Financial Institution Supervision and Credit
FEDERAL RESERVE BANK OF SAN FRANCISCO

SUPERVISION IN BRIEF

A REGULATOR'S PERSPECTIVE ON ISSUES FACING 12TH DISTRICT BANKS

December 2017

Greetings!

In remarks last month at the Economic Forecast Luncheon in Phoenix, FRB San Francisco president John Williams highlighted what many of you have felt this year: strong confidence in the economy and conditions ripe for growth and other business investment. In general, our research and data supports these sentiments, but as 2018 approaches, with all signs pointing in a positive direction, there remains a need for vigilance and preparation for the next economic cycle.

We recently published the third quarter 2017 issue of *First Glance 12L*, "Bank Margins Made Headway Amid Slackening Job and Loan Growth." In the 12th District, we continue to see strong but moderating growth in jobs and housing prices, which, as expected, have led to strong but moderating loan growth and continued improvements in earnings. While nonresidential construction and land development loans continue to show the highest growth rate, it is off a much lower base than in the years leading up to the financial crisis. Likewise, average commercial real estate concentrations remain well off their pre-crisis peak. As the economy matures, when competition for loans is strong, and when it is tempting to make accommodations to maintain loan volume and earnings momentum, management must look closely at the balance between risk and reward and between current versus longer-term profitability. Two recent articles in *Community Banking Connections* reinforce the importance of a longer-term view of today's decisions.

First, Jennifer Burns from the FRB Richmond, another district with CRE concentrations, reminds community banks in "Managing Risks of Commercial Real Estate Concentrations," that the lessons of the financial crisis showed that there is no substitute for sound underwriting for all loans (both owner-occupied and nonowner-occupied), CRE concentration stress testing, and effective capital planning. These reminders really resonate with us in the 12th District given that institutions in our district rely heavily on real estate related loans. A second article in *Community Banking Connections*, "Banks are Becoming More Efficient – Is that Good or Bad?" was written by Wally Young and Alex Lightfoot in our Risk Coordination Unit. In this article, they look at trends in noninterest expenses to average assets, and challenge institutions to ask themselves whether today's cost control efforts are sacrificing tomorrow's internal controls. In other words, will the short-term profitability benefits derived from increased efficiency lead to higher risks, control deficiencies, and losses in the future? This is a bank-specific analysis, so you might expect examiners to ask questions if it appears that your institution is becoming "too efficient."

Shifting gears a bit, I want to draw your attention to some additional items from the Federal Reserve System that may be of interest to you. In November, we held a fair lending webinar where representatives from seven federal agencies discussed a variety of emerging issues. An archived version of this discussion, which is part of a series of events in coordination with the Fed's *Consumer Compliance Outlook* quarterly newsletter, is available here. In October, there was an Ask the Fed call that provided an update on the Financial Accounting Standards Board's Current Expected Credit Loss (CECL) model. This followed the latest release of several interagency CECL frequently asked questions in September. If you missed this event, you can access the archived presentation here. The next Ask the Fed session on December 18, 2017 is a year-end update on the U.S. economy, and on January 17, 2018, there's a call about underwriting practices and market indicators for commercial real estate, entitled "Regional Banking Series: Supervisory Perspectives on Credit Risk." You can register for these calls on the Ask the Fed website.

On a lighter note, in October, I had an opportunity to attend the joint Federal Reserve – Conference of State Bank Supervisors Community Banking in the 21st Century research and policy conference. I was quite impressed with the depth and breadth of the research presented, and it was fascinating to hear the discussions between academicians, community bankers, and regulators about issues that are important to all of us. Thirteen papers addressed three major themes: Supervision, Regulation, and Bank Risk; Factors Influencing Bank Behavior and Performance; and Real Effects of Government Policies. In addition, a team of students from the University of Akron presented their winning case study competition paper and video that analyzed succession planning at a local community bank. Not only were their case study findings informative, it was inspirational to hear from those who will be in the next generation of community bankers! Finally, the capstone panel discussed the future of community banking through several different lenses. After 1 ½ days, it was clear that despite a variety of headwinds, the community banking business model still makes sense and that community banks that can embrace change will be well positioned to take advantage of the exciting future ahead. You can read the papers, view the presentations, and watch the videos through the conference website.

As always, I appreciate feedback and suggestions for topics that are of particular concern to your institutions. Happy holidays!

Best regards,
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