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Central Banker

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News and Views for Eighth District Bankers

How Can Bankers Help Customers through Subprime Mess?

Many consumers who bought a subprime mortgage may now be finding themselves in a world of hurt. They may be realizing that they really couldn't afford to buy that home and shouldn't have refinanced to get the money to pay down credit card debt. Furthermore, they may lose their house if their adjustable rate mortgage goes up.

As an Eighth District banker, how can you help? Use the following resources with your customers:

- The Board of Governors offers a web site with resources on dealing with—and avoiding—foreclosure at www.federalreserve.gov/pubs/foreclosure/default.htm.
- The Fed also created a consumer-oriented site that focuses on general mortgage resources at www.federalreserveconsumerhelp.gov/index.cfm?nav=9493.



- Refer a homeowner suddenly facing foreclosure to 1-888-995-HOPE, a hotline run by a partnership between the Homeownership Preservation Foundation and NeighborWorks America. Read more at www.995hope.org.

In addition, federal and state regulators are working together to conduct targeted consumer-protection compliance reviews of selected nondepository lenders with significant subprime mortgage operations. The pilot project is designed to help improve supervision of subprime mortgage lenders.

On pages 2 and 5 of this issue of *Central Banker*, read about the causes of the subprime mess and some of what you can expect next. ■

St. Louis Fed President Bill Poole To Retire in March

St. Louis Fed President Bill Poole will retire in March 2008 after 10 years as Bank president. A search is under way for his successor.

As Bank president, Poole directs the activities of the Bank's head office in St. Louis and its three branches in Little Rock, Louisville and Memphis. In addition, he represents the Bank on the Federal Open Market Committee (FOMC), the Federal Reserve's chief monetary policymaking body.

Poole has often explained that the anecdotal evidence gathered from industries throughout the Eighth District helps him formulate a clearer picture of the District's overall economic situation, which in turn informs his reports for and decisions at FOMC meetings. Poole

also travels frequently to give speeches on various economic and Bank-related topics.

"For many years, the St. Louis Fed has played a noteworthy role in the formulation of U.S. monetary policy," says Irl F. Engelhardt, chairman of the St. Louis Fed's Board of Directors, who is leading the search committee to identify candidates to succeed Poole. "Our goal is to select a president who will maintain that tradition and help the St. Louis Bank play an important role in the Federal Reserve System as it adapts to a changing operating environment."

Read Poole's complete biography at www.stlouisfed.org/news/press_room/bios.html. □



Feditorial

The Subprime Mess: What's Happening Now and What's Next?

By Julie Stackhouse, senior vice president, Banking Supervision and Regulation

In the summer 2007 issue of *Central Banker*, I talked about why subprime lending is news and will continue to be. At the time, I could not foresee the impact that this specialized type of lending would have on financial markets in general. So, what happened and what's to come?

In August, financial markets stopped functioning normally. While there were many contributing factors, one reason for the market disruption was that investors were uncertain about the extent and ownership losses of subprime mortgage debt securities. The securities are complex, and some owners may not have fully understood their risk.

In response to market uncertainty, the Federal Reserve announced on Aug. 10 its intention to provide extra liquidity through open market operations. Similar operations were also carried out by most other major central banks around the world. Then, on Aug. 17, the Federal Reserve temporarily reduced the primary credit rate at the Fed's discount window to 50 basis points above the target federal funds rate and made available extended-term financing.

The challenges in the financial markets created uncertainty for the economic outlook. In response, the Federal Open Market Committee also reduced the target for the federal funds rate on Aug. 17 by

50 basis points to "help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and to promote moderate growth over time."

The financial markets have since stabilized somewhat. Nonetheless, many challenges remain. The origination of subprime mortgages has come to a standstill. At the same time, we are seeing a clear uptick in mortgage delinquencies—even before the subprime market hits the peak of mortgage rate resets! Moreover, housing inventories in many parts of the country are significant—including here in the Eighth District—and a number of communities are facing real housing price declines.

What does this mean for community banks? First, community banks are scouring their securities portfolio to understand what investment, if any, they have in non-GSE mortgage-backed securities. If so, they are attempting to define any impairment in value. Second, community banks are paying special attention to the risk management of their construction and land development portfolios. When the housing market faces pressure, so will developers and builders.

The next year or two will present challenges not faced by the industry in quite some time. To quote the Missouri Bank Commissioner, it will be "important to get the fundamentals right!" ■

New \$5 Bill To Circulate in Early 2008

The newly redesigned \$5 bills will be safer, smarter and more secure, according to the U.S. Treasury. The Treasury introduced the updated design in September and will circulate the new bills in early 2008.

"The new bills will be harder to fake and easier to check. They'll also stay ahead of savvy counterfeiters and be more secure to protect the integrity of U.S. currency," says Rich Harper, manager of Cash operations at the St. Louis Fed. "The new design incorporates features that are more difficult for counterfeiters to reproduce well; so, they often do not try and hope that cash handlers and the public won't check their fake money."

Two new design features will help deter counterfeiters:

- The \$5 bill will include two watermarks: one is a large 5 to the right of Abraham Lincoln's portrait; the other is a column of three 5s to the left of the portrait.
- The embedded security thread will be moved to the right of Lincoln's portrait. The letters "USA" followed by the number 5 will run in a pattern along a thread that is visible from both sides of the bill.

Help prepare cash handlers and consumers to recognize the new design and protect themselves against counterfeits. Download or order free educational materials (available in multiple languages) at www.moneyfactory.gov/newmoney. ■

Decade Sees Growth in State Member Banks Seeking Fed Supervision

The number of state-chartered banks choosing Federal Reserve membership is growing in the Eighth District.

Mergers and acquisitions have reduced the *total* number of banks both District- and nationwide over the past ten years; however, the ranks of state-member banks increased. There were 72 state member banks in 1998 and as of late October, there are 95. This translates to 12.6 percent of the District’s total number of banks, up from 7.8 percent in 1998.

What’s behind the growth?

One major reason is that the Fed offers consistency to financial organizations by having all supervision conducted by the Fed. By law, the Fed automatically regulates bank holding companies, but not their bank subsidiaries. In the Eighth District, the Fed supervises more than 550 bank holding companies that own approximately 700 subsidiary banks—most of which are regulated by different federal agencies.

The desire for a common regulator spurred Home Bancshares Inc., based in Conway, Ark., to re-evaluate the supervisory situation for its several bank subsidiaries in Arkansas and Florida. Says Ron Strother, president, CEO and director of Home Bancshares, “As our number of affiliates began to grow at Home Bancshares, the burden of dealing with multiple regulators was also increasing. In an effort to streamline and simplify our processes, the management team evaluated the attributes of becoming a Fed member banking organization.

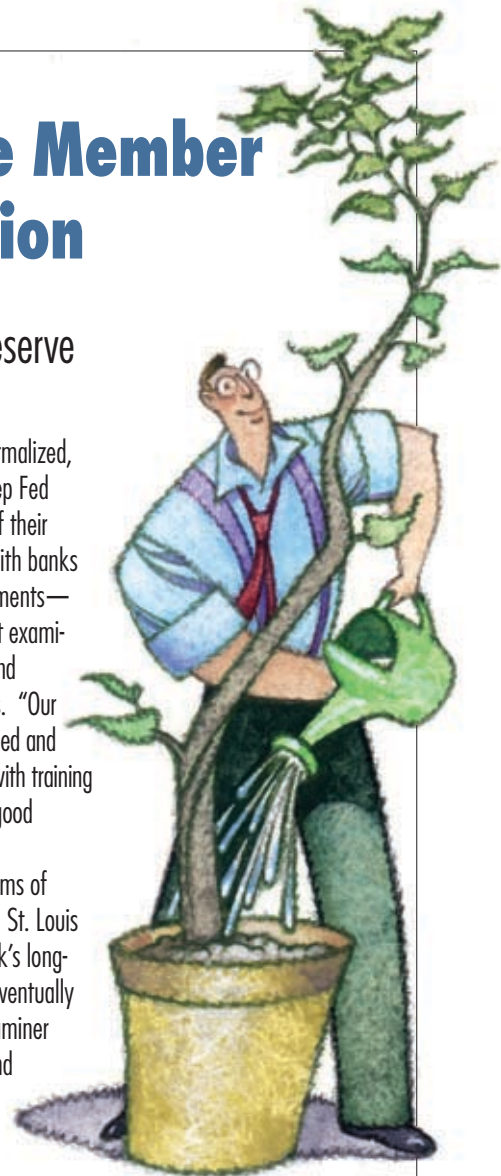
“By reducing our number of regulators to two, the Arkansas State Bank Department and the Fed, we found consistency, thoroughness and a common knowledge of our strategic direction,” Strother says. “We have been very pleased with our move.”

Says Dennis Blase, assistant vice president in Banking Supervision & Regulation at the St. Louis Fed, “We work hard to be accessible and responsive in terms of timeliness and getting answers to questions,” he says. “With safety and soundness the primary focus of bank examinations, making certain that bankers have an approachable and fast-responding supervisor is critical.”

The Fed strives to make sure to maintain good working relationships with all seven state banking departments in the Eighth District, explains Blase. He refers to the departments collectively as “our regulatory partners.”

The Fed provides formalized, ongoing training to keep Fed examiners at the top of their game when working with banks and state bank departments—and to help ensure that examinations run smoothly and deliver in-depth analysis. “Our examiners are well-trained and very experienced, and with training and experience comes good judgment,” Blase says.

While functional teams of examiners are based in St. Louis and Memphis, the Bank’s long-range strategy might eventually include supervisory examiner offices in Little Rock and Louisville, according to Blase. ■



Number of State Member Banks Per Year in the Eighth District:

Number	Year
95	2007 (as of Oct. 19)
92	2006
85	2005
80	2004
77	2003
75	2002
79	2001
80	2000
75	1999
72	1998

Regional Roundup

Check Customer Service Call Centers Consolidate

The Federal Reserve consolidated the Check Services call center in October into a national customer service center located in the Fourth District (the Cleveland Fed). The toll-free number you are accustomed to dialing (1-866-433-3227) remains the same for now; your calls are being automatically routed to the new call center. Although the voices on the other end of the line are new, the customer service experience you count on remains the same. ■

Study Examines Joblessness Concentration

Between 1980 and 2000, America's urban neighborhoods became increasingly polarized into high- and low-unemployment areas. Fed research economist Christopher Wheeler presents his findings in *The Rising Residential Concentration of*

Joblessness in Urban America: 1980 to 2000.

Wheeler studied neighborhood-level unemployment in more than 360 U.S. cities, including Little Rock, Louisville, Memphis and St. Louis. Access the report at www.stlouisfed.org/community/assets/pdf/wheeler_report_July07.pdf. ■

Bankers among Execs Named to New Fed Advisory Council

The St. Louis Fed has created a Community Development Advisory Council to provide a dependable line of communication between the Fed and the public regarding community development issues.

The council will meet twice annually and advise the Bank's president and Community Affairs officers and staff members on activities, issues and barriers to community development in the District. They will discuss ways the Bank can help with community development efforts,

encourage effective use of District resources and more.

Council members are executives from 13 organizations representing nonprofits, financial institutions, universities, government and foundations from throughout the District. ■

Fed Will Cut Check 21 Fees in 2008

Fees for Check 21 deposits that go to electronic recipients will decrease by 3 percent in 2008, while paper-check deposit fees will increase by 12 percent. Both these measures are meant to encourage consumers to choose electronic check processing options.

The Fed's priced services will increase about 3 percent in 2008, which reflects an approximate 5 percent rise in check-service fees and an 8 percent decrease in fees for the Fed's electronic payment services. Read more at www.federalreserve.gov/newsevents/press/other/20071106a.htm. ■

Use the Fed's Discount Window for Immediate Short-Term Needs

The Federal Reserve's discount window is a ready funding source that is available on short notice for financial institutions needing to meet temporary shortages of liquidity. Credit can be accessed when other sources are not available, such as late in the afternoon or during tight market conditions. All loans must be fully collateralized. The discount window accepts a wide array of collateral.

Types of credit include the following:

- **Primary credit** is available to sound depository institutions normally on a very short-term basis—typically overnight—on a “no questions asked” basis. The rate is 100 basis points above the Fed's target rate for fed funds. The use of primary credit strengthens an institution's funding options, especially in contingency situations. In response to recent tightness in the mortgage funding markets, the terms were changed to allow for maturities of up to 30 days and at a rate only 50 basis points above the federal funds target. These terms will remain

available until the Federal Reserve determines that market liquidity has improved.

- **Seasonal credit** is designed to assist small depository institutions (typically under \$500 million in total assets) in managing significant seasonal swings in their loans and deposits. Seasonal credit is available to depository institutions that can demonstrate a clear pattern of recurring intra-yearly swings in funding needs at a market-based rate for maturities up to nine months.
- Other credit consists of **secondary credit**, which is available to depository institutions that are not eligible for primary credit at terms that are more restrictive; and **emergency credit**, which is made available only in unusual and exigent circumstances.

For more information and required legal documentation, go to www.frbdiscountwindow.org or call the St. Louis Fed's credit office at 1-866-666-8316. ■



Richard G. Anderson is vice president of Research at the Federal Reserve Bank of St. Louis.

Subprime: What Were They Thinking?

By Richard G. Anderson

A year ago, few had heard the phrase “subprime mortgage mess.” Today, a Google search for this phrase returns more than 150,000 hits. Defaults and foreclosures on subprime loans have soared, and some analysts have suggested the wealth effects might reduce economic growth. How did this happen? What were mortgage originators thinking when they originated so many loans to homebuyers now unable to repay?

The seeds of the subprime mortgage problem, in part, are international. During 2003 and 2004, large surpluses of savings were evident in the Far East (including China), in oil-exporting areas and in many developing countries. International investors hungry for yield and safety sought U.S. Treasury securities and agency-issued (Fannie Mae and Freddie Mac) mortgage-backed securities (MBS). This phenomenon was cited by many, including then-Fed Chairman Alan Greenspan and then-Governor Ben Bernanke, as a factor behind lower-than-anticipated long-term U.S. interest rates. One factor driving this higher savings rate was developing countries’ desire to build foreign exchange reserves in the aftermath of currency crises in Thailand, Brazil, Argentina, Mexico and elsewhere. To do so, developing countries purchased financial assets denominated in the currencies of countries unlikely to be engulfed by a currency crisis, including the United States, France, Italy, Spain, Australia and the United Kingdom. These purchases supported the developed countries’ exchange rates and, in turn, encouraged a deterioration in their current account balances.

These countries all experienced substantial increases in house prices, housing investment and household wealth.¹

Into this market stepped U.S. investment banks. The investment banks’ innovation was to expand the sale of private-label MBS and derivatives backed by pools of mortgages. The role of the mortgage broker/lender was to originate new loans and sell them to the securitizing firms. Customers for new mortgage loans were not difficult to find. Mortgage brokers advertised heavily, attracting families who doubted they ever would be able to buy a house. Mortgage lenders knew they would not hold the paper they originated. They knew that the buyers of the mortgages were casual with regard to quality and that serious recourse against the lender for future delinquencies was unlikely.

Fault lines in the subprime lending market became visible during late 2006. During late 2005 and 2006, as the pool of higher-quality borrowers had thinned, originators had maintained origination volume by reducing lending standards. Between 2003 and 2006, for example, the share of subprime loans made with little or no documentation of income approximately doubled and the share of piggyback loans (two mortgages, combined to cover 100 percent of the purchase price) quadrupled. During the same period, early delinquency rates—payments more than 60 days in arrears during a loan’s first five months—increased. In some cases, such delinquencies triggered contract provisions requiring that originators repurchase the loan from the upstream investor. Some originators exited the business, often via bankruptcy. As subsequent losses mounted for investors, including hedge funds and some banks, the subprime business collapsed.

Proposals to address subprime mortgage problems must recognize that, to date, the cause is excess borrower leverage, *not* rate increases on adjustable rate mortgages; loans originated during 2005 and 2006 have not yet reset. Encouraging are anecdotal reports of increased flexibility among some mortgage servicers, including delaying payments, extending the terms of loans and refinancing adjustable-rate borrowers into fixed-rate loans while reducing or waiving prepayment penalties.

Recently, the International Monetary Fund has estimated that there is approximately \$2.3 trillion of subprime-related mortgage derivatives held around the world. The sorting out of the subprime mortgage mess will be a topic of discussion for many more years. ■

ENDNOTE

¹ See Ben Bernanke’s Homer Jones Lecture at the Federal Reserve Bank of St. Louis, April 14, 2005, “The Global Saving Glut and the U.S. Current Account Deficit,” available at www.federalreserve.gov/boarddocs/speeches/2005/20050414/default.htm. See also Alan Greenspan’s speech of Feb. 4, 2005, at www.federalreserve.gov/boarddocs/speeches/2005/20050204/default.htm.

Agencies Propose Rule on Internet Gambling Act

Internet gambling businesses would not be able to accept payments from credit cards, electronic funds transfers and checks under a new rule proposed by federal agencies. The proposed rule, which implements the Unlawful Internet Gambling

Act passed by Congress in 2006, would require U.S. financial institutions to set policies that are reasonably designed to prevent payments being made to gambling businesses in connection with unlawful Internet gambling. Comment on the rule until Dec. 12 at www.federalreserve.gov/newsevents/press/bcreg/20071001a.htm. ■

FedFacts

Agencies Expand Range for Extended On-Site Exams

Federal and thrift agencies earlier this year expanded the range of small institutions eligible for an extended on-site examination cycle. Well-capitalized and well-managed banks and savings associations with up to \$500 million in total assets and a composite CAMELS rating of 1 or 2 can qualify for an 18-month examination cycle, rather than a 12-month cycle.

Until recently, only institutions with less than \$250 million in total assets could qualify for an extended 18-month on-site examination cycle. The rules also make parallel changes to the agencies' regulations governing the on-site examination cycle for U.S. branches and agencies

of foreign banks consistent with the International Banking Act of 1978. Read the rules at <http://edocket.access.gpo.gov/2007/pdf/07-4716.pdf>. ■

HMDA 2006 Data Available

The 2006 data on mortgage lending transactions at financial institutions covered by HMDA (Home Mortgage Disclosure Act) in metro statistical areas is available at www.ffiec.gov/hmda/.

Financial institutions that are HMDA reporters should access their disclosure statements from the site and make this information available in their public files. Institutions should have those statements on file in their home offices and have one copy per branch office (or provide one upon written request). ■

Strategies for Reaching the Unbanked and Underbanked

LITTLE ROCK, ARK.—DEC. 13

This ongoing series gives financial institutions tools to create products and programs for the unbanked and underbanked. The session will explain how banks can use community partnerships to reach the unbanked. Register now by contacting Julie Kerr of the St. Louis Fed's Little Rock Branch at 501-324-8296 or julie.a.kerr@stls.frb.org or visit www.stlouisfed.org/community/conferences.



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