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CENTRAL Banker

NEWS AND VIEWS FOR EIGHTH DISTRICT BANKERS

FEATURED IN THIS ISSUE: Growth in Noncore Funding | Collapse of the Shadow Banking System

How To Use the Fed's Discount Window

Traditional and New, Temporary Lending Programs Fit Specific Needs

By Kim Nelson

In just a little over a year, the Federal Reserve's discount window has become a popular option for many banks interested in temporary alternative funding sources.

If you're thinking of tapping into a temporary funding program for your financial organization, here is a quick review. The purpose of the discount window is to act as a safety valve to relieve pressures in the market for reserves. Normally, the discount window relieves temporary liquidity strains for depository institutions and the banking system; it is not intended to provide longer-term funding (with the exception of the very small seasonal credit program). However, because of the significant stress in the financial markets that started in August 2007, the Fed's Board of Governors expanded discount window credit programs to provide longer-term liquidity to the financial system.

The Fed introduced several temporary programs for banks first. These included Term Primary Credit, which makes funding available for 90 days, and the Term Auction Facility, which makes funding available for up to 84 days. These programs are available only to financial institutions that are in "generally satisfactory" financial condition. The loans come with essentially the same requirements as a traditional discount window loan,



although loans exceeding 28 days must have an excess margin of collateral for contingency short-term borrowing purposes.

After introducing the temporary programs for banks, the Board of Governors in March 2008 began exercising its authority under Section 13(3) of the Federal Reserve Act, which allows the Fed to extend credit to individuals, partnerships and corporations during what the Board determines to be "unusual and exigent circumstances." Generally, an "unusual and exigent circumstance" presents risk of systemic insolvencies. No loans had been made under this provision since the Great Depression era of the 1930s.

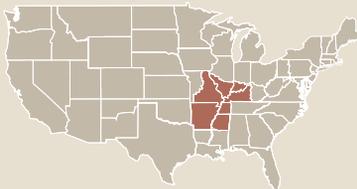
The Fed established two Section 13(3) programs to help with the resolution of specific financial entities: Bear Stearns and American Insurance Group (AIG). Other Section 13(3) programs were

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The Eighth Federal Reserve District includes all of Arkansas, eastern Missouri, southern Illinois and Indiana, western Kentucky and Tennessee, and northern Mississippi. The Eighth District offices are in Little Rock, Louisville, Memphis and St. Louis.



Looking for Regulatory Information in Troubled Times?

We're Here To Help

By Julie Stackhouse

At the St. Louis Fed, we're committed to the goal of being the quality regulatory agency in the Midwest.

One of the ways that we work toward our goal is to provide quality information to banking organizations when it is needed most. We offer a number of programs for your participation:

- **Ask the Fed.** This one-hour monthly conference call-in program provides senior banking officials with critical information on recent financial and regulatory developments. Topics since November 2008, when this program began, have included origins of the mortgage crisis, new developments in the federal funds market, changes to the Fed's payment system risk policy and an economic update by St. Louis Fed President Jim Bullard.
- **Examiner advisory visits.** By request, seasoned Fed examiners will visit state member banks or bank holding companies to discuss Bank Secrecy Act matters, loan-loss reserve issues, flood insurance, fair lending, Home Mortgage Disclosure Act data submission and other matters. These informal advisory visits are often beneficial to new compliance officers and staff as a matter of introduction and personalized training.
- **Regulatory reports consultation.** At your request, our staff will conduct an on-site tuneup for your institution's regulatory reporting needs. Benefits include improved report accuracy, access to in-person training, and in-depth analysis and data verification.
- **Fed officials' visit.** Periodically, Banking Supervision officers will visit your area to meet with small groups of senior officials from state member banks. This informal forum has been well-received as a unique opportunity for frank and informal discussion on matters that are most important to you, such as regulatory burden.
- **Visit to the St. Louis Fed.** We invite you to come to our offices and meet with me and other officials in our Banking Supervision function. This program is especially beneficial for new executive officers who need a sound understanding of regulatory operations.

We hope that you will take advantage of one or more of these opportunities. To find out more, contact Patrick Pahl, senior coordinator, Banking Supervision and Regulation division, at 314-444-8858 or patrick.pahl@stls.frb.org.



Julie Stackhouse is senior vice president of the St. Louis Fed's division of Banking Supervision, Credit and the Center for Online Learning.

Performance Ratios Go from Bad to Worse at District and U.S. Banks

By Michelle Neely

A dismal banking environment and a very weak economy continued to wreak havoc on bank balance sheets and income statements in the fourth quarter, resulting in an awfully poor showing in earnings and asset quality at District banks and their U.S. peers.

At District banks, return on average assets (ROA) fell 22 basis points to 0.45 percent in the fourth quarter. ROA was down 49 basis points from its year-end 2007 level. (See table.) Profitability at U.S. peer banks (banks with average assets of less than \$15 billion) plunged in the fourth quarter, resulting in year-end ROA of just 0.15 percent, a 29 basis point drop from its third quarter level and a stunning 90 basis point decline from its year-end 2007 level.

The double-digit declines in ROA in the fourth quarter at both sets of banks were due to large increases in net non-interest expense and loan loss provisions; the average net interest margin stayed flat at 3.79 percent for District banks and 3.82 percent at peer banks.

Loan loss provisions as a percent of average assets climbed to 0.74 percent at District banks and 1.03 percent at U.S. peer banks. The LLP ratio has more than doubled at District banks and has almost tripled at peer banks over the past year.

Despite the large increases in provisions, the coverage ratio (the loan loss reserve as a percentage of nonperforming loans) has tumbled significantly at both sets of banks over the past two years. At year-end 2006, District banks had \$1.78 reserved for every dollar of nonperforming loans; at year-end 2008, the coverage ratio stood at just 84 cents. U.S. peer banks had just 65 cents reserved for every dollar of nonperforming loans, down dramatically from \$1.83 at year-end 2006.

Increases in loan loss provisions and declines in coverage ratios can be traced to continued deterioration in asset quality at District and U.S. peer banks. The ratio of nonperforming

loans to total loans rose to 1.76 percent at District banks and 2.63 percent at peer banks in the fourth quarter. In the District, increases in nonperforming commercial and industrial loans and commercial real estate loans were the main contributors to the rise in the composite nonperforming loan ratio. More than 5 percent of District banks' outstanding construction and land development (CLD) loans were nonperforming at the end of the fourth quarter. At U.S. peer banks, the decline in quality was even more pronounced, with almost 9 percent of outstanding CLD loans in nonperforming status.

Despite the dreary earnings and asset quality numbers, District banks remain on average well-capitalized. At the end of the fourth quarter, only one District bank (out of 700) failed to meet at least one of the regulatory capital minimums. District banks averaged a leverage ratio of 8.99 percent.

Michelle Neely is an economist at the Federal Reserve Bank of St. Louis.

From Bad to Worse

	Q4 2007	Q3 2008	Q4 2008
RETURN ON AVERAGE ASSETS			
District Banks	0.94%	0.67%	0.45%
Peer Banks	1.05	0.44	0.15
NET INTEREST MARGIN			
District Banks	3.89	3.79	3.79
Peer Banks	3.99	3.82	3.82
LOAN LOSS PROVISION RATIO			
District Banks	0.35	0.60	0.74
Peer Banks	0.35	0.77	1.03
NONPERFORMING LOANS RATIO			
District Banks	1.55	1.68	1.76
Peer Banks	1.26	2.19	2.63

SOURCE: Reports of Condition and Income for Insured Commercial Banks

Banks with assets of more than \$15 billion have been excluded from the analysis. All earnings ratios are annualized and use year-to-date average assets or average earning assets in the denominator. Nonperforming loans are those 90 days or more past due or in nonaccrual status.

Noncore Funding Growing in Importance among Most Types of Banks

By Rajeev Bhaskar and Yadav Gopalan

Noncore funding sources have always played an important funding role for banks; however, in the last decade, reliance on them has increased.

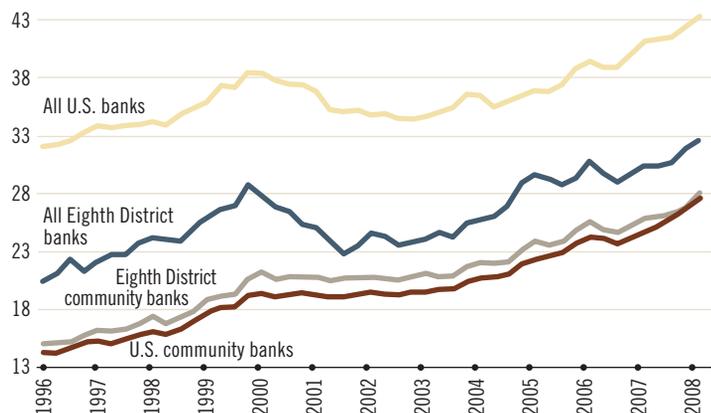
Noncore funding sources include federal funds purchased, Federal Home Loan Bank (FHLB) advances, subordinated notes and debentures, CDs of more than \$100,000 (jumbo CDs) and brokered deposits. Aside from a blip during the 2000-01 recession, reliance on these noncore funds has increased

steadily at banks of all sizes over the last decade. (See Figure 1.)

As the financial services industry has evolved over the past 10 to 20 years, depositors have had the opportunity to invest in the stock market, mutual funds and money market funds. As such, there has been a shift in core deposits away from banks to these alternate investment vehicles, which have potentially higher return. Banks, meanwhile, have experienced tremendous growth in loans over the same period. To keep up, banks have turned to more nontraditional noncore sources of funds.

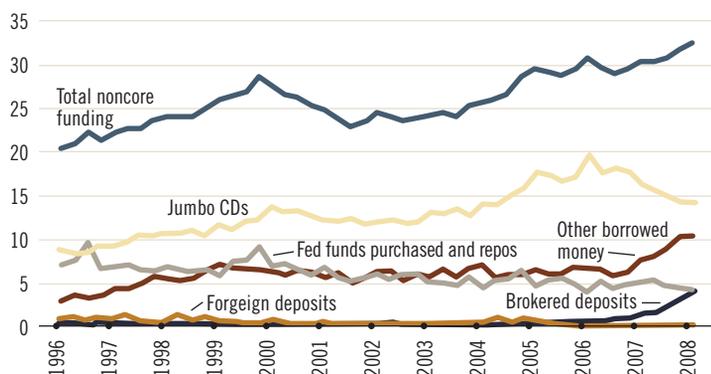
As a percentage of assets, noncore funds are more important to large banks than community banks. Still, the growth in noncore funding has been much faster at community banks.

FIGURE 1
Percentage of Noncore Funds to Total Assets



NOTE: Data were captured on Sept. 30 of each year.

FIGURE 2
Eighth District Noncore Funding Activity as a Percentage of Total Assets



NOTE: Data were captured on Sept. 30 of each year.

All U.S. Banks

For all U.S. banks, average noncore funding as a percentage of total assets has grown by 11 percentage points over the past 12 years. The ratio was 43 percent at the end of September 2008, compared with 32 percent at the end of September 1996. For the larger U.S. banks, which are weighted heavily in all bank averages, foreign deposits make up the largest component of noncore funding, followed by other borrowed money (OBM) and jumbo CDs. Since the credit crisis began, both OBM and brokered deposits have risen sharply. Other borrowed money is a broad category and includes Federal Reserve discount window loans and FHLB advances. The growth in this category is not surprising, given deterioration in the financial sector and banks' sudden inability to access unsecured market sources.

Community Banks

For all U.S. community banks—banks with \$500 million or less in total assets—average noncore funding as a percentage of total assets has doubled over the period, rising from 14 percent

at the end of September 1996 to 28 percent at the end of September 2008. Despite the tremendous growth, this ratio is still much lower than that of all U.S. banks. Jumbo CDs make up the bulk of this funding, followed by OBM. Like the trends at all U.S. banks, there has been a noticeable upsurge in brokered deposits and OBM since mid-2007. However, the growth in jumbo CDs has remained flat over this period.

Eighth District Banks

At most Eighth District banks (mostly community banks), the noncore-funding ratio remains above that of U.S. community banks but less than that of all U.S. banks. Noncore funds as a percentage of total assets rose 12 percentage points from 21 percent in September 1996 to 33 percent in September 2008. Here, too, jumbo CDs comprise the largest component of noncore funds. Figure 2 shows the breakdown of the noncore-funding ratio by component at Eighth District banks over the past 12 years. During the past year and a half, the jumbo CD share has been decreasing while the importance of OBM and brokered deposits has been rising.

Trends at Eighth District community banks have paralleled those at U.S. community banks. In the past, the District's community banks relied on noncore funds (as a percent of assets) slightly more than their peers did. (See Figure 1.) However, peer banks caught up over the past few quarters. The trend lines have merged: Noncore funds to total assets now stands at 28 percent for both U.S. and Eighth District community banks.

As is the case with most banks, both OBM—from the Fed and the FHLB banks—and brokered deposits have spiked during the recent credit crisis.

Rajeev Bhaskar is a senior research associate and Yadav Gopalan is a research associate, both with the Banking Supervision and Regulation division at the Federal Reserve Bank of St. Louis.

Navigate the Financial Crisis with New St. Louis Fed Web Site

Don't get lost amid the stories, events, rumors, analyses and actions surrounding the current financial crisis. Make sense of it all with a new, dynamic St. Louis Fed web site.

The Financial Crisis: A Timeline of Events and Policy Actions site outlines events in financial markets from February 2007 to the present. The web site includes brief descriptions of market events and actions that the Fed and other government agencies have taken, links to relevant St. Louis Fed research papers, and links to press releases, SEC filings, congressional testimony and other primary documents.

The site features charts and data showing the effects of the Fed's new lending facilities. It also answers questions on the causes of the financial crisis and compares the current crisis with the Great Depression.

Interested bankers can subscribe to the site's RSS feed for the latest news and updates. (Look for the Timeline RSS link near the top of the center column.)

"The Federal Reserve and other agencies have taken many steps to contain the financial crisis and limit its impact on the broader economy," said St. Louis Fed President Jim Bullard. "As we begin to move forward, it is critically important that we clearly communicate these actions to better ensure their success."



>>VIEW ONLINE

www.stlouisfed.org/timeline

Bankers Invited To Explore Community Innovation and Financing in Changing Times

Changing economic conditions are presenting new challenges for those working in community development. Financing, particularly in moderate- and low-income areas, is getting more difficult, and understanding how to leverage limited resources is more important than ever.

The Federal Reserve Bank of St. Louis is hosting an April 22-24 conference in St. Louis to address financing, resources and other community development topics. The 2009 *Exploring Innovation in Community Development* conference, "Innovation in Changing Times," will be of interest to bank senior management, directors, loan officers and Community Reinvestment Act officers.

Katherine D. Siddens, U.S. Bank in St. Louis, attended the first *Exploring Innovation* conference, in 2007 "As the community development manager for U.S. Bank, I found the *Exploring Innovation* conference to be extremely beneficial to me, but also truly believe it would be a worthwhile experience for any bank representative who is interested in better understanding community needs," Siddens says. "The information helped me uncover new opportunities to fulfill our CRA obligations and provided affirmation that

bankers can serve as important connectors between the financial industry and the community at large."

Laura Gilbert, a mortgage officer with Commerce Bank in Clayton, Mo., who also went to the 2007 conference, says "The regulators are continually urging banks to be innovative in their response to CRA guidelines. And I welcome any opportunity to meet with other bankers and experts to brainstorm ideas about these issues."

This year's conference will bring together high-level leaders from across the industry to explore best practices, innovative policies, and thinking in community and economic development. Topics will include:

- expanding economic opportunities through financing innovations,
- building wealth in urban and rural areas,
- accelerating regional development, and
- examining the future of community development.

For more information, visit the conference web site at www.exploringinnovation.org. For an invitation, contact Cynthia Davis at 314-444-8761 or communitydevelopment@stls.frb.org.

Discount Window

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established to "unfreeze" securities markets. These programs include the Primary Dealer Credit Facility, the Residential Mortgage-Backed Securities Facility and the Collateralized Debt Obligations Facility.

Finally, the Fed created additional Section 13(3) programs to focus on supporting money market liquidity. These programs include the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, the Commercial Paper Funding Facility and the Money Market Investor Funding Facility.

All of these programs are temporary and will be unwound when the Board

determines that current market turmoil has ended.

Information regarding traditional discount window programs is available at www.frbdiscountwindow.org. Additional details regarding Section 13(3) programs are available by e-mailing the Federal Reserve Bank of New York at general.info@ny.frb.org.

>> MORE ONLINE

www.frbdiscountwindow.org

www.newyorkfed.org/markets/Forms_of_Fed_Lending.pdf

Kim Nelson is a vice president in the St. Louis Fed's Banking Supervision and Regulation division.

The Credit Crunch Reflects Collapse of a “Shadow Banking System”

By Julie Stackhouse and Bill Emmons

Many consumers and business owners are wondering: Have banks stopped lending?

The answer depends on the status of financial institutions. Most banks, especially in the Eighth District, remain in generally sound financial condition and continue the economic necessity of lending to customers with good credit quality. However, some banks are facing severe financial distress, creating a need to preserve capital—which gives the appearance of a credit crunch. To improve their regulatory capital-to-asset ratios, some banks are reducing their total assets on the balance sheet by reducing the amount of loans outstanding. Some banks are improving ratios by raising more capital either privately or through recent government programs if eligibility requirements are met.

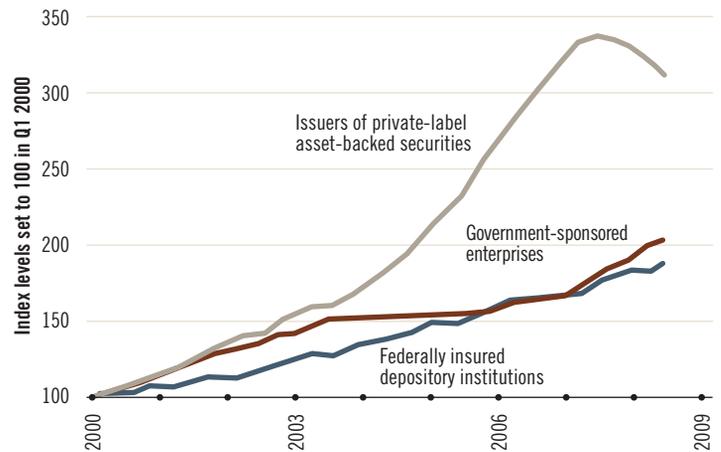
In large part, the reduction in credit availability can be attributed to the partial collapse of the “shadow banking system.”

In its simplest sense, the shadow banking system represents credit instruments that exist outside of the traditional commercial banking system, especially those related to consumer credit. Older parts of the shadow system include financial assets issued through government-supported institutions, such as Fannie Mae and Freddie Mac.

More interesting is the growth in assets in the nongovernment-supported and nongovernment-insured sectors. As shown in the chart, these so-called private label assets grew at a three-fold rate over the past eight years. Some of these financial instruments, including the vast majority of the subprime mortgage market, were high-risk in nature as well. The securities created from these assets were often complex, with poor transparency and sometimes questionable suitability for unsophisticated customers. The intermediaries issuing and trading

FIGURE 1

Financial Assets: Growth Since 2000



the securities included nationally and internationally active investment banks, hedge funds and some insurance companies. Most of these entities were not required to be supervised by banking regulators.

It is this part of the lending market that has collapsed. According to Federal Reserve data, total household loans outstanding (mortgages and other consumer credit) decreased during the six months ending Sept. 30, 2008. This marked the first six-month decline since at least 1952, when comprehensive data first became available.

To the extent that the underpinnings of the shadow banking system were unsound, we should not expect that system to return anytime soon—especially the market for securitized subprime mortgages. For other segments, return of the securitized market will depend on investor confidence and a move toward increased transparency for investors.

Julie Stackhouse is senior vice president of Banking Supervision, Credit and the Center for Online Learning. Bill Emmons is an officer and economist at the Federal Reserve Bank of St. Louis.

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Let Us Know What You Think of the New *Central Banker*

By now, you've noticed that this issue of *Central Banker* features a new look. We've expanded the number of pages, loosened and simplified the design to make articles easier to read, provided more links to related online materials and rearranged some of the items for a more logical flow of information.

Although the design is new, our goal of providing concise banking news from the Fed perspective remains the same. We value your time and want to make sure that our information is easy to absorb and use. You'll get economic research pertinent to the Eighth District; in-depth looks at the facts of banking today; local perspectives on national issues; and explanations about Fed-related topics, such as providing liquidity and community programs.

Your feedback is important, too, and we'd like to hear from you. What topics should we cover? What would you like to know more about? What did you like or not like in an issue?

Send your ideas and suggestions to Scott Kelly, *Central Banker* editor, at scott.b.kelly@stls.frb.org or call him at 314-444-8593.



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