security risks that must be understood and managed. Aside from the obvious (mobile devices can be stolen or easily lost), employees may unintentionally load insecure or malicious applications, or they might respond to fraudulent emails or text messages that then compromise the device and steal information, record conversations, or create an entry point into the corporate network. Most consumer-owned devices have little or no security; consequently, management should assess the risk before allowing staff to use their own devices for work, and they should implement controls to mitigate the associated risks.

Some Thoughts on Vendor Management

Vendor management is often thought of as just an IT issue, but it is actually more than this. Many institutions outsource a wide variety of operations to third party vendors, such as service providers, consultants, and contractors. Outsourcing to vendors can expose an institution to additional operational, legal, compliance, and reputational risks. These risks will vary based on the nature and volume of the outsourced activity as well as the extent to which the vendor has access to customer and corporate information.

The best example of vendor management risk is the "robo signing" foreclosure failures brought to light a few years ago. Now, there are reports that debt collection agencies engaged by financial institutions are pursuing consumers for credit card debts that have already been paid or which the institution cannot prove are actually owed by the consumer. These reports are drawing the attention of law firms, attorneys general, and the CFPB. As financial institutions outsource high-profile activities like these, we encourage their management teams to develop and implement risk-based oversight programs to ensure appropriate due diligence and ongoing monitoring.

Bankers who haven't given this issue much thought might begin by creating an inventory of all vendors engaged by the institution. From there, they can document the risks associated with each vendor and outsourced activity. Those vendors with access to confidential information and data, or whose activities are governed by consumer laws and regulations, will likely be regarded as higher risk and receive heightened attention and monitoring. Finally, no risk management process would be complete without a good reporting process to ensure that the monitoring efforts are documented and problems are appropriately identified and addressed.

Resources

Coming Up! Commercial and Industrial Lending: Pitfalls and Risk Mitigants (September 13, 2012) A *Call the Fed* webinar on expanding C&I lending. Click on the title for more information and to register.

First Glance 12L— Second Quarter 2012 (August 2012) A first look at financial performance of 12th District banks for the 2nd quarter.

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

The Economic Outlook and Challenges to Monetary Policy (July 12, 2012) Speech by John C. Williams, President and CEO, Federal Reserve Bank of San Francisco, to Portland community leaders in Portland, OR. 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.