WINTER 2009

CENTRAL Banker

NEWS AND VIEWS FOR EIGHTH DISTRICT BANKERS

FEATURED IN THIS ISSUE: A Four-Part Examination of CRE Lending and Debt Problems

Commercial Real Estate Lending Challenges Banks in District

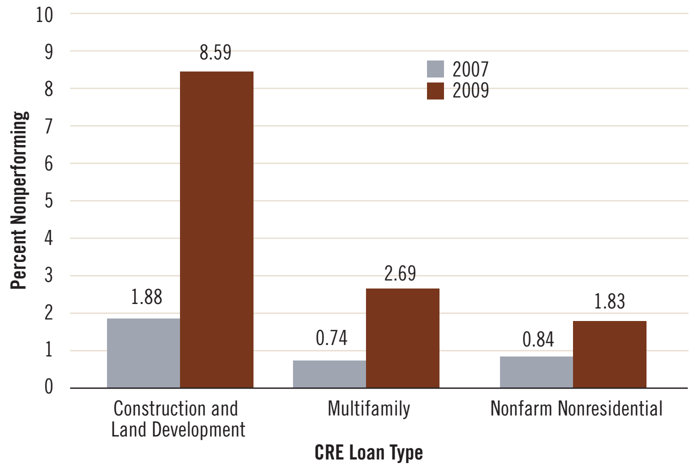
By Michelle Neely

The importance of commercial real estate (CRE) lending to U.S. banks—especially community banks—is difficult to overstate. According to Federal Reserve data, the nation's commercial banks hold almost half of U.S. CRE debt outstanding. CRE lending has especially edged up in significance at the nation's community banks as other types of consumer and business lending have been lost to competitors. Now that conditions in commercial real estate sectors have deteriorated, banks face the possibility of significant losses.

Unlike the last commercial real estate crisis in the late 1980s/early 1990s, problems this time stem from a lack of demand rather than massive overbuilding that was spurred by tax law changes, among other factors. Coming on the heels of tremendous losses in residential real estate, the downturn in CRE markets is the proverbial second blow of the one-two punch that has staggered the nation's banking industry.

Though not as severely affected as banks elsewhere, Eighth District banks have not been immune to real estate woes. Earnings have rebounded somewhat over the past few quarters (see "Profits Up at District Banks" on Page 3), but continued increases in nonperforming rates across all categories of CRE loans (i.e., construction and land development, multifamily, and nonfarm nonresidential) threaten further improvement. As of Sept. 30, CRE loans made up 43.5 percent of total bank loans at District banks yet accounted for 63.4 percent of all nonperforming loans.

What a Difference Two Years Make: Nonperforming CRE Loans at District Banks



SOURCE: Call Reports. Figures are from third quarter 2007 and third quarter 2009.

The rapid deterioration in CRE portfolios over the past two years is illustrated in the figure. The ratio of nonperforming construction and land development (CLD) loans to total CLD loans (which includes residential as well as commercial construction) has skyrocketed since September 2007 and is approaching double digits. (It's near 14 percent for U.S. peer banks.)

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CRE AND DEBT PROBLEMS

PART 1

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Banker

News and Views for Eighth District Bankers
Vol. 19 | No. 4
www.stlouisfed.org/publications/cb

EDITOR
Scott Kelly
314-444-8593
scott.b.kelly@stls.frb.org

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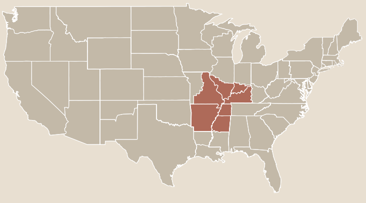
The Eighth Federal Reserve District includes all of Arkansas, eastern Missouri, southern Illinois and Indiana, western Kentucky and Tennessee, and northern Mississippi. The Eighth District offices are in Little Rock, Louisville, Memphis and St. Louis.



CENTRAL VIEW

Too Big To Fail Is Too Big To Ignore

Joel H. James is assistant vice president for external relations and public policy for the Federal Reserve Bank of St. Louis.

In the wake of the global financial crisis, Congress and the administration are reviewing a number of proposals to reform the structure and regulation of the financial industry. In addition, financial regulators are taking action to reign in certain activities to ensure these practices do not undermine the safety and soundness of the banking system.

To be sure, the Federal Reserve's actions and many legislative initiatives seeking to curb suspect banking practices aim to restore the strong and stable foundation on which our nation's financial system was built. Yet one issue that does not seem to have gained the same level of attention within the legislative debate is the question of how to deal with extremely large, financially related and interconnected organizations, whose instability can significantly disrupt operations of the global financial system. Dealing with the "too big to fail" issue, or TBTF, is crucial to meaningful reform of our nation's financial system.

Without question, the inability to deal effectively with TBTF organizations is the problem that jeopardized the functioning of our global financial system—it is that critical. As of this writing, it is simply too early to tell what substantive legislative proposals will take hold and win passage, but it appears that regulatory oversight and reforming consumer protection are getting the most attention. This focus is understandable, as many financial institution customers have in some way been adversely affected by the recent financial turmoil.

However, this crisis uncovered the susceptibility of world economies to the condition of financial institutions that were not only too big, but too big to fail quickly. The lack of clear resolution strategy to manage the rapid deterioration and eventual resolution of TBTF organizations left governments and regulators worldwide scrambling to piece together plans for rescue operations for these firms, financial markets and national economies.

Reform efforts must deal with this issue and in a substantive manner. If we learned nothing else from this crisis, it is that if these kinds of institutions fail suddenly, panic ensues, in much the same way the panic during the Great Depression shuttered some 7,000 banks. We need to focus on several channels: enhanced regulatory oversight that is implemented responsibly, development of a resolution regime that insulates taxpayers and the macro economy from damage, and global cooperation in managing the oversight and resolution of TBTF firms with international operations. It is a large task, but one that is too big to ignore and one we can't afford to get wrong.

Profits Up at District Banks, but Problem Assets Cloud the Outlook

By Michelle Neely

A modest improvement in profitability that began in the second quarter continued into the third quarter for District banks. Return on average assets (ROA) climbed 6 basis points to 0.25 percent. (See table.) While that result would not be cause for celebration in normal times, it is certainly a piece of good news for an industry that has been walloped by a housing crisis and a deep economic recession.

For U.S. peer banks (banks with assets of less than $15 billion), the results were also somewhat encouraging as ROA rose by 4 basis points to -0.29 percent. As in the second quarter, losses were concentrated at larger institutions. Excluding banks with assets of more than $1 billion, ROA hit 0.58 percent at District banks and 0.11 percent at U.S. peer banks.

The improvement in earnings was not driven by earning assets. The net interest margin (NIM) at District banks rose by just 1 basis point from the second quarter and remains 12 basis points below its year-ago level. What helped profits this quarter was a 6 basis-point decline in noninterest expense and a leveling off in loan loss provisions. Loan loss provisions as a percentage of average assets increased by just 1 basis point, the smallest quarterly increase in several years.

The smaller additions to loan loss provisions, however, do not portend an improvement in asset quality. Nonperforming loans continue to rise at District and U.S. peer banks. The ratio of nonperforming loans to total loans at District banks rose 18 basis points to 2.62 percent in the third quarter; the ratio increased 25 basis points at U.S. peer banks, reaching 4.02 percent.

Also troubling is another decline in the nonperforming loan coverage ratio at both sets of banks. At the end of the third quarter, District banks had 68 cents reserved for every dollar of nonperforming loans. U.S. peer banks had an even thinner cushion, with an average coverage ratio of just 52 percent. Further, other real estate owned as a percent of total assets has almost doubled at both sets of banks over the past year, averaging 0.76 percent at District banks and 0.68 percent at U.S. peers at the end of the third quarter.

Problem loans remain concentrated in the real estate portfolio, and increases in nonperforming rates are occurring in residential and commercial real estate lending. (See "Commercial Real Estate Lending Challenges Banks in District" on Page 1 for a more detailed analysis of commercial real estate lending.) At the end of the third quarter, nonperforming real estate loans as a percent of total real estate loans topped 3 percent at District banks and hit almost 5 percent at U.S. peer banks. Because real estate loans now make up about 75 percent of all loans at these banks, troubles in the real estate sector have a profound effect on bank performance.

The nonperforming loan rates for consumer and commercial and industrial loans increased very modestly in the third quarter and remain below

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A Glimmer of Hope?

	3rd Q 2008	2nd Q 2009	3rd Q 2009
RETURN ON AVERAGE ASSETS			
District Banks	0.67%	0.19%	0.25%
Peer Banks	0.43	-0.33	-0.29
NET INTEREST MARGIN			
District Banks	3.79	3.66	3.67
Peer Banks	3.83	3.57	3.61
LOAN LOSS PROVISION RATIO			
District Banks	0.60	0.94	0.95
Peer Banks	0.78	1.52	1.50
NONPERFORMING LOAN RATIO			
District Banks	1.68	2.44	2.62
Peer Banks	2.20	3.77	4.02

SOURCE: Call Reports

Note: 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.

Vacancy Rates Are High and Climbing

MSA	3Q 2009 Office	Forecast Peak Office	3Q 2009 Industrial	Forecast Peak Industrial
Fayetteville, Ark.	15.7%	15.9% (1Q 2010)	20.1%	21.0% (2Q 2011)
Little Rock	6.2	11.9 (4Q 2011)	16.0	16.7 (3Q 2010)
Louisville	12.7	14.3 (4Q 2011)	14.2	15.3 (1Q 2012)
Memphis	17.6	21.9 (2Q 2011)	20.7	22.8 (1Q 2011)
St. Louis	15.4	19.6 (1Q 2011)	13.2	15.9 (4Q 2010)
Springfield, Mo.	13.3	16.6 (1Q 2012)	14.2	14.2 (3Q 2009)
National Average	15.7	18.4 (1Q 2011)	13.2	15.4 (4Q 2010)

SOURCE: CBRE Econometric Advisors

Lending Challenges

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The nonperforming rate for multifamily loans has more than tripled, while the rate for nonperforming nonfarm nonresidential loans has more than doubled over the same time period. CRE charge-off rates have similarly escalated, as has CRE other real estate owned (OREO).

According to forecasters, CRE market conditions are still a year or two away from turning around, which is typical of post-recession periods. Like unemployment, CRE vacancy rates are lagging indicators of economic activity. Further, unemployment and CRE vacancy rates tend to move together because demand for commercial real estate is highly dependent on employment growth.

The table shows third quarter 2009 vacancy rates for office and industrial space for six metropolitan areas in the District plus a national average. Also included are forecast peaks in these vacancy rates and the associated time period.

Office Sector

Third quarter office vacancy rates varied widely across the District, from a low of 6.2 percent in Little Rock to 17.6 percent in Memphis, and rates in all District metro areas except Memphis are at or lower than the national average of 15.7 percent. Fayetteville is the only District metro area where the third quarter office vacancy rate (15.7 percent) was near its forecast peak (15.9 percent, occurring in the first quarter of 2010). For the other five metro areas in the table, peak office vacancy rates are at least a year away.

Industrial Sector

The industrial sector is weaker than the office sector in most District metro areas. All metro areas have industrial availability rates at or greater than the national average of 13.2 percent. As with office space, peak availability rates for industrial space are at least a year away in the District. Springfield is the exception here; its rate peaked in the third quarter and is expected to start coming down, while Memphis and Fayetteville have industrial availability rates in excess of 20 percent, and improvement is forecast to be more than one year away.

Multifamily Sector

Third quarter and forecast multifamily vacancy rates are available for Louisville, Memphis and St. Louis. Louisville and St. Louis currently have relatively low rates of 6.1 percent and 8 percent, respectively. Although the vacancy rate is near its expected peak in Louisville, the rate in St. Louis is forecast to rise to 11.3 percent by year-end 2011 before starting to decline. The multifamily vacancy rate in Memphis is substantially higher at 11.4 percent but is not expected to rise much above 12 percent.

Retail markets are weak everywhere. Though up-to-date retail data and forecasts are not available for District metro areas, anecdotal information suggests that this sector's overhang won't be absorbed for some time.

The trends occurring now in CRE markets are typical of post-recession periods. The degree to which the banking industry in the District and elsewhere ultimately suffers depends on how well problem credits are dealt with and how quickly jobs-producing economic growth picks up.

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

Get Back to the Basics on CRE

Examiners Offer Six Best Practices To Help Banks

By Sam Ciluffo and Carl White

Banking organizations' exposure to commercial real estate (CRE) is substantial. Therefore, banks should get back to basics and ensure that a proactive risk management strategy is in place, which is critical to manage CRE credits.

Total outstanding commercial and multifamily debt is $3.5 trillion, with $1.6 trillion or approximately 45 percent held in U.S. commercial banks. Due to the weakness in securitization markets and limited ability to place CRE debt in these markets, refinance risk in banks is high and increasing. Projections indicate that $300 to $500 billion in CRE debt will mature in 2010. Increasing capitalization rates, coupled with increasing vacancy rates and decreasing net operating income (NOI), have resulted in a valuation problem. Bankers are expressing a growing concern that income-producing properties will lack sufficient NOI to cover break-even debt service coverage (DSC), even on an interest-only basis in some cases.

With these concerns in play, how do banking organizations get back to the basics in managing CRE loans? Here are some best practices to keep in mind.

First, enhance policies and procedures to address today's emerging issues. In general, credit policies should:

- articulate clearly the bank's practices for identifying, monitoring and reporting troubled debt restructures (TDRs);
- provide specific guidance regarding loan modifications and restructures;
- cover procedures for loans made to facilitate the sale of other real estate owned (OREO) (terms and conditions, approval process, etc.); and
- address procedures for determining when to obtain a new appraisal to understand the collateral value and credit risk implications for a particular credit.

Second, CRE portfolio monitoring is important. Common practices include segmenting CRE loans by property type, maturity and geographic area to obtain a clearer understanding of the risk.

Third, key staff must also become active in the monitoring of the credits. Site visits are a key; they should include taking pictures to determine the condition of properties, vacancies, etc. Lease and financial information needs to be obtained and analyzed to determine the property's current performance and future prospects.

> "Banks should ensure that a proactive risk management strategy is in place, which is critical to manage CRE credits."

Furthermore, the lender should review documentation for completeness and ensure that property taxes are paid.

Fourth, other best practices include talking with the borrower to determine his or her plans to obtain or retain tenants. How will these plans affect the property's cash flow? In addition to analyzing market conditions, lenders should determine if any new competition has come into the borrower's market area and what affect it has on the borrower's NOI and ability to retain or obtain tenants.

Fifth, most, if not all, of these CRE loans have guarantors. Therefore, a robust guarantor analysis is needed to assess the value, sufficiency and liquidity of a guarantor's net assets and the magnitude of ongoing cash flow that considers both actual and contingent liabilities. The analysis of a guarantor's global cash flow should consider inflows, as well as both required and discretionary cash outflows from all activities. This may

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CRE AND DEBT PROBLEMS

PART 2

IN-DEPTH

Debt Restructuring

Is It a Simple Refinancing or Troubled Debt Restructuring?

CRE
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PART 3

By Jim Warren

Given current economic conditions, borrowers of all types are experiencing declines in income and cash flow. As a result, many borrowers are seeking to reduce contractual cash outlays, the most prominent being debt payments. Moreover, in an effort to preserve net interest margins and earning assets, institutions are open to working with existing customers in order to maintain relationships. Both of these matters lead to the question: Is a debt restructuring a simple refinancing or a "troubled" debt restructuring (TDR)?

To answer this question, we need to know the three factors that must always be present in a troubled debt restructuring.

First, an existing credit agreement must be formally renewed, extended and/or modified. Informal agreements do not constitute a restructuring because the terms of a note have not contractually changed.

Second, the borrower must be experiencing financial difficulty. Determining this factor requires a significant amount of professional judgment. However, accounting literature does provide some indicators on financial difficulties, including:

- The borrower has defaulted on debt obligations.
- The borrower has declared or is in the process of declaring bankruptcy.
- Absent the restructuring, the borrower cannot obtain funds from another source at market rates available to nontroubled debtors.
- The borrower's cash flow is insufficient to service existing debt based upon actual or projected performance.

Third, the lender grants a concession that it would not otherwise consider. Concessions can take many forms, including the lowering of the effective interest rate, interest and/or principal forgiveness, modification or extension of repayment requirements, and waiving financial covenants to enhance cash flow.

If all three factors are present, a troubled debt restructuring has occurred, and various issues must be considered and appropriately accounted for. Some of these issues include the Statement of Financial Accounting Standards (SFAS) 114 portion of the allowance for loan and lease losses, revenue recognition and internal credit risk grade. Under SFAS 114, a troubled debt restructuring is considered to be impaired, and an impairment analysis must be performed.

While three impairment measurement techniques are available, the valuation technique generally prescribed is the discounted cash flow method. This method results from the fact that the lender and borrower have established an expected stream of cash flows. If these underlying cash flows are separate from collateral liquidation or loan sales, then the fair market value techniques are not available.

Consider Interest Income Recognition

Another measurement to consider is interest income recognition. Generally, if a credit was on nonaccrual prior to the restructuring, regulatory guidance indicates that the credit should remain on nonaccrual until the borrower displays a willingness and ability to repay. If the credit was on accrual, income may continue to be recognized, provided that a documented analysis of the borrower indicates that performance is assured. Lastly, troubled debt restructurings should generally remain within an institution's criticized or classified internal credit risk ratings until repayment is reasonably assured, well-defined weaknesses have subsided and loss is not anticipated.

Use Sound Risk Management

Sound risk management practices are an important aspect when considering the issues and risks associated with troubled debt restructurings. The foundations of these practices include the development and implementation of appropriate policies, procedures and limits; sound management information systems; and adequate internal controls. An institution's credit policies and procedures must provide a clear understanding of what a troubled debt restructuring is, how it is to be handled, who has the ability to authorize such transactions and what associated limits are in place (authority as well as risk tolerance limits). From a management information systems perspective, procedures must be established to ensure that restructurings are correctly reported in regulatory as well as financial filings. In addition, reporting should keep senior management and the directorate apprised of the extent of this activity and its relative success.

Moreover, effective internal control systems are needed to effectively identify and manage associated risks. Two very important control functions are internal loan review and internal audit. An effective loan review function will report on compliance with established policies and procedures, assist in the identification of troubled debt restructurings, attest to the appropriateness of restructurings, and ensure that appropriate internal credit risk ratings are maintained. Sound internal audit functions verify that appropriate reporting procedures are in place and reporting is accurate. They ensure that troubled debt restructurings are included within the SFAS 114 portion of the allowance for loan loss analysis and that the impairment measurement technique used is correct. Finally, they attest that sound revenue recognition practices have been established and are being followed.

Jim Warren is a supervisory examiner in safety and soundness in the Banking Supervision and Regulation division at the Federal Reserve Bank of St. Louis.

>>MORE ONLINE

St. Louis Fed Safety & Soundness Supervision Guidance
www.stlouisfed.org/banking/safety_soundness.cfm

SFAS 114
www.fasb.org/pdf/fas114.pdf

Quarterly Report

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2 percent at District banks. Across all categories of loans, District banks had lower nonperforming rates than their U.S. peers did. For both sets of banks, larger banks (those with average assets of $1 billion to $15 billion) had higher nonperforming rates than smaller institutions in most loan categories.

Meager earnings and problem assets have had little effect on capital ratios thus far. The average tier 1 leverage ratio increased 11 basis points to 9.06 percent in the third quarter at District banks. U.S. peer banks' average leverage ratio also rose, hitting 9.10 percent.

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

When Problems Arise

The Transfer of Problem Assets from Banks to Holding Companies

CRE AND DEBT PROBLEMS

PART 4

By Patrick Pahl and Tim Bosch

A growing portfolio of problem assets will unfavorably impact a bank's earnings performance and capital adequacy. Asset workouts can take time and, thereby, affect financial performance for several reporting periods. For this reason, some banking organizations are considering the sale or transfer of problem assets from the bank to the parent holding company. Assets could include whole loans, loan participations, securities and other real estate owned (OREO).

If you're considering such a move for your organization, you should keep in mind the following:

Is This Legal?

The Federal Reserve System's Board of Governors' Regulation Y states that a bank holding company should be a source of financial and managerial strength to its subsidiary banks and not conduct bank holding company operations in an unsafe and unsound manner. Therefore, if handled properly, a bank may transfer problem assets to its parent, as long as the bank clearly benefits from the transaction.

How Would a Bank Benefit?

Problem loans, securities and OREO typically are nonearning assets. By removing nonearning assets from the bank's balance sheet, earnings performance indicators should improve at the bank level. Asset quality should also improve by reducing the volume of problem assets and replacing them with cash and/or performing assets. If replaced with cash, then liquidity will also improve.

What Are the Regulatory Considerations?

The Board of Governors' Regulation W stipulates that a bank may not be disadvantaged as a result of any covered transaction with its parent company. Regulation W also requires that the terms and conditions of any covered transaction are consistent with safe and sound banking practices. Therefore, the transfer of assets from a bank to its parent company must be at fair value. Fair value should be established prior to the transaction and be supported with appropriate documentation. You should use a third-party valuation for the transfer of real estate.

The transfer of loans or securities from a bank to its parent company may constitute a nonbanking activity for the parent company. The transfer would require prior approval under Regulation Y if the parent company had not previously received approval to engage in lending activities and intends to engage in lending on an ongoing basis. No prior Federal Reserve System approval is required if the parent company is a financial holding company in compliance.

What Are the Accounting Considerations?

There are two simple methods for transferring assets from the bank to the parent company:

Dividend in kind involves a dividend of the assets to the parent company. The assets should be booked at fair value, and the bank should fully recognize any gain/loss versus book value. The bank should consult with its regulator for any possible dividend limitations, restrictions or filing requirements.

Sale or transfer involves consideration paid by the parent company to the bank. The transaction must be at fair value, and the bank should fully recognize any gain or loss. The bank should not fund the parent company's purchase of the asset from the bank. With respect to assets acquired in satisfaction of debts previously contracted, the required divestiture period is not altered by virtue of the transfer from bank to parent company.

If you have any questions or would like additional information, contact Patrick Pahl at 314-444-8858 or Tim Bosch at 314-444-8480.

Patrick Pahl is a senior coordinator for new member banks, and Tim Bosch is a vice president over safety and soundness examinations, both in the Banking Supervision and Regulation division at the Federal Reserve Bank of St. Louis.

Back to Basics

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involve integrating multiple partnership and corporate tax returns, business financial statements, K-1 forms and individual tax filings. Anything short of a comprehensive global cash flow analysis diminishes confidence in the assessment of guarantor strength, even in the face of significant liquid assets, because liquidity may be needed to fund contingent liabilities and global cash shortfalls.

Sixth, senior management and directors should develop enhanced capital analysis and planning processes for measuring the appropriateness of the capital structure, given the risk profile of the organization. Good analysis takes into consideration asset quality and asset concentrations, as well as the composition of those concentrations.

Sam Ciluffo is a senior examiner and Carl White is a supervisory examiner in the Banking Supervision and Regulation division at the Federal Reserve Bank of St. Louis.

REGIONAL SPOTLIGHT

Explore Innovative Ideas for Revitalizing the LIHTC Market

Eighth District bankers interested in how they can work with their communities on the Low Income Housing Tax Credit (LIHTC) program should check out *Innovative Ideas for Revitalizing the LIHTC Market.* Released in November, the publication's six short articles were prepared by the St. Louis Fed's Community Affairs department and the Federal Reserve's Board of Governors and present fresh ideas on how to strengthen the LIHTC market.

The articles consider:

- the St. Louis Equity Fund's strategies to continue developing LIHTC projects despite the market downturn,
- ways the Community Reinvestment Act could be altered to attract increased investment in LIHTCs by financial institutions,
- a proposal to restore the market for LIHTC projects through federal co-investment in the tax credit,
- a case for using innovative ways to expand the LIHTC investor pool to individual investors,
- a secondary market solution to bring additional investors into the market, and
- a model for an enhanced structure for a LIHTC fund that would provide equity for high-quality projects.

Download the publication at www.federalreserve.gov/newsevents/press/other/other20091110a1.pdf.

Missouri Homeownership Preservation Summit Set for January

What are foreclosure trends in Missouri? What can your community do to reduce foreclosures, stabilize neighborhoods and maintain the tax base? What help can you provide your customers and community?

To help answer these questions, bankers in central Missouri should consider attending the Missouri Homeownership Preservation Summit on Jan. 14 in Jefferson City, Mo. Registration fee is $25.

Topics include current foreclosure, fraud and loan performance trends and new consumer protection and residential lending laws.

See details and register at www.stlouisfed.org/newsroom/events/?id=101. For more information, contact the St. Louis Fed's Matt Ashby, senior community affairs specialist, at 314-444-8891 or matthew.w.ashby@stls.frb.org.

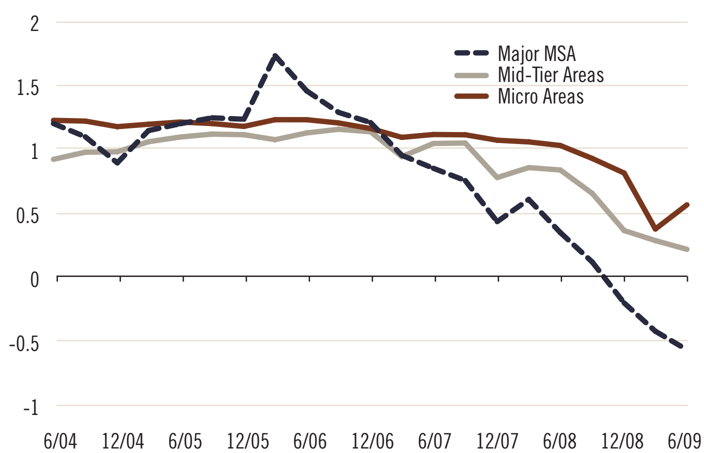
Banks in Smaller Markets Have Outperformed Larger Metro Banks

By Gary S. Corner and Rajeev R. Bhaskar

Data from call reports paint a bleak picture for banks in large Eighth District cities. In aggregate, banks in the larger metropolitan areas are performing worse than banks in smaller markets.

Why are smaller banks doing better? The reasons are not yet clear. We used various metrics to help discover why by reviewing three groups of District banks: banks in the four major metropolitan statistical areas, or MSAs (St. Louis, Little Rock, Louisville and Memphis), banks in 18 mid-tiered metro areas (population between 50,000 and 500,000) and banks in 60 micropolitan statistical areas (population between 10,000 and 50,000). To gauge the performance of banks in these three groups, we looked at aggregate numbers for health of the overall industry and then looked at the median numbers for the health of the average banks. The total number of banks in each of these areas is similar: 145 in the major areas, 139 in the mid-tier metro areas and 175 in the micro areas.

ROA for Three Different Groups of Banks



Metrics Show Micro Area Banks on Top

The figure shows the aggregate return on assets (ROA) for the three bank groups. Until the end of 2006, all the groups were performing at a similar level of profitability, with an ROA of about 1 percent or higher. Since then, there has been a striking difference in performance. Banks in the major MSAs have been hardest hit, with a weighted ROA of -0.6 percent as of June 30, 2009. Banks in the micro and mid-tier metro areas have also experienced challenges, though not as severe. Micro-area banks have performed consistently better than the other two groups through this downturn, with a weighted ROA of 0.6 percent, while profitability of mid-tier metro area banks falls between the two groups, with an ROA of 0.2 percent.

On other aggregated metrics, such as nonperforming loans, loan losses and net interest margin, the conclusion is similar. Banks in micro areas are performing better than banks in mid-tier metro areas, which, in turn, are performing better than banks in major metro areas.

Different Metrics Reveal Similar Gaps

What affects the performance of the different groups of banks? When we aggregate ratios such as ROA, larger banks weigh more heavily than smaller banks within a geographic group. To overcome this size issue, we looked at the median bank performance metrics for the three groups of banks. The median banks in the three groups are similar in ROA size: $187 million in the major metro areas, $171 million in the mid-tier metro areas and $143 million in the micro areas. Although some differences in size still exist, for practical purposes these median banks are all small-sized community banks.

The table shows the median statistics and bank performance measures for the three groups of banks. Even at the median level, banks in micro areas performed best, followed by mid-tiered metro area banks and then the major metro banks. However, the performance range narrows when

Median Statistical Area Bank Performance as of June 30, 2009

	Major Metro Areas	Mid-Tier Metro Areas	Micro Areas
Number of Banks	145	139	175
Median Assets	$186.7 million	$170.7 million	$143 million
Return on Assets	0.54%	0.67%	0.91%
Net Interest Margin	3.53	3.82	3.86
Nonperforming Loans / Total Loans	1.88	1.46	1.08
Loan Loss Reserves / Nonperforming Loans	77.29	97.87	115.63
Loan Losses / Total Loans	0.31	0.36	0.23
Tier 1 Leverage Ratio	9.28	9.08	9.10
CRE to Total Loans	28.84	22.21	18.32

SOURCES: Call Reports. Numbers in red indicate unfavorable differences when compared with the medians of other sized markets.

switching from aggregate to median. The median (50th percentile) ROAs now range from 0.54 percent in major MSAs to 0.91 percent for the micro market banks. This narrowing of the performance band shows that the performance of larger banks in the major and mid-tier metro markets pulls down the averages. Sizable differences still exist in the average bank profitability for different size markets after accounting for outliers. This difference in performance holds for most of the metrics we analyzed, including the ratio of nonperforming loans, net interest margin and coverage ratios. (See the table.)

Better Performers or Slow To Recognize Risk?

All the factors influencing this performance difference may not be fully understood today. However, our experience with commercial bank examinations raises some possible explanations. One distinguishable factor is the level of commercial real estate (CRE) lending. The proportion of CRE loans to total loans at a micro area bank (18.3 percent) is 3.9 percentage points less than at a mid-tier metro area bank (22.2 percent) and 10.5 percentage points below a major metro bank (28.8 percent). CRE, which is under severe stress in the current environment, could be a possible reason for the difference in performance.

Another possible explanation is that smaller market banks may lend more on a relationship basis compared with transaction lending in larger banks. Economic factors, such as higher unemployment rates in the larger markets, could also be at play. It is also possible that the smaller market banks could be somewhat slower to recognize troubled assets. If this is true, then the performance gap should close in time.

Smaller community banks have outperformed their larger market brethren during this economic downturn both at the aggregate and individual level. In the ensuing quarters, the reasons will become clear. We may conclude that banks in smaller markets have indeed been more conservative and managed risk better. Or, we may find it takes varying amounts of time for risk recognition to work through all sizes of banking markets. As Paul Harvey famously stated, "Stay tuned for the rest of the story."

Gary Corner is a senior examiner and Rajeev Bhaskar is a senior research associate in the Supervisory Policy and Risk Analysis group of the Banking Supervision and Regulation division at the Federal Reserve Bank of St. Louis.

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Is the vacancy rate for commercial real estate (offices and stores, for example) in your part of the Eighth District higher now than a year ago?

- **Much higher.** I see more vacancies now than ever before.
- **Only a bit higher.** It looks like vacancies have leveled off.
- **The same.** The amount of vacancies I see is no different than it was a year ago.
- **Lower.** I'm seeing fewer empty commercial buildings now than a year ago.

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