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News and Views for Eighth District Bankers

Gloomy Times Continue at District Banks

By Michelle Neely

In response to tight credit markets and a still-weakening economy, earnings and asset quality at Eighth District and U.S. peer banks continued their descent in the third quarter.

In the District, return on average assets (ROA) declined another 14 basis points in the third quarter to 0.67 percent. ROA was down 39 basis points from its year-ago level. (See adjoining table.) U.S. peer banks (banks with average assets of less than $15 billion) fared even worse, with ROA declining to 0.45 percent in the third quarter compared with 1.18 percent one year ago.

The decline in ROA in the third quarter was due to a slight increase in net noninterest expense and a more substantial increase in loan loss provisions. The trend in earnings components was similar at U.S. peer banks. Once again, the average net interest margin (NIM) stayed flat at 3.79 percent at District banks. Loan loss provisions (LLP) as a percent of average assets hit 0.60 percent at District banks and 0.76 percent at U.S. peer banks.

The LLP ratio has almost tripled at District banks and has more than tripled at peer banks over the past year. The coverage ratio (the loan loss reserve as a percentage of nonperforming loans) has sunk over the same time period at both sets of banks. At the end of the third quarter, District banks had just 84 cents reserved for every dollar of nonperforming loans compared with $1.28 reserved one year ago.

Increases in loan loss provisions and declines in coverage ratios can be traced to continued deterioration in asset quality at District and U.S. peer banks. The ratio of nonperforming loans to total loans rose to 1.68 percent at District banks and 2.19 percent at peer banks in the third quarter. In the District, increases in nonperforming real estate loans—especially construction and land development (CLD) loans—and commercial and industrial loans drove the uptick in the composite nonperforming loan ratios. Almost 5 percent of District banks' outstanding CLD loans were nonperforming at the end of the third quarter, compared with less than 2 percent one year ago. At U.S. peer banks, the decline in quality is even more pronounced, with almost 7 percent of outstanding CLD loans in nonperforming status.

Despite the bleak picture painted by the earnings and asset quality numbers, District banks remain on average well-capitalized. At the end of the third quarter, just three banks (out of 707) failed to meet one of the regulatory capital minimums. District banks averaged a leverage ratio of 9.07 percent. ■

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

Not a Pretty Picture[1]

	3rd Q 2007	2nd Q 2008	3rd Q 2008
RETURN ON AVERAGE ASSETS[2]			
District Banks	1.06%	0.81%	0.67%
Peer Banks	1.18	0.61	0.45
NET INTEREST MARGIN			
District Banks	3.91	3.79	3.79
Peer Banks	4.02	3.83	3.83
LOAN LOSS PROVISION RATIO			
District Banks	0.23	0.52	0.60
Peer Banks	0.25	0.71	0.76
NONPERFORMING LOANS RATIO[3]			
District Banks	1.02	1.53	1.68
Peer Banks	1.00	1.92	2.19

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 average earning assets in the denominator.
3 Nonperforming loans are those 90 days or more past due or in nonaccrual status.

Feditorial

How To Plan for the Unexpected

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

Before the disruptions in financial markets, "planning for the unexpected" was typically described as contingency planning for disaster recovery. In today's uncertain environment, planning for the unexpected involves a different contingency: alternative sources of liquidity.

One source of potential liquidity for banks is the Federal Reserve discount window. For smaller banks, the Fed's primary credit program (a Fed discount window lending program) has become attractive. Loans under this program are available for up to 90 days and are priced at the primary credit rate—currently, the federal funds rate plus 25 basis points. Other banks may be interested in the Term Auction Facility (TAF). Under this program, auctions are announced and funds made available through a bidding process, similar to the process used in Treasury auctions.

For both of these facilities, the institution must be in generally sound financial condition, have filed legal documents with the Federal Reserve and pledged acceptable collateral. Details can be found on the Fed's discount window web site at www.frbdiscountwindow.org.

Banks that are *not* eligible for participation in the TAF have special liquidity planning challenges. Contingency liquidity sources may not be as reliable as expected. For example, when an institution is designated as "undercapitalized" for prompt corrective purposes, it must seek a waiver from the FDIC for the acceptance, renewal or rollover of brokered deposits. (See *Prompt Corrective Action* at www.stlouisfed.org/publications/cb/2008/c/pages/views.html.) Moreover, the effective yield on deposits may be subject to interest rate restrictions. (See Part 337.6(b)(3)(ii) of the FDIC's Rules and Regulations.) Funding arrangements may also be reduced, or the lender may request the pledge of additional collateral.

Therefore, contingency liquidity planning should consider funding concentrations. Concentrations might include a large reliance on uninsured deposits, dependency on a few large depositors or a single lender, or large blocks of funds maturing near the same point in time.

Contingent liabilities should also be considered, such as unfunded loan commitments and letters of credit. Rapid changes in contingent liabilities can result in a quick drain on liquidity when sources of liquidity are no longer available.

Reviewing your bank's liquidity position with your board of directors is a good idea. Plan for the unexpected—be comfortable that your sources are available should conditions unexpectedly change. ■

Bernanke Drops By Bank Commissioners' Meeting

Julie Stackhouse, senior vice president of the St. Louis Fed's Banking Supervision and Regulation division, hosted the Eighth District's seven state bank commissioners and their deputies at a Sept. 11 meeting at the St. Louis Fed. The commissioners also met Fed Chairman Ben Bernanke and St. Louis Fed President Jim Bullard and discussed the state of the economy.

Shown are, from left: Arkansas Commissioner Candice Franks, Senior Vice President Julie Stackhouse, Tennessee Commissioner Greg Gonzales, Kentucky Commissioner Charles Vice, Chairman Ben Bernanke, Missouri Commissioner Eric McClure, President Jim Bullard, Mississippi Commissioner John Allison, Illinois Commissioner Jorge Solis and Indiana Commissioner Judith Ripley.

Ask These Questions about Bank Liquidity

By Tim Bosch and Gary Corner

The current financial environment has drawn bankers' attention to an often forgotten component of the CAMELS rating: the "L" component, liquidity. Management of liquidity has become a challenge for many banks experiencing asset quality issues. In some cases, the inability to cover maturing deposit outflows can cause a bank to fail.

Locally generated FDIC-insured deposits have historically been a stable source of funds for banks. Unfortunately, over the past decade stable core deposits have declined as a percentage of most banks' liabilities. Banks now rely on many other sources of funds that are not as stable, including high-rate deposits, Federal Home Loan Bank advances, fed funds purchases and brokered deposits.

If your bank depends significantly on noncore deposit funding, then it is important to "stress test" liquidity and contingency liquidity sources. Here are a few commonsense questions to get started:

What is a good way to measure liquidity?

Your liquidity position is best estimated as a flow of funds over multiple time periods. In other words, measure expected cash inflows and outflows in near-, medium- and longer-term periods. A simplified analysis might include elements in the adjoining list.

This analysis can be conducted under multiple scenarios, ranging from normal operations to broad, systemic disruptions. The point of stress scenarios is to identify liquidity vulnerabilities and to identify appropriate contingency funding sources well in advance of the need.

How many and what type scenarios should be completed?

This depends on your liquidity risk profile. At a minimum, we suggest two scenarios: a normal state and one with your bank undergoing a specific stress state. If your bank is exposed to significant asset quality issues, we suggest more scenarios. As discussed later, liquidity sources that are dependable in good times often disappear when the balance sheet becomes distressed.

This is a simplified analysis. Find a downloadable version with 30-, 60- an 180-day increments at www.stlouisfed.org/publications/cb/2008/d.

TIME HORIZON
- Sources of liquidity
- Loan collections and maturities
- Investment collections and maturities
- New deposits generated
- Other sources

USES OF LIQUIDITY
- Loan originations
- Deposit maturities
- Scheduled Investment/asset purchases
- Federal funds purchased maturities
- Repurchase agreement maturities
- FHLB borrowing maturities
- FRB discount window maturities
- Other borrowing maturities

TOTAL CHANGE IN LIQUIDITY
- Estimated borrowing capacity
- Available federal funds purchased capacity
- Available repurchase agreement capacity
- Available FHLB capacity
- Available FRB discount window capacity
- Available other lines/borrowing capacity

TOTAL ESTIMATED BORROWING CAPACITY

TOTAL CHANGE IN CASH

BEGINNING CASH

ENDING CASH

OTHER UNENCUMBERED, READILY MARKETABLE ASSETS

How do I think about the liquidity risk of insured high-cost CDs and brokered deposits?

When an institution is designated "undercapitalized" for prompt corrective action purposes, it must receive a waiver from the FDIC to accept, renew or roll brokered funds. Moreover, the rate paid on deposits may not exceed 75 basis points over the local market rate. This creates an important stress scenario that cannot be overlooked.

Can I count on Federal Home Loan Bank advances as a contingency liquidity source?

When a borrower's financial condition begins to deteriorate, any lender may take steps to reduce a possible loss on the loan, such as require additional collateral, reduce the available line or call the loan. If you rely significantly on FHLB advances, consider a reduction in the line as another scenario to test.

Should I consider the discount window in my liquidity contingency planning?

Setting up a borrowing relationship and pledging collateral to the discount window is a sensible component of a contingency liquidity plan. Discount window credit is then available when unexpected events occur. Note, however, that federal law limits the Federal Reserve's ability to provide discount window credit to undercapitalized and critically undercapitalized institutions.

Your bank regulator expects you to adopt a well-thought out policy and implement commensurate practices to control liquidity risk. Having a realistic, tested, contingency funding plan is essential to weather today's volatile financial environment. ■

Tim Bosch is a vice president of the Banking Supervision and Regulation division and Gary Corner is a senior examiner at the St. Louis Fed.

Foreclosure Forums Present Solutions

Many cities across the nation had already been struggling with their own problems when the foreclosure crisis hit. The foreclosure crisis wiped out decades of neighborhood stabilization progress in a matter of months, according to Alan Mallach, nonresident senior fellow at The Brookings Institution.

Mallach was one of several hundred participants from community groups, the private sector, various levels of government, and the Federal Reserve System who gathered for a series of foreclosure forums this summer and fall across the country. Some of the common themes that developed include the need to:

- give realistic expectations for all parties concerning scarce funding resources,
- alleviate foreclosures so that properties don't become REO (real estate owned) or lead to evictions,
- develop mutually agreeable plans for vacant property, and
- bring all parties to the table.

The short takeaway from the forums is that each municipality needs a good, localized plan. Youngstown, Ohio, Mayor Jay Williams, who spoke at the final forum Oct. 20 in Washington, D.C., said smart citywide planning is critical. As with many forum speakers, Williams talked about how to use the $3.92 billion Neighborhood Stabilization Program money allocated by HUD (Department of Housing and Urban Development) in September. While the money is welcome, Williams cautioned that during hard economic times, some people think that *any* investment is good investment.

"There *must* be a good plan because resources invested in needy but ill-prepared cities will result in disaster. We have to maintain a pragmatic approach of what we can actually do and when," Williams said. "Using a peanut-butter strategy, where resources are spread thin, will typically fail to achieve measurable successes."

A place at the table. Good planning should include all parties. Bankers, servicers and lenders can and should definitely play a role in community revitalization, said Faith Schwartz, executive director of the nationwide HOPE NOW Alliance. "There needs to be a bridge between servicers and locals to get a grip on these unprecedented volumes and understand each other," Schwartz said at the final forum. Mary Tingerthal of the Housing Partnership Network agreed. "It's apparent that nonprofits alone won't solve this," Tingerthal said at the Washington, D.C., forum. "Even

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though it's sometimes tough for an angry mayor or nonprofit to call a servicer to talk about a specific property, it's necessary to try to understand the situation from the servicer's point of view."

That's something Jack Bailey can appreciate. As a mortgage officer with Heartland Bank in Chesterfield, Mo., Bailey needs to produce. From the bank's perspective, he's an originator who closes loans. "But it's critical that we plug into what's going on beyond what we're doing," says Bailey, who attended the St. Louis forum, held Sept. 24-25. "The concentrations of foreclosures and vacant properties are quite dramatic—and it's incumbent upon us as individuals and organizations to do something.

"One thing that can help, though, is remembering that every loan—good or bad—is unique, and every issue is a one-on-one situation," Bailey says. Using the tools already at hand—such as offering an FHA loan instead of a prime loan—can help.

Cynthia Jordan, business development representative at Southwest Bank in St. Louis, also attended the St. Louis forum and saw some opportunity. "The forum gave us new ideas and strategies to add to what we are already doing as a community or looking at putting in place," said Jordan, whose bank has a foreclosure task force.

What next? If you're wondering what you can do next, check out what some of the following organizations are doing. (Links go to forum presentations.)

- **HSBC Bank USA:** "Your Home Counts" pilot REO disposition program. See www.stlouisfed.org/RRRseries/event2/Event2_Dallis.pdf.
- **Living Cities:** weak-market programs in Cleveland and Detroit. See www.stlouisfed.org/RRRseries/event4/Event4_Novotny.pdf.
- **Genesee County (Michigan) Land Bank:** vacant property disposition program. See www.stlouisfed.org/RRRseries/event5/Event5_kildee.pdf.

See www.stlouisfed.org/RRRseries for forum notes and PDF files of the presentations. For more on foreclosures, see the Foreclosure Resource Center at www.stlouisfed.org/foreclosure. ■

How Will Fannie and Freddie Operate in the Future?

By William R. Emmons

William R. Emmons is an officer and economist with the Banking Supervision and Regulation division at the Federal Reserve Bank of St. Louis.

The U.S. mortgage market has gone through enormous change during the past few years. Fannie Mae and Freddie Mac, two giant government-sponsored enterprises (GSEs), have been at the center of much of this upheaval. Today, Fannie and Freddie are in an unprecedented and paradoxical position. They dominate mortgage lending to an extent never seen before, yet the firms themselves lie in financial ruin. How will Fannie and Freddie operate in the future?

Fannie, Freddie and the financial crisis. Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Mortgage Loan Corp.) dominated the mortgage market early in the decade, with almost $2.5 trillion of mortgages underwritten to their credit standards—so-called prime conventional/conforming mortgages—during the peak year of 2003. This accounted for 62 percent of all mortgage loans made that year. The surge since early 2007 occurred because other mortgage lenders were contracting or exiting the market altogether. Moreover, Congress increased the loan amounts that Fannie and Freddie could purchase—that is, the conforming-loan limit was raised, creating the new category of "conforming jumbo loans."

Despite their commanding market presence, Fannie Mae and Freddie Mac collapsed into government conservatorship on Sept. 7, 2008, a form of suspended animation in which holders of the GSEs' common and preferred stock were virtually wiped out. But the mortgage operations continued uninterrupted, and all the debt and mortgage-backed securities that the firms issued were guaranteed by the federal government.

How did we get here? Despite many advantages, including an expectation by many market participants that the federal government would not let them fail, Fannie and Freddie badly misjudged the risks involved in mortgage lending. The GSEs and many other mortgage lenders essentially (and foolishly) had assumed that house prices could not decline significantly across the entire country at the same time. Once this began to happen after 2006, the rate of default and the losses lenders suffered on each default began to increase sharply. The initial spike in defaults appeared in subprime mortgages, but, by mid-2008, it had become clear that near-prime and even prime mortgage portfolios were suffering loss rates many times higher than previously expected. Because they held so little capital against unexpected losses, Fannie and Freddie—by far the largest mortgage funders and guarantors in the market—had became insolvent.

The future of Fannie and Freddie. Many people are asking how Fannie and Freddie will operate in the future. No one really knows because the fates of Fannie and Freddie lie with a future Congress. Federal lawmakers must decide whether, and how, to rehabilitate and reform the GSEs.

There are at least four distinct options under consideration. Will we go back to the traditional GSE model, in which the federal government provided numerous financial and competitive advantages to the firms while private shareholders provided equity capital and expected competitive returns on their stock? Will we, instead, liquidate the GSEs' operations and allow the private sector to fill the void created by the disappearance of Fannie and Freddie? Or will we effectively nationalize the former GSEs, operating them much like the Federal Housing Administration (FHA) and Ginnie Mae? Or will the GSEs' huge portfolios be carved up into many small mortgage lenders that are privatized separately with no federal-government preferences or guarantees?

The ultimate decisions on Fannie's and Freddie's fates are sure to be hard-fought politically. Whatever political choices are made, the technical and legal obstacles to a smooth transition likely will be formidable. Yet, the future of mortgage lending in the United States depends critically on how the fates of Fannie and Freddie are resolved. ■

Central Banker Online Compares Present Bank Failures with Collapses during the 1980s

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

- Failures of banks, thrifts and other key financial institutions set a record in 2008
- St. Louis Fed President Jim Bullard discusses systemic risk
- Fed examines what the data say about crime rates relative to a community's desirability
- Treasury offers new Treasury Covered Bond Framework
- Major Federal Reserve action reports gathered at new site
- Reg Z fee-based trigger increase takes effect Jan. 1
- Reg R entity compliance outlines bank broker exceptions
- Fed outlines Treasury early ACH/ check deliveries

Senior Bankers: Ask the Fed

The St. Louis Fed recently began a call-in program for senior officers of state-member banks and bank holding companies.

Titled Ask the Fed, the monthly call-in program features representatives of the Fed's Banking Supervision and Regulation division taking your questions following a briefing on a pertinent financial or regulatory topic.

Potential topics include economic updates, liquidity issues, loan losses and causes of financial challenges.

At the present time, the program is by invitation only. If you are a senior officer of a state-member bank or bank holding company and did not receive an e-mail or postcard invitation, contact the St. Louis Fed's Pat Pahl at 314-444-8858 or patrick.pahl@stls.frb.org.

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