CENTRAL Banker
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NEWS AND VIEWS FOR EIGHTH DISTRICT BANKERS

FEATURED IN THIS ISSUE: Meet the New Advisory Council | District, Peer Banks Still Navigating Difficult Waters

What if Debit Card Transactions Exchanged at Par?

By Gary Corner

Explore More

See the following for further information on the Dodd-Frank Act debit interchange fees rulemaking:

- The article "Debit Card Interchange Fees and Routing Proposals" in the online version of this issue (www.stlouisfed.org/publications/cb/) gives a macro overview of the proposals.
- The Regulation II proposed rule can be read at http://stlouisfed.org/regreformrules/rules/2010-32061.cfm on the St. Louis Fed's Dodd-Frank Regulatory Reform Rules web site.

Since the passage of the Dodd-Frank Act in July 2010, which required the Federal Reserve Board to establish standards for determining whether debit interchange fees are "reasonable and proportional" to the cost of the transaction, one argument in favor of this section of the legislation has been that debit cards are essentially "plastic checks." Many merchants, in particular, have suggested that the swipe of a debit card should translate to a par payment like paper checks.

To understand the reasonableness of this assertion, it's helpful to explore the development of the check platform that began during the national banking era (from the Civil War to World War I). Over this more than 50-year period, checks emerged as a more efficient payment medium than bank notes and drafts. Initially, checks could clear at either par or par less an exchange fee, the latter a precursor to what is called an "interchange fee" today. Rules associated with exchange fees were not standard in the late 19th and early 20th centuries, and the imposition of a fee could depend on whether local banks had agreements in place to clear each others' checks at par.

As railroads expanded and regional commerce increased, check clearing at par became more problematic. Checks drawn on distant banks cost more to clear and were riskier. Critics at the time claimed exchange fees were "excessive" and even "monopolistic" on the part of banks. Common law, however, provided that check cashers could receive face value if they presented the check in-person at the check payer's bank, thus creating a market distortion that led to less-than-optimal pricing.

In 1915, the Federal Reserve entered the check clearing business partly in response to the concerns over not-at-par banking. The Fed set up a national system for check clearing and

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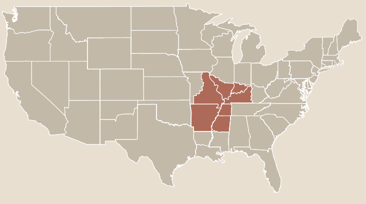
The Eighth Federal Reserve District includes all of Arkansas, eastern Missouri, southern Illinois and Indiana, western Kentucky and Tennessee, and northern Mississippi. The Eighth District offices are in Little Rock, Louisville, Memphis and St. Louis.



CENTRAL VIEW

Broadening the Dialogue

By Julie Stackhouse

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

This issue of *Central Banker* contains two articles on the recent Federal Reserve rulemaking that would limit debit interchange fees. (See articles on Page 1 and online at stlouisfed.org/publications/cb.) Banks from across the country have voiced their opinions on this controversial rulemaking by using a public comment process that closed in late February. More than 7,000 comments were received by the Board of Governors.

The formal comment process on proposed regulations is one channel open to bankers to express opinions. There are many other channels, as well. Clearly, much communication occurs through the supervisory process. Moreover, it is not uncommon for Fed economists and regulators to speak at community and industry events in which bankers, community groups, academics and members of the general public are in attendance.

More recently, the Board of Governors announced a new communication vehicle for depository institutions, created through the formation of Community Depository Institutions Advisory Councils. (See article on Page 4.) These councils, which have been established in all 12 Federal Reserve Districts, will be comprised of senior executives from community lending institutions (commercial banks, thrifts and credit unions with less than $10 billion in assets). At least twice per year, council members will meet to discuss a variety of issues, including local economic and banking conditions, and regulatory matters. The leader of each council will travel to Washington, D.C., twice per year to share the view of his or her District council with the Board of Governors.

Information sharing and dialogue is important for bankers and regulators alike. We view it as critical that the voice of "main street" lending institutions be considered in the formulation of good supervisory policy.

We will do our best to improve and grow the dialogue process. We hope you will feel comfortable contributing your voice!

District, U.S. Peer Banks Still Navigating Difficult Waters

By Michelle Neely

Profitability at the nation's banks made quite a turnaround in 2010, but asset quality issues—linked primarily to commercial real estate—are still weighing heavily on the industry. Return on average assets (ROA) averaged 0.53 percent at District banks at year-end 2010, up 44 basis points from a year ago. ROA at U.S. peer banks—those with average assets of less than $15 billion—also rose substantially in 2010, but remains below the District's average at 0.28 percent.

The year-over-year improvement in profitability is due in large part to marked upticks in the net interest margin (NIM), which rose 20 basis points in the District and 25 basis points at peer banks. Rising NIMs are due entirely to decreases in interest expense that exceed decreases in interest income. A substantial reduction (13 basis points) in net noninterest expense provided another boost to ROA at District banks in 2010. Earnings also increased because of significant declines in loan loss provisions in 2010 at both sets of banks, even though asset quality has improved modestly, if at all.

The ratio of nonperforming loans to total loans at District banks held basically steady between the third and fourth quarters at 3.27 percent, a worsening of 41 basis points from a year ago. In contrast, the nonperforming loan ratio fell 13 basis points in the fourth quarter at peer banks; the year-end ratio of 3.95 percent is 20 basis points below its year-ago level.

Real estate loans remain the driver for the performance of the overall loan portfolio both in the District and nationally, and market conditions—both residential and commercial—have not improved appreciably. Within the real estate portfolio, there were declines in nonperforming construction and land development (CLD) loans in the fourth quarter. In the District, the proportion of CLD loans that were nonperforming fell 21 basis points to 12.27 percent, while it fell 33 basis points at U.S. peers to 14.81 percent. Though this is certainly good news, these ratios remain near historic highs.

Nonperforming rates in the nonfarm nonresidential segment continue to rise at District banks of all sizes; the proportion of nonfarm nonresidential loans that were nonperforming at year-end was 2.93 percent, up 17 basis points from the third quarter. The nonperforming rate for these loans at peer banks actually declined slightly in the fourth quarter but remains well above the District's average at 3.61 percent.

Although delinquency rates remain steady in the consumer segment, they continue to edge up in the commercial and industrial (C & I) portfolio; the nonperforming C & I ratio hit 2.19 percent at District banks and 2.40 percent at peer banks at year-end 2010.

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Steady as She Goes[1]

	2009: 4Q	2010: 3Q	2010: 4Q
RETURN ON AVERAGE ASSETS[2]			
District Banks	0.09%	0.57%	0.53%
U.S. Peer Banks	-0.37	0.32	0.28
NET INTEREST MARGIN			
District Banks	3.67	3.84	3.87
U.S. Peer Banks	3.65	3.87	3.90
LOAN LOSS PROVISION RATIO			
District Banks	1.07	0.82	0.86
U.S. Peer Banks	1.60	1.06	1.06
NONPERFORMING LOAN RATIO[3]			
District Banks	2.86	3.30	3.27
U.S. Peer Banks	4.15	4.08	3.95

SOURCE: Reports of Condition and Income for Insured Commercial Banks

NOTES: [1] Because all District banks but one have assets of less than $15 billion, banks larger than $15 billion have been excluded from the analysis.

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

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

Community Banking, Credit Union Execs Meet To Discuss Top Financial Industry Issues

The condition of the current banking and credit markets and the outlook for regional economies were among the key topics discussed at the inaugural meeting of the St. Louis Fed's Community Depository Institutions Advisory Council (CDIAC) on March 1-2.

Twelve executives representing community banks, thrifts and credit unions from across the Eighth District met at the St. Louis Fed with President James Bullard to discuss the top issues currently facing community financial institutions and their customers.

Key findings from the St. Louis session will be included in a discussion with Federal Reserve Chairman Ben Bernanke when St. Louis Fed CDIAC Chairman Dennis M. Terry meets April 1 with the CDIAC leaders of the System's 11 other District banks in Washington, D.C. for the first of two annual System-wide meetings.

"Community financial institutions are vital in creating and sustaining economic growth in our nation's communities," said Bullard when he announced the nomination of the 12 regional members to the council on Jan. 20. "As a key source of credit for small businesses, these institutions provide an important perspective on the relative health of the U.S. economy."

The St. Louis Fed's council will also meet twice a year. The next meeting is scheduled for Oct. 5-6, with the next System-wide meeting scheduled for Nov. 4.

Meet the 2011-2012 Council

Dennis M. Terry (council chairman) is president, CEO and director of First Clover Leaf Financial Corp. of Edwardsville, Ill. He has been president and CEO of First Clover Leaf Bank, FSB, since 2000. Previously, Terry served as president of Mark Twain Bank of Edwardsville, as well as its predecessor, Edwardsville National Bank and Trust Co.

Kirk P. Bailey is chairman, president and CEO of Magna Bank, based in Memphis. He is a founding director of Magna and has served on the bank's board of directors since Magna's inception in 1999.

Glenn D. Barks has served since 2001 as chief executive officer of First Community Credit Union, based in Chesterfield, Mo. He joined the company 25 years ago as executive vice president following a 12-year career in the savings and loan industry.

H. David Hale is chairman, president and CEO of Louisville-based First Capital Bank of Kentucky, which was founded in 1996. Previously, he served as chairman, president and CEO of Cumberland Federal Savings Bank in Louisville.

D. Keith Hefner has served as president and CEO of Citizens Bank & Trust Co. of Van Buren, Ark., since 2004 and has been with the bank since 1990. He also serves on the board of directors of the Arkansas Bankers Association.

Gary E. Metzger has served as chairman, president and CEO of Liberty Bank and Liberty Bancshares Inc. in Springfield, Mo., since 1995. Previously, Metzger was president of Southwest Bank in Springfield, and vice president at Southwest Bancshares Inc.

William J. Rissel has been the president and CEO of the Fort Knox Federal Credit Union in Radcliff, Ky., since 1991. During Rissel's tenure as CEO, Fort Knox has been recognized as the "Best Credit Union in the Army," and the National Association of Federal Credit Unions has named it Credit Union of the Year.

Mark A. Schroeder is the chairman and CEO of German American Bancorp, based in Jasper, Ind. Schroeder is a member of the board of directors for ICBA Bancard and the Indiana Department of Financial Institutions.

Gordon Waller has been president and CEO of First State Bank & Trust Company of Caruthersville, Mo., since 2004. He serves as a member of First State Bank's board of directors and vice chairman of the First State Bancorp Community Development Corporation.

Larry T. Wilson is chairman, president and CEO of First Arkansas Bank & Trust, based in Jacksonville, Ark. He serves as a director of the Association of Military Banks of America, is a member of Team 21 for the American Bankers Association, and has held several positions with the Arkansas Bankers Association.

Vance Witt is chairman and CEO of BNA Bancshares and BNA Bank, based in New Albany, Miss., where he has worked for more than 40 years. He is a past chairman of the Mississippi Bankers Association.

Larry Ziglar is the president and CEO of First National Bank in Staunton, Ill., which he joined in 1976. He has been president of First Staunton Bancshares since 2002.

>>MORE ONLINE

Additional CDIAC Information and Extended Member Biographies
www.stlouisfed.org/cdiac/

Eighth District Bank Data 4Q 2010[1]

COMPILED BY DAIGO GUBO

	2009: 4Q	2010: 3Q	2010: 4Q
RETURN ON AVERAGE ASSETS[2]			
All Eighth District States	-0.21%	0.46%	0.39%
Arkansas Banks	0.58	0.86	0.81
Illinois Banks	-0.60	0.34	0.15
Indiana Banks	-0.19	0.49	0.49
Kentucky Banks	0.49	0.92	0.84
Mississippi Banks	0.42	0.59	0.55
Missouri Banks	-0.49	0.29	0.38
Tennessee Banks	-0.42	0.21	0.07
NET INTEREST MARGIN			
All Eighth District States	3.55	3.76	3.80
Arkansas Banks	3.99	4.13	4.16
Illinois Banks	3.29	3.65	3.67
Indiana Banks	3.74	3.77	3.78
Kentucky Banks	3.88	4.04	4.00
Mississippi Banks	3.87	3.89	3.92
Missouri Banks	3.34	3.51	3.67
Tennessee Banks	3.61	3.79	3.81
LOAN LOSS PROVISION RATIO			
All Eighth District States	1.36	0.92	0.97
Arkansas Banks	0.92	0.72	0.85
Illinois Banks	1.82	1.19	1.28
Indiana Banks	1.19	0.90	0.89
Kentucky Banks	0.61	0.54	0.58
Mississippi Banks	0.86	0.82	0.80
Missouri Banks	1.51	0.86	0.85
Tennessee Banks	1.31	0.89	0.94
NONPERFORMING LOAN RATIO[3]			
All Eighth District States	3.72	3.88	3.76
Arkansas Banks	2.65	3.27	3.47
Illinois Banks	5.26	5.05	5.04
Indiana Banks	2.99	3.13	3.08
Kentucky Banks	2.43	2.49	2.39
Mississippi Banks	2.34	3.13	2.97
Missouri Banks	3.83	3.98	3.29
Tennessee Banks	2.79	3.49	3.54
NONPERFORMING LOAN + OREO RATIO[4]			
All Eighth District States	4.82	5.38	5.28
Arkansas Banks	3.92	5.05	5.45
Illinois Banks	6.34	6.48	6.54
Indiana Banks	3.51	3.80	3.81
Kentucky Banks	3.17	3.55	3.56
Mississippi Banks	3.42	4.56	4.61
Missouri Banks	5.27	6.01	4.86
Tennessee Banks	4.17	5.37	5.52

SOURCE: Reports of Condition and Income for Insured Commercial Banks

NOTES: [1] Because all District banks but one have assets of less than $15 billion, banks larger than $15 billion have been excluded from the analysis.

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

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

Bankers Invited to Exploring Innovation Conference on Community Development Finance

By Faith Weekly

During lean times, problems get magnified, but opportunities can arise—especially if you look at things a little differently. Difficult times can help reveal new paths to community development finance.

You can discover the possibilities at Exploring Innovation: A Conference on Community Development Finance on May 9-11 in St. Louis. This will be the third biennial Exploring Innovation conference sponsored by the Federal Reserve Bank of St. Louis, along with the Federal Reserve Banks of Atlanta, Dallas and Minneapolis. Organizers want to provide bankers and other conference-goers with real-world examples of innovative models that will address the financing of all aspects of thriving communities—from housing and infrastructure to community engagement and leadership development. Each of those contributes to vibrant, desirable places to live, work and play.

Bankers and CRA officers will learn about the latest in financial product innovations, investment platforms and green strategies being implemented by peer financial institutions, all geared to help enhance their institution's CRA performance. Top community bankers from across the nation will share the secrets to being a top-notch community bank. Former community banker Governor Elizabeth Duke of the Fed's Board of Governors will be one of the main speakers.

Sessions of interest for bankers include:

- **The Role of a Healthy Community Bank** – Community banking experts from across the country will share their secrets in this panel discussion for meeting CRA requirements by creating products, making investments and delivering services that meet their community's most pressing needs.
- **Changing Savings Behavior with Workplace Loans & Personal Financial Coaching: A Sustainable, Scalable Solution** – Learn sustainable and scalable strategies aimed at changing savings behavior among low-income, underbanked workers to transition them to savings and mainstream bank products.
- **Innovations in Community Investing: Make Your Money Matter** – Learn how a bank has leveraged technology to work with unbanked and underbanked individuals and families. Bankers will see how they might implement similar strategies to meet the needs of low- and moderate-income populations in their communities, stabilize neighborhoods and position themselves for favorable CRA consideration for their efforts.

See full details and register at http://2011.exploringinnovation.org. Highlights from the 2009 conference can be found at www.stlouisfed.org/exploringinnovation/default09.html.

Faith Weekly is a community affairs specialist in the Louisville Branch of the Federal Reserve Bank of St. Louis.

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Exploring Innovation Speaker Gov. Elizabeth Duke Talks about Her Community Banking Experience
www.stlouisfed.org/publications/cb/

What if Debit Card Transactions Exchanged at Par?

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mandated check collection at par. At first, thousands of banks resisted, but over time, their numbers dwindled.

Up until 1980, the Fed shouldered the cost of this national check-clearing platform. In 1980, however, Congress passed the Depository Institutions Deregulation and Monetary Control Act. One feature of this legislation required the Fed to charge banks fees to recover its check processing costs and price its services to be more competitive with the private sector. Banks absorbed the Fed's new fees, and par checking, now firmly entrenched in society, continued.

Today, the volume of check usage has declined dramatically, while use of debit cards has exploded. Payment card networks have emerged and, like the early days of paper checks with exchange fees, interchange fees are seen by banks and card networks as necessary charges that enhance infrastructure investment and processing of electronic payments by the private sector.

For today's banking industry, interchange fees have become an increasingly important source of income in the face of ever-shrinking revenue streams. The Federal Reserve Board estimates that approximately $11 billion of industry revenue is sourced to debit card interchange and another $5 billion of debit interchanges goes to support card networks annually. The profits generated by banks have, in turn, made interchange fees a source of contention with merchants. And while it's true that merchants today bear the direct costs of these fees, it is likely that some portion of the interchange fee finds its way into the price of goods and services consumers purchase, regardless of their chosen payment mechanism.

A modern, well-functioning payment system network is not cost free. The bearer of costs will play out as the Federal Reserve's debit interchange rulemaking moves toward completion and subsequent market adjustments occur.

Gary Corner is a senior examiner at the Federal Reserve Bank of St. Louis.

District, U.S. Peer Banks Still Navigating Difficult Waters

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Declining loan loss provisions and rising nonperforming loan levels in 2010 led to a 528 basis point drop in the average loan loss reserve coverage ratio at District banks. At year-end 2010, District banks had about 61 cents reserved for every dollar of nonperforming loans compared to 66 cents at year-end 2009. The average coverage ratio increased at U.S. peers in 2010 by more than 300 basis points, but it remains below the average at District banks at 56 cents.

Capital ratios rose at both sets of banks in 2010. The average tier 1 leverage ratio was 9.05 percent at District banks and 9.46 at U.S. peer banks at year-end 2010, significantly above the regulatory minimum level of 4 percent.

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

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Keep track of what St. Louis Fed President James Bullard and other members of the Federal Open Market Committee (FOMC) are talking about via this comprehensive repository of participants' speeches, testimony, interviews and commentary.

Dodd-Frank Regulatory Reform Rules

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Use this site to follow and comment on the rules being written to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The various federal regulatory agencies (the Fed, FDIC and nine other agencies) are writing approximately 200 rules to implement Dodd-Frank directives. The web site is updated frequently as new rules move their way through the rule-making process. Users can search rules by agency and topic, such as investor protection.