Banking in the Ninth

June 2012

Ninth District Highlights

Conditions of banks in the Ninth Federal Reserve District have improved materially over the past couple of years by most balance sheet measures. A summary measure of conditions as assessed by bank supervisors' bank composite ratings shows less improvement. Why this difference in improvement, and how long might this gap continue?

First, a few facts. Accounting measures have improved in the aggregate. Consider asset quality for the median district bank: A standard measure I prefer (the ratio of noncurrent plus delinquent loans to capital plus the allowance) hit its peak three years ago in the first quarter of 2009 at 22 percent. This same figure as of first quarter 2012 was about 13 percent. Even measures that are not near pre-crisis levels show gains. Year-over-year loan growth for the median district bank is very close to zero as of first quarter 2012; loan growth was about –4 percent in mid-2011 at its nadir.

As of first quarter 2012, about 30 percent of district banks had ratings in the "3" or below range ("less than satisfactory"). About 11 percent of banks are "4" or "5" rated, which puts a bank into "problem" status. There has been some improvement since the third quarter of 2010 when 33 percent of District banks were in less than satisfactory condition. But the total improvement seems small relative to the accounting gains.

What drives the difference?

Ratings lagged the weakening in conditions on the way down. The asset quality data just referenced had the worst point about 18 months before the low point for the supervisory measure. It is not surprising that ratings are lagging the transition on the way up.

Ron Feldman

I think two other features of supervisory ratings explain the lag.

First, bank supervisors tend to avoid short-term volatility in ratings. Ratings, particularly weak ones, have consequences. Problem banks, for example, will almost always face a formal and public legal action from their supervisor. A bank supervisor will want to make sure that the factors driving such an action are persistent before downgrading, guaranteeing that supervisory ratings will lag accounting data during downturns. A preference for persistence means that the numbers will likely improve a bit before supervisors improve their ratings.

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SAFETY and SOUNDNESS UPDATE

Annually, the Reserve Bank conducts a survey of state member banks whose loan portfolios are concentrated in agricultural lending[1] to gauge their views of agricultural conditions and agricultural credit markets. The survey, conducted in January and February, included contacts with representatives of 39 institutions.

Overall, the results of the 2012 survey are consistent with last year's survey. In the survey, we ask about three distinct areas: general outlook, credit market conditions, and risk management. We also looked at whether examination results over the past year are consistent with the respondent's observations.

General Outlook

Of the surveyed bankers, 36 had a generally positive outlook for their agricultural customers, with the other three having a negative outlook. Most bankers indicated the demand for agricultural loans, including agricultural real estate loans, was stable or decreasing; 23 percent in-

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dicated that demand was increasing. The majority of bankers (67 percent) indicated land prices continue to increase. These results are largely unchanged from our 2011 survey, although more bankers noted decreasing loan demand as opposed to stable demand in 2012.

Credit Market Conditions

When asked for their views on issues related to agricultural operating loans, some respondents noted strong borrower cash incomes have changed practices regarding use of these lines. Often, lines are being drawn near year-end for tax purposes and repaid early the following year. In prior years, draws were typically taken early in the year with loans repaid at year-end using crop sale proceeds. With respect to agricultural real estate lending, bankers noted there are few farm real estate transactions in most areas, thereby increasing demand when parcels come up for sale. Respondents noted most sales are to local buyers and often funded with cash. In response to elevated commodity prices, the movement of production land to recreational purposes has all but ceased, and bankers noted more borrowers with land in the Conservation Reserve Program are considering returning the land to production. Bankers noted fierce competition for those real estate loans that are being made and expressed concern that competitors' loan terms are potentially helping drive up land values.

Risk Management

We also asked banks about the risk management techniques they are using to mitigate risks associated with current high commodity prices and land values. Responses reflected that the vast majority are using a variety of techniques to mitigate risk. Bankers frequently stated, "We remember the '80s" when responding to these questions. Risk management techniques in use included:

- Setting a maximum lendable amount per acre or using commodity price assumptions well below current prices when evaluating loan requests;
- Requiring significant down payments or taking additional collateral on real estate loans;
- Performing break-even analysis on operating credits; and
- Requiring purchase of multi-peril crop insurance.

These mitigations, together with the fact that many borrowers have reduced debt, purchased real estate with limited leverage, or upgraded equipment while improving liquidity and net worth, lead our respondents to conclude that most borrowers are well positioned for a decline in market prices over the near term. Longer term, most anticipate a correction in commodities prices and are concerned about the impact of high input costs.

Examination Results Support Respondent Observations

We also reviewed examination and financial data for Ninth District state member banks comparing those concentrated in agriculture to those not so concentrated. Overall, conditions are improving at agricultural banks as with other banks. At agricultural banks that are in less-than-satisfactory condition, weaknesses in agricultural loan credit administration or quality are rarely responsible for the problem condition. Rather, the bank's decision to expand lending outside its traditional area of expertise, often by purchasing out-of-territory commercial real estate loans, was usually the cause of deterioration.

[1] Banks with agricultural loans exceeding either 100 percent of tier one capital plus the allowance for loan and lease losses or 25 percent of total loans.

Ninth District Highlights Continued

Second, supervisory ratings reflect more than "the numbers." A bank, for example, could face a less-than-satisfactory rating if its credit administration falls below acceptable standards even if accounting data are not that bad.

Based on the data I have seen from Federal Reserve exams and conversations with other bank supervisors, I expect the overall improvement in district bank ratings to be more noticeable by the end of 2012. In 2011, about 20 percent of the roughly 70 Federal Reserve Bank of Minneapolis exams led to upgrades in the composite rating. That level of upgrades should continue in 2012, which would reduce the number of problem banks and banks in less-than-satisfactory condition. I see this trend as consistent with recent Federal Reserve guidance on upgrades for banks with assets less than $10 billion (SR 12-4). This guidance notes that upgrades can occur when firms demonstrate improvements in condition and risk management that are likely to continue. There is no fixed time period before an upgrade can occur.

—*Ron Feldman*
Senior Vice President, SRC

Individuals who own shares of bank holding company (or bank) stock often consider transferring such shares to a trust for estate planning purposes. Since a trust is a separate entity, a transfer of bank or bank holding company shares to a trust can raise issues under the Bank Holding Company Act (BHC Act) and/or the Change in Bank Control Act (CIBC Act).

BHC Act Considerations

If the Federal Reserve finds that a trust is being operated as a *business trust*, it will be considered a "company" as defined by the BHC Act and potentially a bank holding company, depending on the number of shares it plans to acquire. Usually, individuals want to avoid a determination that a trust is a "company" due to increased regulatory compliance.

Generally, a trust is presumed not to be a "company" if the trust:

1. Terminates within 21 years and 10 months after the death of grantors or beneficiaries of the trust living on the effective date of the trust or within 25 years;
2. Is a testamentary or *inter vivos* trust established by an individual or individuals for the benefit of a relative, "exempt" charitable organization, or themselves (unless they are the sole beneficiary of the trust);
3. Contains only assets previously owned by the individual or individuals who established the trust;
4. Is not a Massachusetts business trust; and
5. Does not issue shares, certificates, or any other evidence of ownership.

In addition to these factors, the Federal Reserve reviews the nature and value of assets in the trust as well as whether the trust engages directly or indirectly through ownership in any business activities to help determine if it is being operated as a business trust.

CIBC Act Considerations

Any person acquiring control of a bank holding company or state member bank must give prior notice to the Federal Reserve. This requirement applies to trusts and their trustees. A notice under the CIBC Act will be required when the proposed ownership is 25 percent or higher or 10 percent or higher and no other shareholder controls more shares.

The Board of Governors has an exception to those requirements for certain transfers to testamentary trusts if the following factors are met:

1. The beneficiaries are members of the grantor's immediate family;
2. The trust terminates upon the death of the grantor or within 21 years and 10 months after the death of individuals living on the effective date of the trust;
3. The trust contains only banking assets;
4. The trust contains assets from only one grantor;
5. The trust does not have shares, certificates, or any other evidence of ownership;
6. The trust has a sole trustee, who is usually the grantor;
7. The trust is revocable; and
8. The trust is not a Massachusetts business trust.

Because a trust's status under the BHC Act and CIBC Act requires a close review of the trust instrument and its assets, we encourage individuals to contact staff of the Applications section prior to transferring shares to a trust. We can then decide if the circumstances warrant a review of the trust to

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determine whether any issues are raised under either the BHC Act or the CIBC Act. Our contact information is available at http://www.minneapolisfed.org/banking/apps/info/contacts.cfm.

CONSUMER AFFAIRS UPDATE

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) required institutions to disclose to bank customers and applicants a credit score and information related to that score if used as part of an adverse action decision.[2] The new credit score disclosure requirement, which reflects an amendment to the Fair Credit Reporting Act's (FCRA) section 615(a), became effective on July 21, 2011.

The disclosure of credit scores for deposit-related transactions may be new for some banks. FCRA requires an institution to provide notice if taking adverse action on a requested or existing deposit account based on information in a credit report. Similarly, if the institution takes such action based on credit score information, it must now provide the credit score and related disclosures in writing or electronically. In addition to the credit score, the following information must be included:

- The range of possible credit scores under the model used;
- All the key factors that adversely affected the credit score of the consumer in the model used, the total number of which shall not exceed four;
- The date on which the credit score was created; and
- The name of the person or entity that provided the credit score or credit file upon which the credit score was created.

Some banks have asked if they must disclose the QualiFile score provided by Chex Systems, Inc., under the new credit score requirement. Chex Systems, Inc., has recommended disclosure of the QualiFile score if used in deposit-related adverse action decisions. We recommend that banks contact Chex Systems, Inc., to obtain additional information regarding this guidance if relevant.

Additional information regarding FCRA's credit score disclosure requirements is available at http://www.federalreserve.gov/newsevents/press/bcreg/20110706a.htm.

[2] The law also required the disclosure of credit scores in risk-based pricing notices in certain situations. A recent *Consumer Compliance Outlook* article provides more information regarding credit scores and risk-based pricing notices http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/2011/third-quarter/overview-of-the-credit-score.cfm.

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