SUMMER 2009
CENTRAL Banker
NEWS AND VIEWS FOR EIGHTH DISTRICT BANKERS

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Not Normal Times

What Is the Future of CRA?

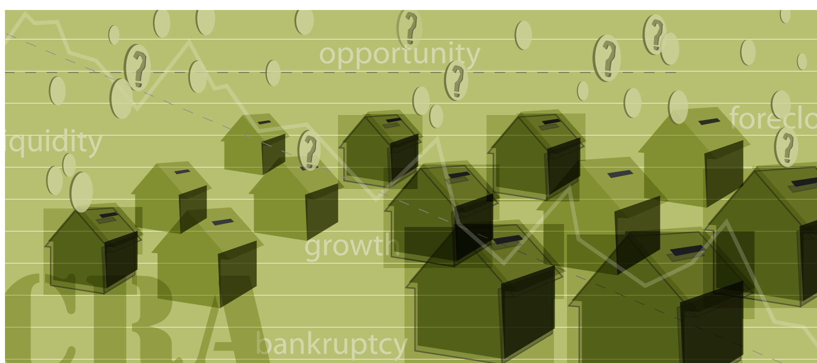
Since the financial crisis began, many bankers have wondered how the Community Reinvestment Act (CRA) will be updated to fit the changing financial landscape.

The 1977 law was created to make financial services more readily available in low- and moderate-income communities. However, some observers say it is time to update the law. Fed Gov. Elizabeth Duke, a former community banker, outlined the principles needed for a new CRA framework in a speech earlier this year.

"Keep the most effective feature of the law—its flexibility," she said. "Any new regulatory structure should also be clear about the problem we are trying to solve, determine who is in the best position to solve the problem, and be transparent and designed to ensure that community benefit is maximized without placing excessive regulatory burden on financial institutions."

Locally, bankers are seeing fewer opportunities to pursue CRA activities, and are wondering what's going to change. "Obviously, during normal economic times CRA is a challenge for lending, service and investment," says William Stemmler, vice president for CRA Community Development of Cadence Bank N.A. in Memphis, who attended a Fed CRA Interagency Training Workshop in April.

"These are not normal times, and I must say I have never lived through such a challenge during my 40 years in banking," he says. "Foreclosures, bankruptcy, unemployment and the banking liquidity crisis have made community development extremely difficult in most markets across the United States. Now, you have to work a lot harder to uncover opportunities for CRA."



To help you understand where CRA is headed, download the Fed's new "Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act" at www.bos.frb.org/commdev/cra/index.htm. The book offers a variety of ideas and opinions on revising the law.

>>MORE ONLINE

Read Gov. Duke's speech: www.federalreserve.gov/newsevents/speech/duke20090224a.htm

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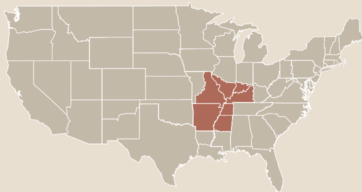
The Eighth Federal Reserve District includes all of Arkansas, eastern Missouri, southern Illinois and Indiana, western Kentucky and Tennessee, and northern Mississippi. The Eighth District offices are in Little Rock, Louisville, Memphis and St. Louis.



CENTRAL VIEW

Why Stress-Test Large Banks?

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.

Earlier this year, Treasury Secretary Timothy Geithner outlined a comprehensive plan to restore stability to our financial system. The plan encompasses several components, including a public/private investment program for legacy loans and securities, a mortgage refinancing program and a Capital Assistance Program (CAP).

The CAP has received significant attention because it serves as a complement to the recently completed "stress-test" of the nation's 19 largest financial organizations. The stress-test is a forward-looking assessment by bank supervisors, intended to ensure that these very large banks remain well-capitalized in the event of a worse-than-expected recession.

So, why was it beneficial to stress-test large banks?

Large-bank lending is of vital importance to the health of the economy. Large corporations redeploy loans from large banks into productive economic resources. Without a healthy financial system, economic growth weakens.

Market concerns over the capital positions of these large organizations have made it impossible for them to raise the capital they need on favorable terms and have led them to pull back from lending. This pullback materially reduces the ability of the financial system overall to perform the critical role of credit origination. A capital buffer increases the likelihood of lending and reduces the risk that problems at a very small number of institutions—through the many linkages across institutions—lead to the failure of otherwise viable institutions.

What happens now that the stress test is complete? By early June, the 10 banking organizations needing to augment their capital buffer were to develop detailed capital plans to be approved by their primary regulators, in consultation with the FDIC. The 10 organizations will have six months to implement the plans. If needed, the Treasury is making capital available under the CAP as a bridge to private capital in the future. The assistance, in the form of mandatory convertible preferred stock, is expensive. CAP securities carry a 9 percent dividend yield. After seven years, the security will automatically convert into common equity if not redeemed or converted before that date.

Slump Persists for District and U.S. Banks

By Michelle Neely

Earnings and asset quality continued their downward slide in the first quarter at Eighth District and U.S. commercial banks, reflecting the nation's real estate overhang and economic contraction.

Profitability at District banks fell yet again in the first quarter. Return on average assets (ROA) declined six basis points to 0.34 percent, and was down 59 basis points from its year-ago level. (See table.) U.S. peer banks (banks with average assets of less than $15 billion) actually collectively posted losses, with ROA measuring –0.02 percent. Negative earnings were concentrated at peer banks in the $1 billion to $15 billion size range. U.S. banks with assets of less than $1 billion recorded an average ROA of 0.38 percent; District banks posted an average ROA of 0.73 percent.

In the District, the ROA drop can be attributed to a fairly sharp decline in the net interest margin and an increase in the loan loss provision (LLP) ratio. For peer banks, the ROA decline was due entirely to sharp increases in LLP, as the net interest margin stayed flat and net noninterest expenses declined.

LLP as a percent of average assets rose to 0.88 percent at District banks and 1.25 percent at U.S. peer banks. The LLP ratio has increased at a rapid rate at both sets of banks to replenish loan loss reserves that are being drained by ever-increasing charge-offs of nonperforming loans. Still, the coverage ratio continues to decline. On March 31, District banks had 74 cents reserved for every dollar of nonperforming loans compared with 86 cents at year-end 2008 and $1.78 at year-end 2006. U.S. peer banks had 55 cents reserved for every dollar of nonperforming loans at the end of the first quarter, down from 64 cents at year-end 2008 and $1.83 at year-end 2006.

Increases in LLP 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 2.19 percent at District banks and an unusual 3.31 percent at peer banks in the first quarter. In the District, increases in nonperforming commercial and industrial loans and all types of real estate loans were the main contributors to the rise in the composite nonperforming loan ratio. Construction and land development (CLD) loans remain—by far—the most troubled part of loan portfolios. At the end of the first quarter, 6.26 percent of District banks' outstanding CLD loans were nonperforming; at U.S. peer banks, an astonishing 11.05 percent of CLD loans were nonperforming.

Despite the poor earnings and asset quality numbers, District banks remain on average well-capitalized. At the end of the fourth quarter, just three banks (out of 695) failed to meet at least one of the regulatory capital minimums. District banks averaged a leveraged ratio of 8.92 percent.

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

No Turnaround in Sight

	Q1 2008	Q4 2008	Q1 2009
RETURN ON AVERAGE ASSETS			
District Banks	0.93%	0.40%	0.34%
Peer Banks	0.80	0.08	–0.02
NET INTEREST MARGIN			
District Banks	3.79	3.78	3.64
Peer Banks	3.99	3.82	3.82
LOAN LOSS PROVISION RATIO			
District Banks	0.43	0.77	0.88
Peer Banks	0.58	1.06	1.25
NONPERFORMING LOANS RATIO			
District Banks	1.72	1.76	2.19
Peer Banks	1.63	2.69	3.31

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.

Re-establishing Connections

With Checks Gone, Fed Staff Looks To Rekindle Frequent Contact

By Robert Hopkins

Not long ago, Federal Reserve banks and branches had what seemed like continuous contact with financial institutions across the country. This was, in large part, attributable to involvement in near round-the-clock processing of check payments for financial institutions.

What Is the FI Touch?

The Financial Institution Touch (FI Touch) program has three broad objectives:

1. Through face-to-face meetings with Eighth District bankers, share key Fed messages and relay banker concerns to appropriate Bank management.
2. Acquire additional, contemporaneous input for the Bank's economic information-sharing initiatives, e.g., *Beige Book* and *Burgundy Books*, through the informal surveying of bankers on local economic activity.
3. Share Fed resources and technical expertise with communities throughout the various District zones and identify opportunities where the Federal Reserve Bank of St. Louis can provide added value to communities and leaders, i.e., bankers, chambers of commerce, educators, community development groups, etc.

With paper check-processing consolidated down to a few offices, we realized that we missed the everyday, valuable interaction that we once enjoyed with bankers, and we could use a fresh start. Last year, my colleagues and I—Martha Perine Beard and Maria Hampton, respectively the senior branch executives of the Memphis and Louisville branches—started a new program called Financial Institution Touch (FI Touch), through which we systematically and routinely meet with officials from Eighth District financial institutions to rekindle that interaction.

We have many reasons for doing this. (See sidebar: What Is the FI Touch?) In addition to reconnecting with bankers, we're also assessing local economies—such information can make its way into the Fed's *Beige Book* and *Burgundy Books* reports—as well as seeking feedback on other important issues confronting financial institutions and the Federal Reserve. In conjunction with these visits, we assess community needs and identify possible opportunities to provide Bank resources to the financial institutions and their communities.

Not surprisingly, my colleagues and I are finding the anecdotal economic information provided by bankers thoughtful and helpful. Because bankers and community leaders have unique perspectives on their local economic conditions and community needs, our discussions enable us to more effectively provide suggested assistance.

For example, one banker indicated that he had recently attended a Fed forum where an economist had presented current research and believed a similar program in his community would be beneficial. Another banker inquired about a recent regulatory issue confronting community banks and another about steps required to become a state member bank.

Another example: Steve Trusty, president of Simmons Bank of Hot Springs, Ark., told me recently, "I appreciate the opportunity to visit with Federal Reserve officials to share both the economic successes and challenges of the community we serve. I also find it beneficial to provide perspectives on policy debates occurring in Washington, D.C., and across the country that likely will have an impact on large financial institutions and community banks like ours."

The bankers that my colleagues and I have met with so far have put us in touch with local school administrators, where we shared economic and personal finance curricula and teacher

training programs that the St. Louis Fed produces. Bankers learned about the Fed and subsequently partnered with us in April (national Personal Finance Month) to teach local primary school children how to save.

We've also shared information and technical assistance with communities that historically have not functioned well so that we can help improve community development finance, asset building, and neighborhood stabilization and revitalization. Bankers have partnered with us to consider better ways to improve credit access for low- and moderate-income communities.

Because there are approximately 700 banks located in parts of seven states, St. Louis Fed officials have an ongoing challenge to personally maintain existing relationships, as well as build new ones, with bankers across the Eighth District. Through our public programs, supervision activities, financial services account executives and, now, our FI Touch program, we intend to meet the challenge. We can serve you better by understanding the unique economic conditions and needs of your communities.

For more information on St. Louis Fed banking and other programs, see www.stlouisfed.org/banking.

>>MORE ONLINE

Little Rock Branch:
www.stlouisfed.org/littlerock/

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Memphis Branch:
www.stlouisfed.org/memphis/

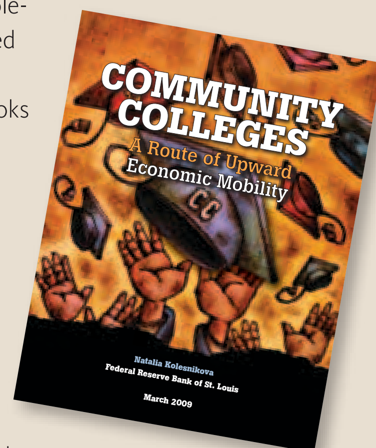
Robert Hopkins is the senior branch executive of the St. Louis Fed's Little Rock Branch.

REGIONAL SPOTLIGHT

Fed Looks at Student Loans and Community Colleges

Bankers might find two separate reports from the St. Louis Federal Reserve useful when considering loans for higher education.

Rajeev Bhaskar and Yadav Gopalan, research associates at the St. Louis Fed, explore the difficulty of getting school loans these days, even as college costs are rising. Their study, explored in the summer issue of the *Bridges* newsletter (www.stlouisfed.org/publications/br/), takes a closer look at various aspects of the financial needs of college-bound students, from what makes up the overall cost to what types of student loans are available. The authors also look at the rising cost of college and the impact of the credit crisis on student loans.



Second, economist Natalia Kolesnikova has written a report titled *Community Colleges: A Route of Upward Economic Mobility.* It looks at the advantages and disadvantages of attending community colleges and the characteristics of their students. Among the advantages are affordability, an open-admission policy and, ultimately, higher wages compared with the pay earned by those who have only a high school diploma. The study found that there is an increase in annual earnings of 5 percent to 8 percent for each year of community college education. Those who obtain an associate degree earn 16 percent to 17 percent more on average than high school graduates. Kolesnikova has been presenting the results of her study to audiences around the Eighth District of the Fed.

>>ONLY ONLINE

View a clip of Kolesnikova's presentation:
www.stlouisfed.org/video/community-colleges.mp4

Community Colleges report:
http://stlouisfed.org/community_development/assets/pdf/CommunityColleges.pdf

Banking Sector in Springfield, Mo., Shows Stress of Competition

By Gary S. Corner and Rajeev R. Bhaskar

To learn why, we compared Springfield with four similar mid-sized metro areas.

Springfield, Mo., is a mid-sized metropolis nestled in the Ozark Mountains in the southwest corner of the state. The local economy is heavily dependent on health care, education, manufacturing, retail and tourism. The gross metro product for Springfield in 2007 was $14.5 billion, giving it a national rank of 127 among metro areas. Solid economic growth has attracted many banks to operate in the area. Recent reports indicated, however, that there was some weakness in the banking sector.

To analyze the Springfield market, we performed a comparative study by looking at four mid-sized markets representing a cross section of the Eighth District outside of the four major metropolitan statistical areas (MSA). Besides Springfield, the other four markets were Columbia, Mo., Fayetteville, Ark., Jonesboro, Ark., and Jackson, Tenn. The study entailed comparing Springfield's economic and banking statistics with those of the four metropolitan areas.

TABLE 1

Fact Sheet on Springfield, Mo.

	Springfield, Mo.	5 MSA Average
Population	420,020	249,422
Population Growth Rate	2.4%	2.2%
Unemployment Rate	6%	5.6%
Current Total Workforce	220,026	130,280
Gross Metro Output (in billions)	$14.5	$9.2
Current Per Capita Income	$29,577	$30,107
Cost of Living Index	87.4	89.2

SOURCES: Springfield Business Development Corporation, Bureau of Labor Statistics, Bureau of Economic Analysis, Bureau of the Census and Council for Economic Activity and Research

Springfield Shows Banking Weaknesses

Table 1 compares economic data for Springfield with that of the other four MSAs; in terms of population and economic output, Springfield is somewhat larger than the average of the other MSAs. It compares fairly equally on the other metrics of unemployment, population growth rate, per capita income and cost of living. Springfield does not appear to be experiencing any unique economic shocks, such as big factory closings. Conditions there resemble what's typically happening in other parts of the nation.

However, in our analysis of banking conditions, we observed that of the five markets, Springfield showed some extra weakness on a number of metrics. (See Table 2.) At year-end 2008, return on assets at all Springfield banks was –0.15 percent, compared with 0.56 percent for Jonesboro (the second lowest) and 1.02 percent for Columbia (the highest). For the other metrics examined—loan loss reserves, CAMELS ratings and leverage ratio—Springfield banks ranked in the middle. Only one other metropolitan area (Fayetteville, 2.42 percent) had a higher proportion of nonperforming loans than Springfield (1.84 percent).

Springfield banks have higher levels of commercial real estate (CRE) concentration and noncore funding ratios compared with banks in the other areas. These observations, along with some of the other metrics, point to an extremely competitive market in Springfield.

Is Springfield's Market Overcrowded?

Springfield has had a decent share of banks open since the 1990s that have contributed to the crowded local financial services environment. Currently, 22 banks are headquartered in Springfield, compared with 12 in the

second highest MSA. In addition, 18 banks that are headquartered elsewhere operate branches in the Springfield market. When we applied the Herfindahl-Hirschman Index (HHI) to Springfield, a measure that attempts to capture the level of competition within a market by using the market share of all institutions operating in the region, we saw that Springfield has a very high level of competition. The value of HHI varies from zero to 10,000; the lower the number, the more competitive a market is. The HHI for the Springfield market is 730, the lowest of all metro areas in the study. See Table 2 for HHI scores of the other MSAs.

Springfield's overcrowded market observation has been echoed by local representatives of other regulatory agencies and banking leaders. It has also been noted that the market has not experienced a significant economic downturn in recent history. Consequently, some institutions may not have an institutional history of working through stressful economic periods. This lack of experience affects the competitive forces at work and influences credit underwriting, pricing and deposit practices.

In general, we do observe some extra weakness in the Springfield market compared with the other MSAs, although nothing we would categorize as severe. This weakness, we believe, is due to the relatively higher level of competition. Springfield has always been an attractive banking market with newer banks adding to the pressure on growth and earnings at existing banks. Until recently, banking conditions were largely unaffected by the increase in competition. The funding and asset deployment strategies in such a competitive market, though, are proving to be less resilient in an economic downturn.

Gary Corner is a senior examiner and Rajeev Bhaskar is a senior research associate of the Banking Supervision and Regulation division at the St. Louis Fed.

TABLE 2

A Comparison of Springfield Banks with Other Metropolitan Area Banks, Q4 2008

	Springfield, Mo.	Columbia, Mo.	Fayetteville, Ark.	Jonesboro, Ark.	Jackson, Tenn.
Banks Headquartered in Town	22	8	12	6	3
Total Assets (in millions)	$5,888	$1,982	$12,961	$3,356	$571
Return on Assets	-0.15%	1.02	0.68	0.56	0.96
Nonperforming Loans / Total Loans	1.84%	1.05	2.42	0.76	1.29
Loan Loss Reserves / Nonperforming Loans	94.97%	141.3	67.82	189.06	98.2
Tier 1 Leverage Ratio	8.83%	8.16	8.0	8.25	9.14
CRE to Total Loans	30.26%	26.35	28.12	27.7	21.9
Herfindahl-Hirschman Index (HHI)	730	1407	1943	1634	1474

SOURCES: Call Reports and CASSIDI (Federal Reserve Bank of St. Louis). Numbers in red indicate notable differences when compared with the other metropolitan areas' banks.

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Understand the Financial Climate with the Fed

You can't escape the word "recession" in today's news. But do the raw numbers contain a different message? Is this really a depression instead of a recession? And how is the Fed responding? Understand what's going on with two dynamic Fed web sites:

Tracking the Global Recession

http://research.stlouisfed.org/recession/

This site tracks the current economic environment through easy-to-understand charts of monthly indicators, such as employment, industrial production, retail sales and real income; current GDP data breakdowns; data from other countries; and more.

The Financial Crisis

http://timeline.stlouisfed.org/

The St. Louis Fed began this site last year to help the public better understand the major financial events and policy actions that the Fed has taken over the past months. Since spring, the site has been enhanced with new functionality and a wider array of material.