Steve's Corner

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Communicating in Troubled Times

I hope all is well with you and your organizations during these very challenging times. Fortunately, there are signs that actions taken by the government and banking organizations are starting to bear fruit in providing a more stable environment. However, as we all know, there are many more challenging times ahead for us all, and our collective best efforts will be needed if we are to build on the progress already achieved. It's during troubled times like these that I feel it is even more important to reach out to institutions in this District and build a mutual understanding on the issues most significant for all of us. As head of banking supervision & regulation in the 12th District, I want to continue to take every possible opportunity to speak directly to you, and to hear from you, about issues that concern us all at this time of turmoil in the banking industry. Hopefully, efforts by me and my staff at conferences, roundtables, individual meetings, and publications like this one, are helping to build that understanding.

Same Storm, Different Boats

First quarter data, now available in our First Glance 12L report, shows that District banks continue to face extraordinary challenges. Not every bank is in the same boat, but the numbers show that the Twelfth District is clearly the most adversely affected area of the country, as the District average ROA of -0.41% is 66 basis points less than the next lowest District average ROA (Atlanta), and 107 basis points worse than the U.S. as a whole. The main reason for the losses was loan loss provisions, which shot up to an annualized 1.47% of assets on average in 1Q09. The net charge-off rate also soared to 1.4%, driven by very high residential construction and development loan losses. Net interest margin continued the narrowing trend of the past three years and at 3.8% is fully 1.5 percentage points below its recent peak in 2006, but equal to the national average.

Capital ratios held steady in the 12Th District. A significant factor in this encouraging statistic is the help District banks received from the TARP Capital Purchase Program (CPP). About 120 banks benefited from capital injections via the CPP, and those banks saw their capital ratios improve by an average of 200 basis points. Without this capital, the District average capital ratios would have dropped to the lowest level in several years.

Hope for the Best, but Plan for the Worst

The stress testing program recently conducted on the 19 biggest U.S. bank holding companies was a first-ever exercise to assess the adequacy of bank capital levels under a consistent and uniform scenario. The results of this effort required 10 of the 19 institutions to increase their capital by amounts that would position them not only to survive the worst credit loss cycle since the Great Depression, but also to have enough capital to serve the anticipated needs of consumers and businesses.

While for practical reasons the stress test was directed at the largest firms, there are clearly lessons for all banks. The most obvious is that "planning for the worst" is a strategy that will give bankers a significant edge during the challenging times we now face. While it would be impractical for supervisors to conduct stress tests on each community bank, you should understand that the Federal Reserve and other supervisory agencies are placing increasing emphasis on capital adequacy and will engage with management about whether the bank has a sufficient cushion under adverse scenarios. In anticipation of these discussions, I would advise you to conduct your own stress testing under a range of scenarios that reasonably reflect local economic conditions and your bank's unique risk profile on a forward-looking basis.

Related to capital planning, you should also know that we are paying particularly close attention to the allowance for loan and lease losses (ALLL). To be truly safe and sound and instill confidence in your depositors and creditors, it is critical that organizations have a disciplined process for ensuring that adequate reserves are set aside. It is essential that this dynamic process takes into account both identified problem loans and the inherent weaknesses emerging in the loan portfolio from the changing conditions in the local market place and economy more broadly. An allowance process that provides an objective and directionally consistent result throughout the credit cycle is fundamental to safe and sound banking.

ALLL best practices methodology include clear written policies and procedures, accurate internal risk ratings, a well-defined and executed credit risk grading system, a strong independent credit review process, the consistent application of reserve factors, well-documented, high-quality FAS 114 impairment analyses, and strong, ongoing board/management oversight. Banks with these essential elements are well positioned to accurately reflect the health of their loan portfolio.

While the allowance is designed to absorb probable and expected losses, you are all well aware of the need for a strong capital base to absorb unexpected losses. This is particularly relevant in these uncertain times, when the ability to maintain and build capital is essential for successful banking organizations. With this in mind, the Federal Reserve has issued guidance, Supervisory Letter SR 09-4, reminding banking organizations about the importance of capital planning and capital preservation under deteriorating conditions. Capital planning should address both the level and quality of capital needed to cover unexpected losses and build for growth, thereby maintaining the public's confidence in your institution.

In particular, the guidance reminds holding companies of their responsibility to act as a source of strength to their subsidiary banks, to hold capital commensurate with risk, and to look beyond simple capital ratios when evaluating their capital needs. In this regard, it urges boards of directors to consider forward-looking factors in determining whether the current level of dividend payout is appropriate. Boards should consider the outlook for the quality and level of prospective earnings under different economic scenarios, the ability to raise externally generated capital, the potential need for increasing reserves due to deteriorating credit, and the institution's ability to maintain the confidence of its customers and counterparties, among other factors. As conditions deteriorate, bank holding companies should confer with the Federal Reserve regarding their intention to continue to pay dividends, despite negative trends in earnings, asset quality or capital adequacy.

Appropriate capital planning also provides a basis for determining a bank's participation in the TARP Capital Purchase Program. This is particularly important given options currently available to healthier banks, ranging from redemption of TARP capital (with Treasury's consent following consultation with the primary federal regulator) to making initial or supplemental applications for TARP capital up to a total of 5 percent of risk-weighted assets.

The analytics supporting a bank's capital planning and related components need not be overly sophisticated or time consuming. What is needed is thoughtful analysis based on realistic assumptions, including careful consideration of a range of adverse scenarios, with the conclusions presented to the board of directors and senior management in a concise, understandable manner, so that they can guide the bank's capital raising, policy setting, and operational decisions.

Lastly, the industry is experiencing an unprecedented number of new and changing rules and regulations impacting various credit products and services (e.g., credit cards, mortgages, overdraft protection services, etc.). Continued diligence is required on management's behalf to indentify the impact of these new and changing rules on their respective organizations and to their customers.

In conclusion, let me again call your attention to the many resources listed in the box below, and to encourage you to consult frequently with us as we navigate with you through this economic storm.

Sincerely,

Steve

Resources and FRBSF Contacts for Current Industry Issues

Recent Federal Reserve Actions. Visit this site to keep updated on recent policy statements and actions of the Federal Reserve Board. Of special interest may be the Supervisory Letter SR 09-4 regarding dividends and capital planning.

TARP and the Emergency Economic Stabilization Act. The latest information on the US Treasury's initiatives for economic stabilization. Please see in particular Secretary Geithner's speech extending the TARP CPP.

FRBSF contact for TARP: Kenneth Binning, Vice President, Applications and Enforcement

The Outlook for CRE & Bank Performance. (April 21, 2009) ***Call the Fed*** program on challenges facing the commercial real estate market in the West.

FRBSF contact on CRE issues: Gary Palmer, Manager, Project Analysis & Coordination

First Glance 12L (May 2009) A first look at financial performance of commercial banks in the West, through 1Q 2009.

12L Economic Trends (April 2009) Most recent performance indicators for the 12th Federal Reserve District economy.

Economic Trends and Conditions (May 2009) Monthly review & analysis of key trends in the 12th District economy.

FedViews. (May 2009) Monthly research reports on the current economy and the outlook.

Consumer Compliance Outlook (First Quarter 2009) Federal Reserve System publication focused on consumer compliance issues.

Financial Turmoil and the Economy. (May 2009) Federal Reserve Bank of San Francisco 2008 Annual Report, featuring a series of articles from the major areas of our Bank that are working to promote economic recovery.

Recent Speeches by Federal Reserve Bank of San Francisco President and CEO Janet L. Yellen.