

Supervisory Spotlight

A Regulator's Perspective on Issues Facing Western Banks

Banking Supervision & Regulation
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Positive Momentum amid Challenging Banking Conditions

We recently issued our quarterly [First Glance 12L report](#), covering the performance of banks headquartered in the 12th Federal Reserve District through the third quarter of 2011. Given the slow economic recovery we're experiencing, it's not surprising that banking conditions remain weak throughout the region. But despite the challenging environment, we see some positive momentum. Here are highlights from the report:

- Average earnings were in the black for the third consecutive quarter, and nearly three out of four banks in the District posted an improved bottom line through September 30 compared to the same period last year. The average District bank ROA was 0.52% (annualized), well above the year-ago level. In general, smaller banks continued to show the weakest profitability.
- Overall asset quality metrics continued to improve, with moderating rates for both delinquencies and charge-offs. The average District noncurrent loan ratio dropped from a peak of 4.5% a year ago to 3.4% at 9/30/11. We welcome this trend but would not be surprised by further deterioration in commercial real estate income property loan portfolios.
- Total loan balances continued to contract at most banks, with an average annual decline of 2.8% driven by the pullback in construction lending. But several loan categories expanded including commercial & industrial (C&I), multifamily, and agricultural loans. New loan originations in these portfolios were concentrated at healthier banks and at those with over \$1 billion in assets.
- With limited lending opportunities in a weak economy, balance sheets have become increasingly liquid, especially in the 12th District. Three years ago, the average bank's short-term investments totaled just over 5% of assets at both the District and national level. By the third quarter, the national average had risen to 8.8% while the District average climbed much more sharply to 13.3%. On the other side of the balance sheet, a significant accumulation of liquid deposits has reduced the need for noncore funding, at least temporarily.
- The percentage of District banks rated less-than-satisfactory edged down for the fourth consecutive quarter to 54% from a peak of 60%. The District percentage remains relatively high, but bankers' efforts to address weaknesses have caused regulatory upgrades to outpace downgrades for the past two quarters.

In summary, we're encouraged by continuing improvements in profitability, asset quality, liquidity, and capital adequacy. We expect those trends to continue, but many institutions are still weak and a number of challenges will likely prevent full recovery of banking conditions in the near term.

The Lending Environment

Recent loan growth—even at very modest levels—is clearly

From the Director of Banking Supervision and Regulation



As the year winds down, we're continuing to see slow improvement in banking conditions but realize that full recovery will take more time. This issue highlights the lending market and rising liquidity, two challenges that are familiar at this point in the business cycle. We also touch on two issues that reflect the evolution of the financial services industry: the rise in cybercrime and key regulatory developments. In this environment, it is clear that success requires both a steadfast focus on sound risk management and the ability to adapt effectively to ongoing change.

As always, I look forward to hearing from you about any issues of concern. I hope that you, your management teams, your boards of directors, and your families enjoy a cheerful and restful holiday season.

Happy New Year!

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good news for the economy. We certainly encourage the reasonable expansion of credit resulting from sound lending decisions made within a framework of solid underwriting practices and proper internal controls. At this point in the economic cycle, it's not unexpected to hear about intense competition for a limited pool of good borrowers. Some community bankers report that it's especially hard for them to compete against large banks on loan pricing and terms. This raises concerns that bankers might be tempted to relax their standards too much in order to book more loans. In fact, at some banks across the country we've seen loosening of loan covenants and aggressive pricing and terms. And a number of banks are shifting their portfolio mix away from real estate and toward other areas such as C&I loans. In fact, one in five District banks increased C&I loans 20% or more over the past year.

So as the welcome recovery in lending markets continues, it's important not to let the basics of prudent underwriting slip from focus. As you know, long-term success comes from adhering closely to established policies and limits, having a mechanism in place for tracking and reviewing any credit policy exceptions, and ensuring that loan pricing reflects adequate risk return. In addition, any expansion into new types of lending must be accompanied by relevant expertise and an appropriate infrastructure to manage the growth.

Some Thoughts on Liquidity

As noted above, the modest economic recovery has boosted bank liquidity. With low interest rates and an uncertain outlook, many businesses and consumers are holding off on significant investments and spending. Instead, they're letting cash accumulate in their bank accounts. It's common to see this trend following a recession, but core deposit levels are much higher now compared to similar points in prior business cycles.

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When the economic recovery strengthens and consumer and business sentiment improves, bank deposits will likely return to more normal levels. Cautious bankers are closely reviewing their deposit structures and carefully evaluating runoff assumptions used in their interest rate risk models. Assumptions for non-maturity deposits are particularly important, as these accounts are especially vulnerable to rising interest rates that would inevitably come with a significant pickup in the economy.

The Rise of Cybercrime

The remarkable expansion of online banking services has come with a serious downside: an increased risk of cybercrime. Criminals specializing in financial fraud are organized and sophisticated, and several financial institutions have suffered multi-million dollar losses from crimes committed over the internet. Last month, we focused a ["Call the Fed"](#) event on the threat of unauthorized remote access to customer accounts. This is timely because on January 1, 2012, bankers should be ready for regulators to assess conformance with the [June 2011 Interagency Supplement to Authentication in an Internet Banking Environment](#).

The Supplement updates—but does not replace—the [2005 guidance](#) on authentication. Topics include risk management, risk assessment, layered security, and customer education and awareness. It also establishes minimum control expectations for certain online banking activities and identifies controls that have become less effective over time. A few takeaways from the Supplement follow.

- Risk assessments must be conducted at least annually, and whenever an institution's risk profile materially changes. Assessments must also differentiate between retail and commercial accounts.
- Authentication for high risk accounts must have layered security, which means different controls at different points in a process. At a minimum, layered security should include anomaly detection and response at initial customer login and at initiation of funds transfers to other parties.
- Customer awareness programs should provide advice on controls that the customer can implement. Programs should also explain protections and limitations of the Federal Reserve's Regulation E, which provides a framework establishing the rights and responsibilities of participants in electronic fund transfer systems.

If you didn't have a chance to participate in the event, we encourage you to [review the material and listen to the](#)

[discussion](#).

Rules and Guidance Underway

The flow of rules and guidance from financial regulators shows no signs of slowing, especially since the implementation of the Dodd-Frank Act (DFA). Some new policies apply to the country's largest institutions and are designed to enhance overall financial stability. We encourage you to weigh in with the appropriate agency on proposals that affect you significantly, and to be on the lookout for new developments with respect to several issues in particular:

- [Alternatives to Credit Ratings](#) – The banking agencies recently issued an amended notice of public rulemaking that proposes alternative standards of creditworthiness to be used in place of credit ratings to determine the capital requirements for certain debt and securitization positions, as required by DFA.
- ["Know Before You Owe"](#) – The Consumer Financial Protection Bureau has launched this series of initiatives involving studies and proposals intended to simplify disclosures required by the Truth in Lending Act (TILA) and the Real Estate Settlement Procedures Act (RESPA) for mortgages, student loans, and most recently, [credit cards](#).
- [Flood Insurance](#) – In October, the banking agencies released Interagency guidance and proposed revisions to Q&A regarding flood insurance which should be useful for mortgage lenders.
- [Capital Plans and Stress Test for Large Firms](#) – The Federal Reserve Board issued a final rule requiring bank holding companies with over \$50 billion in assets to submit annual capital plans for review. The release also launched the 2012 Comprehensive Capital Analysis and Review (CCAR) process for these firms, which includes a supervisory stress.
- [Living Wills](#) – The Federal Reserve Board approved a final rule to implement DFA's resolution plan requirement for bank holding companies with over \$50 billion in assets. Known as "living wills," each plan must describe the company's strategy for rapid and orderly resolution in bankruptcy during times of financial distress.

Finally, the [Regulatory Reform website](#) provided by the Federal Reserve provides current information on DFA implementation.

Resources

[Outlook Live](#) webinar (December 15, 2011) on "Consumer Compliance Hot Topics: 2011 Year in Review/2012 Year in the Making." Outlook Live is produced by the Federal Reserve System's Consumer Compliance Outlook newsletter.

[Real Estate Lending Risks Monitor](#) (November 2011) Survey and analysis of commercial real estate conditions in the 12th District.

[Economic Trends and Conditions](#) (November 2011) Monthly review & analysis of key trends in the 12th District economy.

[FedViews](#) (December 8, 2011) Fed economists' views on the current economy and the outlook.

[Swimming Upstream: Monetary Policy Following the Financial Crisis](#) (November 18, 2011) Speech by John C. Williams, President and CEO, Federal Reserve Bank of San Francisco at the Summit Meeting of Central Banks on Inflation Targeting, Santiago, Chile.