

FEATURED IN THIS ISSUE: Why Are Banks Failing? | Spotlight on Evansville (Ind.) Banks

Congress Considering 15 Regulatory Reform Proposals

Track Financial Reform with New St. Louis Fed Web Site

By Jim Fuchs

If ultimately signed into law, the regulatory reform proposals presented to Congress this summer could significantly alter how financial institutions in the United States are regulated and, in some cases, structured.

Since releasing its regulatory reform white paper June 17, the Treasury Department has submitted more than 15 legislative proposals to Congress. In turn, Congress has held more than 22 hearings, formally introduced two of the bills to a key oversight committee and conducted a full House of Representatives vote on one of them, all in less than six weeks.

The St. Louis Fed created the Reforming the Nation's Financial System Timeline web site (www.stlouisfed.org/regtimeline/) to track the proposals, congressional and regulatory agency hearings and testimony, and committee members' statements.

The most significant proposals as of late August include:

- creation of an eight-member Financial Services Oversight Council to identify and mitigate threats to the financial system;
- elimination of the federal thrift charter and creation of one single national bank supervisor;



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- creation of an independent Consumer Financial Protection Agency to oversee and enforce consumer protection laws and regulations at all financial institutions (except for the enforcement of the Community Reinvestment Act);
- mandatory registration of all credit rating agencies with the Securities and Exchange Commission;
- creation of an Office of National Insurance to issue and collect reports on the insurance industry;
- establishment of uniform de novo branching standards, regardless of charter;
- conversion of industrial loan companies, credit card banks and thrift holding companies to bank holding companies;

continued on Page 7

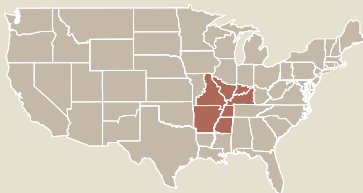
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The Eighth Federal Reserve District includes all of Arkansas, eastern Missouri, southern Illinois and Indiana, western Kentucky and Tennessee, and northern Mississippi. The Eighth District offices are in Little Rock, Louisville, Memphis and St. Louis.



CENTRAL VIEW

St. Louis Fed Stationing Examiners in Little Rock

By Julie Stackhouse

During these challenging times, bankers want answers quickly. And sometimes, there is no substitute for a face-to-face meeting.

State member banks in Arkansas will now find this quick in-person access even easier with the opening of the St. Louis Fed satellite supervision office in Little Rock. The office, staffed with 10 examiners, mirrors an initiative undertaken four years ago, when the St. Louis Fed established a satellite office in Memphis. Bankers in Memphis told us that the local presence enhanced overall communication and supported an effective supervisory process.

Among the many benefits we have seen:

- greater accessibility and quicker response time;
- more efficient opportunities to conduct advisory visits on matters of special interest, such as the Bank Secrecy Act and risk management practices; and
- streamlining of collaboration with the state banking authorities, thereby promoting more consistency and higher quality in our examinations and other supervisory processes.

At the same time, we will continue our other communication efforts, including the monthly “Ask the Fed” program and periodic informational forums for bankers. In these challenging times, it is more important than ever that the St. Louis Fed provide you with the information and answers you need.

For further information on the supervisory duties of the St. Louis Fed, please see www.stlouisfed.org/banking/safety_soundness.cfm.



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

Banks Still Ailing in District and U.S.

By Michelle Neely

Although the U.S. economy has recently shown a few signs of life, the nation's banking industry is still being battered by weak earnings and increasing problems with asset quality.

Aggregate profits at District banks surprisingly rose in the second quarter, albeit by a modest amount. Return on average assets (ROA) increased four basis points to 0.22 percent. For U.S. peer banks (banks with average assets of less than \$15 billion), the news was not even remotely good: ROA declined another 21 basis points to -0.30 percent. For both District and U.S. peer banks, the weakest performers were banks in the \$1 billion to \$15 billion asset range; excluding them, ROA was 0.65 percent at District banks and 0.15 percent at U.S. peers.

The profitability improvement at District banks was driven by a slight uptick in the net interest margin (NIM), which increased three basis points to 3.66 percent. Net noninterest expense also declined, which more than offset the modest increase in loan loss provisions. The average NIM at U.S. peer banks also rose, but that increase was dwarfed by a large increase in the loan loss provision ratio and a moderate increase in the net noninterest expense ratio.

Loan loss provisions as a percent of average assets increased three basis points to 0.93 percent at District banks in the second quarter. For U.S. peer banks, the hike was more substantial, as the LLP ratio rose 18 basis points to 1.49 percent. Despite the additions to reserves, the coverage ratio fell again at both sets of banks. At the end of the second quarter, District banks had 70 cents reserved for every dollar of nonperforming loans, down 4 cents from the prior quarter and 20 cents from a year ago. At U.S. peer banks, the coverage ratio declined 3 cents from the first quarter and stood 22 cents below its year-ago level.

As indicated by the increasing loan loss provisions and declining cover ratios, asset quality continues to worsen at both sets of banks. Nonperforming loans as a percentage of total loans hit 2.44 percent at District banks in the second quarter, up 25 basis points from the first quarter and 91 basis points from a year ago. For U.S. peer banks, the picture is bleaker, as 3.77 percent of loans were nonperforming at the end of the second quarter, up 46 basis points from the first quarter and 185 basis points from the second quarter of 2008. All major categories of loans (commercial, consumer and real estate) had higher delinquencies in the second quarter at both sets of banks.

Commercial real estate (CRE) lending continues to be the area of greatest concern. CRE loans make up almost half of total loans at District and U.S. peer banks. Therefore, problems in this sector have a major effect on overall results. Within CRE, construction and land development (CLD) loans are the most troubled. In the District, 7.35 percent of CLD loans were

continued on Page 7

When Will Woes Be Gone?

	Q2 2008	Q1 2009	Q2 2009
RETURN ON AVERAGE ASSETS			
District Banks	0.81%	0.18%	0.22%
Peer Banks	0.60	-0.09	-0.30
NET INTEREST MARGIN			
District Banks	3.79	3.63	3.66
Peer Banks	3.83	3.56	3.58
LOAN LOSS PROVISION RATIO			
District Banks	0.52	0.90	0.93
Peer Banks	0.72	1.31	1.49
NONPERFORMING LOAN RATIO			
District Banks	1.53	2.19	2.44
Peer Banks	1.92	3.31	3.77

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.

Why Are Banks Failing?

By Jim Fuchs and Tim Bosch

Bank closings are now front-page news in many small communities, with 81 occurring so far this year (as of Aug. 21). Even small towns like Winchester, Ill. (population: 1,650), have experienced the transition of a failed bank to new ownership.

Although today's challenges are great, the four underlying reasons for bank failures have not changed from those of years' past, which are:

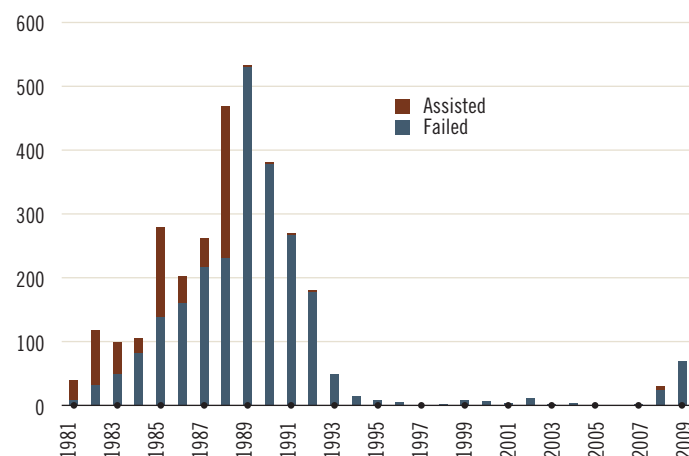
- an imbalance of risk versus return,
- failure to diversify,
- offering products and services that management doesn't fully understand, and
- poor management of risks.

growth into the risky construction and land development (CLD) loan segment was funded through brokered deposits.

On the surface, ANB's loan pricing of the construction and land development loans appeared favorable. Loans were often priced 300 basis points above typical real estate rates. While 300 basis points seemed opportunistic at the time, the rate charged was insufficient for the risk being assumed. A substantially higher premium, perhaps an unimaginable risk premium, would have been necessary to compensate for the lower quality asset.

ANB is an extreme situation. Nonetheless, during strong economic times, the pricing of balance sheet assets is frequently misaligned with the inherent risk acceptance in lending. The result is felt when economic tides turn and losses are experienced.

Number of Failed and Assisted Banks and Thrifts



Source: FDIC website

One: Imbalance of Risk versus Return

The imbalance of risk versus return can best be illustrated through example. In 2008, ANB Financial N.A., Rogers, Arkansas, failed. (See www.treas.gov/inspector-general/audit-reports/2009/oig09013.pdf.) Public data shows that in less than a two-year period, ANB went from being a mid-sized community bank with \$600 million in total assets to a \$2.2 billion institution. The bank's balance sheet showed that most of the

Two: Failure To Diversify

Failure to diversify can occur on both the asset and liability side of the balance sheet. Any concentration of assets by loan category, industry or geography creates the potential for material losses when stress events occur. Choosing *not* to diversify intensifies the need for higher capital ratios.

Diversification needs to occur on the liability side of the balance sheet as well. More than 85 percent of ANB's funding came from brokered deposits. Brokered deposits, while relatively inexpensive, created huge liquidity consequences when the bank's financial condition deteriorated. Prompt corrective action guidelines restricted the renewal of brokered deposits and limited the rates that could be paid on all deposits. In short, ANB experienced an old problem: Liquidity is unavailable when it is needed most.

Three: Failure To Understand Products and Services

A major contributor to today's financial crisis was the failure to fully understand the products in the financial marketplace and their

counterparty risks. Even community banks purchased structured products, such as mortgage-backed securities, presumably designed to lessen balance sheet risk. Banks purchasing the product frequently did not fully understand the composition and risks of the underlying assets, and instead relied on rating agencies or product brokers for the analysis.

Four: Poor (or No) Risk Management

Risk management can be a difficult topic for community bankers who often don't have sophisticated systems in place. In some respects, though, good risk management is simply good management. Good management involves a culture of understanding risks in the institution's operations and how those risks change as product structures evolve, business operations transform, or economic conditions cycle. Good management involves an environment of strong internal controls and high ethical standards on the part of every employee. Good management requires an effort to properly align incentives with performance and to develop appropriate checks and balances through internal audit and board of directors' oversight.

As bank failures are reported over the next few years, each will have its story. Inevitably, the story will reflect one of the themes discussed in this article. Banks that avoid the risk factors will emerge as the survivors in an industry that will end up stronger.

>> ONLY ONLINE

Listen as Tim Bosch discusses how banks can avoid failure at www.stlouisfed.org/publications/cb/

Tim Bosch is a vice president over safety and soundness examinations and Jim Fuchs is a supervisory policy analysis manager in the Banking Supervision and Regulation division at the Federal Reserve Bank of St. Louis.

Key Your Bank into "Green" Finance Sept. 22

Financial institutions interested in exploring "green" financial products, projects and municipal developments can attend Green Finance: Investing in Sustainable, Energy-Efficient Developments from 10 a.m. to 4 p.m. Sept. 22 at the Hyatt Regency in Louisville.

This event will demonstrate how federal, state and local policies, along with new financial products, are providing opportunities for investment in environmentally friendly and sustainable communities. Bankers can learn how investors are considering the financial returns on investments in green projects and the social and environmental returns. Contact the Fed's Emily Lape at 502-568-9282 or emily.k.lape@stls.frb.org to register.

St. Louis Fed's Web Site Revamped

The St. Louis Fed's web site (www.stlouisfed.org) has been revamped and now offers several new features and tools. These features include customizable economic charts and data, including data from the Fed's Little Rock, Louisville and Memphis zones; multimedia features; RSS feeds; an expanded menu of e-mail alert reports; and a new job search tool.



You can find brief videos of St. Louis Fed President James Bullard exploring such topics as exit strategies for the Fed and origins of the crisis, and audiocasts from Fed economists discussing the latest economic data.

Hey, Whatever Happened to That Bank?

Have you ever wondered what happened to a particular bank in the Eighth District? Did it go out of business, change its name or, more likely, merge with another institution? Find out with a handy St. Louis Fed web page that depicts the merger and name change histories of select institutions. The information is presented state by state.

>> GO ONLINE

www.stlouisfed.org/banking/structure/what_happened_to.cfm

Spotlight on Evansville Metro Bank Performance

Data suggest a link between CRE lending and weak bank performance.

By Gary S. Corner and
Rajeev R. Bhaskar

Evansville, tucked away in the southwest tip of Indiana, is the commercial, medical and service hub of the Illinois-Indiana-Kentucky tristate region. The Evansville metropolitan statistical area (MSA) is the 142nd largest in the United States and consists of four Indiana and two Kentucky counties.

A Comparison of Evansville Banks with the Other Eighth District Metropolitan Area Banks, Q1 2009

	Evansville (metro)	Peer Group Average
Number of Banks	12	7.8
Total Assets	\$12,804 million	\$65,409 million
Return on Assets	-0.33%	0.30%
Nonperforming Loans/ Total Loans	3.54%	2.68%
Loan Loss Reserves/ Non Performing Loans	58.09%	62.02%
Tier 1 Leverage Ratio	7.47%	8.68%
CRE to Total Loans	24.25%	30.11%

SOURCES: Call Reports and CensusBureau. Numbers in red indicate unfavorable differences when compared with the averages of other metropolitan areas' banks.

Its strategic location on the Ohio River and close proximity to a number of large MSAs has helped build a broad economic base in the region known for stability and diversity. Major industries include manufacturing, warehousing and distribution, health care, education and financial services. Evansville is home to two universities, the University of Southern Indiana and Evansville University, which together enroll more than 13,000 students and add stability to the employment base.

Although much attention has been paid to economic issues in other areas of Indiana, such as Elkhart (unemployment rate of 17.5 percent), the downturn has affected Evansville, though to a lesser extent. The unemployment rate in the Evansville MSA is 8.7 percent (May) compared with

10.6 percent in Indiana and 9.4 percent for the nation (as of August). Although Evansville does not appear to be experiencing any unique economic shocks, such as large factory closings or losses of company headquarters, it has not been immune to declining real estate values and elevated home foreclosures either.

Banking Analysis

The banking market of the Evansville MSA is made up of 12 locally headquartered banks, 16 banks headquartered outside of Evansville but with a presence in the MSA, and three thrifts. These institutions offer 146 branches in total. A measure of market competitiveness called the Herfindahl-Hirschman Index (HHI) indicates a moderate level of competition for the Evansville market.

Analysis of the aggregate performance of the 12 Evansville-headquartered banks appears to imply relative weakness for the overall market. The asset-weighted return on average assets (ROA) at Evansville banks averaged -0.33 percent in the first quarter, compared with 0.30 percent for peers. Aggregate numbers for asset quality, nonperforming loans and coverage ratio also indicate a weaker banking market compared with the peer markets in the Eighth District.

A look at individual bank performance within the Evansville market, however, reveals that 10 out of 12 banks are actually profitable, and unweighted average ROA is 0.42 percent. Furthermore, all banks have a positive earnings run rate, which means that their net interest income and fee revenue earned more than what covers their operating expenses.

In addition, significant losses at one institution appear to drag down the average profitability of the entire market. The institution with significant losses has a much higher concentration in commercial real estate (CRE) loans (42 percent of all loans) compared with the other Evansville banks. It also has

the highest percent of nonperforming loans (7.8 percent), most of which are in the CRE portfolio. Most other banks in Evansville are performing well and have limited CRE exposure, so there does appear to be an association between CRE exposure and bank performance. CRE portfolios at U.S. banks have witnessed higher loss rates in recent times than most other loan types.

In conclusion, economically the Evansville MSA has fared at par with its peer group in this economic downturn. Aggregate bank performance, at first glance, appears relatively weaker. But most banks in the MSA are actu-

ally performing well, with 10 out of 12 being profitable. Significant losses and weak performance at one bank have pushed the market's average performance metrics below peer markets. A closer examination of the individual bank performance seems to suggest an association between high CRE exposure and weak performance.

Gary Corner is a senior examiner and Rajeev Bhaskar is a senior research associate of the Banking Supervision and Regulation division at the Federal Reserve Bank of St. Louis. Intern Connie He provided data support.

Regulatory Reform Proposals

continued from Page 1

- granting new authority for the Fed to supervise all firms, regardless of structure or charter, that pose a threat to financial stability; and
- creation of a new resolution regime for financial institutions deemed systemically important (identified as Tier 1 financial holding companies).

The consumer agency proposal would require nationally chartered banks to comply with state consumer protection laws and regulations if the state requirements would offer a higher level of consumer protection than those of the new agency.

Before Congress' August recess, only two pieces of legislation had been formally introduced into the House Financial Services Committee: the consumer agency proposal and a bill on executive compensation, which would give shareholders of publicly traded companies a greater say on executive pay. The House passed the compensation bill July 31.

Jim Fuchs is supervisory manager in the St. Louis Fed's Banking Supervision and Regulation division.

Quarterly Report

continued from Page 3

nonperforming at the end of the second quarter. For U.S. peer banks, the ratio topped 13 percent. Poor CLD loan performance is spread among banks of all sizes. District banks with assets of less than \$1 billion had a 6.46 percent nonperforming ratio.

This tough environment has not had a substantial effect on regulatory capital thus far. At the end of the second quarter, just six banks (out of 689) failed to meet at least one of the regulatory minimums. District banks averaged a Tier 1 leverage ratio of 8.94 percent, well above the 4 percent minimum for that ratio.

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



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