Banking in the Ninth

March 2012

The Importance of Banker Feedback: Addressing Concerns about Retaliation

Many banks and representatives of banks have expressed concern about the burdens associated with post-crisis banking regulation and supervision. Banks do a public service when they raise these concerns.

These concerns, at a minimum, help bank supervisors and regulators understand the environment in which bankers operate. Such understanding can lead to more productive working relationships between bankers and supervisors. Typically, the concerns also help supervisors/regulators more accurately gauge the public costs and benefits of their actions. We need that information to maximize public benefits. Finally, supervisors try to be clear in setting expectations. We sometimes fail. Feedback from bankers tells us when we miss the mark.

Sometimes banker feedback leads to a change in policy and the operation of bank supervisors. Sometimes it does not. Bankers may view changes in policy or action as the only definition of success. But the public benefits of feedback noted above arise even if the precise changes bankers want do not occur.

Society loses if bankers do not come forward with their feedback. Unfortunately, a theme in recent banker feedback, particularly over the past several months, focuses on reluctance to provide feedback. The theme was highlighted in a congressional hearing held February 1 by the Financial Institutions and Consumer Credit Subcommittee of the House Committee on Financial Services. Leaders of several state bankers associations addressing the supervisory, regulatory and credit staffs at the Federal Reserve Bank of Minneapolis in February also raised concern that bankers were withholding feedback.

Ron Feldman

I, along with my colleagues in the Federal Reserve, take these concerns quite seriously given the public stakes involved. The source of banker reluctance requires immediate attention from the leaders of supervisory organizations. Bankers report that fear of retaliation drives at least some of the hesitancy to offer feedback.

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SAFETY and SOUNDNESS UPDATE

Supervisory staff at the Federal Reserve Bank of Minneapolis have long regularly compiled and updated a "risk list." We are making key aspects of our list public to better communicate our assessment of current risks facing institutions and potential supervisory responses at firms we supervise. We welcome your comments on the list, which you can provide to Mpls.Src.Outreach@minneapolis.frb.org.

The list highlights current or emerging risks that could adversely impact supervised institutions along with potential supervisory responses. These potential supervisory responses reflect how examiners will assess these risks when present at an institution. In particular, examiners will determine if appropriate risk mitigants or management practices are in place to address these risks. They will also make recommendations to address any noted deficiencies. This list is periodically updated.

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FEDERAL RESERVE BANK OF MINNEAPOLIS RISK LIST – NOVEMBER 2011

Key Risks—Newly Identified and Repeat

Those risks or exposures currently affecting state member banks and bank holding companies in a significant negative way. Risks are listed in the perceived order of severity.

Emerging Areas of Concern

Those risks or exposures that are not currently having a material adverse effect at state member banks or bank holding companies, but which have the potential to do so in the near term (12 to 18 months).

REPEAT KEY RISKS CURRENTLY AFFECTING THE PORTFOLIO

RISK DESCRIPTION	POTENTIAL SUPERVISORY RESPONSES
Loan Quality—Continuing issues associated with CRE; residential lending & HELOCs; ALLL methodologies; appraisal deficiencies; TDR recognition; risk rating accuracy; and incomplete global cash flow analysis. Also, guarantors who could have supported problem credits in previous years may be unable or unwilling to do so.	Continue to focus examination and monitoring efforts on loan quality and credit risk management practices. Focus on continued willingness and ability of guarantors to support projects that do not cash flow. Provide reminders and additional training to examiners.
High or increasing levels of OREO	Include OREO in scope of asset quality review, as appropriate, focusing on appropriate recognition of loss, efforts to market properties, and compliance with state laws and accounting guidance.
Concentrations	Continue to review appropriate management of credit and funding concentrations, including consideration of concentration risk within a bank's capital planning. Assess whether appropriate risk analytics are used when needed.

EMERGING AREAS OF CONCERN

RISK DESCRIPTION	POTENTIAL SUPERVISORY RESPONSES
Capital adequacy given asset quality and earnings deficiencies and limited options to raise capital	Review sufficiency of capital planning at all institutions, paying particular attention to those whose financial condition shows early signs of deterioration or with low capital ratios.
Interest Rate Risk—Immediate IRR concern is associated with increased risk-taking to chase higher yields in a low rate environment.	Focus examination efforts on IRR management with attention to lengthening investment maturities or acquisitions with imbedded options.
Earnings—Persistent low loan demand and rates are negatively impacting the NIM at most institutions. ALLL provisions also reduce earnings for some institutions. Increasing compliance costs and new limits on revenue sources may also reduce earnings. Banks may respond by taking on additional risks to increase earnings.	Evaluate institutions' plans for addressing earnings pressures. Ensure staff reviewing credits monitors changes in credit quality, structure, and terms reflecting increased risk appetite. Monitor continued support for critical functions (such as IT or Audit). Consider developing surveillance tools that detect higher risk-taking in asset mix.
Deteriorating municipal bond and loan portfolios—As state and local revenues face continued pressures, bonds and loans to states and local governments face increasing risk of default. Those not defaulting could be devalued based on perceived weakness in the market.	For banks with significant exposure to this sector, increase focus on prepurchase analysis and ongoing monitoring of this segment of the bond/loan portfolio. Evaluate stress testing and management's awareness of emerging weaknesses. Continue activities to monitor the municipal bond market and communicate developments to staff.

Other areas that warrant continued monitoring but are not currently considered to be key risks:

- Agriculture – The agriculture sector is strong within the district, as commodity prices in general remain well above historic levels. Agricultural land values continue to rise, with some rapid increases evident in select areas. Producers are experiencing robust farm profits. Strong prices for corn, however, will strain ethanol-related loans and will keep feed costs high for livestock producers. Many ag banks are experiencing limited demand for loans, and the potential for a material decline in land prices exists. At the same time, off-farm income may decline as economic conditions remain weak. Additional pressure may come from possible changes to federal government farm subsidy programs. We will continue to monitor developments in agriculture and complete an updated survey of our ag banks.

- Potential revision in ALLL Accounting – The FASB and IASB have proposed a new model for determining credit losses that would split financial assets into a "good book" and "bad book" based on credit risk management policies. Credit losses on the "good book" assets would be recognized on a new time-proportional basis, while the "bad book" credit losses would be recognized immediately. We will continue to monitor developments and the need for additional training and guidance.

NINTH DISTRICT HIGHLIGHTS Continued

The relationship between supervisor and bank lends itself to concerns of retaliation. Supervisors have important powers over banks, and banks and supervisors will have repeated contact over long periods of time. So I fully understand why concern of retaliation exists. Retaliation against a bank expressing concerns is not allowed or tolerated at the Federal Reserve Bank of Minneapolis or any other part of the Federal Reserve. For this reason, I continue to strongly encourage banks to raise concerns they have with their supervision. The Federal Reserve has designed its supervisory process to promote consistency and fairness. We welcome direct feedback if banks experience anything to the contrary. Many banks have provided direct feedback—both positive and negative—and continue to do so.

For the reasons I have already discussed, however, I understand that some banks may want to discuss concerns with parties less vested in or engaged in the issues generating their concern. Chairman Bernanke recently highlighted two such outlets. First, the Board of Governors has an ombudsman. As the chairman noted, the ombudsman "mediates complaints, facilitates appeals, and, where appropriate, refers matters to committees of the Board. We are … encouraging bankers to use the ombudsman for matters that cannot be resolved at the local level."[1] Second, the Federal Reserve Bank of Minneapolis has a formal appeals process. Banks can find a complete description of the process on the Banking section of our web page [http://www.minneapolisfed.org/banking/appeals/].

The Federal Reserve continues to explore additional tools to allow banks to provide feedback. As part of that effort, a new form has been created that banks or anyone in the public can use to send their feedback to me directly and anonymously.[2] You can find the form at http://www.minneapolisfed.org/banking/appeals/feedback.cfm. Note that this tool does not replace the options the chairman highlighted.

In the meantime, please provide direct feedback—positive or negative—to me and anyone else you work with at the Minneapolis Fed. We learn from it. We improve from it. And the public is better served when we receive it.

–Ron Feldman
Senior Vice President, SRC

[1] Chairman Ben S. Bernanke at the Future of Community Banking Conference, sponsored by the Federal Deposit Insurance Corporation, Arlington, Va., Feb. 16, 2012.

[2] Feedback is transmitted anonymously through the use of a form. This bank cannot determine who has sent the form. The information from the form will be sent directly and anonymously to me.

To prevent marital status discrimination, Regulation B limits creditors from requiring spousal signatures on loan documents and mandates documentation of applicants' intent to apply jointly on joint loans. These are not new developments. We have, however, identified more violations or "close calls" in recent years than in the past. Spousal signature violations are serious and can result in a referral to the Department of Justice. As such, we strongly encourage banks to provide periodic reminders on Regulation B's requirements to lenders. We summarize some of the regulation's requirements in this note.

Lenders operating with new lending procedures or underwriting standards may believe the bank is better protected by requiring a spouse to co-sign a loan or serve as a guarantor on a commercial or agricultural transaction. Regulation B makes clear that a creditor may not require a spouse to sign a loan if the applicant qualifies individually for credit and the spouse is not a joint applicant. And even if the applicant does not qualify individually for the credit, the bank should not require the spouse to co-sign the loan; the applicant should designate the co-signer in such situations. Also, a spouse should not be required to guarantee a business loan unless the spouse is a partner, director, or officer of the business or a shareholder of a closely held corporation.

To ensure compliance with Regulation B's spousal signature rules, institutions should ensure that lenders document applicants' intent to apply jointly on joint commercial and agricultural loans. Failing to document joint intent on commercial and agricultural loans is a common violation. A jointly signed financial statement is not generally sufficient to establish joint intent. As such, most banks must document joint intent on these loans using a different form or other method.[1] We have found that most consumer-purpose loan applications adequately show joint intent, so fewer problems arise with these loan types.

Lenders should also be trained to limit inquiries about a spouse when a married applicant applies individually, particularly when the spouse will not use the account or support its repayment in any way. Bank lending policies should also clearly articulate when obtaining a spousal signature is acceptable and when it is not.

We encourage you to review a Consumer Compliance Outlook article on this topic that provides a more in-depth discussion of Regulation B's marital status discrimination rules [http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/2008/fourth-quarter/q4_02.cfm].

[1] Appendix B to Regulation B contains model forms that can be used to document joint intent on various loan types.

Questions on the newsletter can be directed to **Mpls.Src.Outreach@minneapolis.frb.org.**
Updates to contact names or email vs. hard copy preference can be sent to the same address.