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How Bank Supervisors Can Get Early Warning of Banking Problems

R. Alton Gilbert

A bank supervisor's chief task is to prevent banks from failing. When a bank experiences serious problems that could lead to failure, the supervisor intervenes to prevent failure or to limit damage to the deposit insurance fund, bank customers and the community where the failed bank had offices. To be effective in preventing or limiting such damage, supervisors need to act as quickly as possible. Thus, supervisors value any tool that can give them a reliable indication of impending bank problems.

The most important way supervisors assess the condition of a bank is to conduct an on-site examination. Each of you has been visited by examiners employed by your supervisory authority, who review your institution's safety and soundness. Because examiner judgment is a valuable but scarce resource, supervisors supplement the on-site exams with off-site surveillance to help schedule and plan future examinations. Supervisors rely primarily on two analytical tools to conduct off-site surveillance: supervisory screens and economic models. Both tools help identify banks with emerging problems, as well as the sources of the problems, as early as possible.

Supervisory screens are financial ratios that, in the past, have given forewarning of safety and soundness problems. For instance, supervisors may use the ratio of net income divided by total assets as a screen. Banks with relatively low income ratios would be subject to closer scrutiny than others. Because some ratios used as screens are more important than others, supervisors draw on their experience to establish various rules of thumb for combining the information in the ratios.

Econometric models, on the other hand, combine various financial ratios to derive a single measure of bank condition. In some models, the measure is an estimate of the probability that a bank will fail. In others, the measure is an estimate of the probability that a bank's supervisory rating will be downgraded to problem status.

Prior studies report that econometric models are better predictors of emerging problems in banks than supervisory screens. Yet supervisors tend to rely on screens, probably because they are more intuitively appealing than the single numerical rating that an econometric model provides.

In the article cited below, my co-authors and I attempt to develop an econometric model that addresses supervisors' concerns about using econometric models for surveillance. Like some other models, our model is designed to forecast downgrades in supervisory ratings. Our model of downgrades, however, is more forward-looking than existing models. In addition, the model is able to pinpoint specific areas of developing weakness in a bank, instead of just providing an overall rating. For example, the model may highlight a relatively high ratio of nonperforming loans to total loans as the chief reason for a bank's high probability of being downgraded to problem status. For a different bank with the identical overall rating, the model may point to a

relatively low liquidity ratio as the primary concern. In each case, subsequent examinations of these two banks could be tailored to the aspects of their operations highlighted by the model.

Our research does not suggest that screens should be dropped from the surveillance toolbox. When abrupt changes occur in the cause of bank failures and downgrades of supervisory ratings, supervisors can use their first-hand knowledge to modify screens long before models can be revised to reflect these new conditions. We conclude that both screens and models add value in off-site surveillance, but that supervisors should rely more heavily on models in the future than they have in the past.

A longer version of this article, co-authored by Gilbert, Andrew P. Meyer and Mark D. Vaughan, will be published in the Nov./Dec. issue of the St. Louis Fed's *Review*.

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Feditorial: Rising to the Challenge of Economic Education

William Poole

Every citizen needs to be able to read, write and...and, "what else?" Each of us has a favorite list of "what else." Without getting into everything on my own list—and there is a lot—let me focus on basic economics knowledge. The Federal Reserve has a vested interest in furthering the public's understanding of economics. One important way we are reaching a young audience is through the Fed Challenge competition. My personal involvement with this program has given me an appreciation of what a great opportunity Fed Challenge is because it reaches people during their formative high school years.

Why is economic education so important? To live independently, a person must know the basics of how to earn and spend money. The large number of personal bankruptcies in today's economy provides clear evidence that there is a need to educate young people about the basics of household financial management. Day in and day out, our democracy decides issues concerning government taxes and spending. These are also money issues—more precisely, resource-use issues. Almost all government regulations and controls have an economic purpose or, at a minimum, an economic impact. How can citizens and their representatives vote wisely on these matters without knowing a little economics? They can't.

I know that an important element of our society's success is the depth of the economics understanding of our citizens. I also know that the economic education plate is piled high with unfinished business. Economics can be intimidating, and it may sit on the plate untouched like overcooked broccoli (my apologies to broccoli lovers). Fed Challenge is an innovative way to turn that broccoli into a student's favorite vegetable. This program is one of the ways—the most exciting way, I think—we at the Fed are working to educate young people about economics.

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https://www.stlouisfed.org/publications/central-banker/fall-1999/fed-shifts-y2k-plans-to-contingency

Fed Shifts Y2K Plans to Contingency

As 1999 begins to draw to a close, the Federal Reserve Bank of St. Louis is shifting its Y2K preparation from testing to contingency. Even though the banking industry is widely considered as well prepared as any for Y2K, said Jeff Dale, the St. Louis Fed's Century Date Change coordinator, contingency plans are necessary to guard against "something going wrong in spite of everything we did."

At the heart of these efforts is the creation of a Local Communication Center (LCC) at the St. Louis office and each of the three Branch offices. Each LCC will serve as a central hub in its respective part of the Eighth District to disseminate Y2K-related information and provide status updates to Fed staff, customers and the public. Most of the information communicated through the LCCs will be routine, but if the unexpected should happen, a full staff will be present to handle any scenario.

"If anything did happen, we have to be ready to handle any reaction from the public and supply them with realistic information," said the St. Louis Fed's Joe Elstner, who has been charged with tailoring the Bank's crisis communications plan to deal with every possible scenario that might take place. "We want people to be able to turn to us for correct information, instead of gossiping or speculating."

In terms of a liquidity response, the Fed has been encouraging financial institutions to set up borrowing arrangements early to fund their loan requests quickly (see related story in Regional Roundup section). The Fed has also taken steps to ensure that enough cash is available for financial institutions.

"Institutions will have to make sure they order enough funds and have more cash on hand than usual," said Jerry McGunnigle, assistant vice president in the St. Louis Fed's Cash Department. "We are already receiving extra shipments of new currency, and we are processing deposited currency as fast as possible so we can have as much as possible in our ready-to-pay inventory."

For more information on the Fed's Y2K contingency preparation, call Jeff Dale at (314) 444-8400.

CENTRAL BANKER | FALL 1999
https://www.stlouisfed.org/publications/central-banker/fall-1999/updated-community-profiles-to-be-released

Updated Community Profiles to be Released

The St. Louis Fed is revising profiles of two District communities—Little Rock and Memphis—which will be available for distribution shortly. In addition, a new community profile of the Hannibal, Mo., and Quincy, Ill., area will be released later this fall.

Community profiles are created to stimulate awareness of financial institutions about programs designed to meet the community development lending, service and investment needs of the areas profiled. The profiles identify programs that help meet those needs and encourage public/private partnerships that typically involve the efforts of city, state and federal agencies, local community organizations and financial institutions.

The revised profiles include updated demographics, needs assessments, and government program descriptions. The section identifying local community organizations has also been revised to reflect the latest services and programs. Lenders may choose to partner with community organizations or access available government programs to increase their community development participation.

The Little Rock and Memphis profiles are the first in a series of community profiles to be revised. Throughout the next two years, lenders in other parts of the District should be on the lookout for new or updated profiles for their communities. Current profiles include; Fayetteville-Springdale-Rogers and Texarkana, Ark.; Evansville, Ind.; Louisville and Owensboro, Ky.; Columbia, Springfield and St. Louis, Mo.; Jackson, Tenn.; and the Lower Mississippi Delta region (rural counties in Arkansas, Kentucky, Mississippi, Missouri and Tennessee).

As the community profiles are completed, the Fed will distribute them to financial institutions. Profiles are also available on the Community Affairs section of the St. Louis Fed's web site, www.stlouisfed.org.

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https://www.stlouisfed.org/publications/central-banker/fall-1999/ach-fees-reduced-by-nearly-8-percent

ACH Fees Reduced by Nearly 8 Percent

In August, the Federal Reserve reduced fees for its Automated Clearing House (ACH) origination services.

Under the new fee schedule, the cost to originate ACH forward and return transactions will be reduced by $.0005, an average of 7.7 percent. Customers who deposit files of fewer than 2,500 items will be assessed a per-item fee of $.0065. Customers who deposit files of more than 2,500 items will be assessed a per-item fee of $.0055. The cost to receive ACH transactions will remain at $.007 per item.

This fee decrease, coupled with the Direct Deposit and Direct Payment Coalition's national ACH promotion and education campaign, is expected to further encourage ACH growth and help broaden the use of electronic payment systems.

Questions regarding ACH fees should be directed to Cheryl McCarthy at (314) 444-8459. For information regarding the ACH promotion and education campaign, visit the coalition's web site at http://frbservices.org/serviceofferings/fedach/.

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Regional Roundup

Fed Establishes Special Y2K Liquidity Facility

The Federal Reserve Board has voted to establish a Century Date Change Special Liquidity Facility, a program for lending to depository institutions from Oct. 1, 1999, through April 7, 2000. The facility will help ensure that depository institutions have adequate liquidity to meet any unusual demands and enable them to more confidently commit to supplying loans to other financial institutions and businesses through the Y2K rollover period.

The interest rate charged on loans from the special facility will be 150 basis points higher than the Federal Open Market Committee's intended federal funds rate. Although collateral requirements will be the same as for regular discount window loans, there will be no restrictions on the use and duration of loans from the special facility while it is in operation. Moreover, borrowers will not be required to seek funds elsewhere first.

For more information, call Harold Slingerland at (314) 444-8752.

Five Join St. Louis Fed's Business Development Staff

The St. Louis Fed has announced the following staff additions to its Business Development function:

- Robert Kellar, operations officer, St. Louis, (314) 444-8451;
- Pam Hake, account executive, St. Louis, (314) 444-8319;
- Kim Peters, account executive, Little Rock, (501) 324-8251; and
- Chandra Hester, customer service representative, Memphis, (901) 579-2435.

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FedFacts

Revised Handbook on Adjustable Rate Mortgages Available

A revised version of the Federal Reserve Board's brochure entitled *Consumer Handbook on Adjustable Rate Mortgages* is now available. The first 100 copies ordered each year are free; additional copies are $25 per 100, prepaid.

Bankers wanting to order copies should write to: Publication Services, Mail Stop 127, Board of Governors of the Federal Reserve System, Washington, D.C., 20551. The brochure is also available on the Board's web site at www.federalreserve.gov/pubs/arms/arms_english.htm.

Fed Revises Commentary to Regulation Z

The Federal Reserve Board has revised its Official Staff Commentary to Regulation Z, Truth in Lending, to provide guidance on the prohibition against the issuance of unsolicited credit cards and the calculation of payment schedules involving private mortgage insurance. The update also discusses credit sale transactions in which the down payments include cash and property used as trade-in and adopts several technical amendments.

Revisions are effective immediately. Compliance is optional until March 31, 2000. For more information, call Henry F. Dove Jr. at (314) 444-8846.

Commentary to Consumer Leasing Regulation Revised

The Federal Reserve Board has revised its Official Staff Commentary to Regulation M, Consumer Leasing, to provide guidance on disclosures for lease re-negotiations and extensions, official fees and taxes, multiple-item leases and advertisements.

Revisions are effective immediately. Compliance is optional until March 31, 2000. For more information, call Henry F. Dove Jr. at (314) 444-8846.