S&R PERSPECTIVES

The Latest Fifth District Supervision and Regulation News & Events

Spring Issue 2012

“The year 2011 was challenging, and 2012 looks to be as well; however, we are seeing some ‘green shoots’”

– Jennifer Burns, Senior Vice President
Supervision, Regulation and Credit

CEO Community Banker Forums Hosted in Charlotte and Richmond

By Steve Malerba

The Federal Reserve Bank of Richmond hosted two CEO Community Banker Forums last November. The first was held November 14 at our Charlotte, N.C., office. The second was held November 29–30 at our Richmond, Va., location. Attendees included leaders of Fifth District state member banks, bank holding companies, and savings and loan holding companies.
http://www.richmondfed.org/srperspectives/article1.cfm

Questions and Answers From the November CEO Community Banker Forums

http://www.richmondfed.org/srperspectives/article1a.cfm

Upcoming Community Banker Forums:

March 22, 2012 – Charleston, West Virginia
http://www.richmondfed.org/conferences_and_events/banking/2012/ceo_commbank_char_20120322.cfm

April 12, 2012 – Baltimore, Maryland
http://www.richmondfed.org/conferences_and_events/banking/2012/ceo_commbank_bal_20120412.cfm

Stress Testing at Community Banks: The Benefits and the Expectations

By Jody Martin

Stress testing has been a risk management tool of financial institutions for decades, but supervisors and bankers are placing renewed emphasis on this approach. One of the biggest appeals of stress testing is that it takes a forward-looking view of performance. In contrast, many of the other methods used to assess risk give only a historical, or point-in-time, perspective. While this can certainly be informative, it provides us with an incomplete view of existing exposures.
http://www.richmondfed.org/srperspectives/article2.cfm

Jennifer’s Notes

Welcome to the spring 2012 edition of S&R Perspectives. It was great to see so many of you at our Community Banker Forums in November. At the forums, you voiced concerns over regulatory burden, credit availability, the Dodd-Frank Act (DFA) and the Consumer Financial Protection Bureau (CFPB). In this column, I’d like to address some of those concerns, reflect on the past year and look forward to the rest of the year ahead.

In 2011, the Federal Reserve System remained focused on implementation of DFA. There was progress in areas such as the repeal of Regulation Q, the Collins Amendment and the Durbin Amendment. Proposed rule-making on resolution expectations and on enhanced prudential standards was published. We’ve been closely following the devel-

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Jennifer's Notes

opment of the CFPB, as we will need to supervise our institutions in accordance with their rules.

Within the System, the Board recently formed a subcommittee, led by Governors Duke and Raskin, to focus on supervision of community and regional banking organizations. This group is reviewing various policy statements with an eye toward reducing burden and ensuring we are not inhibiting credit availability. Going forward, new supervisory guidance will be explicit regarding its applicability to community banks. The System recently completed a review of the applications process and will be making some changes to improve efficiency and timeliness.

The year 2011 was challenging, and 2012 looks to be as well; however, we are seeing some "green shoots." Asset quality problems are beginning to stabilize, and we're seeing more restructuring of problem loans. We're also seeing some upgrades in CAMELS ratings and the economy seems to be picking up steam. So, there is some light on the horizon.

Now, on to the rest of this edition of S&R Perspectives. Please complete our brief, online survey to ensure that we are covering topics and issues that are important to you.

Jennifer

The Bank Secrecy Act (BSA) and Suspicious Activity Monitoring: Considerations for Your Next Examination

By Elaine Yancey

According to the FFIEC Bank Secrecy Act/Anti-Money Laundering Examination Manual, suspicious activity reporting "forms the cornerstone of the BSA reporting system." In fact, the primary purpose of the act is to identify and report transactions where financial institutions are possibly being used to facilitate money laundering, terrorist financing or other illicit financial activities. Noncompliance can have serious consequences, which is one reason examiners spend significant time reviewing this area.
http://www.richmondfed.org/srperspectives/article3.cfm

Supervison and Reporting for Savings and Loan Holding Companies

By David Powers and Tim Pudner

Effective July 21, 2011, Title III of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) transferred the supervisory authority of savings and loan holding companies (SLHCs) from the Office of Thrift Supervision (OTS) to the Federal Reserve (Fed). Since the enactment of the law 18 months ago, two dedicated supervisory teams were created at the Richmond Fed. These teams have visited SLHCs and coordinated with other regulators to learn about the unique aspects of these holding companies and their subsidiaries. The teams have also collaborated closely with Federal Reserve System colleagues, as well as the local Legal and Statistics departments to help ensure a smooth transition to Fed oversight.
http://www.richmondfed.org/srperspectives/article4.cfm

Are Student Loans the Next Bubble?

By Ibrahim Ergen

The total volume of student loan debt has skyrocketed in the last decade, growing on average more than 10 percent annually. This article is intended to provide insights into the student loan segment of the credit market by providing information on the supply and demand dynamics, as well as the recent performance of the loans.
http://www.richmondfed.org/srperspectives/article5.cfm

Issues Tracking and the Internal Audit Function

By Patrick Holden

Many institutions continue to be challenged with implementing and maintaining comprehensive issues tracking routines, and these challenges are oftentimes cited by examiners in examination reports as matters requiring attention.
http://www.richmondfed.org/srperspectives/article6.cfm

Examiner's Corner

This section highlights examiner insights and sound practices gained from examinations of community banks within the Fifth District.

Information Technology — Authentication in an Evolving Cyberthreat Environment

Due to heightened and evolving cyberthreats in the online environment, regulatory agencies have issued SR 11-9 (Interagency Supplement to Authentication in an Internet Banking Environment), which updates the 2005 guidance of the same name and stresses the importance of implementing more refined alternative approaches to detect and respond to suspicious activity.

This guidance clarifies and increases supervisory expectations in the areas of online activity risk assessments, customer authentication, layered security controls, and customer awareness and education programs. The guidance speaks directly to the sufficiency of certain techniques currently in use, such as challenge questions and simple device identification, and offers alternative approaches to better safeguard against cyberthreats that continue to change with increasing speed. While none of the controls suggested by the guidance provides absolute assurance in preventing or detecting an attack, it does suggest the possible implementation of specific controls.

The agencies acknowledge that not all online transactions pose the same level of risk. Financial institutions should apply more robust controls for transactions with increased risk levels. Although there are multiple ways to authenticate, institutions should ensure that controls are commensurate with the level of risk associated with the online transactions' risk exposures. Institutions should also ensure that they have considered the additional controls and exposures addressed in the SR letter, as examiners will follow up to gauge compliance.

Consumer Affairs: Home Mortgage Disclosure Act

Regulation C — Home Mortgage Disclosure Act (HMDA) — requires a covered institution to complete a Loan Application Register (LAR) with applicant and transaction data for certain mortgage loan applications and to report this information to its regulator. Examiners test reported data, and when error levels exceed certain thresholds, the data must be corrected and resubmitted. Ex-post correction of data can be time-consuming and expensive; therefore, a bank should consider proactive steps to improve the HMDA data collection process. All business lines, such as commercial lending, must be included so that any loans subject to reporting are captured. Internal controls, such as training and monitoring, are important tools for preventing, identifying and correcting errors. Smaller institutions that manually collect and maintain data may find that centralized data collection and validation can be an effective control for improving data accuracy. Some larger reporters might consider utilizing automated systems that integrate the loan application, loan processing and data collection functions to populate the LAR. Regardless, testing of data for accuracy before it is reported is critical.

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

Fifth District Indicators*

3Q 2011

⇧	**Annual Balance Sheet Growth** After a prolonged period of marginal contraction since the beginning of the recession, community bank balance sheets began experiencing gradual expansion in 2011 that continued through the third quarter. Specifically, year-over-year percent change in total assets increased from 3.38% in the first quarter to 4.64% by the third quarter. Percent change in total loans also improved from a 1.15% year-over-year change to 1.57%.
⇔	**Credit Quality** Though the levels of nonperforming loans and loan losses remain significantly high as compared to pre-recessionary time periods, credit quality trends exhibit slight stabilization. Although overall loan losses increased in the third quarter, certain loan categories including CLD, commercial, consumer and real estate losses stabilized. Nonperforming levels as a percentage of total loans declined.
⇔	**Capital** Capital levels remain stable as the average leverage ratio hovers around 10%, Tier 1 risk-based capital ratio around 15% and total risk-based capital ratio around 16%. While the average bank stands firmly in well-capitalized status according to PCA guidelines, ratios have been unable to gain upward traction since declining during the recession.
⇧	**Liquidity** Liquidity ratios showed signs of improvement in the third quarter as evidenced by efforts to enhance core deposits and decrease reliance on noncore funding sources. The average community bank's ratio of loans as a percentage of deposits continues to decline, rounding out at approximately 90% in the third quarter. Though this downward trend has been ongoing since 2008, previous declines were largely driven by shrinking balance sheets. More recently, however, as balance sheets have begun to show signs of marginal growth, liquidity ratios improved as a result of increasing core deposits.
⇩	**Non-Core Funding Dependence** Before the 2008 recession, reliance on noncore funding at community banks gradually trended upward over almost a decade. This trend reversed at the start of 2009 and continued to decline through the third quarter. Since peaking, noncore funding, such as FHLB advances and brokered deposits, has declined by approximately 40%. FHLB advances declined from 5.87% to 3.5% of total assets while brokered funding fell from 10% to 6% of total assets.

Source: Consolidated Reports of Condition and Income.
**Fifth District Community Banks defined as those with Total Assets under $1 Billion*
http://www.richmondfed.org/banking/supervision_and_regulation/newsletter/2012/spring/pdf/5th-dist-ind.pdf

Recent Guidance

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

SR 12-3
Interagency Guidance on Allowance Estimation Practices for Junior Lien Loans and Lines of Credit
http://www.federalreserve.gov/bankinforeg/srletters/sr1203.htm

SR 12-2
Questions and Answers on Interagency Advisory on Interest Rate Risk Management
http://www.federalreserve.gov/bankinforeg/srletters/sr1202.htm

SR 11-15
Disposal of Problem Assets through Exchanges
http://www.federalreserve.gov/bankinforeg/srletters/sr1115.htm

SR 11-14
Supervisory Expectations for Risk Management of Agricultural Credit Risk
http://www.federalreserve.gov/bankinforeg/srletters/sr1114.htm

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

CA 12-1
Second Extension of CRA Consideration Period for Community Development Activities in Hurricanes Rita and Katrina Disaster Areas for an Additional 36 Months
http://www.federalreserve.gov/boarddocs/caletters/2012/1201/caltr1201.htm

CA 11-8
Revised Interagency Examination Procedures for Regulation Z
http://www.federalreserve.gov/boarddocs/caletters/2011/1108/caltr1108.htm

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

Quick Links

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2012 Credit Markets Symposium
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