Steve's Corner

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May 2010

Some Signs of Stabilization

First Quarter 2010 data hold some promising signs for District Banking conditions with asset quality, earnings, and capital positions showing some signs of stability or improvement. But bankers and regulators continue to face challenges in this difficult environment, with the number of District bank failures likely to hit post-Depression highs this year and new financial industry regulations from Washington a near certainty.

The strengthening economy, together with banks' aggressive moves to charge-off and restructure loans, led to declines in noncurrent loan balances at over half the District's banks during the quarter. Relatively high levels of provisions for credit losses and low net interest margins left profitability very weak, essentially at the break-even point on average. Regional and community banks remain hardest hit by conditions; however, large banks (>$10B in assets) are performing much better (average annualized return on assets of nearly 1% in 1Q2010).

Nonetheless, this still was the best quarterly performance for District banks since 3Q2008. Balance sheets again shifted away from loans and into more liquid and lower risk instruments. As a result, liquidity as well as capital ratios strengthened during the quarter, although the portion of banks less than "well capitalized" under the Prompt Corrective Action framework remained high at over 12%.

While the first quarter results are promising, it's too early to call this the start of recovery for District banks. Banks will remain challenged by stubbornly high levels of problem loans, and likely further weakening of income producing CRE credit quality this year. Nonetheless, many other loan categories appear to be stabilizing and slightly improving.

Focus on Fundamentals

While first quarter results are somewhat encouraging, the Fed and other regulators remain focused on vulnerabilities in the banking sector, and have issued several recent policy statements on liquidity, capital, and interest rate and correspondent concentration risk. While each of these issues will continue to receive supervisory attention, I'd like to highlight the March 2010 Interagency Policy Statement on Funding and Liquidity Risk Management (SR Letter 10-6), which reemphasizes several critical elements of sound liquidity risk management, including effective corporate governance through oversight by the board of directors and active involvement by management.

The policy statement emphasizes the responsibility of the board of directors to set and communicate risk tolerances to management, through the approval of strategies, policies, and limits. With the board's oversight, management is expected to utilize effective liquidity stress testing, with scenarios commensurate with the institution's complexity and level of risk exposure, and to have in place contingency funding plans that are sufficient to handle potential adverse liquidity events. Strategies should identify primary sources of funding for meeting daily operating cash outflows, as well as seasonal and cyclical cash flow fluctuations. Strategies should also address alternative responses to various adverse business scenarios, which should be identified in the institution's Contingency Funding Plan and related processes. Funding diversification should be implemented using limits addressing counterparties, secured versus unsecured market funding, instrument type, securitization vehicle, and geographic market.

I believe the guidance represents a helpful roadmap for addressing the recent shifts in funding and liquidity that we're seeing in our District. For example, District banks have been significantly reducing their net noncore funding dependence, and in particular the use of brokered deposits. While this is positive news, we would caution bank boards and management to understand the primary drivers behind this change and whether the changes are tertiary (e.g., flight to quality, de-leveraging, low loan demand, etc.), structural (resulting from management strategy), or a combination of both.

Capital: Changing Standards and the Role of Private Equity

Although much of the discussion of changing international capital standards has focused on the largest systemically important banks, it is highly likely that changes in capital requirements will apply to banks of all sizes. New regulatory capital requirements will better reflect risk exposures, and will be intended to reduce procyclicality of capital and accounting frameworks. The U.S. Treasury has proposed that these and other international capital standards be implemented by the end of 2012.

Banks and BHCs should already be conducting stress tests, consistent with their size and complexity, to help determine appropriate capital levels. For stress tests to be meaningful, they must include a scenario of significantly worse than expected economic and credit sector conditions. Relevant items include changes in employment, real GDP, asset prices and their impact on interest rates, loan loss rates (e.g., stress CRE loans regarding vacancy rates, lease rates, floating interest rates, etc.), loan mix and other balance sheet items (like securities), and off-balance sheet items (loan commitments, letters of credit).

Views expressed in this letter do not necessarily reflect those of the Federal Reserve Bank of San Francisco or the Federal Reserve System.

In this evolving world of capital standards and requirements, regulators have noted both the attraction and the uncertainties surrounding private equity funds. The Federal Reserve Board of Governors took a number of steps, beginning in September 2008, to clarify and liberalize private equity investment thresholds, and the role of private equity fund managers on bank boards and in other relationships. Control issues remain paramount, as do regulatory concerns about the impact private equity funds might exert on risk management—such as placing undue pressure on the bank for quick returns on their investment, or similarly causing the bank to grow too rapidly. To address some of these concerns, the Federal Reserve Bank of San Francisco will hold a "Call the Fed" on the topic of private equity investment on June 9, 2010. Please mark your calendar and register for this important call.

The Role of the Board of Directors

I've recently had the privilege of speaking to several groups of bank directors, and I've used these opportunity to remind them of the critical role they play in bank oversight. In general, the board of directors must understand the risk profile of the institution sufficiently well to comprehend the trade-offs between earnings, capital and risk, both in the normal course of business and during periods of stress or other adverse conditions. The board should use this understanding to set the risk appetite of the institution and communicate appropriate risk tolerances to senior management, to establish, monitor and maintain adequate capital levels that are consistent with the bank's overall financial profile, and to effectively plan for future capital needs.

Board members must request sufficient information from management to ensure that they adequately understand the nature and complexity of the risks facing the institution. If the information provided by management does not allow for a sufficient understanding, board members have the responsibility to request additional information or training in order to remain well-qualified to serve as a director. Earlier this year, the Federal Reserve Board of Governors launched a new website, the Bank Directors Desktop, to provide a convenient location for online training and resources. I urge you to make your directors aware of this site.

Going Forward

It is too early to know the outcome of the negotiations now going on in Washington regarding regulatory reform, and its impact on all types and sizes of financial institutions. It is all but certain, however, that change will be significant for many of us involved in the financial services industry. In this connection, I and my colleagues at the Federal Reserve Bank of San Francisco maintain our commitment to communicate with you about banking conditions as well as regulatory and supervisory matters on a regular basis.

Sincerely,

Steve

Resources and FRBSF Contacts for Current Industry Issues

First Glance 12L (May 2010) A look at financial performance of commercial banks in the West, through the first quarter, 2010.

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Interagency Policy Statement on Funding and Liquidity Risk Management, SR Letter 10-6 of March 17, 2010

FRBSF contact on funding and liquidity risk management issues: David Erigero, Market & Liquidity Risk Coordinator

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Private Equity Investment - What You Need To Know, "Call the Fed" webinar, June 9, 2010 at 11:00 a.m. PDT focused on recent interest in investing in banks by private equity funds and institutional investors.

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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.

12L Economic Trends (April 2010) Most recent performance indicators for the 12th Federal Reserve District economy.

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Economic Trends and Conditions (May 2010) Monthly review & analysis of key trends in the 12th District economy.

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FedViews. (May 2010) Monthly reports on the current economy and outlook—this month with commentary by John Williams, EVP and Director of Research.

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Consumer Compliance Outlook (First Quarter 2010) Federal Reserve System publication focused on consumer compliance issues. Also available on this site are recordings of past ***Outlook Live*** audio conferences, and notice of upcoming programs.

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

April 15, 2010 on *The Outlook for the Economy*