Banking in the Ninth

June 2013

Ninth District Highlights

Managing the Inherent Concentrations of a Community Bank

The Federal Reserve Bank of Minneapolis and the Conference of State Bank Supervisors recently sponsored a supervisor-only seminar on banking and banking supervision in shale energy boom locales.[1] The goals of the seminar were to (1) share information on how the boom affects communities and the community banks operating in them and (2) discuss how supervisors are responding to these changes now and might respond in the future. I found the discussion from my state supervisory colleagues and presenters of significant value, with broadly applicable lessons learned. Speaking solely for myself, I took the following four related points away from the meeting.

▪ It may prove tempting in an environment with pressure on bank profits and growth for banks to seek out lending opportunities in areas with very strong growth prospects. Out-of-territory participations originated out of shale boom areas could provide needed returns to a bank. Supervisors expect banks to underwrite such participations as if they were the bank's originations. That could prove challenging for some banks given the expertise needed to underwrite a loan whose repayment is tightly linked to oil/gas development. To restate this in the affirmative, successful lenders operating within the market manage the risk of a volatile energy sector, in part, by amassing significant information about local conditions and borrowers that is hard for an outsider to replicate.

Ron Feldman

▪ Lending in a shale boom area turns virtually all loans into energy-related loans. For example, an auto loan could be dependent on income from oil exploration employment for repayment. But the boom simply highlights a concentration that is almost always present for community banks, particularly those operating in less urban areas. There are some prudent ways that banks can significantly diversify away from their

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SAFETY and SOUNDNESS UPDATE

Agricultural Lending Standards Remain Prudent

Bankers and examiners need to ensure that loans made during booms are not underwritten based on assumptions that historically exceptional asset prices become even more exceptional. Agriculture is in a boom given high crop and land prices. Annually, Reserve Bank staff conducts a survey of Ninth District state member banks (SMBs) with loan portfolios concentrated in agricultural lending, in part to monitor the underwriting practices of SMBs. In the 2013 survey, bankers report that they do not rely on current asset prices or the growth of such prices when considering a borrower's repayment ability. This article summarizes some of the techniques Ninth District SMBs are using to manage credit risk, briefly compares the financial condition of Ninth District agricultural banks to their nonagricultural counterparts, and concludes with a summary of survey respondents' outlook.

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Underwriting Practices

Despite citing a continued lack of loan demand, bankers report that underwriting practices had not loosened in an effort to attract loans. Some of the main features of reported underwriting include the following.

- When evaluating borrower cash flow and budgets, bankers noted that they
  - Rely on Farm Service Agency estimates for crop prices, which tend to be below market expectations.
  - Rely on historical yields, using a 3- to 10-year look-back period.
  - Base input costs on contracted costs, if available, or a hybrid of historical costs and estimates provided by local suppliers.
- 68 percent of bankers noted that when underwriting loans, they use a commercially available product with the ability to run various scenarios for yield and prices. Remaining bankers use internally developed tools to evaluate projected budgets.
- Bankers noted that they require crop insurance when applicable to further strengthen collateral protection.
- Some bankers reported making greater use of government guarantee programs as a means of retaining relationships.

Virtually all bankers noted that farmland values and cash rents continue to rise. Still, bankers report that they are continuing the sound practice of using historic, rather than current, market valuations when using farmland as collateral. Most noted that they set a maximum loanable value per acre that is well below current reported values and/or take additional collateral beyond the land being purchased when funding real estate transactions.

Agricultural Bank Financial Condition

Overall, Ninth District agricultural banks remain in better condition than their nonagricultural counterparts based on supervisory assessments and standard financial metrics. The percentage of banks that are "problem banks" remains substantially lower for agricultural banks than for nonagricultural banks. Agricultural banks have lower loan delinquency levels, higher returns on average assets and more short-term liquid assets relative to nonagricultural banks. One area of potential concern is capital; agricultural banks report lower capital levels, both risk-based and leverage, than nonagricultural banks. This result is especially pronounced at banks with high concentrations of agricultural loans (greater than 300 percent of tier one capital and the allowance).

Outlook

Nearly all of the bankers surveyed have a positive to stable outlook for agriculture over the next one to two years. This positive outlook is tempered by several uncertainties that could change the picture, including concerns about moisture and high land prices—many noted concern over the impact high land prices and rents are having on young farmers. The damp spring appears to have alleviated drought conditions in the eastern half of the country; however, the May 7 drought monitor still shows pockets of severe to extreme drought in parts of the Ninth District. Continued sound underwriting practices combined with improved moisture going into the 2013 season suggest potentially strong performance for next year.

APPLICATIONS FILING TIPS

State Member Bank Branching Considerations

We have received more inquiries from state member banks (SMBs) considering opening additional branches, perhaps due to improved banking conditions. This article provides information to address common questions we receive about application requirements for establishing *de novo* branches. Acquisition of an existing branch from another institution is treated as a merger and evaluated under the Bank Merger Act.

SMBs wishing to establish a new branch must apply with the Federal Reserve System (System) and the appropriate state banking agency (State). Instructions for applying for a *de novo* branch are available at http://www.federalreserve.gov/bankinforeg/afi/smfilings.htm#domestic. The System does not have an application form; often a copy of the information provided to the State is sufficient. When reviewing a branch proposal, we consider the bank's financial condition, management (including Bank Secrecy Act compliance), capital adequacy, Community Reinvestment Act performance, and investment in premises as well as the convenience and needs of the community.

The System generally discourages branching proposals for a banking organization in less than satisfactory condition, as expansion could distract management from addressing existing issues. However, the System recently issued Supervision and Regulation Letter SR 13-7 describing the circumstances under which an SMB could potentially branch on a *de novo* basis even if it or its parent holding company is in less than satisfactory condition. The letter is available at http://www.federalreserve.gov/bankinforeg/srletters/sr1307.htm.

The Federal Reserve may permit *de novo* branching for SMBs in less than satisfactory condition if the bank's CAMELS composite, management, and consumer compliance ratings and the parent's composite, risk management, and financial components are rated no worse than 3. Under these circumstances, an SMB must demonstrate that it meets six criteria detailed in SR 13-7, including that it can effectively plan and execute branch expansions. Banks that do not have a history of successful *de novo* branching should include an execution plan in the material provided to the Federal Reserve. The letter further describes limits on the number of *de novo* branches an SMB can establish under this policy. We would expect this limit to be one branch annually for Ninth District SMBs subject to this policy given size and complexity.

We also get many questions as to when a bank must file an application and notice of branch closing to move a branch. A branch move considered a "relocation" does not require an application or formal notification of branch closing to customers. A relocation is generally defined as a move within (1) a 1,000-foot radius of the site if the office is located within a central city of a metropolitan statistical area (MSA); (2) a one-mile radius of the site if not located within a central city, but if located within an MSA; or (3) a two-mile radius of the site if not located within an MSA. We do not require an application if the relocation meets these parameters. A move outside these parameters requires an SMB to follow the requirements for closing a branch and to file an application to open the branch at the new location.

SMBs establishing a new ATM or loan production office (LPO) do not need to file an application with the System, but may need to notify the appropriate State (though it is helpful to notify the Reserve Bank). SMBs should ensure that the activities are appropriately limited so that the office does not become a branch when establishing an LPO.

Questions pertaining to the branch application process can be directed to Applications staff or your Relationship Manager. Contact information is available at http://www. minneapolisfed.org/banking/apps/info/contacts.cfm.

Ninth District Highlights continued

home geography—through the size and composition of their securities portfolios. But those diversification tools have important limits, not the least of which is serving the local community, the mission of all community banks. As a result, community banks must manage the risk of heavy exposure to a limited geography within that local area. They can do so by limiting exposure within a concentrated portfolio, adjusting underwriting standards to meet the specific risk posed by a borrower and point in time, considering government guarantee programs, and amassing private information about borrowers more generally. Put another way, banks create the space to serve their local communities through active risk management and detailed information generation about customers.

- Timing matters, but it is nearly impossible to time your way to effective risk management. It seems likely that financing the first new hotel in an energy boom's heretofore small locale is less risky than financing the 20th hotel. But timing markets with a fair amount of volatility is challenging to say the least. Banks trying to make the last loan at the peak seem more dependent on luck than may be prudent.

- While it is a cliché, supervisors must find a balanced approach to the potential risks I just noted. Just because times are at their best does not mean the end is near. Moreover, banks exist to provide credit; a boom seems a reasonable time for credit to flow. At the same time, supervisors cannot count on a permanent elimination of volatility to ensure that banks are safe and sound. Finding the right lines is the challenge for banks and supervisors.

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[1] http://www.cvent.com/events/shale-energy-boom-seminar/event-summary-2432187ab7a8461d8cb21aa7578aef93.aspx

Regulation Z prohibits basing a mortgage loan originator's compensation on any of the transaction's terms or conditions or on a proxy for any terms or conditions. In complying with this rule, institutions found it challenging to determine what constituted a proxy for a loan term, particularly because of limited guidance on this issue. New loan originator compensation rules take effect January 10, 2014; these rules clarify existing regulations and commentary regarding compensation, including what constitutes a proxy for a loan term. In this update, we summarize the most relevant features of the new rules for community bank compensation practices based on banker questions and examinations.

What is a transaction term? In the new rule, terms of the transaction are defined as any right or obligation of the parties to a credit transaction, excluding the loan amount, but including

- The interest rate,
- Fees, and
- Charges for services required as a condition of the credit.

For example, a mortgage loan originator cannot receive compensation based on the loan's interest rate. Likewise, an originator cannot receive compensation for steering a borrower to purchase title insurance from an affiliate. In both cases, the borrower is obligated to pay both interest and title insurance as conditions of the loan.

What is a proxy for a transaction term? According to the final rule's definition, a proxy (1) consistently varies with a loan term over a significant number of transactions and (2) can be added, dropped, or changed by the loan originator during origination. Many banks have asked if the rule prohibits profit-sharing payments to mortgage originators. The new rule clarifies that banks can use mortgage-related business profits to make contributions to certain tax-advantaged retirement plans such as a 401(k) or a Simple Employee Pension. Banks can also use mortgage-related profits to pay bonuses involving an individual loan originator with 10 or fewer originations or when the payments do not exceed 10 percent of the loan originator's total compensation. However, banks cannot compensate mortgage loan originators based on the terms of their transactions or on their transactions' contribution to profits.

What additional compensation is acceptable? The new rule continues to permit mortgage loan originator compensation based on criteria other than the terms of the transaction. Banks can continue to compensate originators if the borrower is a new customer as well as on the quality of the loan files, the long-term performance of the loans, and the percentage of consummated applications. Banks can also continue basing compensation solely on loan volume, but should strongly consider the safety and soundness implications of this practice.