S&R PERSPECTIVES

> "We're aware of the regulatory challenges that you have felt, as well as the stressful banking conditions you have faced. We understand those challenges and want to continue an open dialogue with you."
>
> – Jennifer Burns, Senior Vice President
> Supervision, Regulation and Credit

The Latest Fifth District Supervision and Regulation News & Events

Fall Issue 2011

Capital Planning: It's Not Just for Problem Banks

By William Harrison

Capital planning discussions between bankers and regulators are nothing new, but they have changed in recent years. Five or six years ago, the discussion probably sounded something like this:

Examiner: *"I see in your strategic plan that you'd like to grow 10 to 15 percent per year over the next five years. Can income and capital support this level of growth?"*

Banker: *"Sure. Many of our shareholders want to buy more shares, and our directorate could easily provide up to $3 million if we needed it."*

In the past year or so, however, the discussion has become more like this:

Examiner: *"I see you have a capital policy that states your intention to maintain a well-capitalized position. Your current ratios far exceed those limits now, but what if capital ratios drop to near the minimums? Then it might be too late to initiate your strategy."*

Banker: *"Well, what do you suggest? Where is the guidance?"*

http://www.richmondfed.org/banking/supervision_and_regulation/newsletter/2011/fall/article1.cfm

The Quest for a 'Reasonable' Allowance for Loan and Lease Losses

By Steven Wilson

Over the past several years, the emphasis on the level and adequacy of the Allowance for Loan and Lease Losses (ALLL) by bank regulators has increased. After significant dialogue among bankers, regulators, and external accountants, it appears that most institutions are utilizing ASC 450 and ASC 310 in their methodologies. In many cases, however, it's difficult to determine how much is enough, as the processes for calculating the ALLL are not always producing sufficiently reasonable estimates of loss in today's economic environment. As the current environment continues to challenge the effectiveness of existing ALLL methodologies, some banks may still need to augment their existing processes. *http://www.richmondfed.org/banking/supervision_and_regulation/newsletter/2011/fall/article2.cfm*

Jennifer's Notes

Welcome to the fall 2011 edition of S&R Perspectives. We've redesigned our newsletter to make it shorter, less technical, and easier to follow. We hope you enjoy the new format. More changes will follow as we strive to make the newsletter mobile friendly. This issue discusses a variety of topics: ALLL, capital planning, vendor management, and the state of Fifth District small community banks.

Previously, we addressed some of the regulatory changes brought about by the Dodd-Frank Act (DFA). Now that the one-year anniversary of DFA has come and gone, let's reflect upon the act and what lies ahead.

DFA transferred supervisory and rule-making authority for Savings and Loan Holding Companies (SLHCs) and their nondepository subsidiaries from the Office

Jennifer's Notes

of Thrift Supervision (OTS) to the Board of Governors of the Federal Reserve System (FRS). As part of the transfer, the FRS helped define the supervisory program and set of guidance and regulations to be used for the SLHCs; ironed out logistics of the transfer; hired and trained staff; worked with the OTS to learn about the companies; and worked with the Office of the Comptroller of the Currency to understand their supervisory plans going forward. The Federal Reserve Bank of Richmond has taken on supervision of 34 SLHCs.

The FRS spent much of the past year contributing to, and commenting on, proposed rules. In Supervision, Regulation and Credit, we contributed to our Bank's comments on those rules, with most of our efforts being focused on enhanced prudential standards. For the first time, we will be enforcing new regulations written by another agency, as much of the FRS rule-writing activities will transfer to the CFPB.

Looking ahead, we'll host Community Banker Forums in Charlotte on November 14, and in Richmond on November 29 and 30. Forums will be held next year in other areas of the District. We hope to see you.

Now, on to the rest of S&R Perspectives. If you would like to suggest topics or changes for future editions of our newsletter, please submit your suggestions through our online survey.

Jennifer

CEO Community Banker Forums

November 14, 2011 — Charlotte, North Carolina
November 29–30, 2011 — Richmond, Virginia

The Federal Reserve Bank of Richmond will be hosting two Community Banker Forums in November. For your convenience, the forums will be held at two locations. One will be held at our Charlotte, North Carolina Office; the other will be at our Richmond, Virginia Office.

The program will consist of a Supervision, Regulation and Credit session and dinner with program. President Lacker will deliver remarks on the economic outlook. First Vice President and Chief Operating Officer Sally Green will discuss payments and Senior Vice President of Supervision, Regulation and Credit Jennifer Burns will discuss banking issues. After the program, guests will have an opportunity to ask questions and provide comments.

Click on one of the links above for more information and to register.

The State of Fifth District Small Community Banks Versus the Nation

Highlights Through the Second Quarter 2011: Banks With Assets Less Than $1 Billion*

By Ben Carter and Donna Thompson

Current newspaper articles and business commentary seem to indicate that the banking industry is beginning to rebound from the depths of the recent financial turmoil. In addition, the latest Consolidated Reports of Condition and Income show that there is some improvement in many key performance measures nationwide. However, this is in stark contrast to the data for Fifth District small community banks, which continue to lag the improvement reflected nationally. *http://www.richmondfed.org/banking/supervision_and_regulation/newsletter/2011/fall/article3.cfm*

Four Steps to an Effective Vendor Management Process

By Benjamin Chisolm

Choosing a vendor to support your operations is a difficult, but important, task. Managing your vendor is equally important. Your institution can be exposed to many risks when outsourcing operational functions, as vendors are not your employees, and their priorities might not always align with those of your firm. While selecting and managing a vendor might not be easy, examiners will expect you to have a consistent and formalized vendor selection and management process in place. With that in mind, here are some of the key steps for ensuring that you have a strong vendor selection and management process: *http://www.richmondfed.org/banking/supervision_and_regulation/newsletter/2011/fall/article4.cfm*

Examiner's Corner

This section highlights key issues noted by examiners conducting examinations of community banks within the Fifth Federal Reserve District.

Flood Insurance

A high-risk area for consumer compliance examinations is the adequacy of institutions' practices and internal policies regarding flood insurance. When a loan is secured by a building (residential or commercial) located in a special flood hazard area (SFHA), section 208.25 of Regulation H requires member banks to notify the borrower that the property is in an SFHA and, where available, ensure the borrower maintains adequate flood insurance for the term of the loan. If a borrower fails to maintain adequate insurance on a subject property, the bank is required to force place such insurance.

Preclosing loan documentation checklists, insurance calculation worksheets, and tickler systems to ensure policy renewal are some examples of procedures and internal controls that can aid compliance. To determine compliance, examiners review these and other policies and procedures, internal controls, and a sample of recently originated loans, as well as loans that require flood insurance. Common violations include: not providing borrower notice; originating loans without adequate insurance (particularly loans involving junior liens and cash-out refinances); and not force placing insurance. Compliance failures can subject a bank to financial loss, civil money penalties, and/or an adverse rating.

Sensitivity

A primary focus for examiners is evaluating compliance with the Interagency Advisory on Interest Rate Risk Management, which was released on January 6, 2010 (SR Letter 10-1). While banking organizations across the Fifth District have taken positive steps to conform to many aspects of this guidance, other areas of the guidance have not received the required attention. One such area is sensitivity testing. On the plus side, many banks have coordinated with their interest rate risk model vendors to ensure that shock scenarios of significant magnitude exist (e.g., 300 and 400 basis points) and that earnings simulations are modeled over a two-year time horizon. However, a significant number of banks have not incorporated sensitivity testing into their risk management practices. Sensitivity testing serves to highlight which assumptions have the most influence on model output.

One key benefit of sensitivity testing is that it allows senior management and the bank's board of directors to see the linkage between a change in assumptions and the impact on interest rate risk model output. To properly conduct sensitivity testing, institutions should focus their efforts on verifying the assumptions that are most influential to their model results. These assumptions may vary by institution. Some key assumptions to think about include: adjusting the sensitivity of nonmaturity deposit pricing to changes in market rates (e.g., beta factors); changing the runoff of nonmaturity deposit account assumptions; and/or adjusting the prepayment speed on mortgage-related assets.

If you have any questions about these or other topics, please contact your Fifth District relationship manager or email BKSRCommunications.RICH@rich.frb.org.

Fifth District Indicators

2Q 2011

Includes institutions with total assets over $1B

⇩	**Annual Growth in Loans and Leases** Fifth District balance sheets continued to marginally contract in the second quarter. Annual loan growth was -2.89% while median total assets only grew 1% – slowing since the start of the year when asset growth was approximately 2%.
⇩	**Loan Losses and Nonperforming Loans as a Percentage of Total Loans** Nonperforming loans and losses as a percentage of total loans decreased for the 2nd quarter – though declining trends are largely supported by negative annual loan growth. For the 2nd quarter, the declining trend in aggregate loan losses was mainly driven by banks with over $1B in total assets. Smaller institutions saw increasing loan losses. Nonperformings trended downward from a year-end 2010 peak, settling at 5.90% – a substantially higher level than the national aggregate. Despite the overall trend, commercial real estate (especially the construction and land development aspect) remains the most stressed loan category.
⇔	**Earnings** Earnings held relatively steady among Fifth District institutions during the 2nd quarter. Median ROAA declined only 2 basis points to 0.4%. Ratios remain suppressed largely due to the tapering off of net interest margin growth since the beginning of 2010. Institutions over $1B in total assets saw declining net interest income while their community bank counterpart experienced increasing net interest income . Loss provisioning also continues to suppress earnings; though trending downward, levels remain significantly higher than the national median.
⇧	**Net Non-Core Funding Dependence** After peaking during the heart of the financial crisis and experiencing steady declines over the last three years, 2nd quarter 2011 marked the first increase in the median net noncore funding dependence ratio at Fifth District institutions. This trend reversal is supported by slight declines in core deposits as a percentage of total assets and, for large institutions , an uptick in short-term collateralized borrowing. While loans to deposits continued to decline, loans as a percentage of core deposits increased slightly for the first time since peaking in the fourth quarter of 2008.
⇧	**Capital** Capital ratios increased across the board in the Fifth District, assisted by slow asset growth. Most notable this quarter was median Total Risk-Based Capital which increased 1.5% to 14.46%, a level not seen since the early 2000s. Median Tier One Leverage Ratio and Equity Capital as a percentage of total assets also increased.

Source: Consolidated Reports of Condition and Income and Uniform Banking Performance Reports. Large institutions defined as those with total assets greater than $5 B.

Recent Guidance

Supervision and Regulation (SR) Letters:
http://www.federalreserve.gov/bankinforeg/srletters/srletters.htm

SR 11-13
Guidance Regarding Prior Notices With Respect to Dividend Declarations by Savings Association Subsidiaries of Savings and Loan Holding Companies
http://www.federalreserve.gov/bankinforeg/srletters/sr1113.htm#access

SR 11-12
Deregistration Procedures for Certain Savings and Loan Holding Companies
http://www.federalreserve.gov/bankinforeg/srletters/sr1112.htm#access

SR 11-11/CA 11-5
Supervision of Savings and Loan Holding Companies (SLHCs)
http://www.federalreserve.gov/bankinforeg/srletters/sr1111.htm#access

SR 11-10
Interagency Counterparty Credit Risk Management Guidance
http://www.federalreserve.gov/bankinforeg/srletters/sr1110.htm#access

Consumer Affairs (CA) Letters:
http://www.federalreserve.gov/boarddocs/caletters/

CA 11-7
Funds Availability and Payment of Interest
http://www.federalreserve.gov/boarddocs/caletters/2011/1107/caltr1107.htm

CA 11-6
Revised Examination Procedures for the Servicemembers Civil Relief Act
http://www.federalreserve.gov/boarddocs/caletters/2011/1106/caltr1106.htm

CA 11-4
Revised Interagency Examination Procedures for Regulation P
http://www.federalreserve.gov/boarddocs/caletters/2011/1104/caltr1104.htm

CA 11-3
Revised Interagency Examination Procedures for Regulation Z
http://www.federalreserve.gov/boarddocs/caletters/2011/1103/caltr1103.htm

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