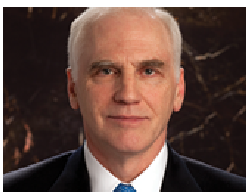
Financial UPDATE

Vol. 24, No. 4
Fourth Quarter 2011

Board Proposes Steps to Strengthen Regulation of Big Banks
The Fed has proposed strengthening regulation and supervision of large bank holding companies and systemically important nonbank financial firms. The proposals address issues of capital, liquidity, credit exposure, stress testing, risk management, and early remediation requirements.

Atlanta Fed's Lockhart Shares Views on Economy, Risks in 2012
The U.S. economy should grow moderately in 2012, but that forecast is subject to risk from Europe, said Atlanta Fed President Dennis Lockhart during a recent speech. In his outlook for the upcoming year, he said he expects "decently behaved" inflation and continuing progress on unemployment.



Fed Gov. Tarullo Describes Goals of Dodd-Frank Implementation
During recent congressional testimony, Fed Governor Daniel Tarullo described the progress made implementing the Dodd-Frank act, although he cautioned lawmakers that much work lies ahead for the agencies involved in the law's implementation.

Agencies Release Annual CRA Adjustments
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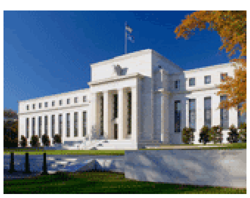
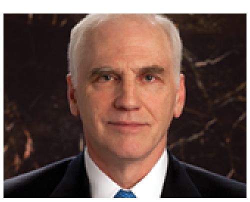
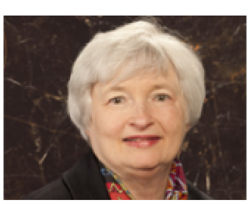


Fed Announces Annual Capital Review of Biggest Banks
The Fed recently issued a rule requiring the nation's largest bank holding companies to submit annual capital plans for review. Institutions with at least $50 billion in consolidated assets will undergo review for capital adequacy.

Fewer Banks Eased Lending Standards in Third Quarter, Fed Says
A new Federal Reserve survey indicated that fewer banks eased standards and terms on loans to businesses in the third quarter. Only a small share of surveyed banks reported easing standards on commercial and industrial loans, citing an uncertain economic outlook as a reason.



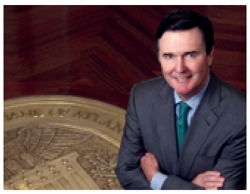
Stronger Capital Standards a Start, but More Work Needed, Says Fed Gov. Tarullo
Although progress is taking place on proposed capital and liquidity rules aimed at preventing another financial crisis, Federal Reserve Governor Daniel Tarullo recently said U.S. and international regulators must address pressing issues that remain.



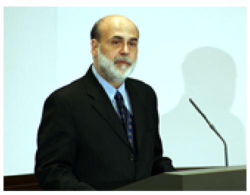
Vice Chair Yellen Explains Fed's Role in Financial Stability
Federal Reserve Vice Chair Janet Yellen recently discussed macroprudential regulation—a means to achieving financial stability by reducing systemic risk—and the implementation of processes for identifying and responding to sources of systemic risk in the financial system.

Fed Opens Comment Period on Volcker Rule
The Fed recently requested public comment on a proposal implementing the "Volcker Rule." The rule would bar some financial firms from engaging in certain activities and from owning, sponsoring, or having certain relationships with a hedge fund or private equity fund.

Fed, FDIC Issue "Living Will" Rule
The Fed and the FDIC have issued a rule implementing the "living will" requirements of the Dodd-Frank reform act. The rule requires certain financial companies to submit plans for rapid and orderly resolution in bankruptcy during times of financial distress.



Lockhart: Trust Vital to Financial System
In the wake of the 2008 financial crisis and the ensuing recession, there's work ahead for regulatory authorities and financial firm managers in rebuilding public trust in the financial system. Atlanta Fed CEO Dennis Lockhart recently addressed the role of trust in the system.



Fed Chair Bernanke: Crisis Is Changing Central Banking
The global financial crisis and recession that followed caused central banks worldwide to broaden the set of tools they use to implement monetary policy, Federal Reserve Chairman Ben Bernanke said in a recent speech.

Atlanta Fed's Lockhart: Policy Actions Should Be Viewed in Total
In a recent speech, Atlanta Fed President Dennis Lockhart addressed the Federal Reserve's latest measures aimed at lowering long-term interest rates and supporting mortgage markets. He said the moves should be seen as part of a broader strategy to promote economic recovery.

Board Proposes Steps to Strengthen Regulation of Big Banks

The Federal Reserve Board has proposed steps to strengthen regulation and supervision of large bank holding companies and systemically important nonbank financial firms. Mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the proposals address issues of capital, liquidity, credit exposure, stress testing, risk management, and early remediation requirements.

The Fed's proposal generally applies to U.S. bank holding companies with assets of $50 billion or more and nonbank firms deemed systemically important by the Financial Stability Oversight Council. This set of proposals does not apply to foreign banking companies or savings and loan holding companies. The Federal Reserve Board will issue separate proposals addressing those firms.

Public comments on the current proposal are requested by March 31, 2012. The Federal Reserve Board's proposed measures include:

- **Risk-based capital and leverage requirements** that will be enacted in two phases. Phase one would institute the capital plan rule the Board issued in November. That rule requires firms to develop annual capital plans, conduct stress tests, and maintain adequate capital. In phase two, the Board would propose to create a risk-based capital surcharge based on the work of the Basel Committee on Banking Supervision.

- **Liquidity requirements**. Among a series of phased-in measures, companies would be required to conduct internal liquidity stress tests and set limits to manage liquidity risk.

- **Stress tests**. The Board would conduct annual stress tests of the companies using three economic and financial market scenarios. A summary of the results, including company-specific information, would be made public.

- **Single-counterparty credit limits.** These requirements would limit a firm's credit exposure to a single counterparty as a percentage of the firm's regulatory capital. Credit exposure between the largest financial companies would be subject to a tighter limit.

- **Early remediation requirements**. These measures are designed to make sure financial weaknesses within a firm are addressed early. The Board is proposing various triggers for remediation, including capital levels, stress test results, and risk-management weaknesses. Some of the triggers would be forward looking.

December 27, 2011

Atlanta Fed's Lockhart Shares Views on Economy, Risks in 2012

The U.S. economy should grow at a moderate pace in 2012, but that forecast is subject to considerable risk from Europe, said Atlanta Fed President Dennis Lockhart during a November 29 speech. Lockhart shared his outlook for the upcoming year at a conference hosted by the University of Georgia's Terry School of Business. In addition to modest growth, he expects "decently behaved" inflation and continuing, albeit slow, progress on unemployment.

Europe's sovereign debt problems are not the only threat to the U.S. economic outlook. The nation's own fiscal challenges also pose considerable risk, along with other headwinds such as the weak housing sector and its dampening effect on consumer spending, continued deleveraging by households, and weak credit growth. However, "none of these individually rivals the potential for spillover from adverse developments in Europe," Lockhart noted.

A word on forecasts

In addition to sharing his outlook for the upcoming year, Lockhart also discussed the value of such forecasts—even though they are sometimes wrong. In his view, there are several reasons why economic projections may be off. Forecasters may miss the timing of economic activity, or unexpected developments may change the economy's trajectory.

Also, forecasters may not fully understand how fundamentals are playing out in the economy, a possibility recently illustrated when forecasters debated the expected shape of the economic recovery. Some foresaw a sharp recovery similar to those following past deep recessions. Others, meanwhile, were influenced by the research of economists Carmen Reinhart and Kenneth Rogoff, which suggests that economies are slower to recover from downturns precipitated by severe financial crises. "It is now fairly clear that the Reinhart-Rogoff thesis is the appropriate one," Lockhart said. However, forecast misses are still valuable because they "can lead to a better understanding of those fundamentals," he added.

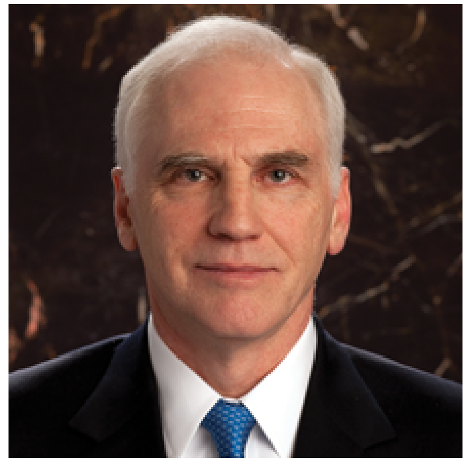
Forecasts built on "appropriate policy"

Private forecasts and those produced by the Federal Open Market Committee differ in their approach, Lockhart explained. Whereas private forecasters normally base their forecasts on policy assumptions, policymakers start with an outlook "that calls for an appropriate policy posture of either staying the course or making an adjustment."

Lockhart's idea of "appropriate monetary policy" is holding rates at their current level of zero to 25 basis points and keeping the Fed's balance sheet at its current scale. And while he's not taking any policy options off the table, he is "skeptical that further asset purchases will produce much gain in terms of increased economic activity."

December 27, 2011

Fed Gov. Tarullo Describes Goals of Dodd-Frank Implementation



The Federal Reserve Board has made considerable progress in implementing the Dodd-Frank Act but much remains to be done, Fed Governor Daniel K. Tarullo told the Senate Committee on Banking, Housing, and Urban Affairs in testimony on December 6.

The Federal Reserve has issued 29 final rules, public notices, and reports and has another 13 rules in the works, Tarullo said in summarizing the Fed's implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Ultimately, the Federal Reserve will issue about 60 sets of rules and formal guidelines related to Dodd-Frank, Tarullo said.

The responsibilities for implementing the Dodd-Frank act span several federal agencies. Thus, much of the work, Tarullo said, involves time-consuming joint rule-making proceedings and coordination among agencies. Despite the "variation and complexity in our Dodd-Frank implementation responsibilities, we have several unifying goals," he said of the Fed and other federal financial regulatory agencies.

Among those goals:

- **Get it right.** The Fed and other agencies, Tarullo remarked, are striving to implement the Dodd-Frank act "faithfully, in a manner that maximizes financial stability and other social benefits at the least cost to credit availability and economic growth."
- **Solicit and consider other views.** The Federal Reserve is consulting with other regulators in order to improve the consistency of regulation across the financial industry and limit overlapping requirements. "We are also trying to make our rule-making process as fair and transparent as possible, with ample opportunity for the public to comment," Tarullo said. He testified that public input helps to identify and resolve issues raised by regulatory proposals.
- **As much as possible, minimize the regulatory burden on small banks**. To this end, the Federal Reserve has established community bank councils at each of the 12 regional Reserve Banks, including the Atlanta Fed. These councils gather input from community bankers on ways to limit small institutions' regulatory burdens and improve the efficiency of the Fed's supervision of those institutions.
- **Finally, complete Dodd-Frank projects as soon as possible while meeting the three objectives listed above.** "There is obviously considerable value in providing as much clarity as possible as soon as possible to financial markets and the public about the postcrisis financial regulatory landscape," Tarullo said.

December 23, 2011

Agencies Release Annual CRA Adjustments

The federal bank regulatory agencies recently announced the annual adjustment to the asset-size standards used to determine how small and medium-sized financial institutions are examined with regard to the Community Reinvestment Act, or CRA.

Financial institutions are evaluated under different CRA examination procedures based upon their asset-size classification. Those meeting the small and intermediate small asset-size threshold are not subjected to the reporting requirements applicable to large banks. The annual adjustments are required by the CRA rules.

Under the new adjustments:

- "Small bank" or "small savings association" means an institution that, as of December 31 of either of the previous two calendar years, had assets of less than $1.16 billion.
- "Intermediate small bank" or "intermediate small savings association" means a small institution with assets of more than $290 million at the end of both of the previous two calendar years and less than $1.16 billion at the end of either of the previous two calendar years.

Annual adjustments to these asset-size thresholds are based on the change in the average of the consumer price index (CPI) for urban wage earners and clerical workers, not seasonally adjusted, for each 12-month period ending in November.

The adjustments are effective January 1, 2012. The agencies—the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency—will publish the adjustments in the *Federal Register*. In addition, the agencies will post a list of the current and historical asset-size thresholds on the website of the Federal Financial Institutions Examination Council.

December 23, 2011

Fed Announces Annual Capital Review of Biggest Banks

The Federal Reserve Board on November 22 issued a final rule requiring the nation's largest bank holding companies to submit annual capital plans for Fed review.

The Federal Reserve will evaluate institutions with at least $50 billion in consolidated assets for capital adequacy and will examine the firms' internal capital assessment processes and their plans to make capital distributions, such as dividend payments or stock repurchases.

Criteria for capital distributions set
The Federal Reserve will approve dividend increases or other capital distributions for companies that meet these criteria: those whose capital plans are approved by supervisors, and firms that are able to demonstrate the financial strength to operate as successful financial intermediaries under difficult macroeconomic and financial market scenarios, even after they make their capital distributions.

Boards of directors of the institutions will be required to review and approve annual capital plans before submitting them to the Federal Reserve.

Anticipating future stress tests
In addition to the annual capital review, the Federal Reserve launched the 2012 Comprehensive Capital Analysis and Review (CCAR) by issuing instructions to the firms. Those instructions include the macroeconomic and financial market scenarios the Fed is requiring institutions to use in the stress testing incorporated in their internal capital plans. In 2012, the Federal Reserve will conduct a supervisory stress test based on the same scenario to analyze the adequacy of the firms' capital.

The economic and markets scenario is not the Federal Reserve's economic forecast. Rather, it is meant to represent an outcome that, while unlikely, could materialize if the U.S economy and other major economies simultaneously fall into a deep recession.

Capital is central to a bank holding company's ability to absorb unexpected losses and continue to lend to creditworthy businesses and consumers. The Federal Reserve expects large, complex bank holding companies to hold sufficient capital to maintain access to funding, continue to serve as credit intermediaries, meet their obligations to creditors and counterparties, and continue operations, even in an adverse environment.

November 30, 2011

Fewer Banks Eased Lending Standards in Third Quarter, Fed Says

Fewer banks eased standards and terms on loans to businesses in the third quarter, according to a Federal Reserve survey released November 7, 2011. The quarterly poll of senior loan officers includes 51 domestic banks and 22 U.S. branches of foreign banks.

Marking a change from previous quarters, a small share of domestic banks reported easing standards on commercial and industrial (C&I) loans, especially those to midsized and large firms. In contrast, foreign banks, which primarily lend to large firms, reported tightening standards on such loans. According to the survey, conducted in early October, banks cited a less favorable or more uncertain economic outlook as a reason for tightening standards on C&I loans.

Banks tighten standards on loans to Europe
A set of special questions about banks' lending to their European counterparts highlighted ongoing concerns related to the region's debt crisis. About half of domestic banks and two-thirds of foreign banks reported lending to European banks. Of them, roughly two-thirds said that they tightened their standards on such loans. For many banks, the degree of tightening was "considerable," the report said.

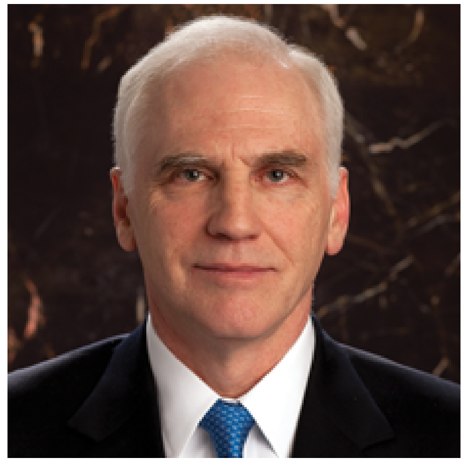
Stronger demand for mortgage, consumer loans
Domestic banks reported little change in their standards for commercial real estate (CRE) loans since the previous quarter, when they were widely described as being "at or near their tightest standards since 2005." In contrast, a large share of foreign banks reported tightening standards on such loans. Demand for CRE loans was reportedly stronger, although less so than in the two previous quarters, according to the survey.

For the first time since early 2010, a greater share of banks reported stronger demand for mortgage loans than those citing weaker demand, "perhaps reflecting refinancing activity," the Fed noted. Similar to previous surveys, few banks reported relaxing their standards on such loans.

However, a number of banks eased standards on various consumer loans, including credit card loans. Banks also reported relaxing standards for auto loans. At the same time, a small number of banks cited stronger demand for credit card and auto loans, while changes in demand for other types of consumer loans were mixed.

November 29, 2011

Stronger Capital Standards a Start, but More Work Needed, Says Fed Gov. Tarullo



Work is under way on proposed capital and liquidity rules aimed at preventing another financial crisis, Federal Reserve Governor Daniel Tarullo told banking lawyers during speech on November 4, 2011. Beyond these new standards, however, remain pressing issues that U.S. and international regulators must address, he said. Tarullo discussed global financial regulation at the fall meeting of the American Bar Association's Banking Committee in Washington, D.C.

Announced in 2010, the Basel III capital and liquidity standards require banks to raise tier 1 capital to 7 percent of risk-weighted assets, up from the current 2 percent. Tarullo said he expects a proposed regulation implementing the new requirements in the first quarter of 2012.

Managing the transition

Tarullo also addressed recent questions about the Federal Reserve's expectations regarding capital levels during the six-year transition period for the new framework. "While the Federal Reserve intends to ensure that firms are on a steady path to full Basel III compliance, we do not intend to require firms to raise external capital or reduce their risk-weighted assets in order to meet any target earlier than at the time specified in the Basel III transition schedule," he said.

However, large bank holding companies (those with $50 billion or more in total assets) will be required to "take affirmative steps to improve capital rations, such as external capital raises, when those steps would be needed to meet each Basel III transition on time," Tarullo added. The Federal Reserve will monitor these firms' progress via its annual review of banks' capital plans. That new rule, finalized earlier this year, requires large bank holding companies to submit capital plans to the central bank for review each year.

Rules for the largest institutions

Also under the Basel III framework, roughly 30 banks designated as systemically important financial institutions (SIFIs) will be required to set aside an additional capital buffer, or capital surcharge, ranging from 1 to 2.5 percent of assets. The list, released recently by the Financial Stability Board, will be updated annually based on financial institutions' size, complexity, interconnectedness, and cross-border activity.

Stronger capital and liquidity requirements are an important step toward a sound financial system, but international regulators must address several priority measures in the coming year, Tarullo said. These include a strong resolution framework for global SIFIs and action on other sources of risk such as wholesale funding channels and the market for over-the-counter derivatives. While a global treaty is unlikely, he said, "there should be room for more limited cooperation agreements, coordinated supervisory work on resolution plans, and other devices."

November 29, 2011

Vice Chair Yellen Explains Fed's Role in Financial Stability

The Federal Reserve and other U.S. financial regulators are adopting a macroprudential approach to supervision and regulation and have implemented processes for identifying and responding to sources of systemic risk in the financial system, Federal Reserve Vice Chair Janet Yellen said during a November 11 speech in Chicago.

"The macroprudential approach,"Yellen said, "focuses on achieving financial stability by reducing systemic risk—that is, the risk of a financial disruption that is severe enough to inflict significant damage on the broader economy. Ideally, this approach is done through preemptive policies that restrain risks to the financial system before they develop into crises."

The pursuit of financial stability

These measures are aimed at pursuing financial stability, as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was enacted just over a year ago. "The bottom line is that developing an effective macroprudential policy is critical to preserving financial stability and supporting overall U.S. economic activity,"Yellen said in a speech at the Federal Reserve Bank of Chicago's International Banking Conference. "Accomplishing this objective will be a considerable challenge, but it is one of great importance."

Unlike the traditional "microprudential" approach to regulation and supervision, which focuses on the safety and soundness of individual financial institutions, markets, and infrastructures, the macroprudential approach also calls for attention to the financial system as a whole, she explained.

New office focuses on stability

The Federal Reserve, Yellen noted, has not only reoriented its approach to the supervision of large bank holding companies but also has created the Office of Financial Stability Policy and Research. The office plays an important role in monitoring financial risks, analyzing the implications for financial stability, and devising strategies for mitigating the risks.

The Fed has established several means to measure cyclical forms of systemic risk. Those methods include monitoring measures of leverage and maturity mismatch at financial intermediaries, examining asset valuations, underwriting standards for loans, and eyeing credit growth for signs of a credit-induced buildup of systemic risk. In gauging systemic risk for the largest banking firms, the Fed's actions include ongoing stress tests and capturing financial market perceptions of the danger such a firm could cause the broader financial system were it to become stressed.

November 29, 2011

Fed Opens Comment Period on Volcker Rule

The Federal Reserve Board on October 11 requested public comment on a proposal that would implement the so-called "Volcker Rule," part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The Volcker Rule, named for its chief backer and former Federal Reserve Board Chairman Paul Volcker, generally bars financial institutions from doing two things. First, it prohibits insured depository institutions, bank holding companies, and their subsidiaries or affiliates from engaging in short-term proprietary trading of any security, derivative, and certain other financial instruments for the banking company's own account. Second, it bans owning, sponsoring, or having certain relationships with a hedge fund or private equity fund.

Some activities would be exempted
Transactions in certain instruments are exempt from the Volcker Rule. Those include obligations of the U.S. government or a U.S. government agency, government-sponsored enterprises, and state and local governments. Consistent with the statute, other activities exempted include market making, underwriting, and risk-mitigating hedging. The statute also permits banking entities to organize, offer, and invest in a hedge fund or private equity fund subject to a number of conditions.

However, the proposed rule requires companies that engage in the exempted activities to establish an internal program to ensure and monitor compliance with the Volcker Rule. The proposed rule includes commentary to help banking companies distinguish permitted market making-related activities from prohibited proprietary trading activities.

The Volcker Rule would also prohibit banking firms from engaging in an exempted transaction or activity if it would involve or result in a material conflict of interest between the firm and its customers or counterparties or that would result in a material exposure to high-risk assets or trading strategies, as defined by the rule. The act similarly prohibits banks from exempted activity that poses a threat to the safety and soundness of the institution or to the financial stability of the United States.

Proposed regulation jointly developed
The Federal Reserve developed the proposed regulation jointly with the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Commodity Futures Trading Commission. The regulation is designed to clarify the scope of the Dodd-Frank Act's prohibitions and, consistent with statutory authority, provides certain exemptions to these prohibitions.

October 31, 2011

Fed, FDIC Issue "Living Will" Rule

The Federal Reserve Board of Governors, along with the Federal Deposit Insurance Corporation (FDIC), has issued a final rule implementing the "living will" requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The rule establishes guidelines under which large banking companies and other systemically important financial firms must annually submit plans, to the Fed and FDIC, for rapid and orderly resolution in bankruptcy during times of financial distress. The rule applies to bank holding companies with assets of $50 billion or more and nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Federal Reserve.

A firm's resolution plan must include a strategic analysis of the plan's components, a description of the range of actions the company proposes to take in resolution, and a description of the company's organizational structure, management information systems, and its interconnections and interdependencies with other financial institutions.

Under the final "living will" rule, companies will submit their initial resolution plans on a staggered basis. The first group of companies, generally those with $250 billion or more in nonbank assets, must submit their initial plans by July 1, 2012. The second group of companies, generally those with $100 billion to $250 billion in nonbank assets, must submit initial plans by July 1, 2013. The remaining companies, generally those subject to the rule with less than $100 billion in total nonbank assets, must submit their initial plans on or before December 31, 2013.

The "living will" requirement is meant as a step toward addressing the too-big-to-fail issue.

October 28, 2011

Lockhart: Trust Vital to Financial System

The economy and individuals' financial security both benefit if Americans take part in and trust the nation's formal financial system. But in the wake of the 2008 financial crisis and subsequent recession, regulatory authorities and financial firm managers need to rebuild public trust in the system, Federal Reserve Bank of Atlanta President Dennis Lockhart said in an October 7 speech in Atlanta.

"As individuals, we must see a financial system that is well governed and well managed," Lockhart said in his keynote address at the Town Hall on Financial Capability at Emory University. "In other words, we must see a system we can trust."

Identifying areas to boost trust
Lockhart noted that a recent survey by the University of Chicago and Northwestern University found that only one in four Americans trust the financial system.

To improve that number, Lockhart believes there are five key areas in which regulators and company managers must be responsible. These areas are regulatory oversight, ensured liquidity, controlled leverage at the system and firm level through adequate capitalization, sound lending and business practices along with healthy incentives for managers, and transparent markets and institutions.

In terms of regulatory oversight, Lockhart said the ideal is a system in which no single financial institution is too big to fail. He said that we are not there yet but the Dodd-Frank Act at least created "a framework for the orderly unwinding of a large, complex financial institution." Lockhart added: "Here's how I think of my responsibility as a banking supervisor: collectively, the community of regulators must judiciously supervise individual institutions and vigilantly monitor the health of the overall system, to guard the public trust and, above all, avoid a systemic crisis."

Risk remains, but can be managed
The last of those five areas, especially, also directly involves regulators. Ensuring transparent markets and institutions, Lockhart emphasized, does not mean eliminating risk. "There's no moving forward without taking risk," he said. "But risk decisions should not be blind guesses or herd-following impulses. They should be based on sufficient information about the working of markets and the condition of market participants."

In order for regulators to effectively guard against severe disruptions in systemically important financial markets, there must be transparency of trading, position taking, and settlement, Lockhart concluded.

October 27, 2011

Fed Chair Bernanke: Crisis Is Changing Central Banking

The overall framework that guides monetary policy remains largely in place after the financial crisis and recession. But central banks the world over have broadened the specific tools they use to implement policy, Federal Reserve Chairman Ben Bernanke said in an October 18 speech.

At an economic conference at the Federal Reserve Bank of Boston, Bernanke delivered an address titled "The Effects of the Great Recession on Central Bank Doctrine and Practice." Bernanke set the stage for his analysis by explaining that in the two decades before the crisis, central bankers and academics largely reached a consensus on the intellectual and institutional framework for monetary policy. This consensus policy framework, Bernanke said, is based on a commitment to medium-term price stability and transparency regarding central banks' policy objectives and economic forecasts.

Increasing transparency a major goal
In recent years, the Fed, for instance, has taken steps to clarify its outlook, objectives, and policy strategy. For example, since early 2009, the Federal Open Market Committee has publicly released its longer-run projections of economic growth, unemployment, and inflation. In addition to communicating more openly, central banks deployed less conventional policy tools as interest rates approached zero. Those tools, Bernanke said, included forward policy guidance—in other words, greater transparency—as well as moves to expand and change the composition of balance sheets. The Fed altered its balance sheet through large-scale purchases of Treasury and agency securities and more recently by selling shorter-term debt and acquiring longer-term debt.

The financial crisis made transparency more important because with interest rates near zero, "influencing the public's expectations about future policy actions became a critical tool," the Fed chairman said. "The commitment to a policy framework that is transparent about objectives and forecasts was helpful, in many instances, in managing those expectations and thus in making monetary policy both more predictable and more effective during the past few years than it might otherwise have been."

Financial crisis raised big questions
While the fundamental tenets of monetary policymaking remain largely unchanged, Bernanke noted that recent experience raised an important question about what he calls "the flexible inflation-targeting framework" employed by the Fed and most central banks. That question addresses the reality that even though the prevailing policy framework contributed to a long period of macroeconomic stability, it alone was not sufficient to ensure financial stability. Consequently, Bernanke acknowledged that some observers have suggested the inflation-targeting approach to monetary policy should be changed or even replaced.

"My guess is that the current framework for monetary policy—with innovations, no doubt, to further improve the ability of central banks to communicate with the public—will remain the standard approach, as its benefits in terms of macroeconomic stabilization have been demonstrated," Bernanke said. "However, central banks are also heeding the broader lesson, that the maintenance of financial stability is an equally critical responsibility."

Atlanta Fed's Lockhart: Policy Actions Should Be Viewed in Total

The Federal Reserve's latest measures aimed at lowering long-term interest rates and supporting mortgage markets are likely to have a modest positive impact, Federal Reserve Bank of Atlanta President Dennis Lockhart said in a Sept. 27 speech. Lockhart emphasized that the recently unveiled program is not a stand-alone measure. Rather, he said this move should be seen as augmenting a broader strategy to promote economic recovery and facilitate necessary adjustment.

Reshaping the Fed's balance sheet

Against a backdrop of significant challenges, the Fed's policy-making Federal Open Market Committee (FOMC) on Sept. 21 announced a "maturity extension program." That program will be structured so that over about nine months, the Fed will sell $400 billion of Treasury holdings that mature in three years or less. Meanwhile, the central bank will acquire an equal amount of securities with maturities of six to 30 years. The FOMC also announced plans to buy more mortgage-backed securities (MBS) from Fannie Mae and Freddie Mac, the government-owned backers of mortgage loans.

"In my view, the maturity extension program along with the MBS purchases represents a measured incremental attempt to add more support to the recovery," Lockhart told the World Affairs Council of Jacksonville, Fla. "It's not a fix for everything that ails the economy, but it should help."

Addressing policy impediments

Lockhart said he shares the view that the effectiveness of monetary policy—or monetary policy transmission into the real economy—"remains somewhat impaired." Lockhart noted some of the impediments to monetary policy transmission:

- Many consumers are still paying down debt and are thus unlikely to seek new credit
- Many large businesses already have substantial cash and therefore are not looking to borrow
- Loan demand is weak in a soft economy, while stricter credit standards mean fewer potential borrowers qualify for loans.

Other elements of the Fed's strategy include earlier large-scale asset purchases, a conditional commitment to keep the federal funds rate between 0 percent and 0.25 percent at least through mid-2013, and maintaining the total size of the Fed's balance sheet.

"The power and sufficiency of these efforts should not be evaluated individually," Lockhart said, "but as a cumulative total policy of support and accommodation."

October 6, 2011

ViewPoint Introduction

By Michael Johnson, Senior Vice President
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Mike Johnson

In the last edition of "ViewPoint," I talked about some positive emerging financial trends for Sixth District banks as we start to see more stabilization and even some earnings improvement. I was pleased to see that positive trend continue into the third and hopefully the fourth quarters of 2011. While I anticipate more bank failures into 2012, it's nice to see aggregate earnings turn positive and an improvement in asset-quality metrics across District banks, although they are coming off low levels. I think you'll agree that our regular State of the District report reflects the beginning of positive trends. Attached here you can see details on overall third quarter 2011 performance.

Despite these emerging positive signs related to financial performance, there is still the potential for strong economic headwinds. Our economy continues to be fragile and vulnerable to external shocks. This fragility is primarily why the European Union sovereign debt crisis is prominent on our radar screen. While direct exposures to EU sovereign debt by U.S. banks are minimal, liquidity contagion can occur through many channels, and a broad economic malaise would surely have an effect on U.S. banks.

Beyond issues in Europe, the state of residential real estate markets continues to be a major concern. The backlog of residential inventory needs to shrink before any material improvement can occur. Particularly for the Sixth District, I believe improvement, or at least broader stabilization, in residential real estate is a necessary precursor to a stronger economic and banking recovery.

Recent meetings across the spectrum of community, regional, and international banks suggest these issues, along with political and regulatory uncertainty and the search for new revenue sources, are on your mind as well. The confluence of the current environment and uncertain future highlight the ongoing need for a healthy investment in risk management infrastructure. Additional articles in this edition of "ViewPoint" address the need for balancing growth, including new product development with strong risk management.

Specifically, we hear from many of our banks that there are renewed plans to expand their commercial and industrial lending business (C&I). While C&I can be an excellent business if managed well, competition is fierce and a sound risk management culture needs to be in place before expansion. You can read some observations here related to striking this balance.

While we're on the topic of considering different lending opportunities, it seems fitting to also offer a summary of how the Small Business Lending Fund (SBLF) has played out and some corollary guidelines for small business lending.

I also want to highlight the recent adoption of two new final rules—the capital plan rule and resolution plan rule—under the Dodd-Frank Act that I believe all bankers should be aware of. Though these rules are generally applicable only to the largest banks, the key concepts can be applied more broadly. I sincerely hope you enjoy the upcoming holiday season and that, while 2012 will continue to be a year of significant change for the banking industry, it will bring change for the better. Once again, please let me know if you have any feedback and feel free to contact me at ViewPoint@atl.frb.org.

ViewPoint National Banking Trends

After a slight dip in the second quarter of 2011, U.S. commercial bank performance, as measured by aggregate return on average assets (ROAA) (see chart 1), improved to its highest level in four years (see chart 2).

Large and midsized community banks have led the improvement, though smaller community banks are also posting improved earnings. The increase in earnings continues to be more a function of cost control than an improvement in net interest margin or increased lending. The net interest margin dipped by 9 basis points from the second quarter, declining from 3.70 percent in the second quarter to 3.61 percent in the third quarter. Loans grew slightly from the previous quarter, up 0.3 percent but declined compared with the previous year. At the same time, loan-loss provision expense continued to decline, falling to 1.04 percent of average loans. At the height of the crisis, provisions represented 4.24 percent of average loans. The efficiency ratio also declined from the previous quarter but has increased compared with the previous year, as banks continue to strengthen their efforts to work out existing loans.

ViewPoint State of the District

Asset Quality :: Balance Sheet Growth :: Bank Failures :: Earnings Performance :: Liquidity

Asset Quality

Asset quality in the Sixth District has dramatically improved over the past year, although overall economic conditions remain subpar compared with some other parts of the country. Charge-offs have fallen to their lowest level since the financial crisis peaked (see chart 1), leading banks to reduce their provision expenses and drop their coverage ratio (see chart 2).

The coverage ratio is a measure of the level of reserves for nonperforming assets. Banks in the Sixth District now have reserves for less than 50 percent of their noncurrent loans, down from a height of 260 percent. However, banks may be decreasing their coverage ratio prematurely. For example, noncurrent loans slowed their downward trend in the third quarter after a steep decline in the second quarter (see chart 3).

The decline of noncurrent loans in the Sixth District reflects a similar trend among commercial banks across the nation (see chart 4), though the level of noncurrent loans at Sixth District banks is still higher than for peer banks.

Balance Sheet Growth

Banks remain unable to grow due to a lack of lending opportunities. Loan growth remains elusive for banks across the country, including the Sixth District (see chart 1).

In 2011, only large banks (in excess of $10 billion) had loan growth, but growth was limited to the first and second quarters (see chart 2).

Small community banks (under $1 billion) saw their total loan to total asset ratio fall from nearly 70 percent in the first quarter of 2009 to around 60 percent as of the third quarter of 2011 (see the table).

In the Sixth District, loans declined by 8 percent from the prior year, more than double the decline observed at out-of-District banks (see chart 3).

This decline occurred across all loan types. According to the Senior Loan Officer Survey, the District's lending environment remained unchanged through much of the year, primarily because of uncertainties in the banking sector and the overall economy. Banks in the Sixth District with a heavy concentration in construction and development loans continue to shed those loans but have been unable to find a type of loan to take their place on their balance sheets. Banks are putting more of their money into lower-yielding assets such as U.S. Treasuries while they wait for loan demand to return. As a result, securities now represent a greater percentage of the banks' balance sheets than their out-of-District peers. One reason for a lower net interest margin is the increased holdings of securities and more problem loans.

For more detailed information on small business conditions in the Sixth District, see the Federal Reserve Bank of Atlanta's Small Business website.

Bank Failures

Although the pace has slowed, Georgia still leads the nation in bank failures (see the table), with 23 in 2011, with seven occurring between the beginning of August and the end of November.

Statewide economic conditions, especially in the Atlanta metro area, have been slow to recover, with state job growth still negative on a year-ago basis and unemployment rates above 10 percent in October 2011. Florida remains in second place in the District behind Georgia, with 12 bank failures in 2011. However, the number of stressed banks in the Sixth District is declining, albeit more slowly than out-of-District banks (see the chart), which should mean fewer failures in 2012 and beyond.

Nationally, the number of banks deemed troubled by the FDIC dropped by 21 to 844 in the third quarter. Through the end of 2011, the FDIC projects 102 failures nationwide.

Earnings Performance

Building on the improving earnings performance from the second quarter, Sixth District community banks (assets less than $10 billion) posted positive earnings in the third quarter (see the table).

Return on assets (ROA) for the third quarter was 0.31 percent versus a ROA for out-of-District banks of 0.90 percent. The improvement in earnings was the result of a combination of factors that helped to push net income into positive territory. The net interest margin, boosted by earnings in the third quarter of 2011, increased 50 basis points over the previous year. Interest income was up slightly, but the margin was improved by the reduction of interest expense, as banks have pushed down interest rates on deposits and other funding.

The continued reduction in Sixth District banks' provision expense also helped improve earnings as the level declined 37 percent from the previous year and 23 percent from the previous quarter. Banks are expecting a significant impact to noninterest income starting in the third quarter. Although noninterest income declined 10 percent from the previous year, banks were still able to increase noninterest income slightly over the previous quarter. Banks are looking for new sources of noninterest income since new rules on interchange fees went into effect. Larger banks are considering new fees on debit cards to replace some of the income, though those fees will not show up in earnings until the fourth quarter. With the concern over the lack of loan growth and the loss of noninterest income, banks in the District once again were able to lower their noninterest expense, countering an upward trend in 2011. As asset quality improves, banks are realizing some cost savings, and closely monitoring other costs.

Liquidity

Banks across the District and across the nation are flush with deposits. In fact, a few banks have started charging their customers for holding the deposits. Bank of New York Mellon started charging fees on large customer balances in August. Other banks have started passing along Federal Deposit Insurance Corporation premiums to their customers. The fees and premiums are partly the result of the lack of loan growth. Core deposits have steadily climbed at a time when banks have not been able to find a way to effectively use the money (see the chart).

In the Sixth District, core deposits represented just over 63 percent of assets, the highest level since 2002. By comparison, in the fourth quarter of 2008, core deposits represented only 52 percent of assets. Noncore funding still represents a higher percentage of assets for Sixth District banks versus out-of-District peers. Still, noncore funding has fallen from its peak of 30 percent, on a median basis, to just under 20 percent.

ViewPoint Spotlight: Non-CRE Lending

C&I, Other Forms of Non-CRE Lending Present Opportunities, Challenges

Financial institutions in today's increasingly competitive marketplace continue to look for new business opportunities and additional loan growth by entering new lines of business or, in certain cases, reentering lines of business they had previously exited. A major focus of this new area of targeted growth is in the commercial and industrial (C&I) space. A number of firms are squarely focused on C&I lending as a way to offset existing commercial real estate (CRE) concentrations and provide increased loan diversification to existing portfolios.

In the second quarter of 2011, total loans outstanding at U.S. banks increased for the first time since the second quarter of 2008. C&I lending accounts for the majority of new loan growth, as C&I lending by U.S. banks has increased 6 percent since hitting its trough in June 2010. New areas of credit growth being explored include indirect automobile lending, asset-based lending, credit cards, student loans, and even hybrid forms of payday lending in certain cases. This movement into new areas by market participants not only presents new opportunities for growth but also raises credit risk management challenges for all firms involved.

Traditional CRE lenders face a number of challenges as they enter new lines of business and make the transition into new lending areas. Several key differences exist between the CRE and C&I business segments that lenders should take into account when making the transition.

C&I lending normally requires a more complex credit administration and credit risk management infrastructure to properly monitor credit exposures, as certain segments of C&I lending—such as asset-based lending and leverage finance—normally require more in-depth monitoring and reporting. In addition, C&I lending is generally more focused on cash flow and places a greater emphasis on balance sheet management with regard to inventories and receivables in a number of C&I segments.

C&I lending also presents additional risks. Certain segments of C&I loans are made on an unsecured basis, whereas CRE lending normally includes tangible collateral that is included as part of the loan structure. Finally, C&I lending requires highly specialized skill sets for the various product segments offered, such as small business lending, leverage finance, asset-based lending, and other specialized product types.

To help ensure a successful transition into new business segments, lenders making the transition into new lending areas should receive appropriate training and support to fully understand and manage the inherent risks associated with the new products they are offering to their customers.

Pricing pressure and underwriting standards
Trends are emerging to which all market participants should pay close attention. Concerns with the high level of competition and the direct impact on market pricing and underwriting standards are shared concerns that arise regarding current credit market conditions. Several bankers have observed that the more conservative market discipline that was reestablished in the marketplace as

a result of the 2007–8 financial crisis has started to erode slowly over the last 12 to 18 months.

Evidence has started to emerge that this relaxed discipline is evident in reviews of recently originated C&I deals. Such reviews have generally indicated weakening underwriting standards as a result of an increase in concessions and a general decline in loan covenant requirements related to key financial covenant measurement ratios.

Certain institutions have recently decided to waive sponsor guarantees as standard practice and granted other underwriting concessions that, in most cases, would not be considered prudent practices in a highly disciplined market environment. Fierce competition and pricing pressures are at the center of current underwriting trends in the marketplace. Additionally, more financial institutions are experiencing an increase in hold level exceptions as a result of a lack of loan growth.

The desire to hold more direct exposure on the balance sheet given the overall weakness in loan demand creates credit risk management challenges as financial institutions increase their overall credit-risk profile through less credit diversification. Moreover, some institutions are trying to counter this weak demand by working with borrowers who have lower credit quality to counter the intense pricing pressures that exist in more traditional segments.

Sound credit risk management practices remain a priority

As a number of financial institutions have discovered as a result of the financial crisis, it is more important than ever to ensure that their boards of directors and management implement a robust credit risk management program to effectively identify, measure, monitor, and control credit risk.

As financial institutions enter new areas of lending, it is imperative that firms ensure that appropriate due diligence and planning have taken place before new lending is originated. A safe and sound operating environment is a key factor for financial institutions to be successful and profitable in the long run. Supervisors continue to identify instances where financial institutions have entered new areas of lending without implementing an appropriate credit risk management infrastructure to effectively manage and control new lending opportunities. Sound management information systems that have the ability to appropriately segment and analyze various credit exposures are vital in today's complex and ever-changing banking environment.

Balancing loan growth with risk management

Banking supervisors understand that sound credit granting by institutions is instrumental to the return of economic prosperity and the improved soundness of the banking industry. They are also conscious of the pressure to improve earnings in an environment where competition for sound credit is intense.

As financial institutions target new lines of business seeking additional revenues and loan growth, institutions must factor in the inherent risk of these lines of business as part of their strategy. Firms are being challenged on a number of fronts as the banking environment is becoming increasingly competitive and the economic outlook remains unclear. Financial institutions must be reasonable in their growth estimates and fully appreciate the risks involved as they explore new business opportunities. A disciplined approach with a focus on ensuring credit risks are managed appropriately is the best way forward.

By Trey Wheeler, credit risk director in the supervision and regulation department at the Atlanta Fed

ViewPoint Spotlight: Small Business Lending

Supporting Small Businesses and Job Creation

In September 2010, the Treasury Department announced the creation of the Small Business Lending Fund (SBLF), a $30 billion fund to encourage lending to small businesses by providing tier 1 capital to qualified community banks with assets less than $10 billion. Applications were processed through September 2011, but demand for the funding was less than anticipated despite the fact that under certain conditions an eligible financial institution could refinance preferred stock issued to the Treasury through the Capital Purchase Program (CPP) or the Community Development Capital Initiative (CDCI).

A little more than $4 billion of the available funds were distributed to 332 community banks nationwide. In the Sixth District, 29 firms were funded at an amount of $402 million; nine of those firms substituted CPP or CDCI capital. In total, 933 institutions nationwide applied for $11.8 billion in funding. The KBW Bank Index has estimated that $2.2 billion of capital by 137 Troubled Asset Relief Program (TARP) recipients was replaced by financing from the SBLF, representing 67 percent of the fund's investments.

Similar to any new business venture, the risks of this new program must be managed. In December 2010, the federal banking agencies issued guidance titled "Underwriting Standards for Small Business Loans Originated under the Small Business Lending Fund Program." The guidance defines small business lending by type—commercial and industrial (C&I) loans; owner-occupied nonfarm, nonresidential real estate loans; loans to finance agricultural production and other loans to farmers; and loans secured by farmland—with original amounts less than $10 million or to a business with less than $50 million in gross revenues. The priority should be placed on prudent risk selection and sound credit risk management, in addition to strong board support and direction.

One of the program risks is that failure to increase lending to small businesses will result in the payment of a higher dividend rate on the SBLF funds. For those firms replacing TARP, which had no incentive for small business lending, the SBLF could be profitable. With an initial dividend rate of 5 percent at most, if a firm's lending increases by 10 percent or more, the rate will fall to as low as 1 percent. Firms that increase their lending by less than 10 percent can benefit from rates between 2 percent and 4 percent. However, if lending does not increase in the first two years, the rate will increase to 7 percent; and, it will increase to 9 percent after four and a half years if funding has not already been repaid.

A firm may exit the program at any time by repaying the funding provided plus any accrued dividends with the approval of its regulator.

By Cynthia Goodwin, vice president in the supervision and regulation division of the Atlanta Fed

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ISSN 0899-6563