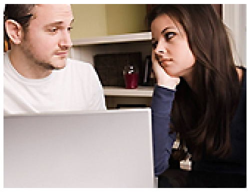
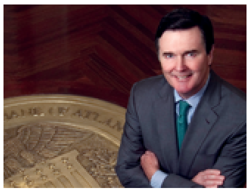
Financial UPDATE
Vol. 25, No. 2
Second Quarter 2012



Fed Survey Details Recession's Impact on Family Finances
The Federal Reserve Board's triennial Survey of Consumer Finances revealed that the financial crisis and recession hit many American families' finances hard. Since 2007, American families' net worth and income have fallen sharply, chiefly due to the decline in home values experienced nationwide.

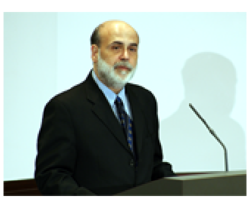


Atlanta Fed President Lockhart: U.S. Economy Still Recovering
Atlanta Fed President Dennis Lockhart said that despite some disappointing economic reports, the national economy continues to recover. However, headwinds such as efforts by households and the financial sector to shed debt, continued weakness in the housing sector, and uncertainty in the European monetary union pose ongoing challenges.

Agencies Agree on Supervisory Coordination
Federal financial regulatory agencies recently clarified how they will coordinate supervisory activities. Their goals include minimizing unnecessary regulatory burden, avoiding duplication of effort, and decreasing the risk of conflicting supervisory directives.

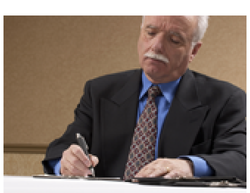
New Video Explains Foreclosure Review Process
A new video released by the Federal Reserve Board explains how eligible borrowers can apply for an independent foreclosure file review. The video details how borrowers who believe they were financially harmed by the foreclosure process in 2009 and 2010 can request a free review.

Fed Gov. Duke: Uncertainty Holding Back Housing
Uncertainty is a key factor preventing a stronger recovery in the housing market, said Federal Reserve Governor Elizabeth Duke. Duke said that no single prescription will cure the housing market and a number of difficult decisions need to be made.



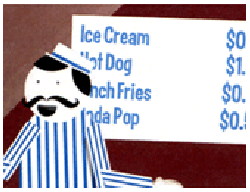
Bernanke Discusses Banking Progress, Challenges
Fed Chairman Ben Bernanke recently discussed banking conditions, saying they have improved since the financial crisis, but banks still face challenges. While banks have shored up capital levels, they are struggling to expand revenues amid the sluggish economy, changes in market conditions, and more stringent financial regulations.

Regulators Clarify Expectations for Stress Testing by Community Banks
Banking regulators recently issued a statement clarifying that community banks don't have to conduct the same types of stress testing required of larger organizations, although all banks should be positioned to anticipate the effects of adverse financial conditions on their operations.



Banks Ease Lending Terms in First Quarter, Survey Says
Loans were a bit easier to come by in the first three months of the year, according to the Federal Reserve's senior loan officer survey. The quarterly survey, which covers 58 domestic banks and 23 foreign banks with U.S. operations, also reported stronger demand for loans.

Fed Creates Expert Council to Advise on Stress Tests
The Federal Reserve Board recently unveiled a series of steps it is taking to include outside expertise in the stress-testing process. One such step is the Model Validation Council, which will advise the Fed on the effectiveness of its stress-testing models.



Atlanta Fed Launches New Web Feature, "The Fed Explained"
A new Atlanta Fed online feature, "The Fed Explained," provides both original and aggregated content geared to making information about the work of the Fed more accessible to the general public. The feature launches with an animated video on inflation.

Lockhart: Wise Regulation Is the "Holy Grail"
At the Federal Reserve Bank of Atlanta's 2012 Financial Markets Conference, Atlanta Fed President Dennis Lockhart said regulators should avoid precipitous action and accept that designing and implementing an improved system will take time.

Atlanta Fed's Financial Markets Conference Explores Future Regulation
Central bankers, finance professionals, and academics recently convened in Atlanta to discuss regulatory matters such as the governmentâ??s future role in mortgage finance and the potential for another shadow banking system to develop in response to new financial regulations.

Bernanke Discusses Fed's Increasing Role in Systemic Stability
Fed Chairman Ben Bernanke recently spoke at an Atlanta Fed conference about the central bank's moves to reorient itself toward being an agency with a broader supervisory focus on systemic financial stability.

Fed Survey Details Recession's Impact on Family Finances

The financial crisis and recession battered many American families' finances, and a newly released Federal Reserve study details the extent of the damage. Since 2007, U.S. families' net worth and income—measured by the median and mean levels—have fallen sharply, according to the Federal Reserve Board's Survey of Consumer Finances for 2010.

Falling home values primary culprit

The median family net worth, representing a family with wealth higher than half of the nation's families and lower than the other half, was $77,300 in 2010, down 38.8 percent from $126,400 in 2007, according to the survey the Fed conducts every three years. The median family net worth was $106,100 in 2001. Declining home values accounted for much of the loss in net worth. For all homeowners, the median amount of home equity dropped to $75,000 in 2010 from $110,000 in 2007. Among families with debt secured by their homes, median home equity—the difference between the value of the home and any debt secured against it—fell to $55,000 in 2010, from $95,300 in 2007.

Meanwhile, real (inflation-adjusted) median family income before taxes fell 7.7 percent from 2007, the time of the last Fed survey, to 2010. Median income dropped to $45,800 in 2010 from $49,600 in 2007. The new survey is based on data collected in 2010, and figures are reported in 2010 dollars.

The mean, or average, measures of family income and net worth also fell substantially between 2007 and 2010, the Fed survey shows. Mean income fell 11.1 percent, while the mean net worth declined 14.7 percent.

Overall value of debt down, but leverage ratio up

The picture concerning debts was a bit more nuanced. Debt fell more slowly than assets over the recent three-year period. Thus, overall indebtedness as a share of assets rose markedly. Offsetting relative declines in mortgage and credit card debt were increases in the share of liabilities accounted for by nonmortgage lines of credit and other installment loans.

The overall value of families' liabilities decreased between 2007 and 2010, but debts fell more slowly than assets. Accordingly, the ratio of the sum of the debt of all families to the sum of their assets—the leverage ratio—rose to 16.4 percent in 2010 from 14.8 percent in 2007. The leverage ratio for families with debt increased at a faster pace, to 22 percent in 2010 from 19.4 percent in 2007.

June 28, 2012

Atlanta Fed President Lockhart: U.S. Economy Still Recovering

Despite some disappointing economic reports, the national economy continues to recover, said Federal Reserve Bank of Atlanta President Dennis Lockhart during June speeches in Florida and Georgia.

"Coming off a reasonably strong fourth quarter in 2011, the indicators of economic strength so far in 2012 have been underwhelming," he said. U.S. gross domestic product grew just 1.9 percent in the first quarter, and the most recent employment report showed weak job growth in May and included downward revisions to the figures for March and April. "As the disappointing numbers illustrate, the economy is working against some strong headwinds," Lockhart noted.

Headwinds persist
Those headwinds include efforts by households and the financial sector to shed debt as well as continued weakness in the housing sector. The Atlanta Fed chief also pointed to the so-called "uncertainty drag," which he believes is holding back hiring and capital investments by U.S. businesses.

Despite those challenges, Lockhart expects the economy to continue growing moderately, albeit with "a slow and possibly halting decline of unemployment." Meanwhile, inflation is expected to stay close to the 2 percent target set by the Federal Open Market Committee (FOMC), he noted. A number of key potential risks could derail that outlook, however. "It is my sense that material risks to the economic outlook are gathering," he said. Four risks in particular are on his radar:

- a further decline in home prices
- the effects of sharp federal fiscal adjustments
- the recession and financial instability in Europe
- a slowdown in large emerging economies, particularly Brazil, China, and India

Europe looms large
Lockhart said he is giving more weight to concerns about the European situation than he did just a few months ago, noting that a severe recession there would affect the U.S. economy through trade channels. Of greater concern is the risk that financial stresses in Europe could cause global debt markets to freeze up, he noted. Although U.S. financial institutions have taken steps to limit their direct exposure to European sovereign debt, "the financial system is too integrated, too liquid to expect that problems could be isolated to Europe," he said.

The FOMC's current monetary policy stance—which remains highly accommodative—is "appropriate" given his outlook for the economy, said Lockhart. However, the committee stands ready to act, if needed. "Should it become clear that something resembling my baseline scenario of continued, though modest, growth is no longer realistic, further monetary actions to support the recovery will certainly need to be considered," he said.

June 21, 2012

Agencies Agree on Supervisory Coordination

On June 4, five federal financial regulatory agencies released a memorandum of understanding clarifying how they will coordinate supervisory activities, consistent with the Dodd-Frank Wall Street Reform and Consumer Protection Act.

A goal of streamlining

The memorandum is intended to codify coordination and cooperation between the Consumer Financial Protection Bureau (CFPB) and the prudential regulators in order to minimize unnecessary regulatory burden, avoid duplication of effort, and decrease the risk of conflicting supervisory directives.

Section 1025 of the Dodd-Frank Act requires that the CFPB and the prudential regulators—the Federal Reserve Board of Governors, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of the Comptroller of the Currency—coordinate important aspects of their supervision of insured depository institutions with $10 billion or more in assets and their affiliates. Coordination includes scheduling examinations, conducting simultaneous examinations of institutions unless an institution requests a separate examination, and sharing draft reports of examination for comment.

Four broad areas of coordination

Under the memorandum, the agencies will coordinate activities and share certain supervisory information concerning:

- compliance with federal consumer financial laws and certain other federal laws that regulate consumer financial products and services
- consumer compliance risk management programs
- underwriting, sales, marketing, servicing, and collections related to consumer financial products or services and
- other related matters that the agencies may mutually agree upon

June 18, 2012

New Video Explains Foreclosure Review Process

A new video released by the Federal Reserve Board explains how eligible borrowers can apply for an independent foreclosure file review.

English and Spanish versions of the video are available on the Board's website and on YouTube. The video details how borrowers who believe they were financially harmed by the foreclosure process in 2009 and 2010 can request a free review.

The Independent Foreclosure Review is part of the April 2011 enforcement actions that the Fed issued against four large mortgage servicers—GMAC Mortgage, HSBC Finance Corporation, SunTrust Mortgage, and the EMC Mortgage Corporation. A number of other servicers supervised by the Office of the Comptroller of the Currency are also included in the program.

Borrowers are eligible for a review if they meet the following requirements:

- The property securing the loan was the borrower's primary mortgage
- The mortgage was at some point in the foreclosure process between January 1, 2009, and December 31, 2010
- The mortgage was serviced by one of the mortgage servicers listed on the Board's site (see related links).

According to the Board's May 23 press release, borrowers "may be eligible to receive compensation if the independent review finds evidence of direct financial injury due to servicer error."

The deadline for borrowers to apply for an independent review is July 31, 2012, and there is no cost to participate in the program.

May 30, 2012

Fed Gov. Duke: Uncertainty Holding Back Housing

Uncertainty is a key factor preventing a stronger recovery in the housing market, said Federal Reserve Governor Elizabeth Duke. Speaking on May 15 to the National Association of Realtors, Duke said that no single prescription will cure the housing market. However, moving forward on a number of "difficult decisions" that will affect mortgage markets is "perhaps the most important solution,"she added.

Other factors, such as a stronger economic recovery and continued efforts to stanch the flow of foreclosures and distressed sales, would also help contribute to a stronger housing market, Duke said.

Uncertainty among potential homebuyers—about the economy and house prices, for example—is influencing demand for housing. At the same time, mortgage lenders also face a host of unknowns, including the strength of the economic recovery, the future path of house prices, and the regulatory environment. These factors and others "have an important bearing on the future strength of the housing market,"Duke explained.

Other indicators also point to factors

The Federal Reserve's most recent Senior Loan Officer Opinion Survey highlights some of these concerns. The April survey indicated that lenders today are less likely to originate loans guaranteed by the government-sponsored enterprises (GSEs) than they were in 2006. Lenders identified several reasons why they were less likely to make such loans, including the risk associated with delinquencies. Of particular concern is so-called putback risk, or the risk that the GSEs may require banks to repurchase delinquent loans.

Pending regulations on servicing requirements, capital requirements, and underwriting requirements could also affect the supply of mortgage credit, Duke noted. The Fed will carefully consider the impact its new rules will have on the availability of credit. But regardless of their final shape, the mortgage market will likely benefit from the clarity that comes from having the rules finalized, she noted.

Persistent questions also restrain market

Another lingering uncertainty is the future role of the GSEs in the mortgage market. The lack of consensus about their future role may be preventing private capital from entering the market, Duke explained. These and other unknowns likely play a significant role in today's tight mortgage lending standards and could have longer-term implications, she noted. For instance, lenders may be delaying investments in their lending and serving capacity, which could crimp housing and mortgage markets in the future.

Although there is no easy response to the complex issues facing the nation's housing market, perhaps the most important step is for "the path for the future of housing finance to be set,"Duke said. "It's time to start choosing that path."

May 30, 2012

Bernanke Discusses Banking Progress, Challenges

Banking conditions have improved significantly since the financial crisis, but banks still face a number of challenges, said Federal Reserve Chairman Ben Bernanke in a May 10 speech.

In remarks delivered via satellite to the Chicago Fed's annual banking conference, the chairman highlighted the "considerable progress" banks have made in strengthening their balance sheets and building capital. Results from the latest supervisory stress tests—formally called the Comprehensive Capital Analysis and Review (CCAR)—highlight the extent to which banks have shored up their capital levels. The 19 banks that participated in the stress-testing process have increased their Tier 1 capital by more than $300 billion since 2009 and "would likely have sufficient capital to withstand a period of intense economic and financial stress," Bernanke said.

New rules costly, yet critical

Despite recent progress, however, banks are struggling to expand their revenues amid the sluggish economy, changes in market conditions, and more stringent financial regulations. While the new rules impose "significant burdens" on banks, they are "critical to safeguard the stability of the financial system" and to prevent a repeat of the crisis, Bernanke said. Regulators are taking steps to minimize any adverse effects the new rules may have on the supply of credit. For instance, many of them are being phased in gradually, and regulators have consulted extensively with various stakeholders in the process of writing and implementing new rules. The chairman also emphasized that many of the regulations are not geared toward community banks but instead are "designed primarily to constrain risks at larger institutions."

Credit conditions improve, but mortgage lending still tight

Improved banking and financial market conditions have contributed to easier credit conditions for many businesses and consumers. However, access to credit is still restrained in some sectors and for some types of borrowers, Bernanke noted. The Fed's Senior Loan Officer Opinion Survey provides further details on the supply of and demand for loans. The April 2012 survey indicated easing standards for commercial and industrial loans, but mortgage lending remained sluggish. While a return to precrisis lending standards "wouldn't be appropriate," current standards may be locking creditworthy buyers out of the market, he said.

Citing the results of a special question in the most recent survey, the chairman noted that respondents indicated that they were currently less likely to originate mortgages eligible for purchase by the government-sponsored enterprises (GSEs) than they were in 2006, even to borrowers with good credit histories and a 20 percent down payment. Tight mortgage lending conditions are unlikely to be resolved overnight, Bernanke noted, pointing to such factors as the sluggish recovery in the housing market and economy, uncertainty about the future role of the GSEs, and lenders' cautious attitudes.

However, as the recovery gains steam, "increasing both demand for credit and the creditworthiness of potential borrowers, a financially stronger banking system will be well positioned to expand its lending," he said. These factors, in turn, will "help create a more robust economy."

May 24, 2012

Regulators Clarify Expectations for Stress Testing by Community Banks

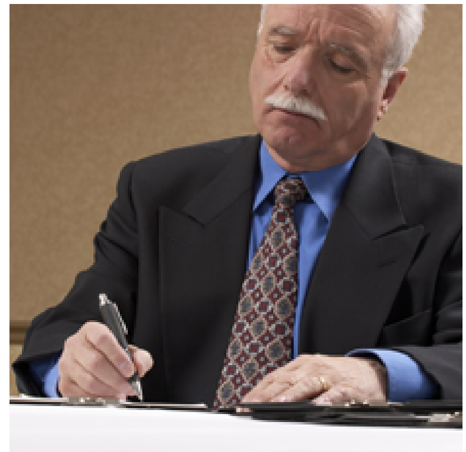
The Federal Reserve Board and other U.S. banking regulators issued a statement clarifying that community banks "are not required or expected" to conduct the same types of stress tests required of larger organizations.

The May 14 press release followed the issuance of final guidance on stress-testing practices at larger banks—classified as those with more than $10 billion in assets. The guidance highlighted the importance of stress testing as part of larger organizations' risk management practices. Additionally, the Federal Reserve earlier this year conducted stress tests of the 19 largest U.S. banks as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The Board, along with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, noted that these initiatives "are raising some questions on the part of community bankers regarding supervisory expectations for stress testing." Although community banks will not be required to undergo the same types of stress tests, the regulators did note that all banks, regardless of size, should be able to "analyze the potential impact of adverse outcomes in their financial conditions."

May 24, 2012

Banks Ease Lending Terms in First Quarter, Survey Says



Loans were a bit easier to come by in the first three months of the year, according to the Federal Reserve's senior loan officer survey. The quarterly survey, which covers 58 domestic banks and 23 foreign banks with U.S. operations, also reported stronger demand for loans.

While the majority of respondents reported little change to their lending standards for commercial and industrial (C&I) loans, a small fraction of foreign banks tightened their standards. Meanwhile, a moderate share of banks reported easing their terms on such loans, citing heightened competition from other banks and nonbank lenders as the primary reason for doing so.

On the demand side, the share of domestic banks reporting stronger demand for C&I loans outnumbered those citing weaker demand for the second consecutive quarter. Banks also reported an uptick in inquiries about new or increased credit lines. The reasons given for stronger demand were varied, including shifts in borrowing, increases in customers' funding needs, and mergers and acquisitions.

Foreign, domestic banks differ on CRE lending

The experiences of domestic and foreign banks diverged again in their commercial real estate (CRE) lending. A modest fraction of U.S. banks reported easing standards on CRE loans, while foreign banks made little change to their lending standards. Demand for such loans was stronger for domestic banks but had not changed for foreign banks.

Similar to the previous two surveys, respondents were asked special questions about their lending to firms with European exposures. Both domestic and foreign banks reported tightening their standards on lending to European banks, while a smaller share said they tightened loans to nonfinancial firms with significant exposure to Europe. "However, in all cases, the net fractions that reported having tightened substantially were smaller than in the January survey," the report said. A majority of the domestic banks that reported competing with European banks for business said they had encountered less competition from European banks and their affiliates or subsidiaries in the first quarter, up slightly from the previous survey.

Lending to households

Most banks reported little change to their standards on prime residential loans, while a modest share of banks said that standards on nontraditional mortgages had tightened. Demand for both categories strengthened for most banks, however.

In another set of special questions, respondents were asked to compare their willingness to originate 30-year fixed-rate mortgages that are eligible for handling by government-sponsored enterprises (GSE) today with their willingness to do so in 2006 for borrowers at different points along the credit risk spectrum. A large majority of banks were less likely than they were in 2006 to originate such loans to borrowers with a credit score of 620 and a 10 percent down payment. Banks cited several reasons for their reluctance to lend, including higher costs for and difficulty obtaining mortgage insurance and a higher risk of "putbacks" of delinquent mortgages by GSEs.

A "small to moderate" fraction of domestic banks reported easing standards on a range of consumer loan products, including credit cards and auto loans. A moderate share of banks said they had lowered the cost of credit for auto loans, but terms across the other consumer lending categories were little changed in the first quarter. Demand for consumer loans, especially auto loans, strengthened during the same period.

May 17, 2012

Fed Creates Expert Council to Advise on Stress Tests

The Federal Reserve Board on April 20 announced a series of steps it is taking to include outside expertise in the stress-testing process. The Dodd-Frank Wall Street Reform and Consumer Protection Act requires the Federal Reserve to conduct annual stress tests of the large bank holding companies and systemically important nonbanks that it supervises.

One such step is the formation of a Model Validation Council to advise the central bank on its efforts to assess the effectiveness of the stress-testing models it uses. The council, made up of academic economists, should "improve the quality of the Federal Reserve's models assessment program and strengthen confidence in the integrity and independence of the program," the Board said in a press release.

The 2012 council is chaired by Francis X. Diebold, an economics professor at the University of Pennsylvania. The other members include

- Peter Christoffersen, of the University of Toronto
- Mark Flannery, of the University of Florida
- Philippe Jorion, of the University of California at Irvine
- Chester Spatt, of Carnegie Mellon University
- Allan Timmermann, of the University of California at San Diego

The Board also announced that it would host a two-day symposium on September 13 and 14 to discuss stress testing models. The event, to be held at the Boston Fed, will bring together experts from academia, the banking industry, and the Federal Reserve.

Additionally, the Board released an extensive list of frequently asked questions (FAQ) and responses about the recently completed Comprehensive Capital Analysis and Review. The FAQ includes information about the methodologies used to project losses for mortgages and other portfolios, mortgage repurchase risk, and wholesale portfolios.

April 27, 2012

Atlanta Fed Launches New Web Feature, "The Fed Explained"

The Federal Reserve Bank of Atlanta recently launched The Fed Explained, a new feature on the Bank's website. The Fed Explained highlights a broad range of new and existing resources that have been aggregated on one web page for general audiences to learn about the work of the Federal Reserve, the nation's central bank.

The Atlanta Fed's dual purposes in developing The Fed Explained are to provide a convenient online source for information on a wide variety of economic issues and to aid the Atlanta Fed's communication by making information about the work of the Fed more accessible.

The Fed gets animated
The Fed Explained kicks off with an animated video, part of series that uses engaging graphics to illustrate economic topics and the Fed's role in the economy. The format is geared to the general public, students, and teachers. The first in the video series is a primer on inflation, which features straightforward examples to help explain the Federal Reserve's role in managing inflation.

In addition, The Fed Explained also highlights "Econ 101," a brief analysis of current economic issues. "Econ 101" is also a regular column in *EconSouth*, the Atlanta Fed's quarterly online and print magazine on the Southeast economy. Adding to The Fed Explained content, the new feature also offers a FedFAQ, which allows users to look for information about the Fed by searching key words or categories.

The new feature page can be found under the frbatlanta.org website tab titled "About the Fed." Original and aggregated content will be continually added to The Fed Explained. New videos will include such topics as gross domestic product (GDP), the role of the central bank, aspects of monetary policy, economic growth, and issues around employment.

April 25, 2012

Lockhart: Wise Regulation Is the "Holy Grail"

In concluding the Federal Reserve Bank of Atlanta's 2012 Financial Markets Conference, Atlanta Fed President Dennis Lockhart said one of the overarching themes of the event was the importance of paying attention to the details in formulating future regulatory policy.

Avoiding precipitous action important
"We should continue to try to avoid the 'ready-fire-aim' syndrome, proceed expeditiously, but very thoughtfully, accept that it is going to take time to design and put in place a better scheme, and accept that that scheme is likely to be imperfect," Lockhart said in summarizing the Atlanta's Fed's major annual policy and research conference. "I hope this conference has contributed in some small way to finding a way forward with this enormous challenge."

Lockhart noted that in his view the financial policymaker's "holy grail" is wise regulation. Reaching that ultimate aim requires a delicate balance between two primary concerns. One is the danger of principle-based reforms and regulations that lead to simple rules will likely be interpreted in various ways and applied inconsistently. On the other hand, detailed rules, Lockhart said, will probably lag market reality, add dysfunctional complexity, encourage gaming of the system, and generate unintended consequences.

Not easy, but essential
"So that's the inherent tension in this regulatory reform—between simplicity and principle-based reform or principle-based regulation, and the complexity of details," Lockhart said. "No one said that this was going to be easy, but also no one is arguing that it isn't necessary, or practically no one."

The conference was titled "The Devil's in the Details." Lockhart called the event "a kind of checking in" on a regulatory reform process that began two years ago. Following the title of the conference, he noted that the presenters and attendees examined details of certain aspects of financial reform.

April 25, 2012

Atlanta Fed's Financial Markets Conference Explores Future Regulation

Central bankers, finance professionals, and academics gathered on April 9–11 for the Federal Reserve Bank of Atlanta's annual Financial Markets Conference (FMC) at Stone Mountain, Ga.

Pondering regulation's effects
Following the theme of this year's conference—"The Devil's in the Details"—attendees considered issues such as the government's future role in mortgage finance and the potential for another shadow banking system to develop in response to new financial regulations. The shadow banking system refers to the largely unregulated activities that happen outside of the traditional banking system. Presentations also focused on the role of regulated intermediaries in providing maturity transformation—i.e., creating liquidity—and the creation of "systemically responsible" money market funds.

Each year, the FMC explores topical issues affecting financial markets and the broader economy. This year's event featured presentations by Federal Reserve Chairman Ben Bernanke, Sheila Bair (the former Federal Deposit Insurance Corporation chairman, now with the Pew Charitable Trust), and notables from the European Central Bank, International Monetary Fund, and other institutions.

Atlanta Fed paper explores mortgage policy
Atlanta Fed financial economist and policy adviser Scott Frame presented a paper examining various proposals to reform the federal government's involvement in the nation's housing finance system. The paper, written by Frame, Atlanta Fed financial economist and senior policy adviser Larry Wall, and Lawrence White of New York University, traces the history of residential mortgage finance in the United States and recent policy proposals to reform the system. The authors pay particular attention to the government-sponsored enterprises that back a huge share of home mortgage credit.

The paper concludes that policymakers broadly agree on a couple of points. One is to reduce the expected cost of federal government involvement in residential mortgage finance; another is to maintain explicit government guarantees for certain narrowly defined borrower populations.

Regarding the question of whether a new shadow banking system will emerge in response to new regulation, there is really no question at all, said Boston College professor of finance Edward J. Kane. In his conference presentation, he said the nation's largest banks will inevitably carve out niches outside the regulatory framework and will also enjoy an implicit taxpayer-funded safety net.

April 23, 2012

Bernanke Discusses Fed's Increasing Role in Systemic Stability

At the Federal Reserve Bank of Atlanta's 2012 Financial Markets Conference at Stone Mountain, Ga., Fed Chairman Ben Bernanke recently spoke about the Fed's moves to reorient itself toward being an agency with a broader supervisory focus on systemic financial stability.

Financial stability gains emphasis
"In the decades prior to the financial crisis, financial stability policy tended to be overshadowed by monetary policy, which had come to be viewed as the principal function of central banks," Bernanke said in remarks opening the three-day conference. "In the aftermath of the crisis, however, financial stability policy has taken on greater prominence and is now generally considered to stand on an equal footing with monetary policy as a critical responsibility of central banks."

Within the realm of bank regulation, the Fed is also taking a broader approach. The shift began before the enactment of the Dodd-Frank Act, Bernanke pointed out. He noted that the Fed in 2009 established the Large Institution Supervision Coordinating Committee, a high-level group that draws on varied skills and experience from throughout the Federal Reserve System. That group is charged with overseeing the supervision of the most systemically important financial firms.

Macroprudential analysis informs regulatory perspective
The Fed is also regularly using macroprudential methods to analyze how economic events might affect the financial system as a whole as well as individual firms the Fed supervises. The European sovereign debt crisis is one such example. Since those concerns arose in the spring of 2010, the Fed has tracked U.S. banks' direct and indirect exposures to Europe and monitored the banks' management of their exposures, the Fed chairman said. The U.S. central bank has also been analyzing scenarios under which European sovereign debt developments might cause wider problems, such as through an increase in investor risk aversion that lowers asset values.

This work on the European crisis has deepened the Fed's understanding of both individual banks' risk profiles and the potential effect the European situation could have on credit flows and economic activity in the United States.

"Continuing to develop an effective set of macroprudential policy indicators and tools, while pursuing essential reforms to the financial system, is critical to preserving financial stability and supporting the U.S. economy," Bernanke said.

April 23, 2012

ViewPoint Introduction

By Michael Johnson, Senior Vice President
Supervision & Regulation
Federal Reserve Bank of Atlanta

Mike Johnson

As we approach midyear, I am glad to report that we continue to see signs of Sixth District banks making progress in overall financial performance. Despite this good news, however, the situation in the eurozone looms large as a risk to the broader economy. Still, there is no denying the increasing positive momentum we are seeing in bank performance in the Southeast. All told, I am cautiously optimistic about the remainder of 2012.

State of the District
Some of the positive trends in earnings and asset quality that were first seen in the second half of 2011 became more pronounced in the first quarter of 2012. Despite the concerns expressed by community banks about the impact of new financial regulation, banks are experiencing stronger aggregate net income growth compared with the same quarter last year. Of course, cost control remains as important as ever to a bank's health. At the same time, asset-quality problems that have plagued banks in the Sixth District since the beginning of the financial crisis lessened in the first quarter of 2012 as charge-offs dropped to a four-year low. Growth continues to be a challenge, with particular weakness seen at community banks with asset sizes under $1 billion. That said, commercial and industrial lending is starting to improve, which bodes well for the small business sector.

Commercial real estate (CRE)
As you know, one of the key areas that we closely track is the CRE market. Recently, even this market has shown some modest signs of improvement. While news for the office, industrial, retail and hospitality sectors remains subdued overall, some specific submarkets and property classes are showing improvement. Within the CRE marketplace, most of the growth and positive news has been within the multifamily sector.

Commercial real estate is an integral part of the economic engine of the Sixth District, and in this edition of "ViewPoint," we explore some of the issues and trends behind the resurgence in the multifamily market and some of the continuing headwinds facing CRE. Please see more of the national and regional story in our spotlight article. For those bankers in our readership, you may also want to visit the latest program in our "Ask the Fed" series recorded on April 16 in Lexington, Kentucky. CRE and the residential markets were featured on the agenda.

Home equity loans (HELOCs)
On the residential side of real estate, HELOC portfolios are coming under increased scrutiny by bank supervisors. Some observers believe that banks have in general not taken losses on these loans commensurate with the decline in house prices. In addition, recent studies have shown that

since the crisis erupted in 2007–08, stressed borrowers have increasingly been defaulting "strategically" on their obligations, which has altered traditional thinking about the relative risk of holding first versus second liens. It's difficult to generalize about the character of these portfolios, however. A number of home equity loans were made as first liens, and some HELOCs are essentially business loans. The ability of the second lien lender to manage the loan is usually affected by whether the holder of the second lien also holds the first one. Either way, we note that default rates increase dramatically once principal amortization kicks in, which will likely happen in more cases as the interest-only periods begin to expire. For all these reasons, we are spending more time reviewing these portfolios consistent with recent guidance issued by the Federal Reserve. We explore the subject more fully in this edition of "ViewPoint."

Finally, I just wanted to draw your attention to several recent regulatory pronouncements.

First, on May 14 the Federal Reserve Board issued an interagency statement. The statement clarifies supervisory expectations for stress testing by community banks. The statement, I believe, is consistent with what I have said in some previous messages: while the supervisory stress-testing expectations for larger organizations will not trickle down to community banks, we still expect banking institutions regardless of size to abide by sound risk management practices and be able to analyze the potential impact of adverse outcomes on their financial condition. This guidance also highlights recent efforts by the Federal Reserve to reduce the burden on community banks by clarifying what guidance applies to them.

Second, on June 7, the Federal Reserve Board approved three notices of proposed rulemaking (NPRs) that would revise and restructure the Board's regulatory capital requirements. The three NPRs propose the Basel III capital standards, a standardized approach for risk-weighted assets, and changes to the advanced approaches rule. The proposals aim to reorganize the Board's capital rules and the market-risk capital rule into a comprehensive, integrated regulatory capital framework. The proposed framework would apply consolidated capital requirements to savings and loan holding companies. Please refer to the publicly available FAQs on the subject NPRs. Also publicly available in their respective NPRs are the appendices that summarize the parts of the Basel III and standardized approach NPRs that would apply to community banking organizations.

Understandably, the biggest impact of these rules is on large banks, but changes to the definition of capital, such as limits on deferred tax assets, will have an impact on all banks.

With that, I will sign off for now and extend my best wishes to all of you for continued financial performance improvement and, most importantly, a safe summer. Please share any feedback you may have with me at ViewPoint@atl.frb.org.

ViewPoint Spotlight: Home Equity

A Closer Look at HELOCs

Since the financial crisis began, all types of real estate loans on the books of Sixth District banks have been high on the Atlanta Fed's list of supervisory priorities. Even as employment and the economy show signs of strength, continued declines in home prices in most Sixth District markets are creating more properties with values less than the debt owed. This situation is variously called "negative equity," "underwater" or "upside down."

By whatever name, the prospect of continued declines in home values, combined with meaningful exposures by some Sixth District banks, may put more pressure on institutions' home equity loan portfolios, which usually consist of junior mortgage liens. (For the purposes of this article, the term "home equity loans" includes both closed-end junior liens and the more prevalent junior lien loans structured as an open end line of credit, often called HELOCs.) Moreover, the potential use of "strategic default" by savvy borrowers means that bankers need to monitor these portfolios carefully and continuously and establish sufficient reserves to cover potential losses.

Strategic default

Several studies have shown that one of the differences between this recession and prior ones is that homeowners often default on their mortgage obligations "strategically." In short, "strategic default" occurs when the most important factor in a borrower's default decision is not whether the borrower can afford to continue to pay that mortgage—although that factor is usually also present—but whether the value of the borrower's home is less than the mortgage obligation. As District housing markets continue to struggle, more homeowners are finding themselves in a negative equity position.

In days prior to the financial crisis, one reason the first mortgage on a primary residence was considered a relatively safe bet for a lender was that it was usually the first bill the borrower paid each month. As housing values have fallen in the last several years, this time-honored tradition seems have changed for a number of borrowers. A December 2010 working paper—" Strategic Default on First and Second Mortgages During the Financial Crisis" by Jalapa Jagtiani and William W. Lang and published by the Philadelphia Fed—looked at default behavior on first- and second-lien single-family mortgages using data from a national credit bureau and reached a number of conclusions about recent mortgage borrower behaviors that are of interest to mortgage lenders and bank regulators alike. For instance, the study found that home equity loans, particularly those structured as HELOCs, were creating the ability for borrowers to default strategically on their first- and second-mortgage loans:

> "As with prior research, we find that people default strategically as their home value falls below the mortgage value... While some of these homeowners default on both first mortgages and second lien home equity lines, a large portion of the delinquent

borrowers have kept their second lien current during the recent financial crisis."

The study's main findings were the following:

1. Beginning in 2008, the rate of first-lien defaults began to exceed second-lien defaults, which contradicts long-held market views about the relative risk in first and second lien loans
2. Second liens, which are current but stand behind a seriously delinquent first mortgage, are subject to a high risk of default
3. About 20 percent of borrowers in the process of foreclosure due to defaults on the first mortgage actually kept their second-lien mortgage current
4. A substantial number (20–30 percent) of HELOC borrowers continue to draw on their lines after having defaulted on their first mortgage
5. Negative equity has been the primary reason for homeowners to default on their mortgages overall

In other words, the fact that a home equity loan is current may not necessarily indicate that the loan is a good loan. The lender needs to know the true condition of the borrower, including the payment status of the first mortgage and whether the borrower is under water.

Negative equity

A March 2012 report from CoreLogic, a data and analytics company, showed that 11.1 million residential properties nationwide, or 22.8 percent, with a mortgage were in a negative equity position at the end of the fourth quarter of 2011, up from 10.7 million properties and 22.1 percent in the third quarter of 2011. After declining somewhat in 2010, the number and percent of all loans under water has returned to about the same level as November 2009, when the company began reporting these numbers. (CoreLogic also includes properties with values up to 5 percent higher than the loan balance as "near negative equity.")

The two states with the highest percentage of underwater mortgages nationally were Nevada and Arizona, while the Sixth District states of Florida and Georgia ranked third and fourth. Since November 2009 the percentage of underwater loans in Georgia and Tennessee has increased. The percentage of underwater properties in Florida, while still twice the national average, has actually declined very slightly (see chart 1).

The Core Logic report also highlighted the significant difference between properties encumbered by only a first lien and properties that had both a first and second lien. Eighteen percent of properties with a first mortgage only were under water, while properties with both a first and second lien, at 39 percent, were almost twice as likely to be under water.

Sixth District bank home equity loan portfolios

Home equity lending, especially HELOCs, have been an important source of loan growth for Sixth District banks since the early 2000s. As chart 2 shows, these loans have been primarily a large-bank product. Although the largest six banks in the District hold almost 80 percent of all home equity loans held on Sixth District bank balance sheets (see chart 2), it is also true that relatively few District banks have no home equity loans. (These percentages represent home equity loans held by banks headquartered in the Sixth District. They are only approximations of the percentage of home equity loans on properties located in the District since some of the larger banks have offices outside the district that likely hold home equity loans on properties outside the District.)

In addition, the largest banks hold proportionately more of their assets and capital in home equity loans than smaller banks.

The median concentration risk exposure of Sixth District banks is not outsized. Looking at the 75th, and 90th percentiles, however, indicates that there are some banks in the Sixth District with meaningful exposures in these loans in banks of all asset sizes (see chart 3).

Having said that, it is hard to make general statements about Sixth district home equity loan portfolios based on high-level analysis alone. In addition to underwriting and product design differences, there are a significant number of loans in some portfolios that are secured by first mortgage liens. That is, even though the loan is made as a HELOC, there are no other outstanding liens. In addition, in the very early years of the crisis, when values began falling, many banks reviewed their portfolios and in many cases reduced commitments to reflect lower values. These portfolios often include many loans that are made for business purposes.

Today's special factors

The above discussions on negative equity, potential strategic defaults, and meaningful exposures at some banks indicate that risk management around these portfolios is very important. There are two factors that can make monitoring and evaluation of junior lien portfolios challenging in the current environment:

1. The potential for strategic default behavior suggests that portfolio risk managers should seek to know the home equity loan borrower's true financial condition, including the status of the first mortgage, and whether the borrower is under water.

   In cases where the home equity lender does not also hold the first mortgage, however, such monitoring can be difficult. Since most home equity loans are relatively small, it can also be expensive. Delays can mean, however, that the lender will not learn the true condition of the borrower until the property is under water and the lender is in a loss position.

2. Many HELOC loans were made in the 2003–07 period with draws permitted for 10 years, at which time amortization begins or a balloon payment is required. These amortization and balloon payment requirements are beginning to occur but will accelerate significantly by 2014. Without a better economy and rising or at least stable home values, defaults will likely increase since borrowers will be required to make higher payments that include principle.

Supervisory considerations

Bank regulators in general have become increasingly concerned. On January 31, 2012, the Office of the Comptroller of the Currency issued guidance pertaining to loan and lease loss estimation for some residential properties.

This guidance reiterates the need for strong policies and practices in estimating reserves for junior lien loans. The guidance also discusses portfolio segmentation and analysis, credit quality indicators, qualitative and environmental adjustments, charge-off and nonaccrual policies, and responsibilities of management and examiners.

As a result of reviewing their portfolios under this guidance or otherwise a number of banks have amended their allowance for loan and lease loss (ALLL) policies to place on nonaccrual those home equity loans in a current payment status that are behind delinquent first liens. This action reflects the realities that have been discussed in this article.

The prospect of continued declines in home values and the potential for strategic default behavior on the part of borrowers, combined with meaningful exposures by some Sixth District banks, contributes to increasing concern about the potential pressure on Sixth District home equity loan portfolios in some banks. Atlanta Fed examiners are looking more closely at their case loads at the institutions where they have responsibility and elevating reviews of home equity portfolios with the recent guidance and today's special factors in mind.

Bill Cha *This article was written by Bill Chalker, director of examinations in the Atlanta Fed's supervision and regulation division.*

ViewPoint Spotlight: Multifamily Housing

Up, Up, and Away: Multifamily Rents, Occupancies Rising

Much has been made about the recent improvement in multifamily market conditions. The multifamily sector has seen a significant rebound in fundamentals, such as demand and supply and increased investor interest, within the last two years. Increased demand has translated into occupancies that have risen significantly since the lows of 2009–10. According to Axiometrics, nationwide occupancies for multifamily housing had fallen to 91.8 percent in 2009 (see chart 1). These lows for multifamily product had not been seen since 1996, when data were first recorded. Since reaching those depressed levels, occupancies have rebounded significantly to 93.7 percent. Contributing significantly to the rebound is the fact that minimal new construction has been brought to market in the past few years. Multifamily occupancies should rise further as the peak leasing season picks up this summer. Industry forecasts have occupancy rising to approximately 95 percent in 2012. Correspondingly, rents are forecast to grow swiftly, at an approximate rate of 5 percent during 2012.

In general, markets located within the Sixth District continue to rebound (see table 1). The two exceptions are Birmingham and Jacksonville: both of these markets experienced modest softening in their occupancy rates. Miami and Nashville had the highest occupancy rates of the eight markets tracked in the Sixth District. Orlando, which experienced significant lows in 2010, showed the most significant rebound in 2011.

The nationwide occupancy rate is composed of the Class A, B, and C properties. Units typically categorized into Class A properties are generally larger, upscale, and owned by large institutions. Class B Properties are nice, but a step below Class A in several regards. Class C properties are generally smaller, older and owned by local community entrepreneurs. Historically, Class C properties have seen smaller rent increases and occupancies have lagged the Class A and B properties. Chart 2 shows the trend of occupancy rising in Class C properties at a faster clip than Classes A and B. This trend is driven by a number of factors, the most notable being the heightened rents for Class A and B properties and the lower price points for Class C rents. This trend should have positive implications for community banks as values increase on Class C properties that compose commercial real estate loans made by community banks.

Multifamily new construction: Can It Be Sustained?

Roughly 650,000 multifamily units across the United States are in various planning stages. In addition, around 135,000 multifamily units nationwide are currently under construction, and an additional 50,000 units where the permits have been approved and construction can commence immediately. As a result of the increased demand and minimal new supply of multifamily units, there have been questions in the industry regarding the scale of the resurgence in multifamily new construction.

Chart 3 showcases new unit deliveries (new construction) and absorption. It uses a four-quarter moving sum to reduce the seasonal volatility of demand. The chart shows that the rate of absorption (demand) has fluctuated greatly over the last 11 years, from a low of 250,000 units to a high of 650,000 units leased nationwide. Over this 11-year period, the average level is roughly 283,000 units. In contrast, new deliveries (new construction) remained relatively steady prior to the downturn, at just over 300,000 units annually. Over the 11-year period, the average level of absorption is roughly 234,000 units per year. The difference between the two long-term average figures includes units that are retired, or that have been converted to condominiums. Currently, new units are being delivered to the marketplace at an approximate rate of 112,000 per year. Present demand for multifamily units is 186,000 units per year.

Based on a level of national economic activity of around 125,000 jobs created per month, it appears that deliveries' present level of 112,000 units annually is sustainable and can be absorbed without difficulty. However, based on the number of units that are permitted, under construction, and in various stages of planning, the level of future deliveries appears headed higher. Only time will tell whether the market can handle a higher rate of newly constructed units. For this level of absorption to occur, however, the market will have to overcome several hurdles, including higher multifamily rents, increases in home affordability, and more young adults living with prior generations.

CMBS: Is the market improving?

During the last ten quarters, volume in the commercial mortgage backed securities (CMBS) market has fluctuated significantly. Quarterly CMBS volumes ranged from a low of zero to a high of almost $8.5 billion. The market restarted in 2010, only to encounter significant hurdles that led to very poor issuance volume. At the beginning of 2011, industry experts had concerns about the minimal volumes of the prior year's CMBS market volume, making predictions about the anticipated market size of $40–$50 billion for the coming year. According to Bloomberg, the CMBS conduit market accounted for roughly $27 billion in 2011. At the beginning of 2012, industry experts again made predictions as to the size of the CMBS market. These predictions ranged from $30–$50 billion.

Year to date for 2012, the CMBS conduit market has issued approximately $9 billion of new securities backed by commercial real estate (CRE) properties, excluding multifamily (see the table). The market started slow, with only one deal completed within the first two months of this year. However, the market showed a notable uptick as five issuances were brought to market in April. Additionally, the transactions that were completed in May and slated to settle in June represented the largest pools of securities for the year.

Brian B

This article was written by Brian Bailey, a senior policy analyst in the Atlanta Fed's supervision and regulation division.

ViewPoint State of the District

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

Asset Quality

Continued economic uncertainty has not curtailed the improvement in asset quality. Asset quality problems that arose during the financial crisis in the Sixth District declined slightly in the first quarter of 2012. The level of decline has slowed over the past three quarters, but the amount of loans that banks are having to charge-off and take losses on is declining at a much faster pace. The ratio of noncurrent loans to total loans was 4.7 percent in first quarter, on par with levels last seen in 2008, before the financial crisis engulfed banks (see the table).

Noncurrent loans (see chart 1) declined in nearly every loan type with the exception of other consumer loans, like automobile loans.

The decline in noncurrents has helped stabilize the coverage ratio of the allowance for loan losses as a result of noncurrent loans (see chart 2).

In the first quarter, the coverage ratio reached its highest level since the fourth quarter 2008. Charge-offs in the first quarter fell to their lowest the level in nearly four years (see chart 3).

The level of charge-offs reflects declining mortgage delinquency rates in the first quarter. Delinquency rates reached the lowest level seen since 2008. Charge-offs are often lowest during the first quarter as many banks charge off their worst-performing loans during the fourth quarter.

Balance Sheet Growth

Sixth District banks are starting to see stronger growth in their commercial and industrial (C&I) portfolio, which is the portfolio many banks have focused on growing for the past year (see chart 1).

According to the April 2012 Senior Lending Officer Opinion Survey, a third of the banks that participated in the survey reported stronger demand for C&I loans for firms of all sizes. On an aggregate basis, C&I loans grew by $5.2 billion, a 21 percent increase over the prior year (see chart 2).

Based on the survey results, banks have maintained their same level of credit standards for approving applications for commercial loans or credit lines, meaning there has not been any significant tightening of credit from the banks' point of view. While credit standards for C&I loans remained unchanged to the prior quarter, banks eased some of their loan terms such as the spreads over cost of funds and the use of interest rate floors. Given that only a third of the banks are reporting higher demand, much of the growth appears to be the result of shifting some commercial customers away from commercial real estate loans (CRE) and into C&I loans. During the first quarter, the amount of CRE loans declined by $1.7 billion, though this category remains the largest loan portfolio on bank balance sheets. As existing customers renew loans, especially with smaller community banks, those banks appear to be changing the type of collateral required for the loan from real estate to other business assets. In changing the type of collateral accepted, it shifts the categorization of the loan.

In addition to C&I growth, Sixth District banks also had growth in their closed-end first and junior lien residential mortgages, perhaps signaling that some housing markets in the district are healing. On an aggregate basis, residential mortgages increased by $1.7 billion over the prior year. Although there has been growth in some parts of the loan portfolio (both residential and C&I loans), overall loans declined in the first quarter. The strong growth in C&I loans was almost completely offset by the decline in construction and development loans. The increase in mortgage lending does not seem to be translating into real estate development projects at this time. With the overall loan decline, loans remained at 62 percent of total assets on the balance sheet of banks versus a high of 70 percent prior to the crisis (see chart 3).

Loans now represent 62 percent of total assets on the balance sheet, down from 70 percent at the start of the crisis (see the table).

Without loan growth, banks are still turning to their securities portfolio in order to generate a yield and improve the net interest margin. In the first quarter, banks' securities portfolio grew by just over 9 percent while the loan portfolio declined by nearly 2 percent.

Without loan growth, banks continue to increase their securities portfolio, which have grown nearly 5.5 percent as a share of assets since the start of the crisis. While banks would like to get a higher yield on their securities, they are reluctant to invest in longer-term products because of the possibility of a rising rate market and having the liquidity to make loans when demand returns.

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

Beyond the increase in earnings, the reduced level of bank failures so far in 2012 provides a clear indication that conditions have improved. Through May 16, 2012, a total of 23 failures have occurred this year nationally, with Georgia once again leading the nation with four. As a result of banking, real estate, and economic conditions in the state, Georgia has been slower to recover than other parts of the country. By comparison, there were 43 failures in 2011 and 72 failures in 2010 through the same point in the year. The continued reduction in the number of Sixth District banks with the highest Texas ratios also points to fewer failures in the district this year (see the chart).

Capital

Even with the recent improvement in earnings and asset quality, capital levels in Sixth District banks have remained fairly stable in recent quarters. Capital ratios have also been helped by the relative lack of loan growth. In the first quarter of 2012, the median tier 1 leverage ratio for community banks was 9.59 percent, a 19 basis point improvement over the same quarter in the prior year (see the chart).

The median tier 1 leverage ratio in the Sixth District remains slightly below the median ratio of 9.72 percent for out-of-district banks, but the gap is the smallest it has been since the second quarter of 2010.

Earnings Performance

Earnings for Sixth District community banks (assets less than $10 billion) increased to an aggregate net income of $1.9 billion, compared with a net loss of $454 million in the same quarter of the prior year (see chart 1).

The improvement was the result of sharply lower loan loss provisions and stronger noninterest revenues. On an aggregate basis, ROAA for the first quarter 2012 was 0.64 the strongest it has been since the second quarter of 2008 (see table 1).

Still, the Sixth District has a larger percentage of community banks reporting negative ROAAs than banks outside the district (see table 2).

Net interest margin improved as the level of noncurrent loans has declined over the past six quarters, though banks have yet to experience any significant loan growth. At the same time, interest expense has declined as low-cost core deposits are reaching their highest level in nearly 20 years. Despite the numerous concerns expressed by community banks about the impact of new financial regulations, such as the Durbin amendment, community banks are still experiencing noninterest income growth.

Banks were also able to generate one-time gains on the sale of securities, which also pushed ROAA higher. Generally, the securities gains are not seen as being a part of the banks' core earnings. Overhead expenses also continued to increase as banks are the process of resolving remaining problem loans. Over the past two years, legal fees, appraisal fees, and taxes on ORE (other real estate, classified as property held for reasons other than conducting bank business) have added to the banks' costs. Provision expense continued to decline even as the overall coverage of noncurrent loans increased slightly for the quarter. Returning provision levels closer to historical norms has aided banksâ?? return to profitability.

Liquidity

At the beginning of the financial crisis, the level of liquidity in banks became a focus of concern. Part of the concern was businesses trying to draw credit lines because of disruptions in the market. In order to ensure enough liquidity remained available, the Federal Reserve lowered the discount rate to record lows. Four years later, with loan demand still tepid, banks are having difficulty determining how to effectively deploy all of the funds that flowed into the banks as a result of economic uncertainty. In the first quarter 2012, core deposits represented just over 66 percent of assets in the Sixth District, its highest level since the early 1990s (see chart 1).

Out-of-district banks are also seeing near record levels of core deposits. The increase in core deposits in the district has sharply curtailed the reliance on noncore funding, which is seen as a volatile funding source. The median net noncore funding dependence ratio in the Sixth District in the first quarter was 17.48 percent, higher than the same ratio for out-of-district peers at 10.42 percent (see the chart).

At the same time, the ratio of loans-to-deposits has dropped to roughly 83 percent from a peak of 128 percent for large banks. Given that core deposits still represent a cost, banks are seeking higher returns on other asset portfolios. However, banks have to be careful not to commit the additional funds into assets with longer maturities. With the Transaction Account Guarantee (TAG) program, which guarantees unlimited insurance on noninterest-bearing transaction accounts, expiring at year, some analysts are wary of some run-off in bank deposits. An estimated $1.2 trillion in deposits could be affected by the expiration of the program.

ViewPoint National Banking Trends

U.S. commercial banks across the nation continued their uneven progress toward better profitability in the fourth quarter. Aggregate return on average assets (ROAA) turned down slightly from the prior quarter of 2011 (see chart 1).

The decline was evident across all sizes of institutions. ROAAs are typically lower in the fourth quarter as banks determine what expenses need to be recognized prior to moving into a new year. Net interest margin improved slightly in the fourth quarter. One of the concerns going into the fourth quarter was centered on noninterest income as a result of caps on interchange fees. For banks under $10 billion, noninterest income actually increased over the prior quarter while it declined for larger banks. Banks under $10 billion were exempted from the interchange fee cap. The story with earnings continues to be more a function of cost control than an improvement in net interest margin.

Loan growth is improving, but only at banks with an asset size greater than $10 billion (see chart 2). Annualized loan growth for all commercial banks was 7.8 percent, but larger banks had annualized growth of 10.4 percent in the fourth quarter, and smaller banks had negative loan growth.

Staff

Policies

E-mail Notification
Please use our WebScriber service to receive e-mail notifications when *Financial Update* is posted on the Web.

ISSN 0899-6563