What Keeps Safety & Soundness Regulators Up at Night?

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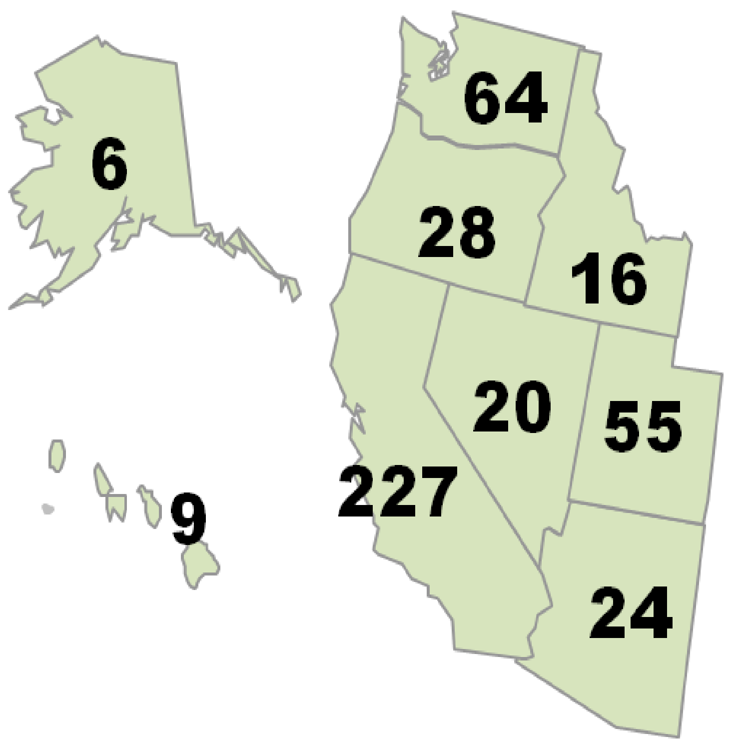
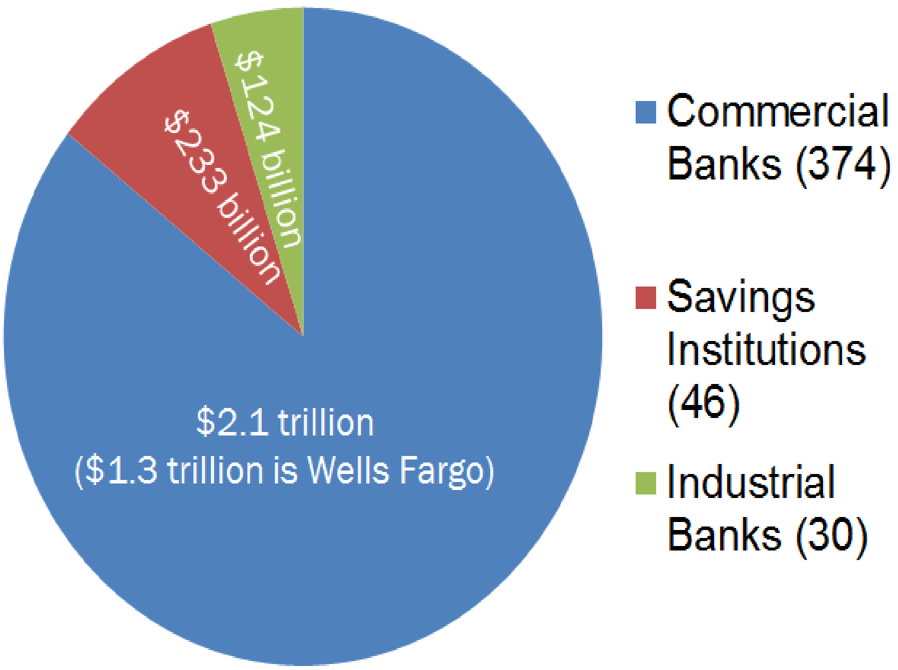
Views expressed are those of the presenter and are not necessarily those of the Federal Reserve Bank of San Francisco or the Board of Governors.

Banking Profile in the West

Number of Financial Institutions

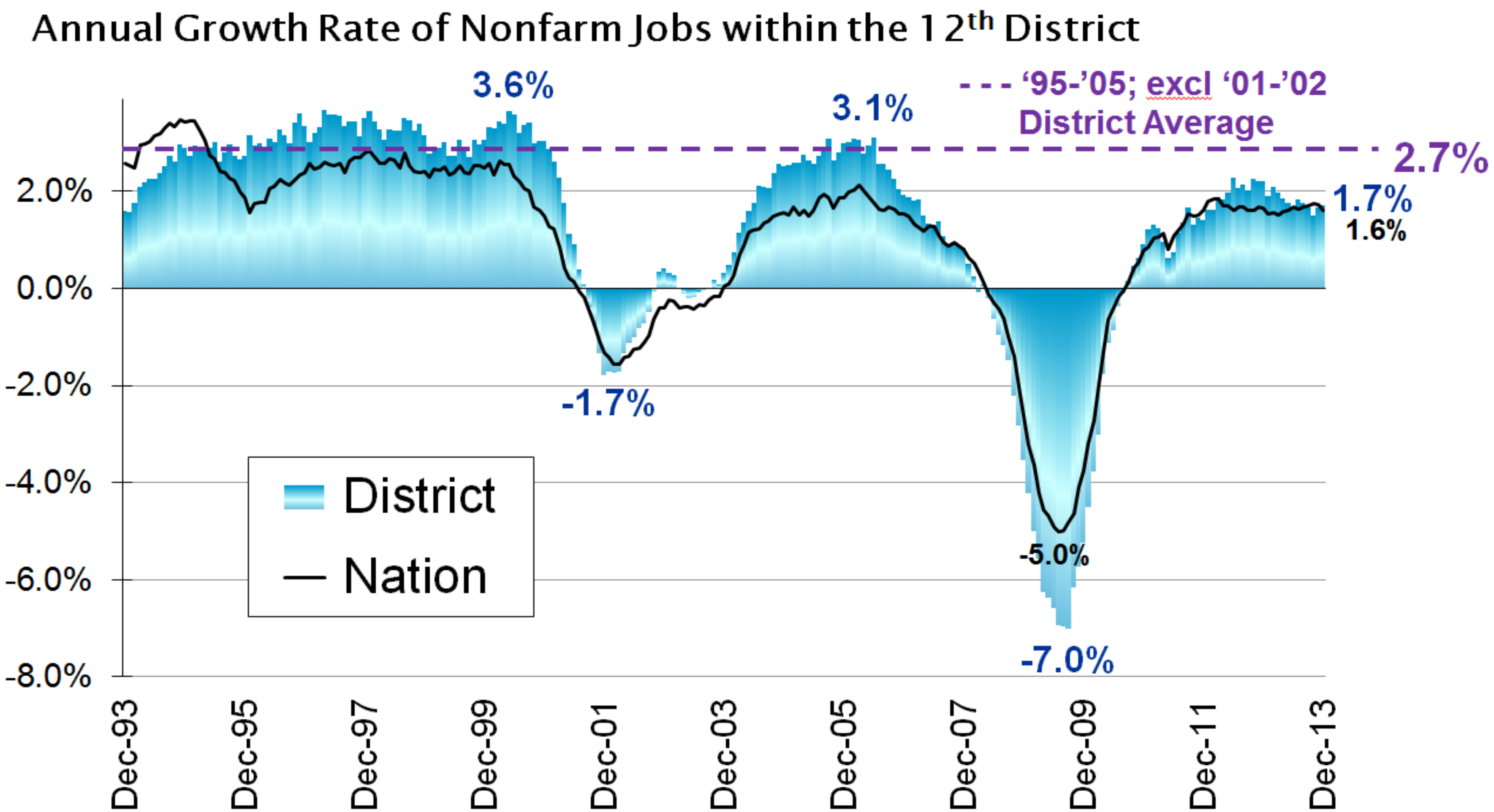


Banking Assets



Annual Job Growth Rates Not Yet Back to "Normal"

Pace of job creation remains well short of typical "normal times" average of 2.7%



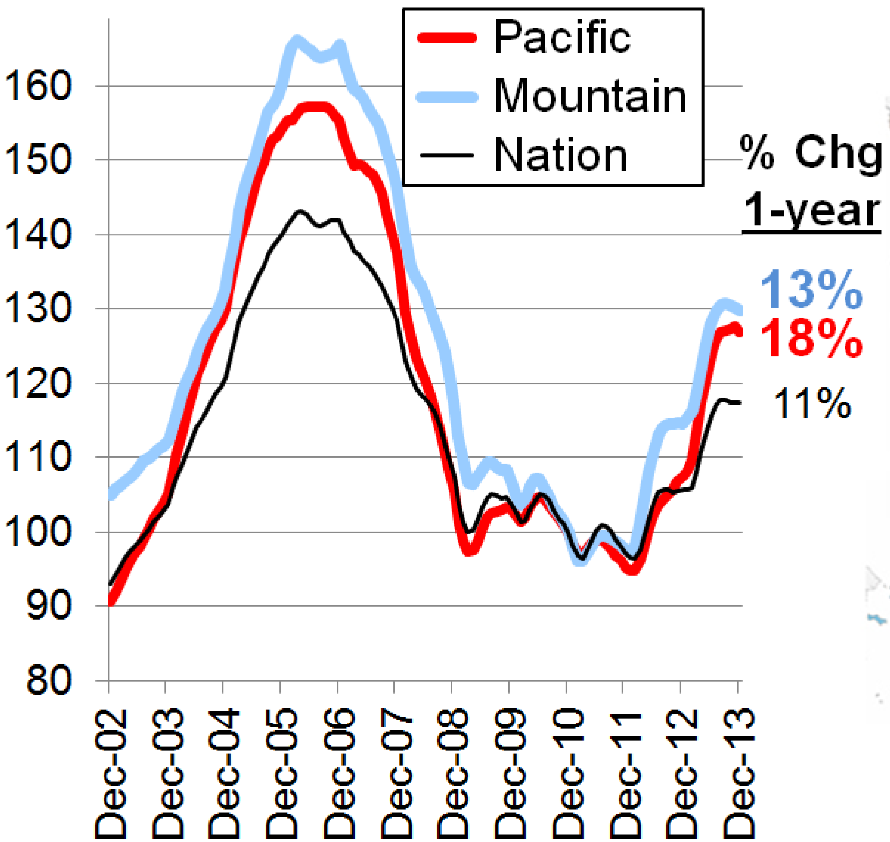
Employment in Each District State Should Fully Recover by 2015 (Except NV)

Total Nonfarm Job Growth (%)	2013	2014	2015	Pct. Of Lost Jobs Recovered by 2015
Alaska	-0.4	1.2	2.8	107%
Arizona	2.0	3.1	3.7	101%
California	1.6	1.8	2.3	101%
Hawaii	1.1	1.8	2.2	103%
Idaho	2.6	2.1	2.5	101%
Nevada	1.8	1.7	2.7	**95%**
Oregon	1.6	1.8	2.3	101%
Utah	2.8	2.0	2.4	106%
Washington	2.2	1.8	2.2	103%
Nation	**1.6**	**1.9**	**2.3**	**103%**
Green shading: at or above 2.6%, a "normal" rate of job growth rate in the District				

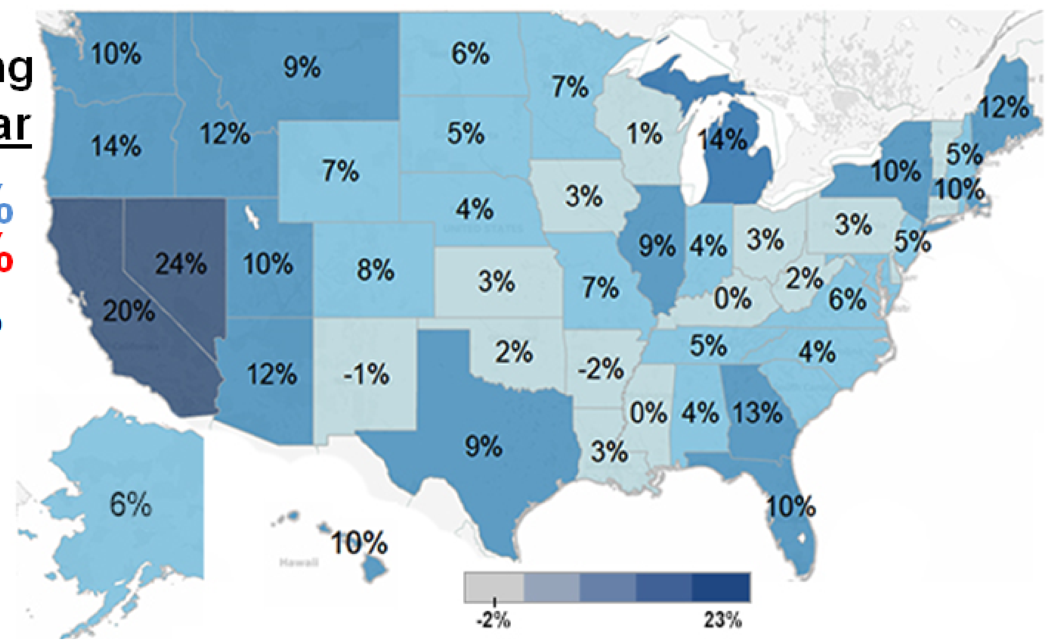
Housing Recovery: Tailwind for District Banks

Home prices flattened or edged down during 4Q13,
but general positive trend for housing market is expected to continue.

Median Home Price Indices



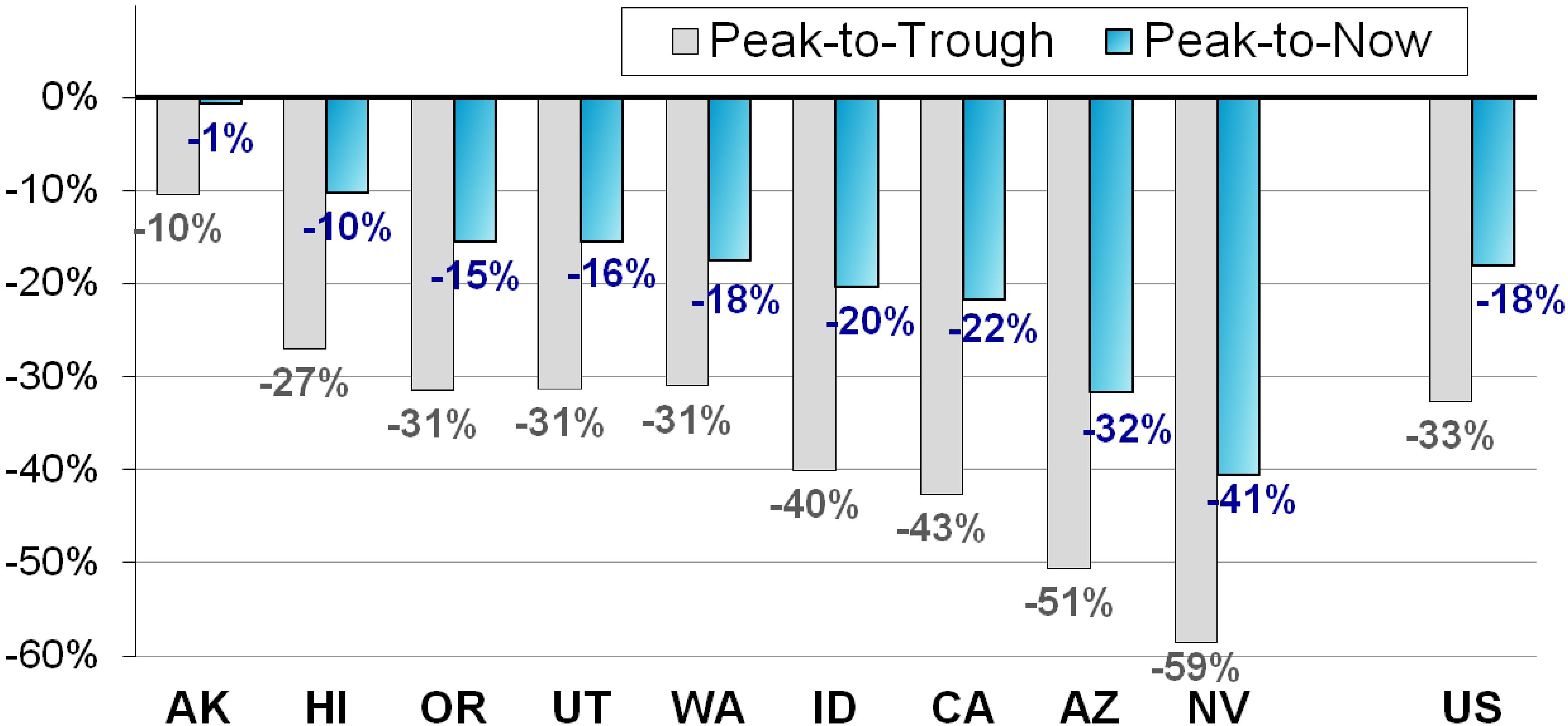
1-Year Home Price Change by State
(December 2013)



Housing Prices Yet to Fully Recover

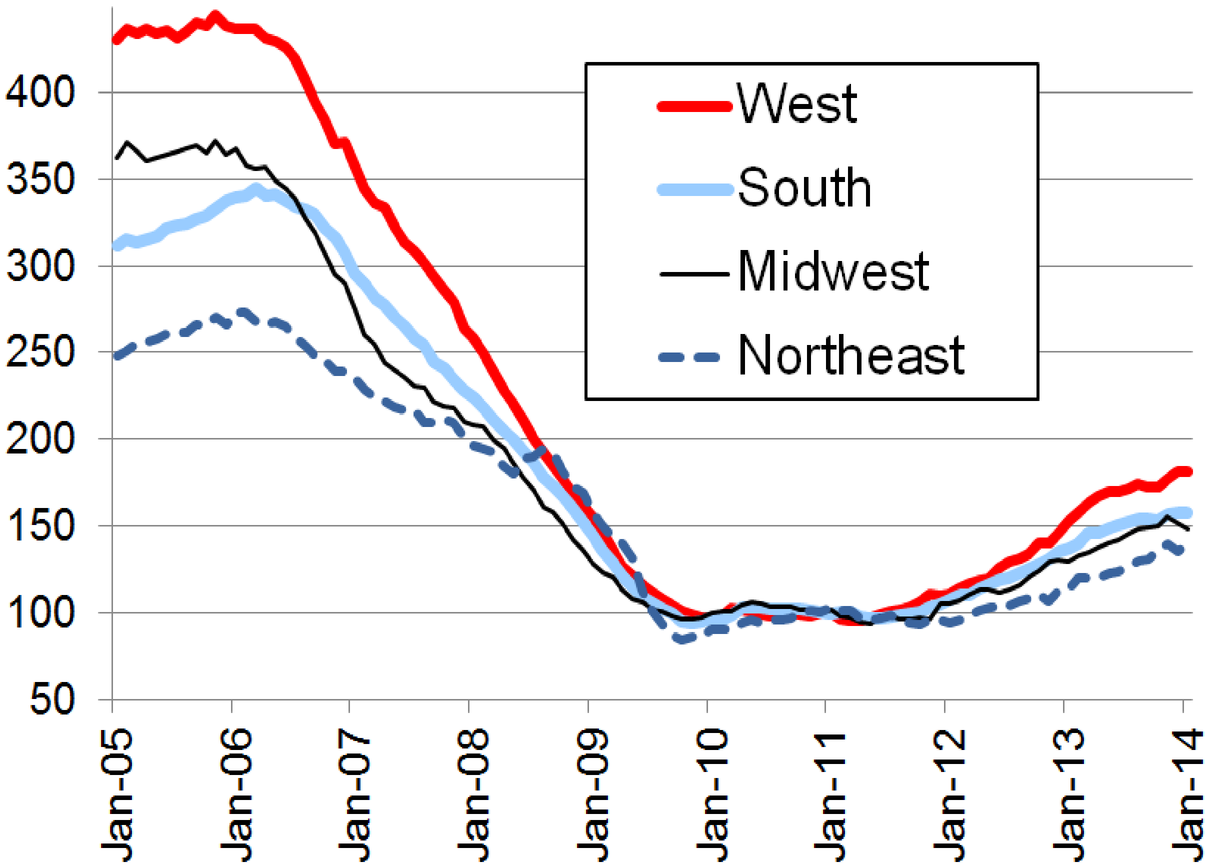
Median prices are well below pre-crisis peaks in most states.

CoreLogic Home Price Indices – % Change from Each State's Pre-Recession Peak through December 2013



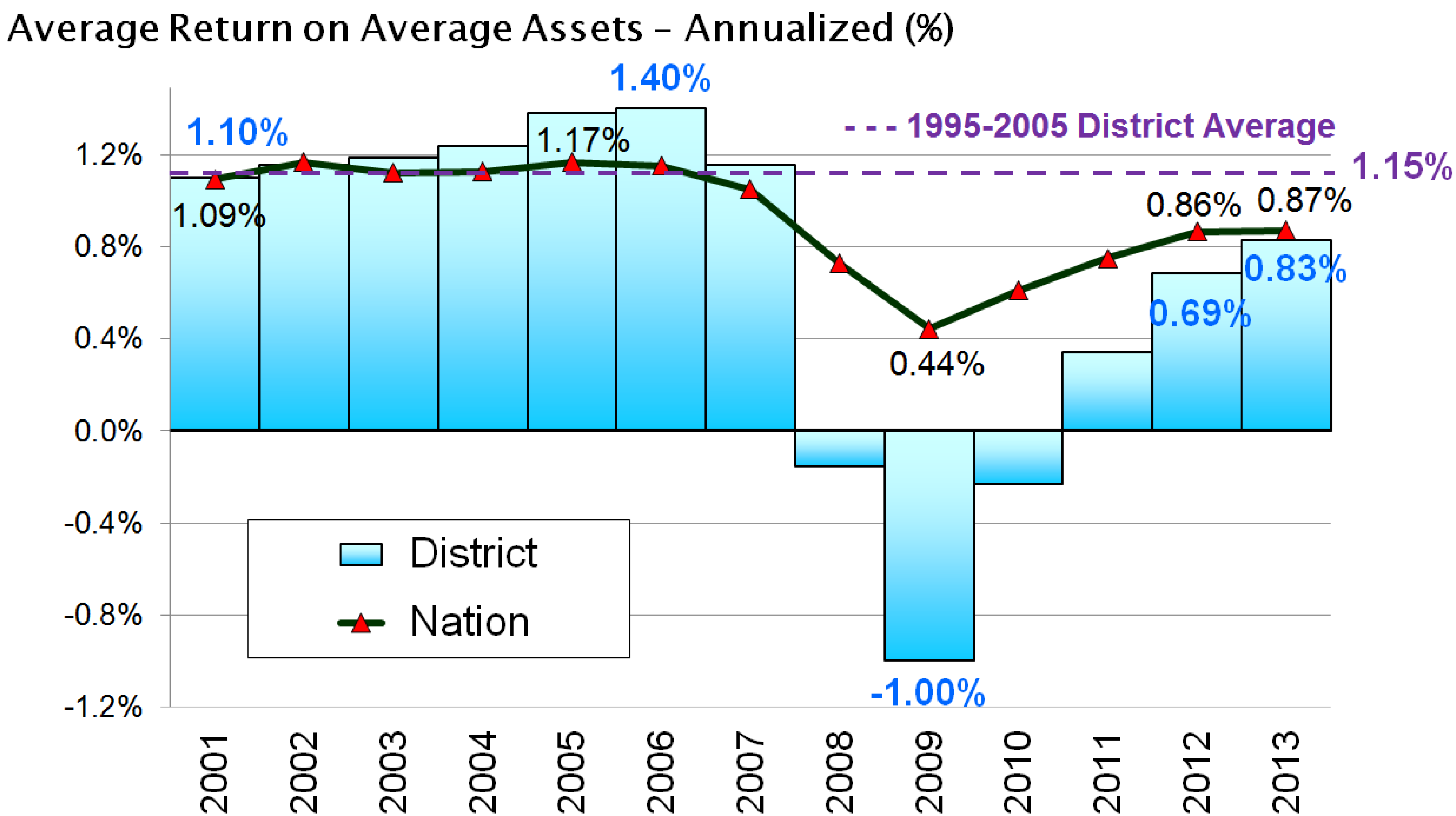
Housing starts have picked up steam in all regions, but particularly in the West – positive for lending opportunities and construction jobs.

Housing Starts: 12-month moving average (indexed to 100 at 12/31/10)



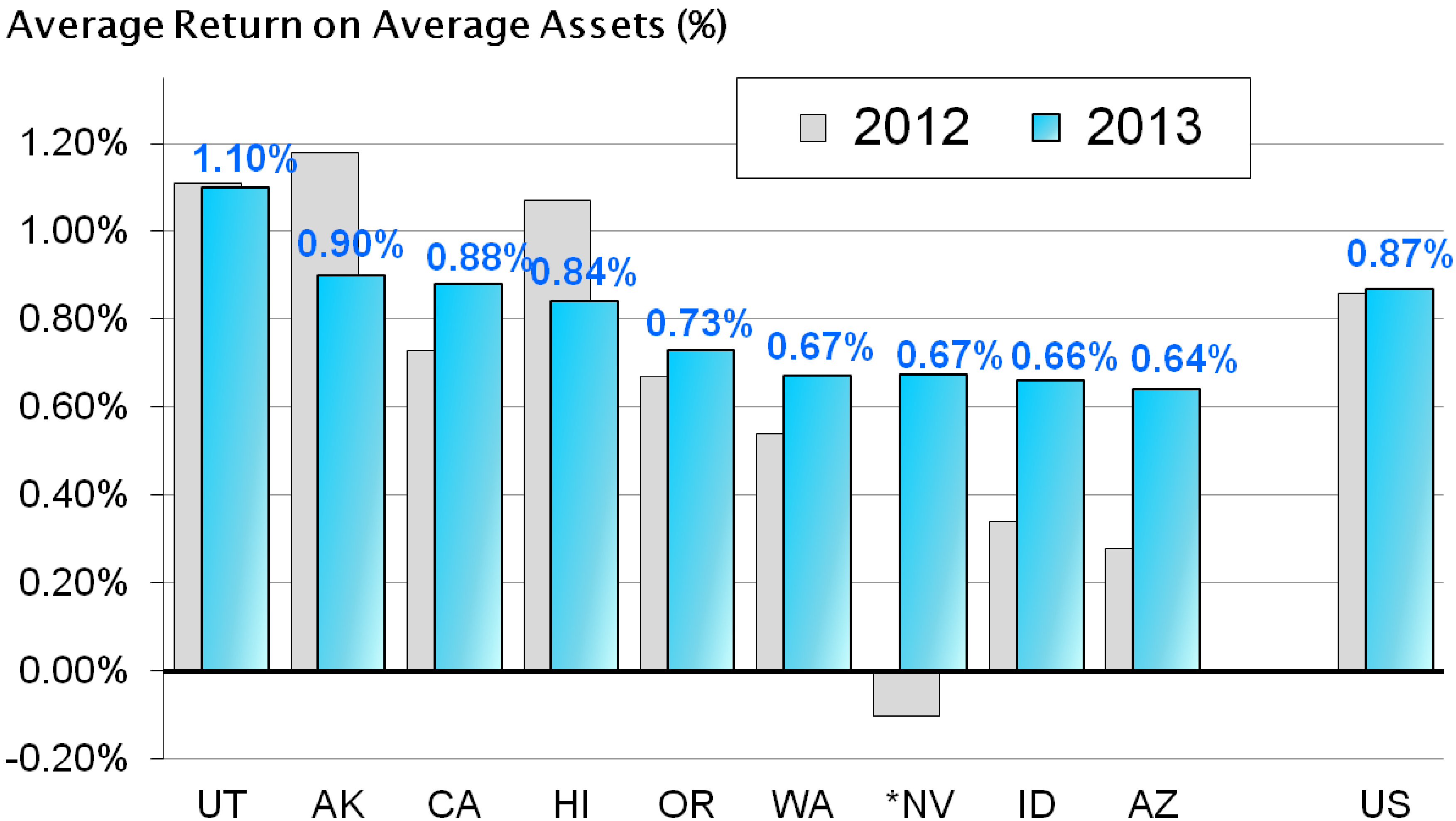
Housing Starts based on 12-mo. moving avg.		
Region	2-yr growth rate	Chg. from peak
West	+64%	-59%
South	+47%	-54%
Midwest	+41%	-60%
Northeast	+49%	-49%

Earnings: District Profitability Up Modestly in 2013; Still Below "Normal Times" Averages



Average ROAAs Improved in 6 of 9 States

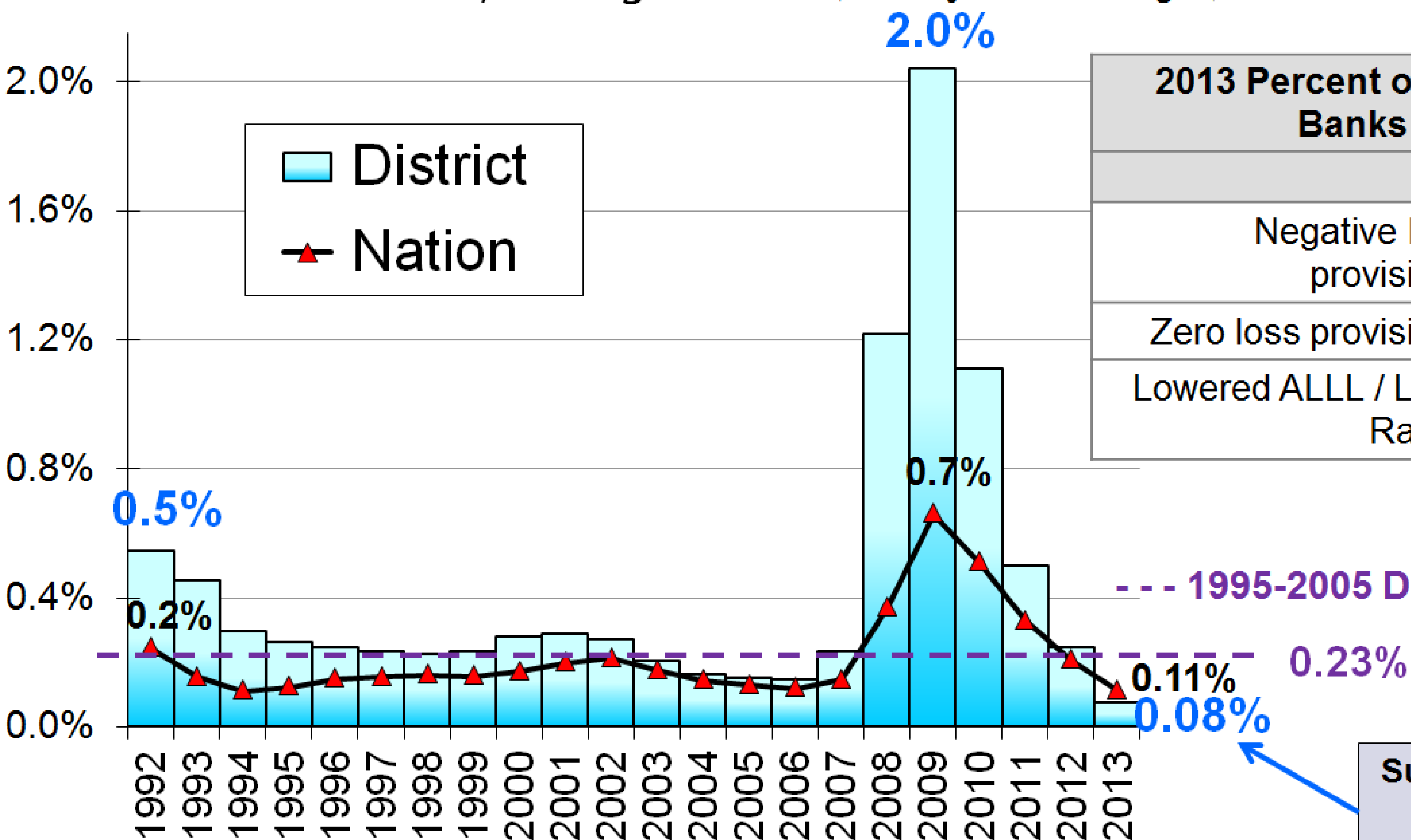
NV, ID, and AZ banks had the strongest improvement, with UT highest Average ROAA



Profit Improvement in 2013 Largely a Result of Loan Loss Provisions Declining to 20+ Year Lows

Nearly 40% of District banks took $0 or negative provisions.

Loan Loss Provisions / Average Assets (% – Adjusted Averages)



2013 Percent of Commercial Banks with:		
	Dist.	U.S.
Negative loss provisions	18%	8%
Zero loss provisions	21%	18%
Lowered ALLL / Loan Ratios	74%	65%

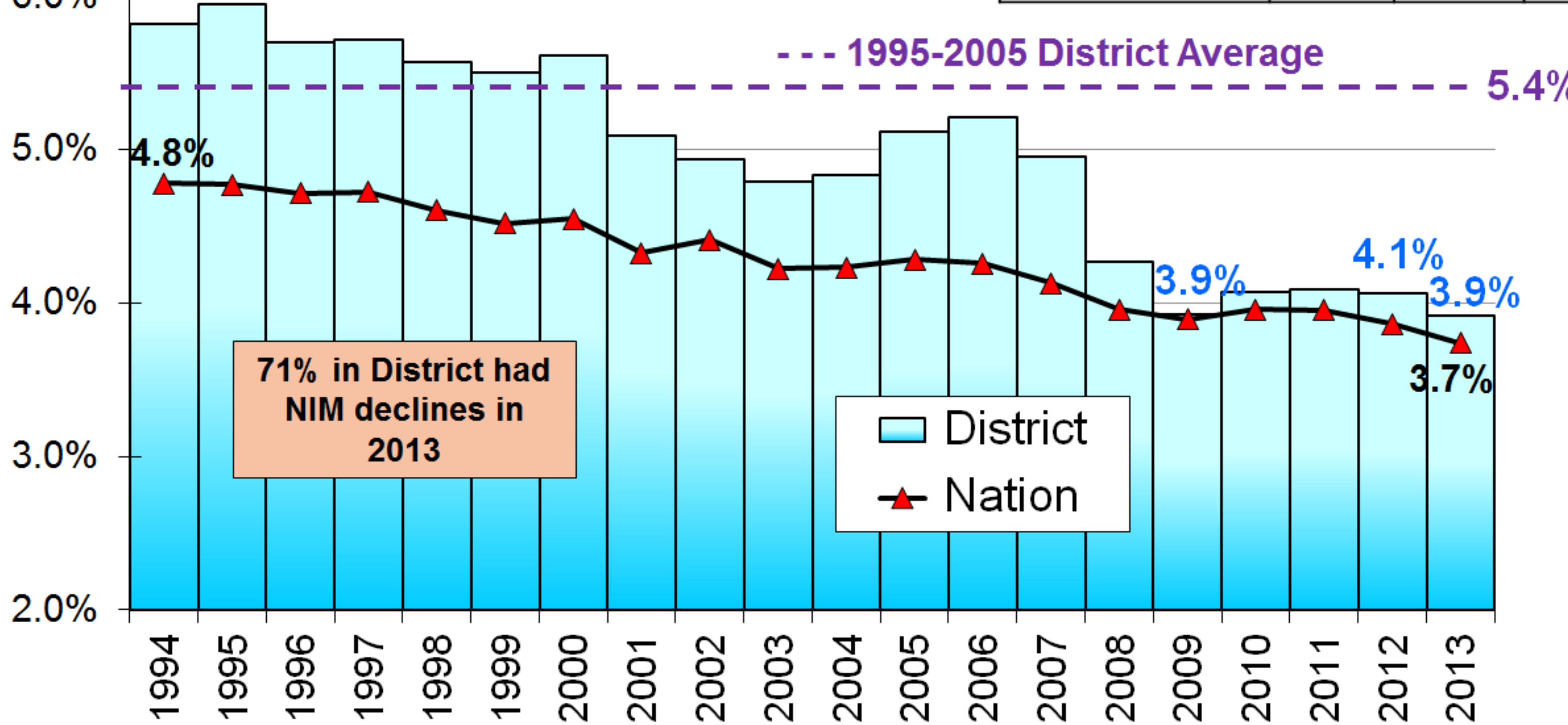
Such low provision rates can't be sustained for long

Net Interest Margins (NIM) Continued to Weaken in 2013

Interest rate environment remains challenging.

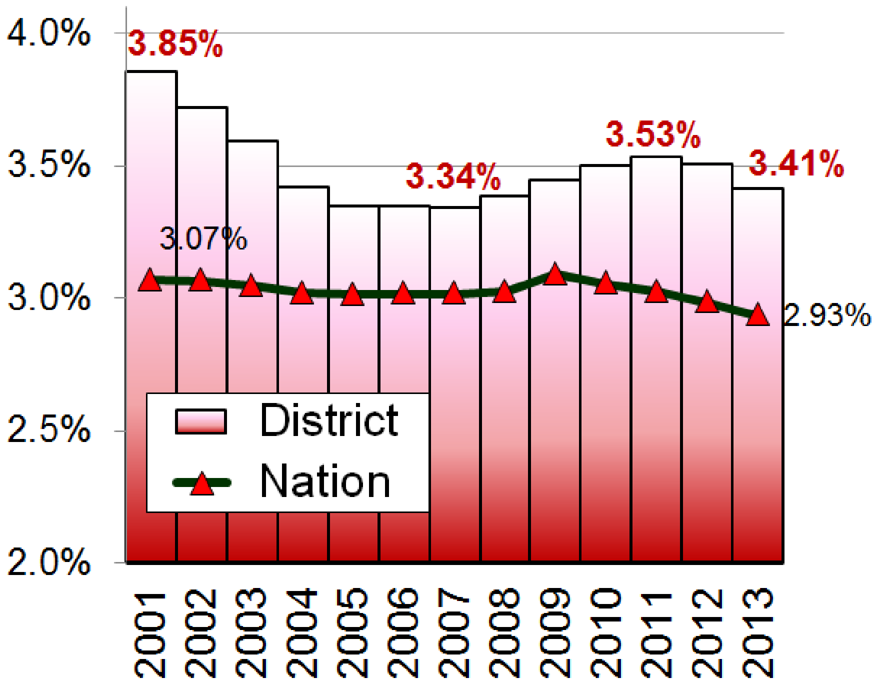
Net Interest Income (tax equiv) / Average Earning Assets

NIM Components			
As a Pct. of Avg. Earning Assets	2006	2013	Chg
Interest Income (te)	7.63%	4.31%	-332 bp
Interest Expense	2.47%	0.35%	-212 bp



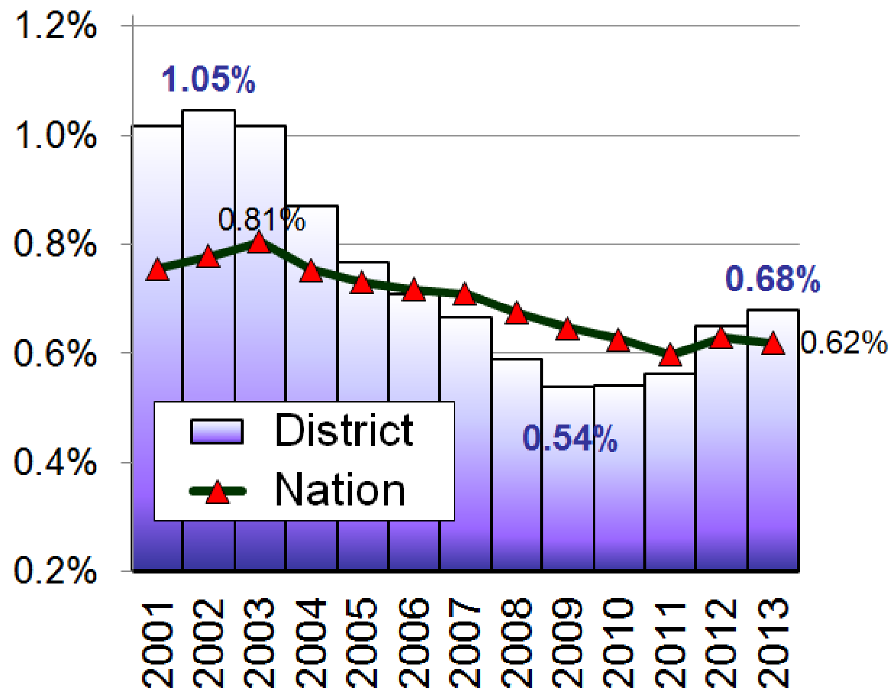
District Noninterest Expense Ratios Higher Than Nation, but Trending Down, While District Noninterest Income Ratios Better Than Nation

Noninterest Expense (% of average assets)



Average Noninterest Expense Ratios		
District Group	2012	2013
Small (<$1B)	3.65%	3.56%
Mid-Sized ($1B-$10B)	3.13%	3.00%
Large (>$10B)	2.28%	2.38%

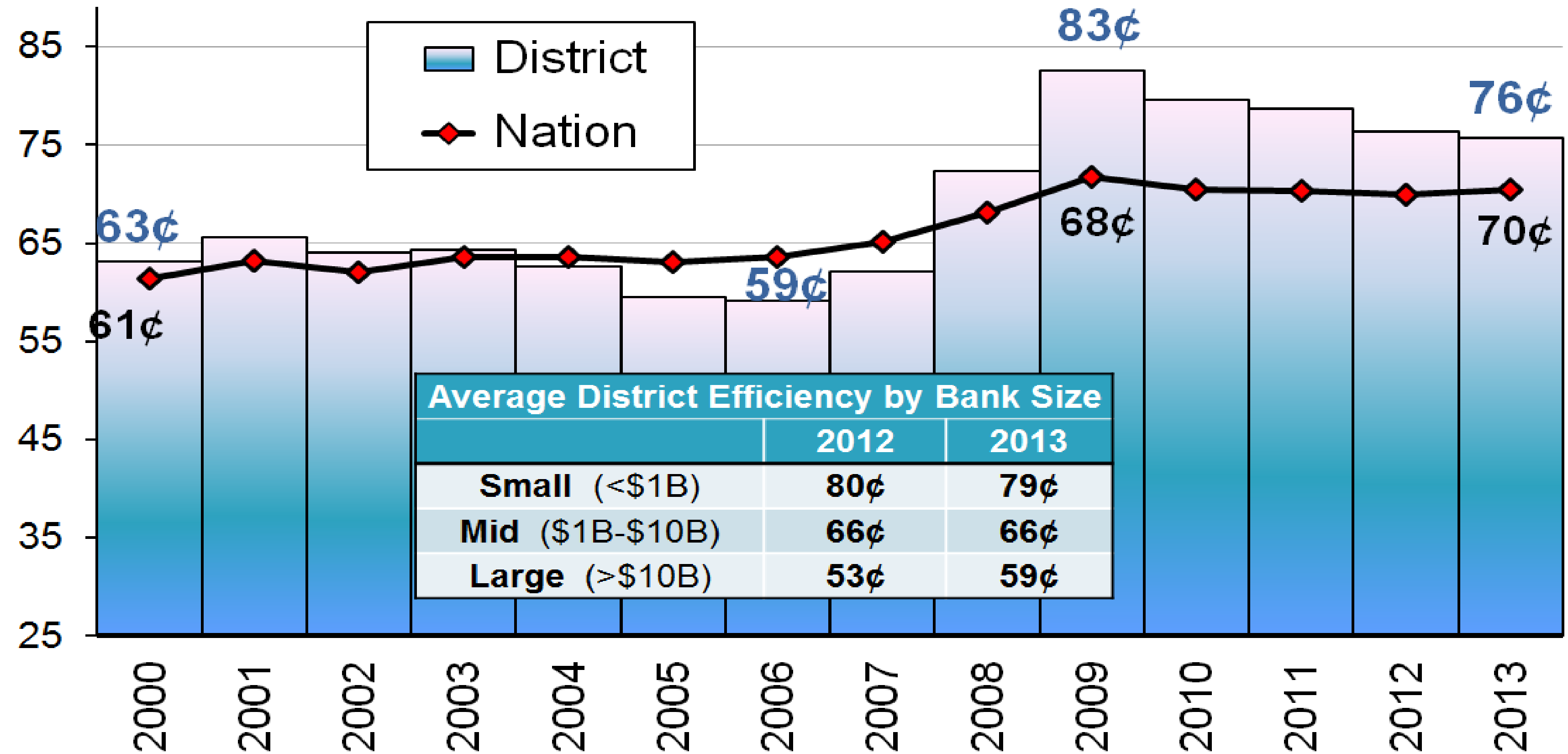
Noninterest Income (% of average assets)



Average Noninterest Income Ratios		
District Group	2012	2013
Small (<$1B)	0.61%	0.65%
Mid-Sized ($1B-$10B)	0.80%	0.76%
Large (>$10B)	0.83%	0.84%

Average District Bank Efficiency Ratio Elevated, but Improving

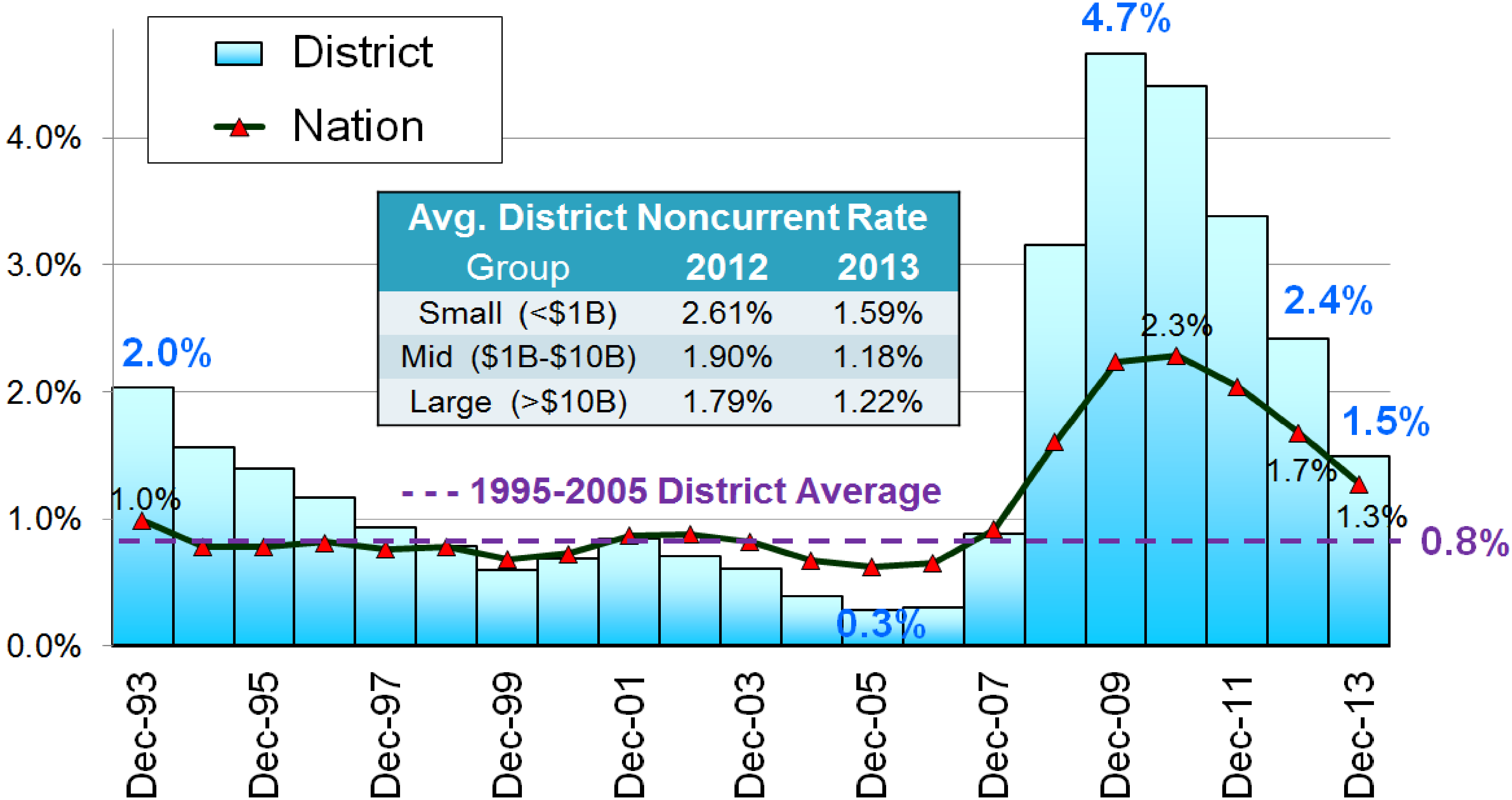
District Banks' Efficiency Measures – overhead / (net interest income + noninterest income) (this metric measures the cost to produce $1 of revenue)



Average District Efficiency by Bank Size	2012	2013
Small (<$1B)	80¢	79¢
Mid ($1B-$10B)	66¢	66¢
Large (>$10B)	53¢	59¢

Credit Quality: Average 12th District Noncurrent Rate Within a Year of “Normal” at Current Improvement Pace

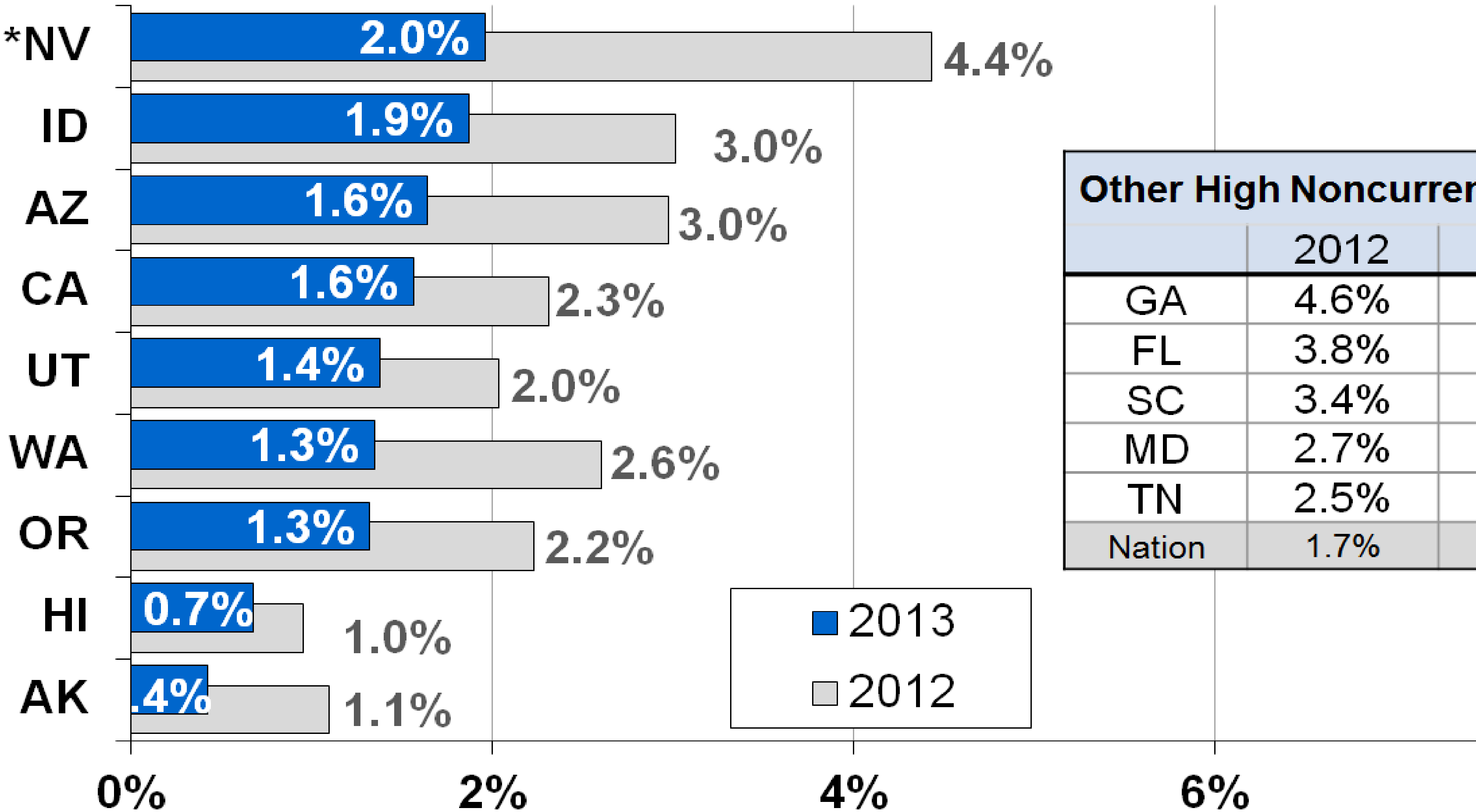
Average Noncurrent Loans + Leases / Total Loans + Leases



Avg. District Noncurrent Rate		
Group	2012	2013
Small (<$1B)	2.61%	1.59%
Mid ($1B-$10B)	1.90%	1.18%
Large (>$10B)	1.79%	1.22%

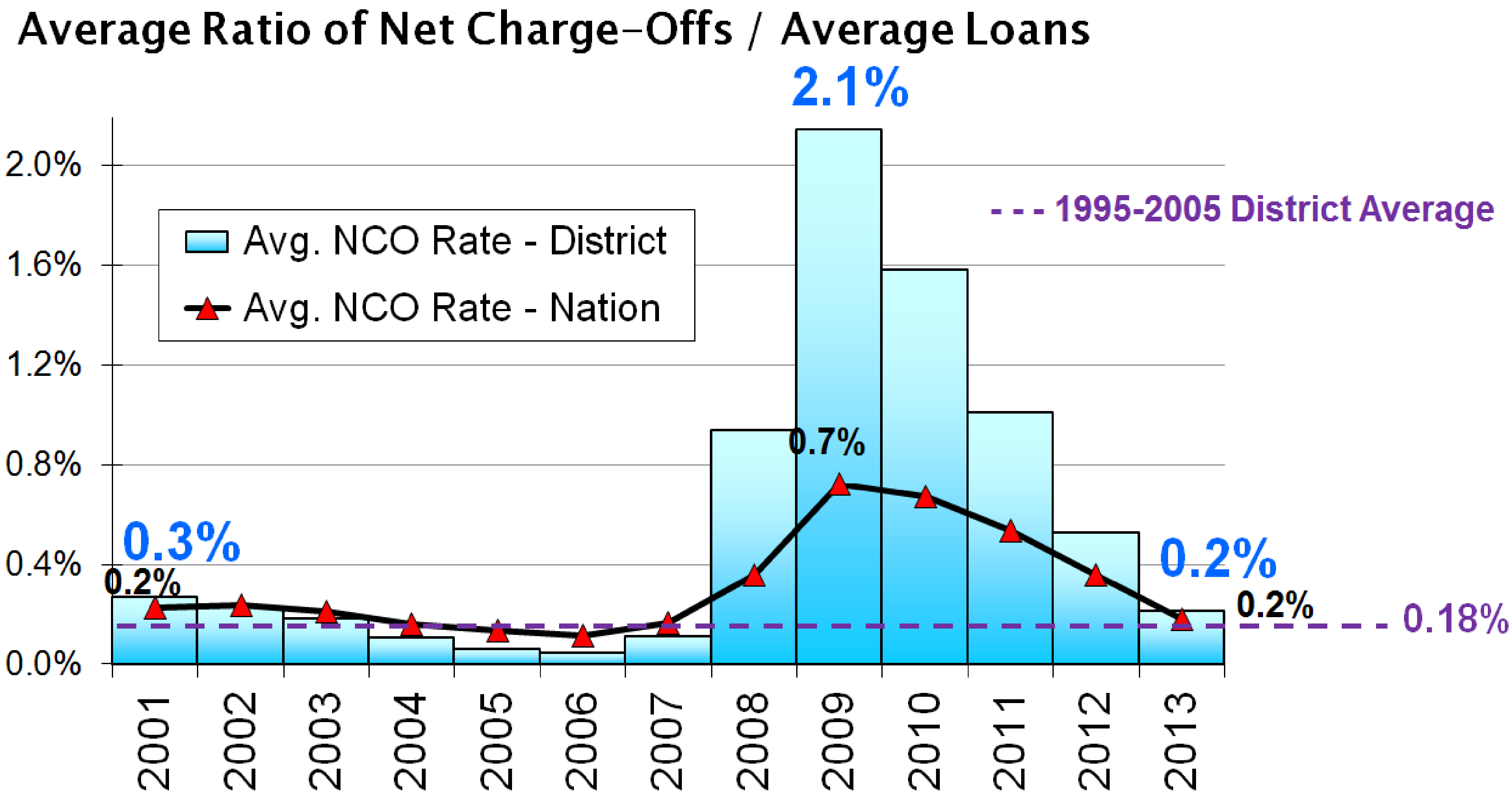
By State: Noncurrent Rates Dropped Most in Nevada and Arizona

Average 12th District Bank Noncurrent Loans + Leases / Total Loans + Leases



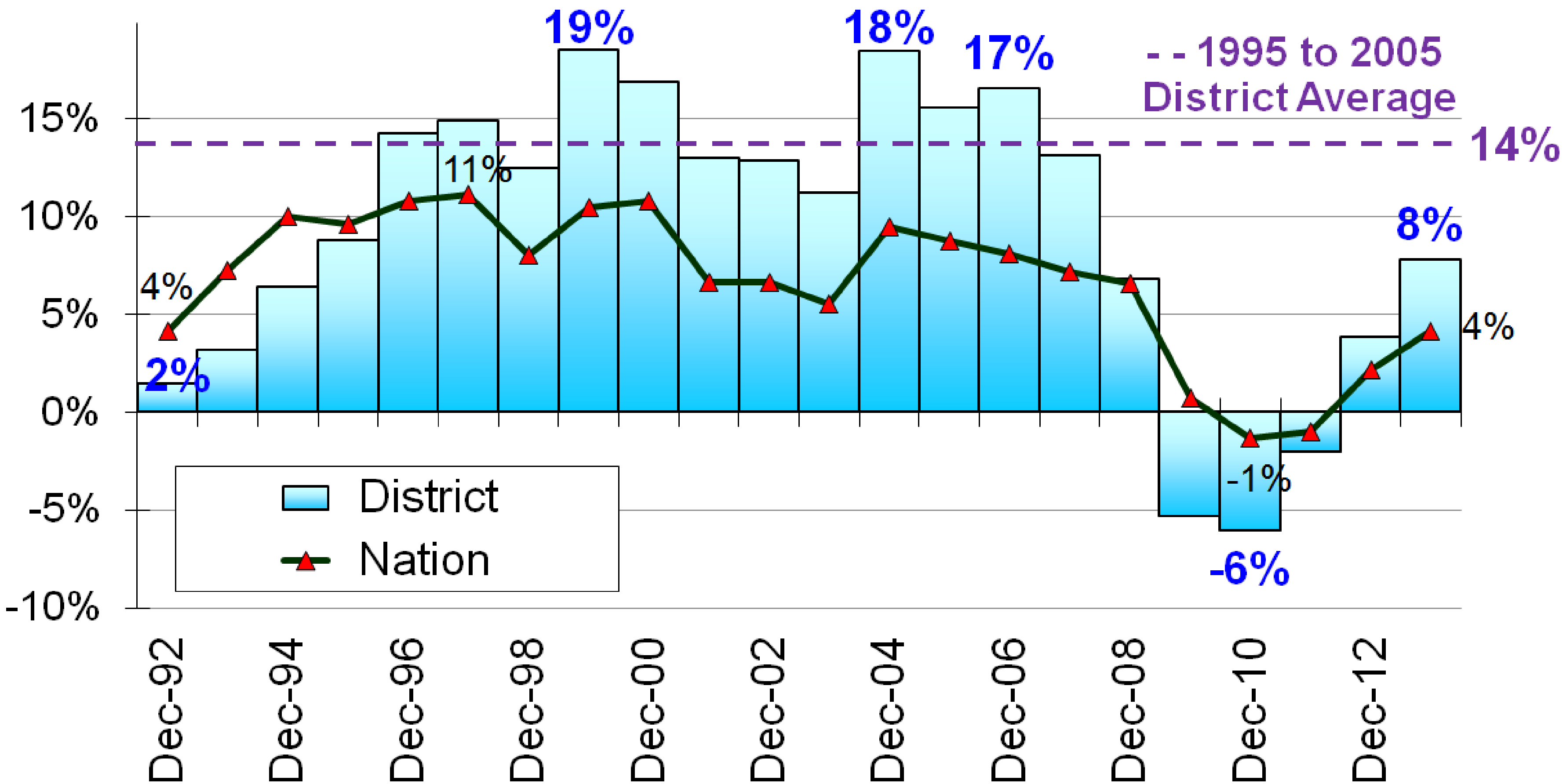
Other High Noncurrent Rates		
	2012	2013
GA	4.6%	3.0%
FL	3.8%	2.3%
SC	3.4%	2.3%
MD	2.7%	2.0%
TN	2.5%	2.0%
Nation	1.7%	1.3%

Average District Bank Net Charge-Off Rate Dropped to its Lowest Level Since 2007



Loan Growth Rates: Approaching "Normal" Levels at District Banks

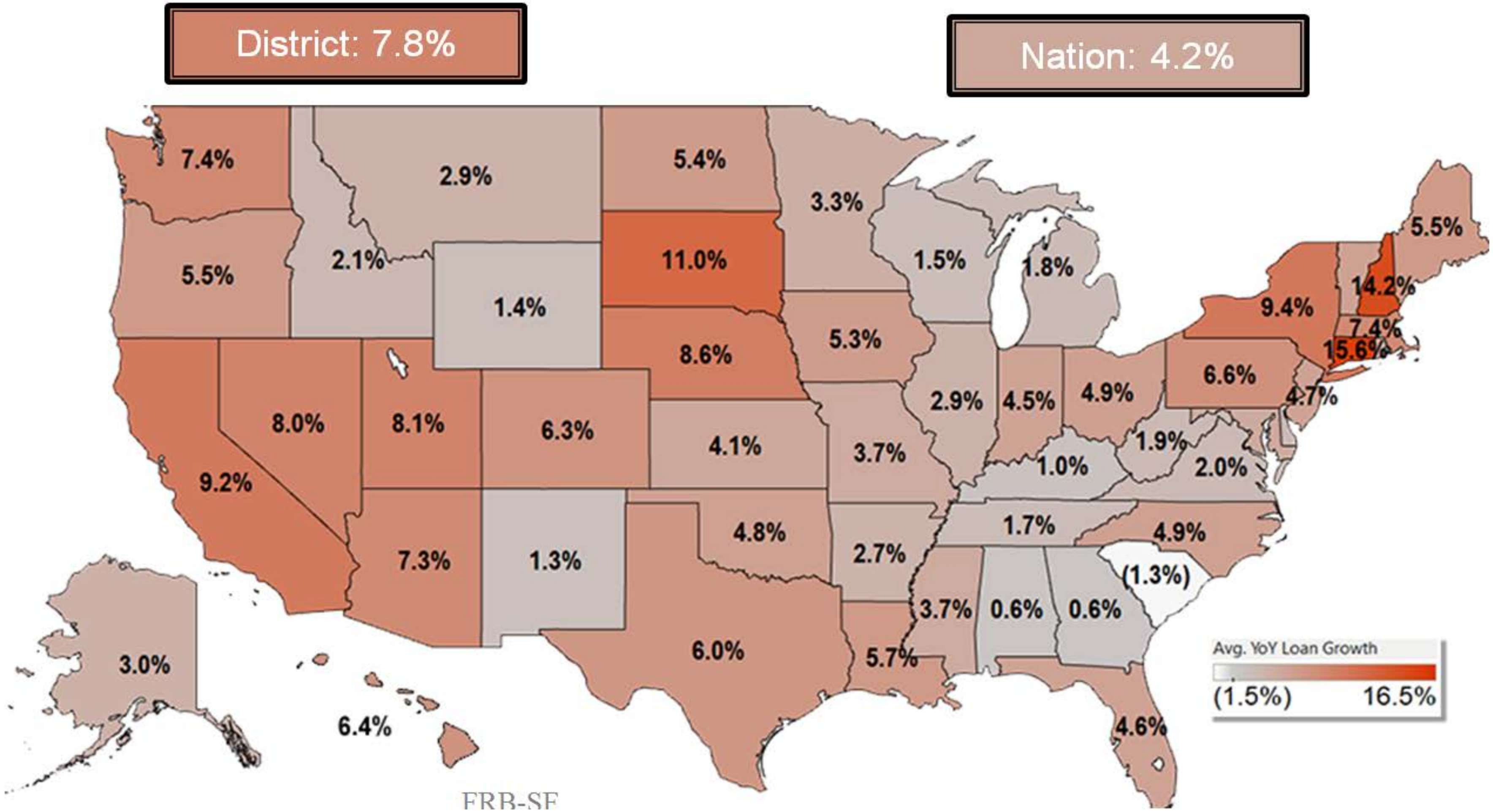
Avg. Net Loan & Lease Annual Growth Rates



Loan Growth Rates Picked Up Across the West

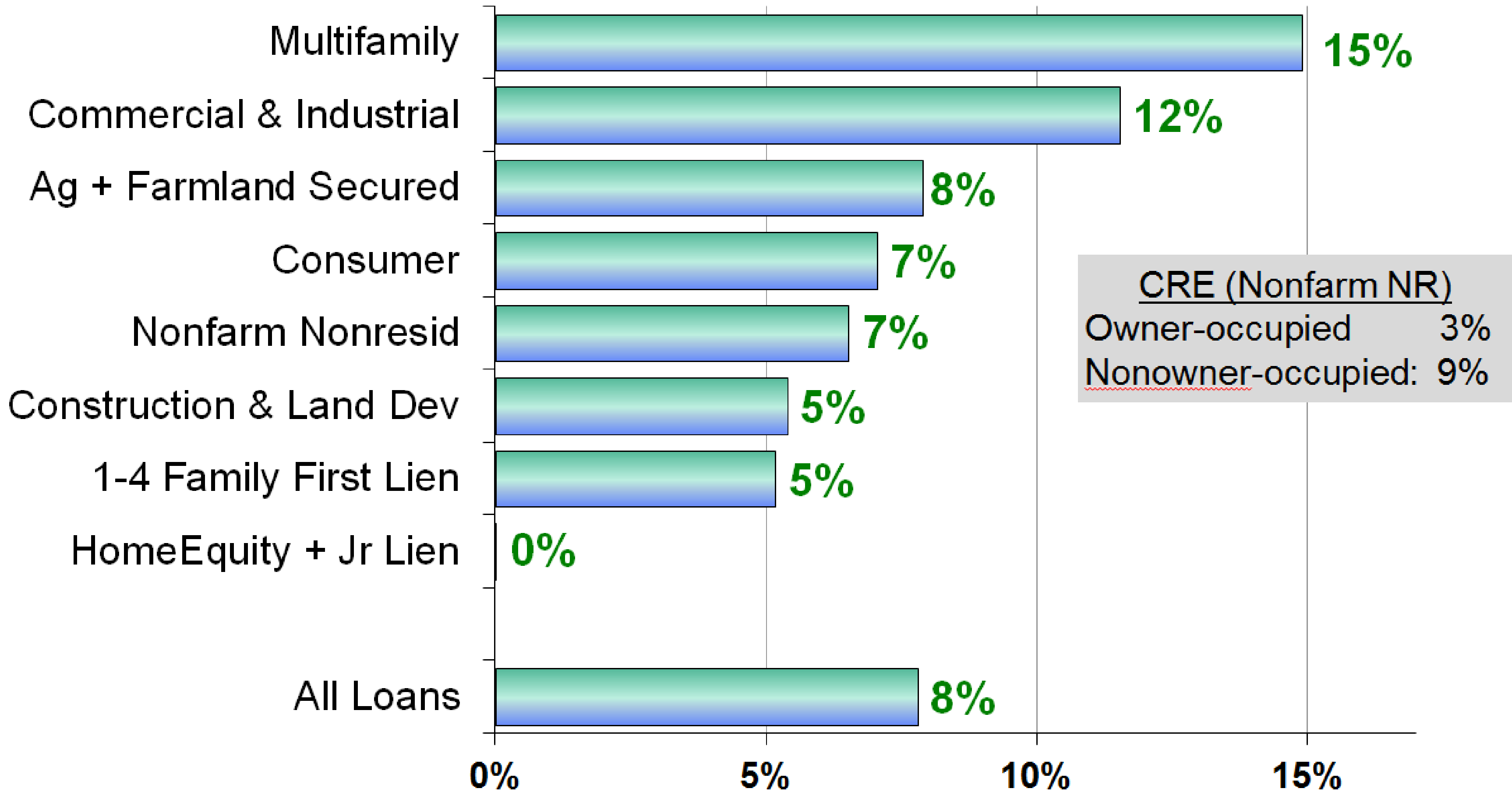
CA, UT, NV, WA & AZ in top 10 nationwide for average loan growth.

12th District Average Year-Over-Year Loan Growth through December 2013

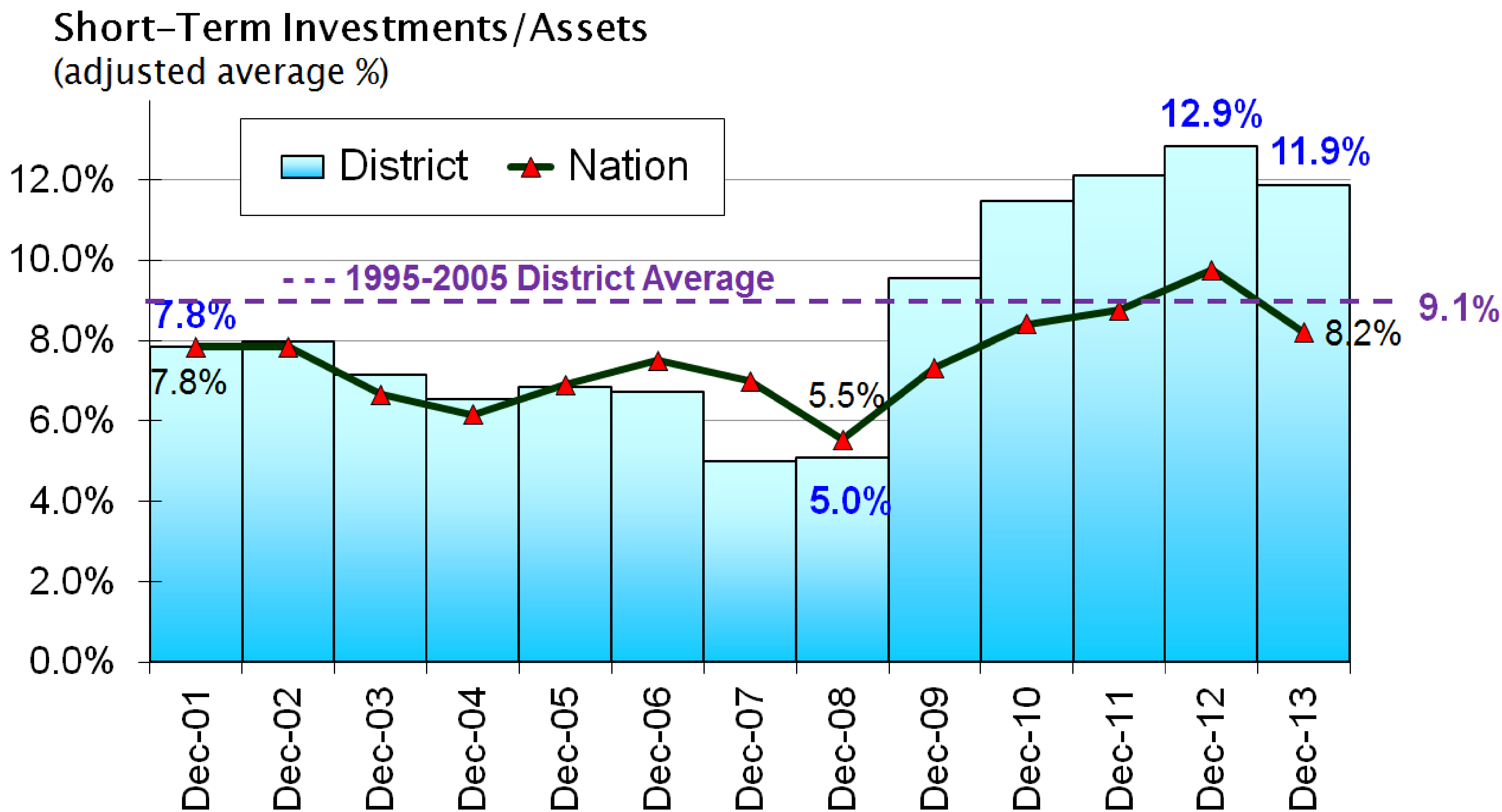


Multifamily and C&I Strongest YoY Growth; HELOC Weakest

12th District Bank Aggregate Loan Growth Rates – 2013

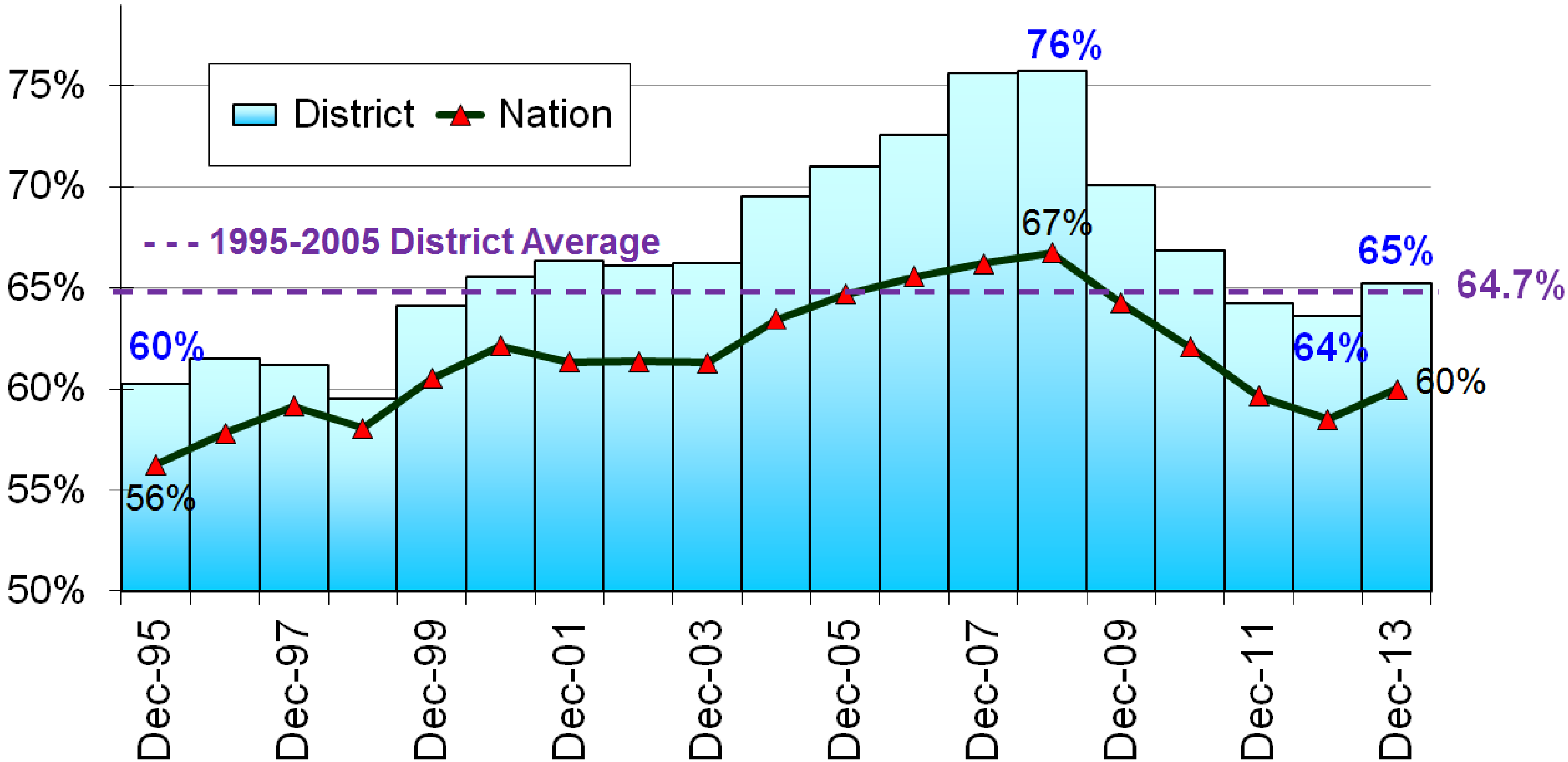


Liquidity: Short-Term Investments Off Peak but Remained Strong

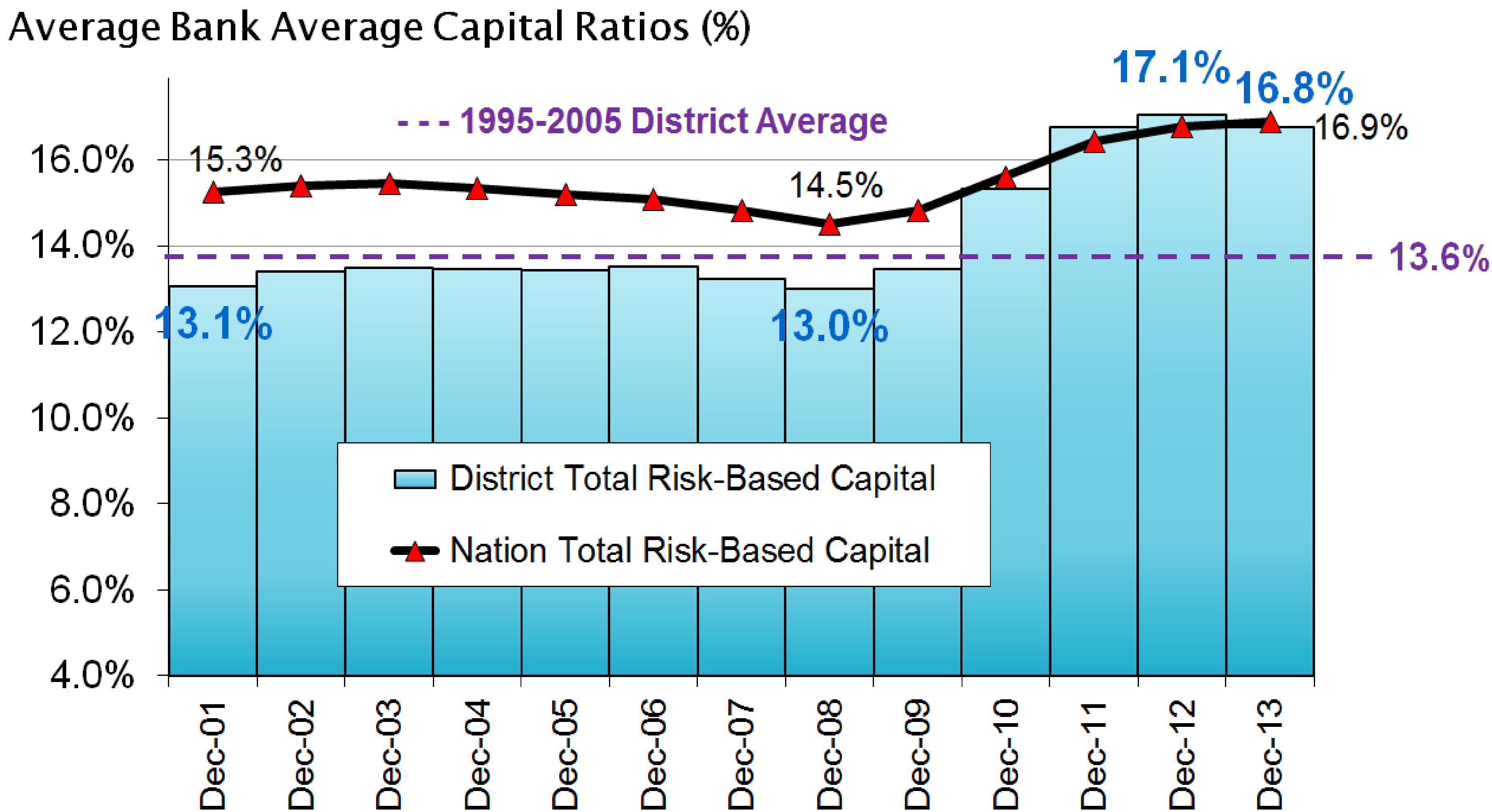


Loan/Assets Ratios Climbed Above "Normal Levels" in 2013, but Well Below 2008 Highs

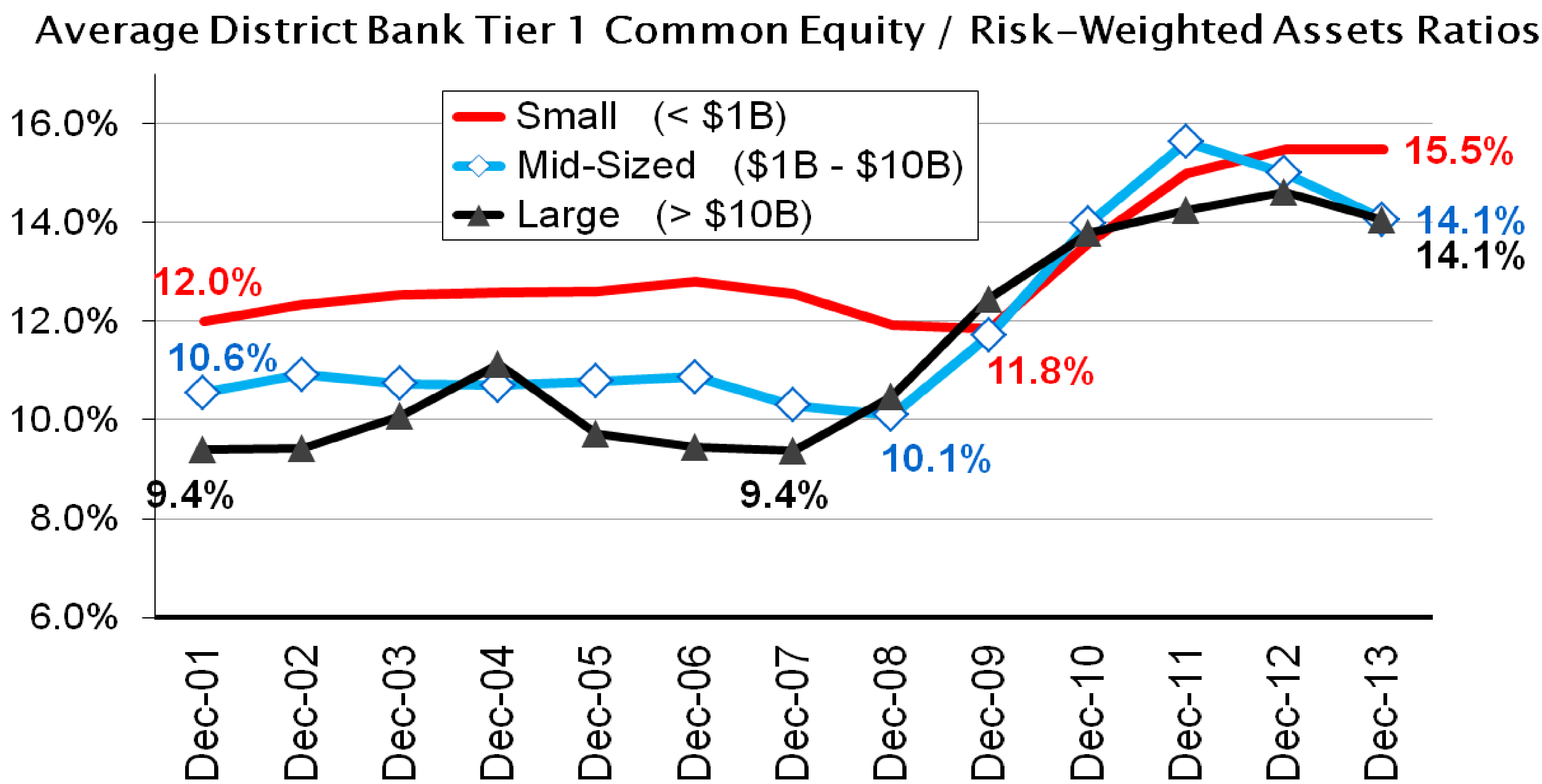
Loans & Leases/Assets (adjusted average %)



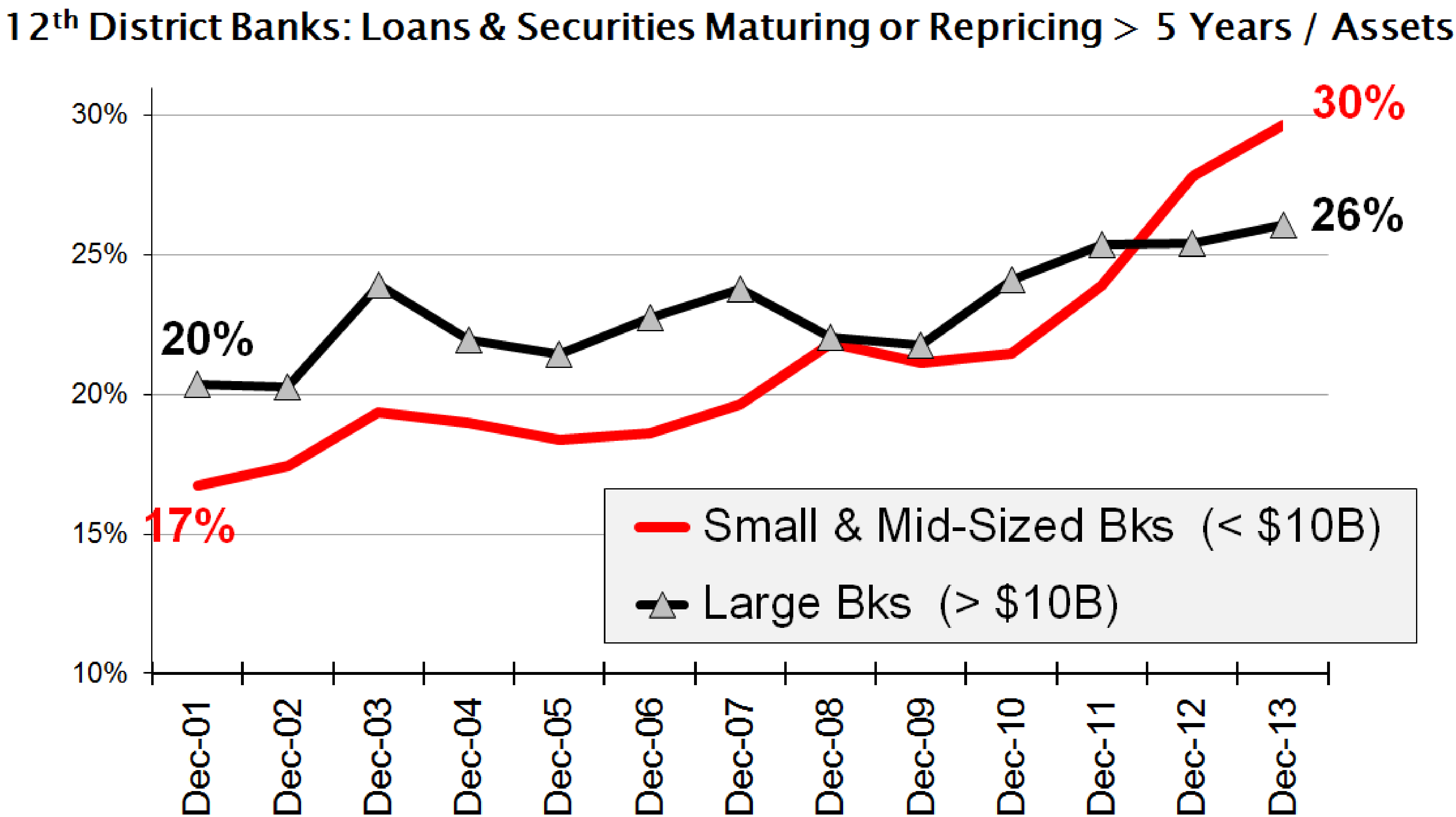
Capital Adequacy: Average District Risk-Based Capital Ratios Remained High, but Down Slightly in 2013



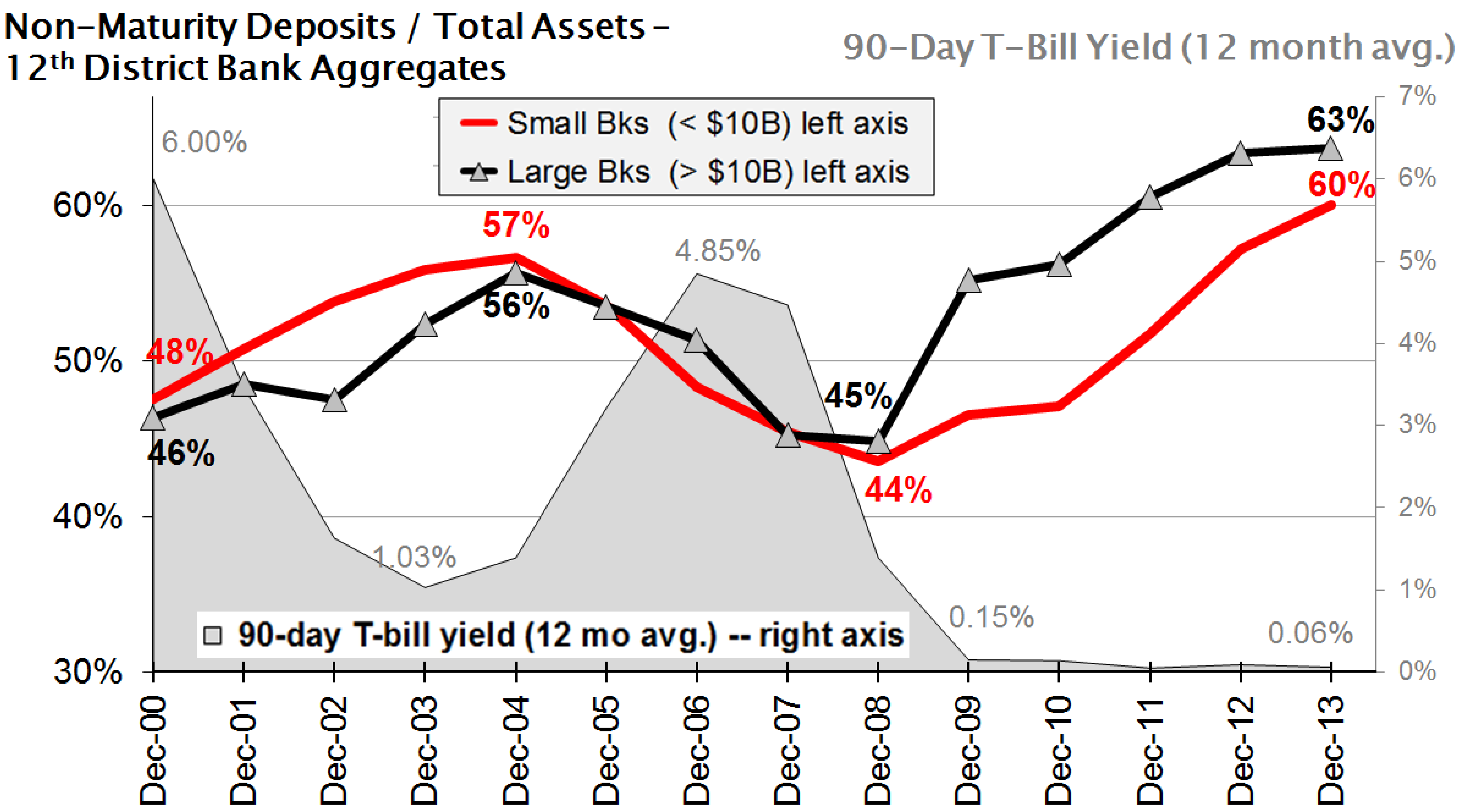
Tier 1 Common Equity Ratios – Also Relatively High but on a Declining Trajectory as Loan Growth Accelerates



Interest Rate Risk: District Banks Extended Asset Maturities in Recent Years

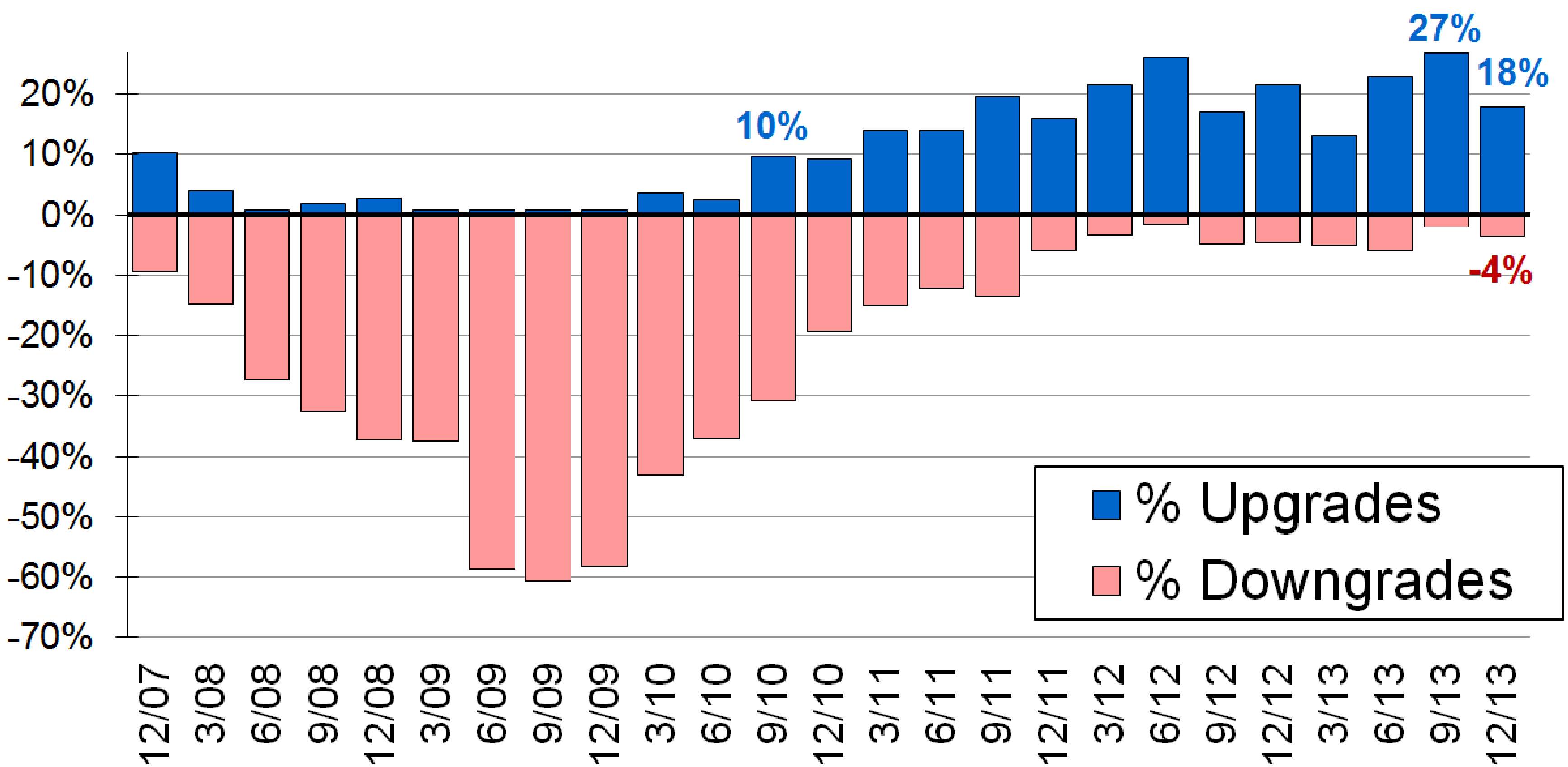


Some Banks are Counting on *Surge Deposits* to be Stable, but they May Flow Out as Rates Rise



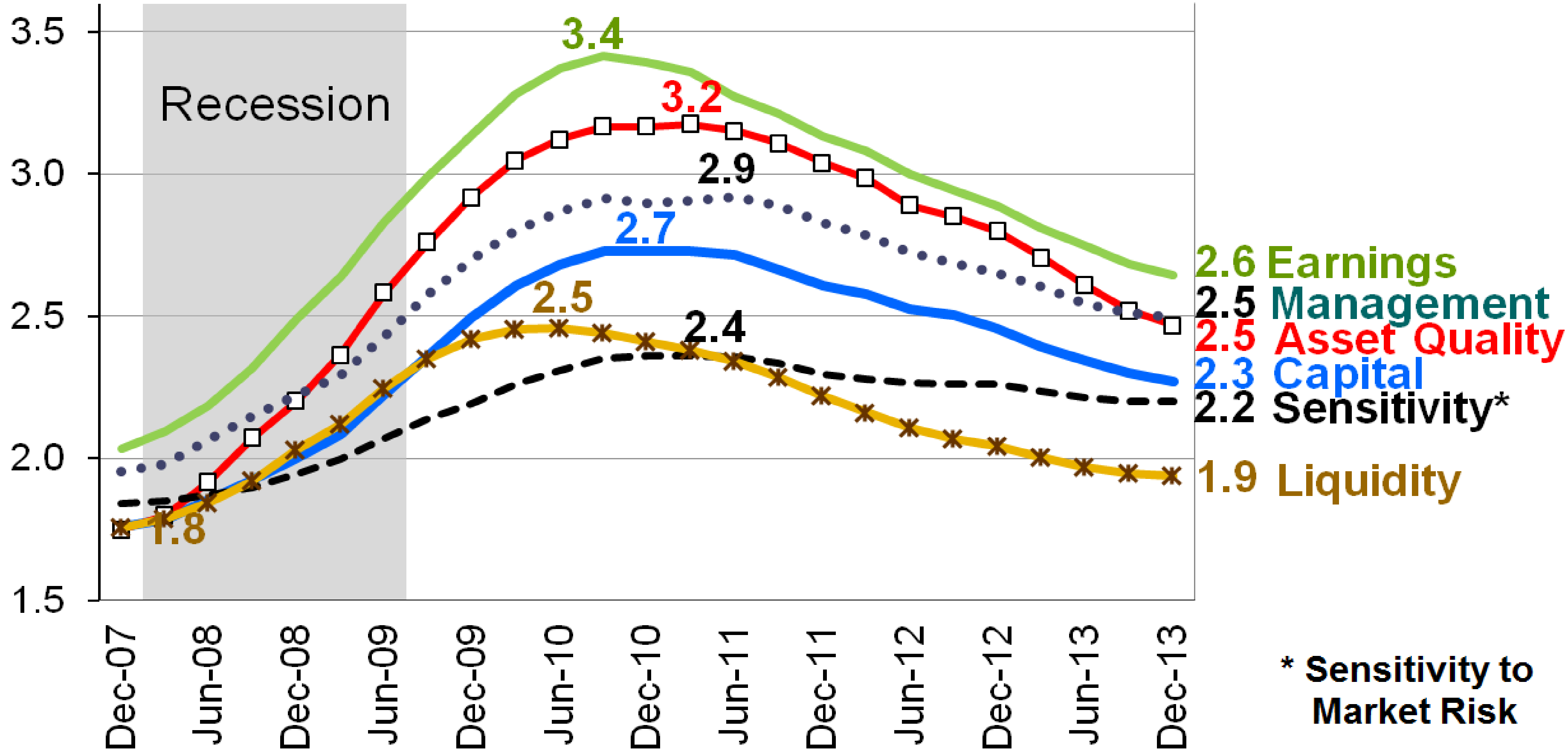
Regulatory Ratings: CAMELS Upgrades Outpaced Downgrades for the Past 11 Quarters

Pct. of 12th District Exams Each Quarter that Resulted in CAMELS Composite Rating Upgrade or Downgrade (downgrades are shown as negative percentages)



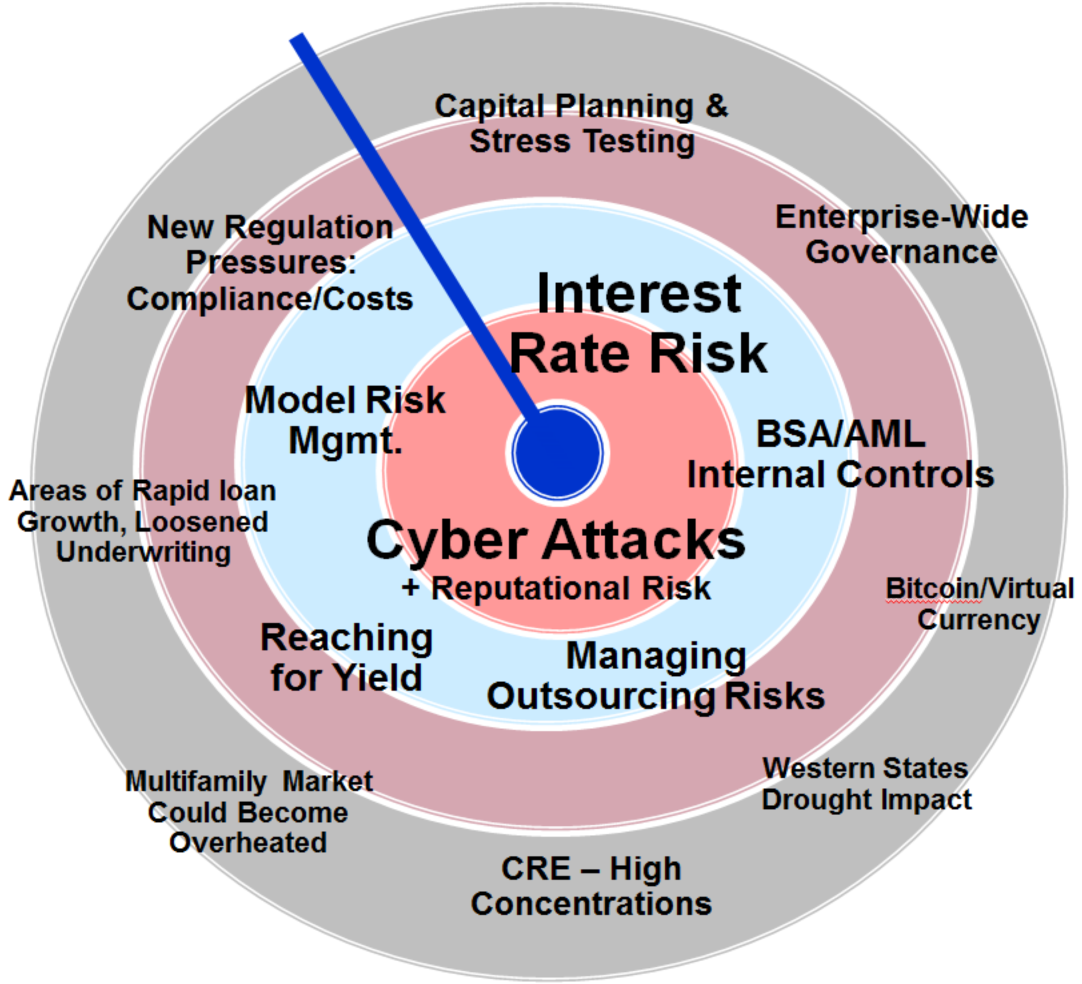
CAMELS Rating Components Continued Improvement

Average CAMELS Component Ratings for 12th District Banks
(1: strong; 2: satisfactory; 3-5: less than satisfactory)



* Sensitivity to Market Risk

Supervisory Hot Topics



Supervisory Hot Topics

1 – Interest Rate Risk

With an extended period of low short-term interest rates, many banks expanded their investments in higher-yielding, longer-dated loans and securities. Over a quarter of District bank assets are loans and securities maturing or repricing more than 5 years out. With the rise in longer-term rates in 2013, District banks now generally have unrealized net losses in securities portfolios. As banks conduct interest rate sensitivity analyses, potential outflows of non-maturity deposit balances need to be considered.

2 – Cyber Security

Cybersecurity remains a top concern. Banks need to protect the confidentiality, integrity and availability of bank data and services and circumvent criminal efforts to steal funds or data. Concerns include distributed denial of service attacks; evolution of malicious software, including software targeting mobile devices; account takeovers/fraudulent funds transfers; coordinated ATM cash-out attacks; vendor security and resiliency; and, targeted attacks against bank employees to steal or destroy data or disable systems. Additionally, banks, vendors, and customers using Windows XP may be at heightened risk from cyber-attacks after April 2014, when Microsoft ends support for this operating system. Banks need tools to effectively monitor for anomalous activity and documented crisis management plans for such events.

Supervisory Hot Topics

3 – Risk in Rapid Loan Growth Areas

Loan growth is a welcome sign of the strengthening economic recovery. While overall loan growth is not fully recovered, many banks are experiencing fairly rapid growth in certain lending areas, such as multifamily, C&I, and even construction & land development. Concerns include 1) loan growth pressures may be pushing institutions to take on greater interest rate and credit risk with relaxed underwriting terms and aggressive pricing and 2) expertise in new lending areas may be lacking. Management must maintain robust risk management processes around all products and credit concentrations; rapid growth must be considered in ALLL methodologies.

4 – California/West Drought

2013 was the driest year in recorded history in California. Reservoirs are at roughly 60% of average, while the mountain snow-pack at year-end 2013 was at 20% of normal. Short water supplies are resulting in higher costs for farmers with the market price for supplemental water reportedly three times the normal level and expected to increase if the drought worsens. Substantial acreage will be fallowed. Lost revenue in 2014 from farming and related businesses such as trucking and processing could reach $5 billion, according to estimates from the California Farm Water Coalition. The drought has the potential to result in accelerated credit losses for banks and to negatively impact local economies.

Supervisory Hot Topics

5 – Capital Planning and Stress Testing Expectations

New capital rules implementing Basel III are being phased-in starting January 1, 2014, for advanced approaches firms. Former Capital Plan Review (CapPR) firms are transitioning to Comprehensive Capital Analysis & Review (CCAR), with their first supervisory stress test to be conducted in 2014. Other over-$10B institutions are preparing for their first submission under Dodd-Frank Act Stress Testing (DFAST) in March 2014.

Large and regional banks are expected to conduct regular stress tests to support their risk identification and capital and liquidity management. For more information on the Basel regulatory framework and U.S. banks, see: http://www.federalreserve.gov/bankinforeg/basel/USImplementation.htm.

Community banks become subject to Basel III on January 1, 2015. In November 2013, the agencies released a regulatory capital estimation tool for community banks – see http://www.federalreserve.gov/newsevents/press/bcreg/20131119a.htm.

6 – Managing Outsourcing Risk

Vendor Management – Institutions need to have risk assessment processes for outsourced activities and appropriate monitoring procedures consistent with their size, risk, and complexity.

Guidance on managing outsourcing risk was issued in December 2013 - see http://www.federalreserve.gov/bankinforeg/srletters/sr1319.htm

Supervisory Hot Topics

7 – Maintaining Compliance with Laws and Regulations

Banks are facing a host of new rules and regulations. Many of these stem from the Dodd-Frank Act, such as the CFPB's "Ability-to-Repay Rule" for mortgage lending. However, regulators also remain focused on legacy laws and regulations in areas such as BSA/AML compliance and foreign wire transfer activities. Management must evaluate the applicability of new and existing rules, particularly as the bank's products and services evolve; implement appropriate processes and controls, including internal audit coverage; and develop effective staff training programs.

Materials from the December 2013 Federal Reserve "Outlook Live" webcast on "Small Creditor Qualified Mortgages" can be found at: http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/outlook-live/2013/small-creditor-qualified-mortgages.cfm

8 – Model Risk Management

Reliance on complex models to manage risks and operations requires strong governance. Risks include the appropriateness of the model for the purpose intended as well as the accuracy of model inputs and assumptions, model implementation, and interpretation of model outputs. Erroneous or misused model results can have significant potential for adverse consequences and / or financial loss.

DODD-FRANK ACT UPDATE

DFA Rules Retrospective

- Approximately 3.5 years since DFA passed
- Called for regulators to draft approximately 400 new regulations
- News agencies and law firms estimate 40% of required rules were completed as of 12/31/13

Major Dodd-Frank Act Provisions

To address…	*DFA created / requires*
Too Big To Fail	• Enhanced regulatory standards for large banks • FDIC orderly liquidation authority (OLA)
Excess Risk Taking	• Volcker rule (proprietary trading, hedge funds) • Incentive compensation rules • Risk retention for mortgages sold
Abusive Lending	• Consumer Financial Protection Bureau (CFPB) • Simplified products and disclosures

Pending Matters

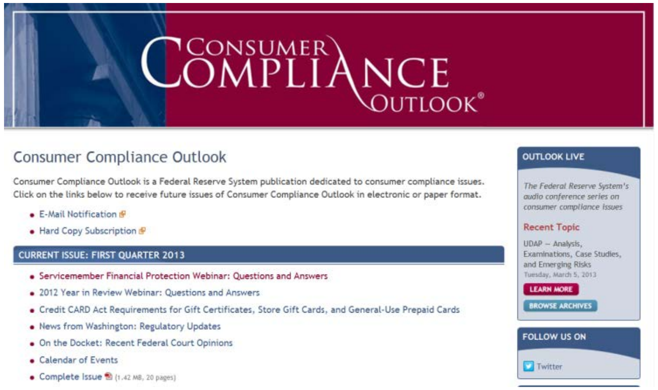
Pending DFA Proposals

- Reg W/Sec. 23A and 23B
- Appraisal Rules
  - Appraisal Independence
  - Appraisal Mgt. Co. Registration & Reporting
  - Automated Valuation Models

Pending DFA Final Rules (can't talk substance)

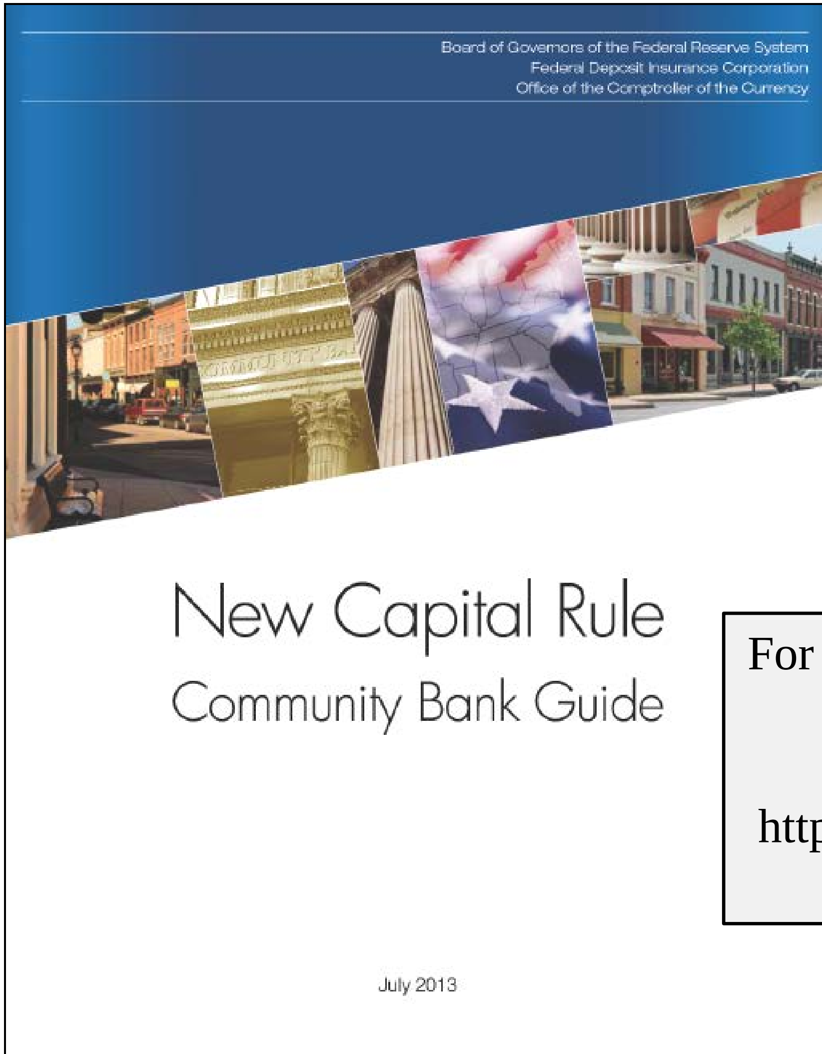
- Incentive Based Compensation (3/30/11)
- Margin Requirements for Swaps Entities (4/12/11)
- Enhanced Prudential Standards (Other Than Stress Tests) (12/20/11)
- Enhanced Prudential Standards – FBOs (12/14/12)

http://www.communitybankingconnections.org/



http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/

http://www.frbsf.org/banking-supervision/publications/first-glance-12l/



For additional information and resources related to new capital rules, see:

http://www.federalreserve.gov/bankinforeg/basel/USImplementation.htm

Questions?

Thank you!

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