

Supervisory Spotlight

A Regulator's Perspective on Issues Facing Western Banks

Banking Supervision & Regulation
Federal Reserve Bank of San Francisco

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12th District Banking Conditions: Is the Recovery for Real?

Based on preliminary figures, 14% of regulatory bank examinations that concluded in 1Q11 resulted in a CAMELS rating upgrade. This is the highest upgrade percentage in any quarter since 1998. By this and most metrics depicted in the latest First Glance 12L, it certainly appears that banks headquartered in the 12th Federal Reserve District are starting to recover. Most likely this recovery will be slow and bumpy, depending on how quickly strong job growth resumes and real estate markets recover.

The year began with profits at 12th District banks reaching a three-year high in 1Q11. The average District return on assets (ROA) climbed to 0.42% from -0.06% a year earlier and three-quarters of banks were profitable, continuing an improving trend in this metric since 4Q09, when well over half were unprofitable. Among District states, only Arizona banks recorded a loss on average. In contrast, for most of 2009, banks in eight of the nine District states lost money on average. While sharply curtailed loan loss provisions largely were responsible for the earnings boost, core earnings metrics continued to show positive signs. Larger banks again outperformed smaller banks in the first quarter; those with less than \$1 billion in assets had an average ROA of 0.26%, while those over \$10 billion averaged 1.25%.

The District average noncurrent loan rate, while still very high by historical standards, continued to trend down and ended the quarter at 3.8%. Loan restructurings and charge-offs remained at high levels, helping to keep problem loan rates in check. Recoveries continued to improve as a percentage of loans, but still remained low as a percentage of prior year gross charge-offs.

District banks showed no measurable loan growth, as total loan balances contracted at a 4.4% annual rate on average in 1Q11, with aggregate Construction & Land Development Loans down a cumulative 62% from the peak. Banks rated CAMELS 1 or 2 generally reported positive loan growth during much of 2010; however, even this group's average loan growth turned negative in the first quarter of 2011, which could reflect soft loan demand and somewhat restrictive credit standards.

In the 12 months ending March 31, 2011, 47 banks (10% of the District) received significant amounts of new capital (over 3% of assets), as banks in need of new capital are increasingly finding willing investors. This, along with a decline in total loans at most banks, helped boost average bank capital ratios to 20+ year highs. The growing availability of capital also helped to sharply reduce the number of 12th District bank failures this year to just six so far (compared to 22 in the first six months of 2010).

Continued Caution on ALLL

As loan losses slow and other credit risk indicators validate an improving loan quality trend, we're not too surprised to see some banks reduce their allowance for loan and lease losses (ALLL). This may be entirely appropriate for some banks. However, the breadth of this trend in the 12th District is somewhat concerning given that significant asset quality problems persist at many institutions, the CRE market remains unsettled, the housing market continues to face significant pressure, and ALLL balances are still low by historical standards. Our examiners are therefore closely evaluating any bank decisions to

From the Director of Banking Supervision and Regulation



As many of you know, I was recently appointed Director of Banking Supervision and Regulation in the 12th Federal Reserve District. I've worked closely with bankers throughout the west during my sixteen years at the Reserve Bank and am committed to maintaining an open and robust dialogue in the months and years ahead. Strong communication serves both bankers and supervisors well, especially during these dynamic times. I look forward to continuing our dialogue as the industry emerges from the financial crisis and recession, and in the face of new and evolving regulatory challenges.

This latest issue of *Supervisory Spotlight* highlights a number of these challenges. I welcome your thoughts and perspectives on the issues raised in this edition, as well as other matters that are on your mind. As you know, *Supervisory Spotlight* is just one way that we are reaching out to the industry. Our Reserve Bank also hosts regular "Call the Fed" webcasts, participates in conferences and workshops sponsored by industry associations, and produces a variety of publications and analyses. I am always interested in your ideas on how we can use these and other means to communicate more effectively.

Again, I look forward to seeing and working with you in my new role.

Best regards,

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reduce the ALLL, and ensuring that these decisions are appropriately documented and supported with good analysis and data.

As our examiners review management's ALLL decisions, they are seeing some disconnects between the use of market data and the bank's own credit risk indicators. Often, bank management will begin to reduce the adjustments for economic and qualitative factors when they see some stabilization or improvement in these factors (economic conditions, real estate market conditions, unemployment, etc.). Sometimes, these so-called Q Factor adjustments are reduced significantly – in some cases moving from a positive adjustment to a negative adjustment in just one quarter. This might be fully appropriate in some cases, but not without similar improvement in the bank's own credit risk indicators, such as the volume of loans past due, on nonaccrual, restructured, and classified. Our examiners will give management latitude in applying judgment to the ALLL, but this judgment should be prudent and be able to hold up to an independent third party review.

Our examiners are also closely evaluating impairment identification and measurement processes when assessing the adequacy of a bank's ALLL methodology. Every bank should have a well-defined and consistently-applied process for identifying loans to be reviewed for impairment. For those loans that are identified as impaired, the bank should have a well-defined and consistently-applied process for measuring impairment. With this in mind, examiners often identify concerns with the bank's use of the present value of cash flow impairment measurement method. In several instances, examiners have found that the support for the cash flow assumptions is deficient or nonexistent. More importantly, the cash flow projections themselves are often found to

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be overly optimistic. Accordingly, bank management should ensure not only that appropriate impairment identification and measurement processes are established, but also that assumptions are appropriate and supportable.

Interest Rate Risk and Model Validation

There are some emerging signs that suggest bankers are accepting more interest rate risk as they search for higher yields in the current low rate environment. Accordingly, we encourage bank management and boards of directors to review last year's *Joint Advisory on Interest Rate Risk Management* (SR Letter 10-01). This advisory reminds institutions of supervisory expectations and sound practices for managing interest rate risk. It addresses corporate governance, policies and procedures, measurement methodologies, stress testing, risk mitigation, internal controls, and model validation.

On the topic of model validation, the Federal Reserve and OCC recently issued *Guidance on Model Risk Management* (SR Letter 11-7), which provides comprehensive risk management guidance for banks that utilize models to help measure, monitor, and control risk. If your bank uses models, we believe you'll find this document to be a valuable resource for making management decisions that impact your bank's balance sheet composition and structure.

Regulatory Changes Continue

Repeal of Regulation Q

Section 627 of the Dodd-Frank Act repeals Section 19(i) of the Federal Reserve Act; as a result, effective July 21, 2011, the Federal Reserve Board will no longer have statutory authority to promulgate Regulation Q, which prohibits member banks from paying interest on demand deposits. The comment period on the proposed rule has just ended, and the Board is now reviewing comments before issuing the final rule. Bankers should be aware that the repeal of Regulation Q will not obligate banks to pay interest on all demand deposit accounts. On the other hand, bank management will likely need to revisit the bank's deposit products and services, which may result in the need to introduce new deposit products or make changes to existing products. We encourage

bankers to begin thinking about how the repeal of Regulation Q will affect their operations and strategic plans.

Reminders on Consumer Compliance

On the consumer compliance front, regulatory changes have been centered in credit-related areas. Two recent developments directly impact mortgage loan originators:

- Changes to **Regulation Z** place restrictions on loan steering and loan originator compensation, effective on April 6, 2011.
- The **SAFE Act** registry began its initial registration period for residential mortgage loan originators on January 31, 2011. The deadline to register is July 29, 2011.

Other important changes include:

- Fee restrictions on credit cards (implementing the third phase of the **Credit CARD Act**), effective on August 22, 2010.
- Risk-based pricing rules, effective on January 1, 2011.
- Enhanced disclosure of interest and payment terms on mortgage loans (required by the **Mortgage Disclosure Improvement Act**), effective on January 31, 2011.

In addition, the comment period is currently underway for a number of proposals. Of particular note are the credit risk retention and ability to repay proposals, which will likely affect the way mortgage loans are underwritten. The credit risk retention proposal provides an exemption for qualified residential mortgages (QRMs), while the ability to repay standards provides options for either a legal safe harbor or a rebuttable presumption of compliance for qualified mortgages (QMs). Despite some overlap, the definitions of QRM and QM are significantly different for each category of loans.

Given the complexities involved, we encourage bankers to understand the proposed changes, and offer comments on the draft rules. A complete list of regulations and rules, including proposals, can be found at the Board's website:

<http://www.federalreserve.gov/bankinforeg/reglisting.htm>.

Resources

[First Glance 12 L](#) (First Quarter 2011) A look at financial performance of commercial banks in the West, through the first quarter, 2011.

[Regulatory Reform](#) website provided by the Board of Governors of the Federal Reserve System, with up-to-date information on the reform process and the DFA.

[Bank Director's Desktop](#) providing online training, a downloadable book, *Basics for Bank Directors*, and links to web based resources for bank directors to develop an understanding of their role in performing bank oversight responsibilities.

[The Federal Reserve System's Consumer Compliance Outlook](#) offered these recent *Outlook Live* webcasts:

[Proposed Ability to Repay Standards for Mortgage Loans](#) (May 26, 2011) explores the proposed rule under Regulation Z that would require creditors to determine a consumer's ability to repay a mortgage loan before making the loan.

[CRA and HUD Neighborhood Stabilization Program](#) (April 6, 2011) on changes to the Community Reinvestment Act, effective January 19, 2011, which encourages depository institutions to support eligible development activities in areas designated under the Neighborhood Stabilization Program.

[Loan Originator Compensation](#) (March 17, 2011) on the new rules for loan originator compensation practices that took effect on April 1, 2011.

FRBSF contact on consumer compliance issues: [Tracy Basinger](#), Vice President

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

[FedViews](#) (May 12, 2011) Fed economists' views on the current economy and the outlook.

[Maintaining Price Stability in a Global Economy](#) (May 4, 2011) Speech by John C. Williams, President and CEO, Federal Reserve Bank of San Francisco to Town Hall Los Angeles. [View the video](#) of the presentation on C-Span.