Banking in the Ninth

September 2011

Ninth District Highlights

Community banks are concerned that new consumer and safety and soundness regulations, along with potentially more intense supervision, will increase their costs without a commensurate increase in revenue. Some banks view this combination as an existential threat. To make this point, many bankers ask me if there is a "plan" to reduce their numbers.

Of course there is no such plan; bankers ask me this question out of frustration. In fact, the interest of the Federal Reserve Bank of Minneapolis lies in a vibrant community banking system. This interest does not arise out of self preservation—many reserve bank employees work exclusively on community bank issues—or an emotional connection to community banks (which I can attest many bank supervisors have).

Rather, the Minneapolis Fed recognizes the critical private market function community banks play. There are many small firms with good projects to finance. There are also lots of bad projects. It is very difficult to figure out which ones are good and worth financing from the outside. Through their relationship lending model, community banks are better able to make that determination than other financial institutions. In doing so, they help GDP and employment grow faster. As such, Chairman Bernanke summarized earlier this year:

> "Given the important role that community banks play in their local economies, we at the Federal Reserve are keenly interested in their health and their collective future. Local communities, ranging from small towns to urban neighborhoods, are the foundation of the U.S. economy and communities need community banks to help them grow and prosper" (Chairman Ben S. Bernanke, At the Independent Community Bankers of America National Convention, San Diego, Calif., March 23, 2011, online at federalreserve.gov).

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SAFETY and SOUNDNESS UPDATE

Rating Savings and Loan Holding Companies

The Federal Reserve, as of July 21, 2011, supervises over 400 savings and loan holding companies (SLHCs). In the Ninth District, there are 25 SLHCs: two with consolidated assets in excess of $50 billion, one with consolidated assets slightly over $1 billion and the balance primarily representing organizations whose primary asset is a savings association with total assets of less than $1 billion (small shell companies).

In April 2011, the Federal Reserve issued a notice of intent explaining how we plan to implement our new supervisory authority (granted under the Dodd-Frank Act), including a discussion of applying the Federal Reserve's RFI/C(D) rating (RFI) for bank holding companies (BHCs) to SLHCs. The Federal Reserve will issue a notice shortly outlining application of the RFI rating system to SLHCs. The notice will offer the public the opportunity to comment. In the interim, SR letter 11-11, Supervision of Savings and Loan Holding Companies, provides guidance on rating SLHCs until final ruling. We highlight a few points related to rating SLHCs from this guidance (which can be found at http://fedweb.frb.gov/fedweb/bsr/srltrs/) that Ninth District SLHCs should be aware of.

As a general matter, the Federal Reserve plans to apply our supervisory program for BHCs to SLHCs to the fullest extent possible. This means, for example, that small shell SLHCs will be supervised like small shell BHCs (per SR letter 02-1). What does that mean in terms of rating SLHCs?

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The Federal Reserve anticipates transitioning SLHCs to the RFI rating (for BHCs described in SR letter 04-18, Bank Holding Company Rating System). A key part of the transition concerns the use of indicative ratings. Specifically, the first inspection and assignment of an indicative rating informing the SLHC how it would be rated if the RFI rating system were formally applied will follow upon receipt of the primary federal or state banking regulator's report of examination of the savings association. Considering the time required for the primary federal or state banking regulator to complete an examination and issue a report of examination, the Federal Reserve does not expect to issue or assign indicative ratings to SLHCs until late 2011 or early 2012.

For small shell BHCs, the Federal Reserve relies significantly—or exclusively, in the case of holding companies with underling banks in satisfactory conditions—on the rating of the primary bank supervisor in assigning a holding company rating. This same approach would govern our ratings of small shell SLHCs. In contrast, for larger or complex organizations, the BHC rating is driven to a much greater degree by an independent Federal Reserve assessment, and the same approach will apply to larger and/or more complex SLHCs. SR letter 11-11 provides general guidance on the Federal Reserve's approach to these SLHCs.

We strongly encourage interested parties to provide comments on the proposed guidance. Your views on the proposal are very important inputs to producing effective guidance.

ONE MEASURE OF ASSET QUALITY

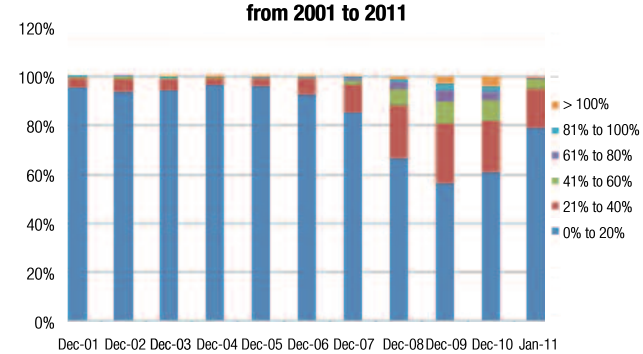
Analysts review many accounting-based metrics to ascertain the condition of a bank. They pay particular attention to measures gauging the repayment on loans and securities (i.e., measures of asset quality); loans and securities make up the vast majority of bank assets, and a drop in timely and full repayment naturally weakens a bank. The so-called Texas ratio—which got its name from its use to analyze weak banks in Texas during the 1980s—is one measure of asset quality that has received attention during the recent downturn in banking conditions.

In lay terms, the ratio compares loans in default plus repossessed property from defaulted borrowers to the financial resources the bank has to absorb losses. The ratio has a straightforward intuition. The higher the ratio, the more loss-producing assets the bank has relative to the money the bank has to cushion those losses. More precisely, the ratio is nonperforming loans plus real estate owned divided by tangible common equity capital plus loan loss reserves. A ratio over 100 percent means that the loss-producing assets exceed the cushion. (The developer of the ratio, Gerald Cassidy, viewed 100 percent as a key threshold that only very weak banks crossed.)

What does the Texas ratio tell us about conditions of Ninth District banks (see Graph 1)? First, the vast majority of banks in the district had very low ratios during the 2000s. Second, the share of banks

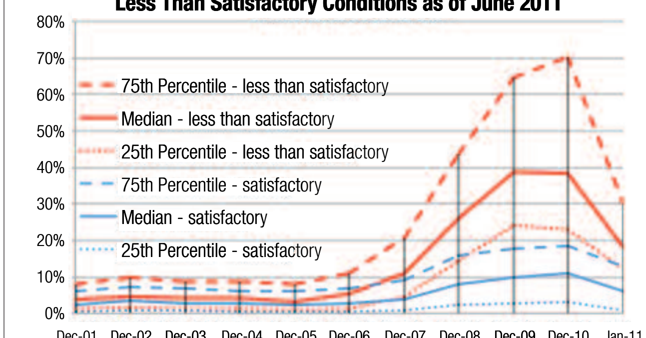
Graph 1

Ratio Distribution from 2001 to 2011



Graph 2

Texas Ratio for Banks in Satisfactory vs. Less Than Satisfactory Conditions as of June 2011



with higher ratios started to decline in 2010 and continued to decline into 2011, suggesting that conditions have begun to stabilize. Finally, the ratio worsened at the same time that banking conditions worsened; the ratio did not seem to predict the crisis.

We explore this final point by dividing all Ninth District banks into satisfactory and less than satisfactory conditions. We make this division based on the safety and soundness ratings of banks made by bank supervisors. Banks receive a 1 through 5 rating under this system, with 1 reserved for the banks in the best condition and 5 for banks in the worst. Supervisors consider a bank receiving a 1 or 2 rating to be in satisfactory condition, while banks with a 3, 4 or 5 are in less than satisfactory condition. We make that division based on ratings as of Aug. 12, 2011. (By definition, this excludes banks that previously failed or merged, but we think this will not materially bias our results, as only a small number of banks fall into this group.) We then review these two groups' Texas ratios over time. As Graph 2 indicates, the Texas ratios of the banks that ultimately became weak were always higher than the banks that remained in good condition. But the difference in the ratios seems slight prior to the crisis that started June 2007.

INVESTMENT PORTFOLIO RISK

Some banks in the Ninth Federal Reserve District have recently taken on more credit and interest rate risk in their investment portfolios. There is nothing inherently wrong with such actions if managed properly. However, as banks presumably seek to generate more investment revenue in the current low-rate and low-demand loan environment, management and boards of directors should review last year's Joint Advisory on Interest Rate Risk Management (SR letter 10-01). This advisory guides institutions in 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.

Examiners have identified deficiencies relative to this guidance and general risk management practices on recent examinations. Highlighted below are those areas where we most frequently identify deficiencies.

Due diligence. The board of directors and management should have a thorough understanding of the investment products they are purchasing and the risks inherent in them before purchase and before initiating a new investment strategy. Banks should not place undue reliance on information and analysis provided by third parties whose interests may not align with those of the bank.

Policies, procedures and limits. We expect banks to have sound policies, procedures and limits in place before embarking on a new investment strategy. The board of directors should set limits relative to the amount of risk they are willing to accept. Limits should go beyond "percentage of the portfolio" and beyond broad categories of investment. For example, for municipal bonds, where we have seen considerable recent activity, limits might include by type of municipal bond (revenue, general obligation), by type of revenue bond (hospital, utilities) and by geographic location (state or municipality). We expect banks to be aware of and manage the risks of securities issued in states or municipalities under significant financial pressure. We also encourage limits to be expressed as a percentage of capital in addition to total assets or the investment portfolio. This measure more accurately captures the risk to the institution. Compliance with the limits should be regularly monitored and reported to the board.

Limits and monitoring of aggregate interest rate risk. Overall interest rate risk limits and ongoing monitoring of interest rate risk should address both the short-term impact (net interest income) and the long-term impact (economic value of equity) of interest rate movements. The interest rate risk inherent in funding sources the bank uses should also be captured in the bank's measurement tool.

While the discussion above focuses on a potential emerging concern regarding the investment portfolio, similar expectations apply regarding due diligence and policies, procedures and limits for the loan portfolio. Any questions from state member banks regarding the discussion above can be directed to their relationship manager.

CONSUMER AFFAIRS UPDATE

On April 1, 2011, new restrictions on mortgage originator compensation took effect. In general, the new rules, as outlined in Regulation Z, prohibit two practices: compensating a mortgage loan originator based on a mortgage loan's terms and conditions, and steering a mortgage borrower to a particular creditor to increase lender compensation without being in the consumer's interest. In this note, we highlight a few questions we have received several times (and include our answers).

Who is a mortgage loan originator?

Anyone who receives compensation to arrange, negotiate or obtain consumer mortgage credit for another person is a mortgage loan originator. In addition to lenders, this includes any staff members, such as tellers or new accounts personnel, for whom the bank pays a fee to refer a mortgage applicant to a lender or creditor. Under the rule, that referral fee cannot be based on a loan's terms and conditions.

What compensation is prohibited based on terms and conditions, and what compensation is acceptable?

In general, compensating a mortgage originator based on a term, such as the annual percentage rate, or a condition, such as adding a prepayment penalty to a loan, is prohibited. Clearly, certain compensation arrangements are no longer valid under this rule, such as providing the lender or broker with a yield spread premium based on the loan's interest rate or compensating a lender based on a loan's loan-to-value ratio. Compensation includes salaries, commissions and any other financial or similar incentive.

Federal Reserve Board attorneys have indicated that, at least in their initial views, linking mortgage loan originator compensation to a branch's or institution's profitability is problematic because loan terms and conditions almost always contribute to profitability. This view was provided in the Federal Reserve System Outlook Live webinar titled Loan Originator Compensation. We encourage all compliance staff to listen to an archived version of the webinar available at

http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/outlook-live/2011/loan-originator-compensation.cfm. The Consumer Financial Protection Bureau will have responsibility for implementing Regulation Z going forward.

Your institution may continue to compensate mortgage loan originators based on criteria other than a loan's terms and conditions, such as (1) the loan originator's overall loan volume, (2) the long-term performance of the loan originator's loans, (3) an hourly rate of pay based on hours worked, (4) a fixed payment amount for each loan originated, (5) the percentage of applications that resulted in originations, (6) the quality of the lender's loan files, (7) legitimate business expenses or (8) a fixed percentage of the loan amount, assuming the percentage amount does not vary for different loan amounts.

Questions on the newsletter can be directed to **Mpls.Src.Outreach@minneapolis.frb.org.**
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