

Supervisory Spotlight

A Regulator's Perspective on Issues Facing Western Banks

Banking Supervision & Regulation
Federal Reserve Bank of San Francisco

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Nascent Recovery Inches Forward

That's the headline in our latest [First Glance 12L](#) report published last month. This report provides a first look at the financial performance of banks headquartered in the 12th Federal Reserve District and suggests that 12th District banks are further along in what is clearly a very slow recovery. While many indicators remain historically weak due to the severity of the economic downturn, the trends are positive and we expect those trends to continue.

You can read the complete report by clicking on the link above, but some key observations stand out:

- On average, banks in the 12th District showed a positive ROA for the second consecutive quarter, the first time this has happened in three years. Only Arizona and Idaho recorded negative ROAs for banks on average.
- The District average noncurrent loan rate continued to trend down, improving faster than the nation as a whole. But loan restructurings and charge-offs remained at high levels and nearly one percent of bank assets on average were comprised of foreclosed real estate (the highest rate in over 20 years).
- Banks rated CAMELS 1 or 2 reported positive loan growth in the 2Q11 while banks with less than satisfactory ratings reported loan contraction. Balance sheet measures reflect relatively high amounts of typically more liquid investments. Total loans fell at a 4.3% annual rate for District banks on average in 2Q11, with C&LD loans down a cumulative 65% from the peak. C&I loan growth turned positive with a year-over-year growth rate of 4.6% through mid-year 2011.
- In the 12 months ending June 30, 2011, 42 banks (9.5% of the District) received significant amounts of new capital (>3% of assets), as many of those in need of new capital found willing investors. This, along with a decline in total loans at most banks, helped boost average bank capital ratios to 20+ year highs. The availability of capital also helped to reduce the number of bank failures year-to-date.
- The percentage of District banks rated less-than-satisfactory by bank regulators declined from a peak of 60% to 56% based on most recent information. While the latest percentage remains extraordinarily high, the improvement is welcome. In the past two quarters, regulatory upgrades have outpaced downgrades, reflecting successful efforts by many banks in addressing weaknesses.

In the 12th District, bank profits, liquidity, asset quality, and capital are all improving; however, problem assets still remain high, loan growth is nominal, net interest margins remain low, and the current low-interest rate environment presents unique balance sheet management issues. So, while we do expect the positive trends to continue, we recognize that we are still in the early stage of the recovery.

Some Thoughts on Risk Management

As we emerge from the recent recession and financial crisis,

From the Director of Banking Supervision and Regulation



Economic headwinds may be getting stiffer but we are also seeing signs of recovery among financial institutions in the 12th Federal Reserve District. Our Supervisory Spotlight this quarter considers these developments—both the positives and the remaining uncertainties—and reminds bankers that this is the kind of environment in which risk management tools, policies, and procedures become critical to a bank's success.

As always, I look forward to hearing from you on any of the topics in this newsletter, or on any other issues of concern.

Best regards,

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it is clear that sound risk management will still be critical. As we are still in the early stage of the recovery, risk management may be even more important as management teams reset strategic priorities, realign objectives, and roll-out new products and services. For some time now, the Federal Reserve has emphasized the importance of sound risk management practices when evaluating the activities of the institutions it supervises. Sound risk management practices include active board and senior management oversight; adequate policies, procedures, and risk limits; adequate risk measurement, monitoring, and management information systems; and, comprehensive internal controls.

With this in mind, bankers should be aware of recently issued regulatory guidance that further emphasizes the importance of sound risk management, in this case in the areas of modeling and internet banking. On April 4, the Federal Reserve and the Office of the Comptroller of the Currency jointly issued [Supervisory Guidance on Model Risk Management](#), which is intended for use by banking organizations and supervisors as they assess organizations' management of model risk. Then, on June 29, the regulatory agencies issued an [Interagency Supplement to Authentication in an Internet Banking Environment](#). This reinforces the original risk management framework guidance and updates the agencies' expectations for supervised financial organizations regarding customer authentication, layered security, and other controls. These documents contain excellent guidance on risk management expectations for specific functions within the organization.

CRE Stress Testing

Speaking of risk management, our examiners continue to evaluate the adequacy of commercial real estate (CRE) risk management practices at institutions that have elevated concentrations of CRE loans. As discussed in SR 07-1 ([Interagency Guidance on Concentrations in Commercial Real Estate](#)), these institutions should perform portfolio-level stress tests or sensitivity analysis to quantify the impact of changing economic conditions on asset quality, earnings, and capital.

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The sophistication of stress testing practices and sensitivity analysis should reflect the size of the bank, as well as the size, complexity, and risk characteristics of the CRE loan portfolio. Over the last few years, we've learned that the stress test scenarios deployed by many institutions were not sufficiently "stressful," or the results of the stress tests were not taken seriously by senior management and the boards of directors.

Bankers should remember that the stress testing process helps quantify risk exposure and facilitates ongoing strategic planning and loan portfolio risk limit decisions. Going forward, our examiners will conduct more thorough and critical evaluations of CRE stress testing processes at institutions with significant CRE concentrations to ensure that assumptions and scenarios are reasonable and well supported, the process is sufficiently comprehensive and conducted in a systemic manner, and the results are thoroughly reviewed and vetted by senior management and the board of directors.

A Few Words on Broker Price Opinions (BPOs)

There still seems to be confusion on the appropriate use of BPOs. A BPO can provide a quick estimate of a property's value, which can be used for ongoing monitoring, risk grading, or other risk management purposes. It is a quick and inexpensive tool; however, the BPO does not satisfy the definition of an appraisal in the Board's appraisal regulation or provide sufficient detail on a commercial property's condition, occupancy, and use to meet the requirements for an evaluation. As a result, for loan transactions that require an appraisal or an evaluation, an institution cannot simply rely upon a BPO.

That said, the BPO may still have some use. For example, a BPO may be an acceptable tool to determine a sales price in a residential mortgage modification as a loan modification does not constitute a "federally related transaction," and therefore does not require the use of an appraiser. Also, while a BPO by itself would not be considered an evaluation, an institution may

utilize information from a BPO in an evaluation. Lastly, BPOs could be incorporated into an institution's ongoing real estate monitoring processes, as BPOs could be one of several tools used to spot-check or otherwise monitor property values.

One final thought on BPOs: we need to recognize that the content and quality of these BPOs will vary from broker to broker. This is not a standardized product with an established framework or content requirements. Some brokers may actually visit the property (or at least do a drive-by), while others may simply prepare a quick desk-top review. So, if bankers choose to incorporate BPOs into their risk management processes (recognizing that the BPO is not an appraisal or an evaluation), bankers also need to understand the extent of analysis being done by the broker.

The Search for Higher Yields

Not surprisingly, in this period of low interest rates and slow loan growth, many bankers are now searching for higher yields in the investment portfolio. Our examiners have seen several instances where institutions have gone outside their typical comfort zones to purchase investments with longer terms, lower credit quality, or non-typical structures (e.g. structured notes). In some cases, the management team did not fully understand what they were buying, or fully appreciate all of the risks that accompany these investments. As we close this issue of Supervisory Spotlight, we simply remind bankers that their investment activities should be aligned with the institutions' own policies and procedures and new investment products should be fully researched, analyzed, vetted, and approved prior to purchase. In other words, there is really no area of a bank's operations, procedures, or policies where sound risk management is not critical to success.

Resources

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

[Call the Fed](#) webinar (September 6, 2011) on "Banking and the Economy: The 12th District Perspective," with [Gary Zimmerman](#), Senior Economist, and [Gary Palmer](#), Senior Manager, Risk Analytics.

UPCOMING! [Outlook Live](#) webinar coming on **October 4, 2011** on Real Estate Owned (REO) Disposition Risks and CRA Opportunities. For more information, and to register for this webcast, [click here](#). Outlook Live is produced by the Federal Reserve System's Consumer Compliance Outlook newsletter.

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

[FedViews](#) (July 14, 2011) Fed economists' views on the current economy and the outlook.

[The Outlook for the U.S. Economy and Role for Monetary Policy](#) (September 7, 2011) Speech by John C. Williams, President and CEO, Federal Reserve Bank of San Francisco at the Rotary Club of Seattle.

[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.

[Symposium on Asian Banking and Finance](#) (September 8 & 9, 2011) on the topic of *Asian Financial Institutions: Risk Management in a Global Environment*, featuring a keynote address by PIMCO CEO Mohamed El-Erian, and a discussion of risk management challenges, innovations, and reforms in Asia and globally.