



Central Banker

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News and Views for Eighth District Bankers

Fed Emergency Contact System To Be Deployed in Arkansas

Clear and open communications are often immediate casualties when a natural or man-made disaster hits an area. As a community leader, you'd want your financial institution up and running again as quickly as possible to help your area return to normal. You may not have the time or the people to address the informational needs of regulators.

The Federal Reserve will provide help through an online tool that will initially be deployed to Arkansas state-chartered banks later this year. The Fed and the Arkansas State Bank Department will use the new Emergency Communications System (ECS) to contact financial institutions quickly and simultaneously during a crisis, gather basic information from institutions and provide them with information on state and Fed regulatory actions. Because the tool is designed to be self-service, the institutions will determine what key personnel should be contacted.

The concept of an ECS grew from discussions between the Fed and Eighth District bank

commissioners. "The tool is for crisis

and contingency purposes only, and the information would never be used for marketing," says the Fed's John Hussey, who is overseeing the tool's development. "ECS could also be used for nonphysical disaster situations, such as information on critical activities within the banking system or operational changes affecting state and federal banking regulators."

The Arkansas State Bank Department and two Arkansas banks—Eagle Bank and Trust in Little Rock and Cross County Bank in Wynne—participated in the ECS pilot program.

Future opportunities and partnerships are being explored with the remaining Eighth District states (Missouri, Indiana, Mississippi, Tennessee, Kentucky and Illinois) and other Reserve banks and regulators so that state-chartered banks in those states could use the system as well. ■



District Banks Face Tough Times but Outperform U.S. Peers

By Michelle Neely

Earnings and asset quality at District banks and their national peers remained weak in the second quarter, reflecting general economic malaise and continued deterioration in housing markets.

In the District, return on average assets (ROA) hit a 20-year low in the second quarter of 2008. ROA averaged 0.81 percent—12 basis points below its first-quarter level and 25 basis points below its year-ago level. Still, District

banks significantly outperformed their U.S. peers (banks with average assets of less than \$15 billion); the latter group posted an average ROA of 0.61 percent in the second quarter, compared with 0.81 percent in the first quarter and 1.18 percent a year ago.

District banks' average net interest margin (NIM) held steady at 3.79 percent, while it declined two basis points at peer banks.

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Feditorial

Continuity and Community Interact at the St. Louis Fed

By Jim Bullard, president and chief executive officer of the Federal Reserve Bank of St. Louis

When I settled into my new position as the St. Louis Fed president in April, I knew one of the first things bankers and others in the financial industry would want to know was, what do I think and believe? As we go forward, I'll be sharing those beliefs through various venues.

Before becoming president in April, I was an economist and deputy director of research for monetary analysis in the Research division. (See <http://research.stlouisfed.org/econ/bullard/index.html> for a list of my published work.) I conducted economic analysis in the field of macroeconomics and monetary theory, and worked side by side with former presidents Bill Poole and Tom Melzer, helping them design policies and prepare for the Federal Open Market Committee meetings. Like both Poole and Melzer, I am committed to preserving the strong monetarist tradition for which the St. Louis Fed is known.

In the past several months, I have had the opportunity to share with the public some of my fundamental

beliefs about monetary policy through various speeches I have delivered. (Speeches are available at www.stlouisfed.org/news/speeches.html.)

An integral part of my role as president of the St. Louis Fed is to meet with bankers, business leaders and community leaders, particularly from our District, but also from throughout the United States and the rest of the world. This interaction lets me hear your thoughts and concerns about the local, national and international economy. This source of information is highly valuable because your feedback provides me with a picture of the economy—at both the macroeconomic and microeconomic levels—that I can use in my policymaking role. I accomplish this through different economic, educational and community events, such as board of directors meetings, economic forums and business luncheons.

I plan to visit all District branch cities in the coming months; so, watch for invitations or visit www.stlouisfed.org/news/conferences.html. I look forward to meeting and hearing from you in the coming months and years. ■

Fed Establishes New Mortgage Rules for All Lenders

The Federal Reserve Board laid out a new rule in mid-July to better protect consumers and facilitate responsible lending.

This rule is an amendment to the home mortgage provisions of Regulation Z (Truth in Lending). Anecdotal evidence gathered from many sources has indicated that few small and community bankers in the Eighth District engaged in subprime loans. However, as a banker or other lender, here's what you need to know:

- The new mortgage rules apply to all lenders.
- Lenders must evaluate the borrower's ability to make scheduled payments; lenders must also verify the borrower's income and assets.
- Prepay penalties are banned in certain higher-priced loan situations and restricted in others.

- Consumers need to be given disclosures earlier in the process.
- Lenders will be required to establish escrow accounts for higher-than-average interest loans so that property taxes and insurance costs will be included in regular monthly payments.

Fed Chairman Ben Bernanke said in mid-July, "The new rules ... will establish lending standards aimed at curbing abuses while preserving responsible subprime lending and sustainable homeownership. ... We believe the new rules will help to restore confidence in the mortgage market."

See the full details at www.federalreserve.gov/newsevents/press/bcreg/regz20080714.htm. ■

Bank Failures Give Lessons in Missed Basics

By Allen North

The summertime collapse of IndyMac represented the second-largest U.S. bank failure ever. IndyMac, a \$32 billion federal savings bank, based in Pasadena, Calif., was the fifth-largest mortgage lender in the country. Locally, Arkansas experienced its first bank failure in seven years when the Comptroller of the Currency closed ANB Financial of Bentonville on May 9.

Both failures were widely publicized due to the banks' size and overall business strategies. According to published reports, IndyMac suffered a liquidity crisis caused by a deposit run. IndyMac was a large originator of alt-A mortgages, which were often made to borrowers with poor credit. As the secondary market for these loans collapsed, the bank's liquidity became strained.

News reports asserted that ANB lacked the capital to withstand a high level of non-performing loans. ANB had approximately \$1.9 billion in total assets, roughly 90 percent funded with brokered deposits, which are more volatile than core deposits. According to published reports, ANB's past due and nonaccrual loans more than tripled during the six months preceding closure.

The FDIC estimates that the failure of IndyMac will result in a material loss to the deposit insurance fund of approximately \$8 billion, while ANB's failure will amount to a \$214 million loss to the fund.

In light of these failures, let's look at issues that affect a bank's financial condition and what lessons can be learned. The problems typically fall into one or more of the following categories:

- Management forgets/ignores the principle of risk and return.
- Management fails to properly diversify.
- Bank personnel engage in activities that they do not fully understand.

- Management is incompetent, or a fraud is committed.

Banks can often achieve impressive returns—which far exceed peer levels—by employing aggressive growth strategies, such as expanding into unfamiliar markets, lowering overall credit quality or exposing the bank to high-risk commercial real estate concentrations. Often,

funding strategies involve more costly and less stable wholesale funding in the form of brokered deposits.

The volatile combination of aggressive asset growth funded with wholesale sources can create tremendous strains on liquidity and increase the bank's sensitivity to interest rate fluctuations.

A better means of achieving growth is a measured approach with an appropriate funding and risk management strategy established prior to any significant growth.

Boards of directors should give close attention to the time-proven fundamentals of lending during good economic times. Otherwise, issues will inevitably arise when credit conditions deteriorate.

Additionally, boards should pay close attention to the liability side of the bank's balance sheets. Brokered deposits, used within prudent levels, can serve as a legitimate source of funding. However, if asset quality deteriorates and capital ratios fall, prompt corrective action triggers can restrict the renewal of brokered deposits. (For more, see "Prompt Corrective Action: What Does It Mean for a Bank's Liquidity?" in this issue's online-only content at www.stlouisfed.org/publications/cb.)

Boards of all banks should also consider contingent funding plans. Where appropriate, these plans should include completing the required documents and pledging collateral for contingency access to the discount window. (See www.frbdiscountwindow.org for more.) ■

Allen North is an assistant vice president in the St. Louis Fed's Banking Regulation and Supervision division.



Regional Roundup

Foreclosure Forum Set for St. Louis

As part of its Homeownership and Mortgage Initiative, the Federal Reserve is sponsoring a series of foreclosure forums across the country, including one in St. Louis. Called "Recovery, Renewal, Rebuilding," the series is designed to generate discussion on the aftereffects of the foreclosure crisis among business and community leaders, government officials and policymakers.

The forums examine the current state of communities that are experiencing significant foreclosures. Creative solutions for recovering and preparing for the future are explored. National experts discuss the challenges that foreclosures present and engage participants in finding solutions.

The Homeownership and Mortgage Initiative is a comprehensive Federal Reserve strategy to provide information to help prevent unnecessary foreclosures and to stabilize communities affected by the crisis.

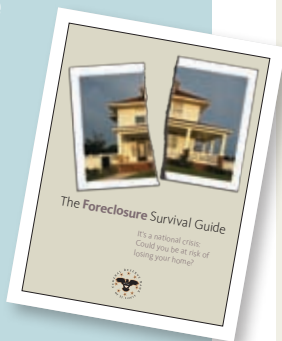
The forum scheduled for St. Louis on Sept. 24 and 25, called Strengthening Neighborhoods in Weak Markets, is open to all interested parties. See www.stlouisfed.org/RRRseries to register.

Banks Can Offer New Foreclosure Survival Guide

Homeowners who are having difficulty making their mortgage payments can get helpful information from *The Foreclosure Survival Guide*, new from the Federal Reserve Bank of St. Louis.

This brochure provides basic information on who is at risk for foreclosure, where to find help and pitfalls to avoid when seeking help. The free publication includes a national hot line number (1-888-995-HOPE) and a list of local counseling agencies that homeowners can call for advice.

Bankers who would like copies of the guide to distribute can call Cynthia Davis of the St. Louis Fed at 314-444-8761 or e-mail communitydevelopment@stls.frb.org.



Tough Times

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Profitability ratios at both sets of banks were brought down by small increases in net noninterest expense and more substantial boosts in loan loss provisions. Loan loss provisions as a percent of average assets (LLP ratio) rose nine basis points to 0.52 percent in the District—almost triple the level of a year ago. At national peer banks, the increase was more pronounced (to 0.71 percent).

Loan loss provision increases reflect, of course, asset quality problems that continue to mount in the District and nation. The ratio of nonperforming loans to total loans was 1.53 percent at District banks and 1.92 percent at U.S. peer banks at the end of the second quarter. The proportion of nonperforming loans has nearly doubled at District banks and has more than doubled at peer banks over the past year.

Problems in the real estate portfolio are primarily responsible for the overall increase: At the end of the second quarter, 1.77 percent of real estate loans were nonperforming at District banks. Within the real estate portfolio, delinquency ratios were most pronounced in construction and land development loans (4.25 percent) and multifamily loans (1.60 percent). Delinquency rates have risen in C&I and consumer portfolios, too. The trends are identical at peer banks.

District banks remain on average well-capitalized. At the end of the second quarter, just one bank (out of 713) failed to meet one of the three regulatory capital ratios. District banks averaged a leverage ratio of 9.11 percent. ■

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

Tougher Times for District Earnings and Loan Quality¹

	2nd Q 2007	1st Q 2008	2nd Q 2008
RETURN ON AVERAGE ASSETS²			
District Banks	1.06%	0.93%	0.81%
Peer Banks	1.18	0.81	0.61
NET INTEREST MARGIN			
District Banks	3.87	3.79	3.79
Peer Banks	3.96	3.85	3.83
LOAN LOSS PROVISION RATIO			
District Banks	0.19	0.43	0.52
Peer Banks	0.22	0.57	0.71
NONPERFORMING LOANS RATIO³			
District Banks	0.89	1.71 ⁴	1.53
Peer Banks	0.83	1.63	1.92

SOURCE: Reports of Condition and Income for Insured Commercial Banks

¹ Banks with assets of more than \$15 billion have been excluded from the analysis.

² All earnings ratios are annualized and use year-to-date average assets or earning average assets in the denominator.

³ Nonperforming loans are those 90 days or more past due or in nonaccrual status.

⁴ Excluding data of ANB Financial brings the 1st quarter NPL ratio down to 1.54 percent.



What Can Be Done about the Widening Income Gap?

By Christopher H. Wheeler

Christopher H. Wheeler is a former Research officer at the Federal Reserve Bank of St. Louis. Access more of his research at <http://research.stlouisfed.org/econ/wheeler/index.html>.

A common mantra among politicians is that the rich are getting richer while the poor are getting poorer. Data point to a dramatic rise in income inequality in the United States between 1980 and 2006.

The findings were published this summer in *Earnings Inequality within the Urban United States: 2000-2006*, which examines hourly labor earnings for 298 U.S. metropolitan areas—including St. Louis, Little Rock, Louisville and Memphis. The full report is available at www.stlouisfed.org/community/assets/pdf/Income_Inequality_report.pdf.

The data on the whole indicate that there is an ever-widening wage gap between those at the top end of the pay scale and workers at the low end. The rise in wage inequality has been driven by such factors as educational attainment, e.g., high school versus post-baccalaureate degrees. Based on an analysis of inequality, some of the most important correlates of rising inequality between 2000 and 2006 were found to be:

- decreasing manufacturing,
- rising fractions of foreign-born workers (which are possibly associated with increased numbers of low-skill workers),
- rising rates of unemployment and

- increased fractions of workers with advanced degrees.

These findings generally support theories that the wage gap is widening because of changes in industrial structure, rising low-skill labor supply and skill-biased technological change.

What Can Policymakers Do?

Evidently, since much of the rise in inequality is associated with the supply of and demand for workers with high levels of skills, inequality is probably best handled by increasing the fraction of workers with high levels of education.

Of course, while helping workers at the bottom end of the distribution acquire human capital would undoubtedly help raise the lower end of the wage distribution, increasing the total supply of highly skilled workers may exacerbate inequality, at least in the short run. An increase in the number of workers with advanced degrees may create even greater bias for the highly skilled and enhance their earnings—while leaving behind those with lesser education.

Over time, however, as workers with high levels of schooling become the majority of the American labor force, the degree of homogeneity among workers increases. In addition, the extent to which employers are forced to bid for relatively few high-skill employees will decrease, dampening growth at the top end of the earnings scale.

Policies aimed at influencing skills are probably more desirable than those attempting to affect what types of industries employ American workers, e.g., subsidizing certain sectors, strengthening trade barriers. Indeed, the decline of jobs in manufacturing represents the confluence of forces well beyond the control of government, forces such as the evolution of technology, the decline of transportation costs and the growing integration of markets around the world.

Therefore, falling wages and the problems associated with workers who have been displaced from this sector are probably most effectively addressed through programs that provide workers with job skills that the American economy now demands, as discussed in the report. Moreover, by augmenting the human capital of all workers in the United States, the ability of individuals to make the transition from one line of work to another is enhanced, with relatively modest losses in earnings. ■

Central Banker Online Looks at Liquidity

Check out this issue's online-only content at www.stlouisfed.org/cb, including the following:

- The Fed's Julie Stackhouse looks at what prompt corrective action means for a bank's liquidity.
- A new Fed web site supports minority-owned institutions and de novo banks.
- The Fed's Community Development Advisory Council is ready to serve.
- Christopher Waller to become St. Louis Fed's director of Research.
- New rules are coming in 2009 for Fed ACH international transactions.
- Innovation Exploration continues in the Eighth District.

CalendarEvents

UPCOMING FED-SPONSORED EVENTS
FOR EIGHTH DISTRICT
DEPOSITORY INSTITUTIONS

Local Business Cycles and Crime Rates

ST. LOUIS—OCT. 29
LITTLE ROCK—NOV. 20
LOUISVILLE—DEC. 3
MEMPHIS—DEC. 9

Fed economist Thomas A. Garrett will discuss his new study on local business cycles and their effect on crime rates. The report includes information on four urban areas in the Bank's district: St. Louis, Little Rock, Louisville and Memphis. Register online at www.stlouisfed.org/community or by contacting the Fed's Cynthia Davis in St. Louis at 314-444-8761, Julie Kerr in Little Rock at 501-324-8296, Lisa Locke in Louisville at 502-568-9292 or Cathy Martin in Memphis at 901-579-4102.

Child Development Accounts: A Research and Policy Symposium

ST. LOUIS—NOV. 12-14
Scholars from around the country will present papers on the national potential of child development accounts, a rapidly emerging idea in the United

States. For information, call or e-mail Washington University's Gena Gunn at 314-935-9651 or ggunn@wustl.edu.

Economics of Ethanol: Costs, Benefits and Future Prospects of Biofuels

ST. LOUIS—NOV. 14
Members of financial institutions and other business leaders are among those invited to a non-technical conference on the economics of ethanol. Session topics include the profitability of ethanol processing, the impact of ethanol subsidies on rural economies, and the effects on food prices and farm production decisions. The St. Louis Fed's Research division is among the hosts for the conference, which will be held at Washington University in St. Louis. For more information, see <http://research.stlouisfed.org/conferences/ethanol/index.html>, or e-mail the Fed's Tom Garrett at tom.a.garrett@stls.frb.org or Washington University's Melinda Warren at warren@wustl.edu.



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