FEDERAL RESERVE BANK OF ST. LOUIS

FALL 2008

# Central Banker

*News and Views for Eighth District Bankers*

## Fed Emergency Contact System To Be Deployed in Arkansas


Clear and open communications are often immediate casualties when a natural or man-made disaster hits an area. As a community leader, you'd want your financial institution up and running again as quickly as possible to help your area return to normal. You may not have the time or the people to address the informational needs of regulators.

The Federal Reserve will provide help through an online tool that will initially be deployed to Arkansas state-chartered banks later this year. The Fed and the Arkansas State Bank Department will use the new Emergency Communications System (ECS) to contact financial institutions quickly and simultaneously during a crisis, gather basic information from institutions and provide them with information on state and Fed regulatory actions. Because the tool is designed to be self-service, the institutions will determine what key personnel should be contacted.

The concept of an ECS grew from discussions between the Fed and Eighth District bank commissioners. "The tool is for crisis and contingency purposes only, and the information would never be used for marketing," says the Fed's John Hussey, who is overseeing the tool's development. "ECS could also be used for nonphysical disaster situations, such as information on critical activities within the banking system or operational changes affecting state and federal banking regulators."

The Arkansas State Bank Department and two Arkansas banks—Eagle Bank and Trust in Little Rock and Cross County Bank in Wynne—participated in the ECS pilot program.

Future opportunities and partnerships are being explored with the remaining Eighth District states (Missouri, Indiana, Mississippi, Tennessee, Kentucky and Illinois) and other Reserve banks and regulators so that state-chartered banks in those states could use the system as well. ■

## District Banks Face Tough Times but Outperform U.S. Peers

*By Michelle Neely*

Earnings and asset quality at District banks and their national peers remained weak in the second quarter, reflecting general economic malaise and continued deterioration in housing markets.

In the District, return on average assets (ROA) hit a 20-year low in the second quarter of 2008. ROA averaged 0.81 percent—12 basis points below its first-quarter level and 25 basis points below its year-ago level. Still, District banks significantly outperformed their U.S. peers (banks with average assets of less than $15 billion); the latter group posted an average ROA of 0.61 percent in the second quarter, compared with 0.81 percent in the first quarter and 1.18 percent a year ago.

District banks' average net interest margin (NIM) held steady at 3.79 percent, while it declined two basis points at peer banks.

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# **Fed**itorial

## *Continuity and Community Interact at the St. Louis Fed*

*By Jim Bullard, president and chief executive officer of the Federal Reserve Bank of St. Louis*

When I settled into my new position as the St. Louis Fed president in April, I knew one of the first things bankers and others in the financial industry would want to know was, what do I think and believe? As we go forward, I'll be sharing those beliefs through various venues.

Before becoming president in April, I was an economist and deputy director of research for monetary analysis in the Research division. (See http://research.stlouisfed.org/econ/bullard/index.html for a list of my published work.) I conducted economic analysis in the field of macroeconomics and monetary theory, and worked side by side with former presidents Bill Poole and Tom Melzer, helping them design policies and prepare for the Federal Open Market Committee meetings. Like both Poole and Melzer, I am committed to preserving the strong monetarist tradition for which the St. Louis Fed is known.

In the past several months, I have had the opportunity to share with the public some of my fundamental beliefs about monetary policy through various speeches I have delivered. (Speeches are available at www.stlouisfed.org/news/speeches.html.)

An integral part of my role as president of the St. Louis Fed is to meet with bankers, business leaders and community leaders, particularly from our District, but also from throughout the United States and the rest of the world. This interaction lets me hear your thoughts and concerns about the local, national and international economy. This source of information is highly valuable because your feedback provides me with a picture of the economy—at both the macroeconomic and microeconomic levels—that I can use in my policymaking role. I accomplish this through different economic, educational and community events, such as board of directors meetings, economic forums and business luncheons.

I plan to visit all District branch cities in the coming months; so, watch for invitations or visit www.stlouisfed.org/news/conferences.html. I look forward to meeting and hearing from you in the coming months and years. ■

# Fed Establishes New Mortgage Rules for All Lenders

The Federal Reserve Board laid out a new rule in mid-July to better protect consumers and facilitate responsible lending.

This rule is an amendment to the home mortgage provisions of Regulation Z (Truth in Lending). Anecdotal evidence gathered from many sources has indicated that few small and community bankers in the Eighth District engaged in subprime loans. However, as a banker or other lender, here's what you need to know:

- The new mortgage rules apply to all lenders.
- Lenders must evaluate the borrower's ability to make scheduled payments; lenders must also verify the borrower's income and assets.
- Prepay penalties are banned in certain higher-priced loan situations and restricted in others.
- Consumers need to be given disclosures earlier in the process.
- Lenders will be required to establish escrow accounts for higher-than-average interest loans so that property taxes and insurance costs will be included in regular monthly payments.

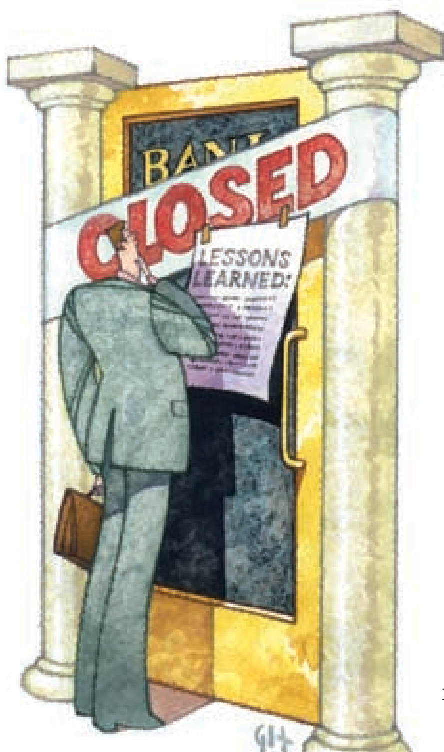
Fed Chairman Ben Bernanke said in mid-July, "The new rules … will establish lending standards aimed at curbing abuses while preserving responsible subprime lending and sustainable homeownership. … We believe the new rules will help to restore confidence in the mortgage market."

See the full details at www.federalreserve.gov/newsevents/press/bcreg/regz20080714.htm. ■

# Bank Failures Give Lessons in Missed Basics

*By Allen North*

The summertime collapse of IndyMac represented the second-largest U.S. bank failure ever. IndyMac, a $32 billion federal savings bank, based in Pasadena, Calif., was the fifth-largest mortgage lender in the country. Locally, Arkansas experienced its first bank failure in seven years when the Comptroller of the Currency closed ANB Financial of Bentonville on May 9.




Both failures were widely publicized due to the banks' size and overall business strategies. According to published reports, IndyMac suffered a liquidity crisis caused by a deposit run. IndyMac was a large originator of alt-A mortgages, which were often made to borrowers with poor credit. As the secondary market for these loans collapsed, the bank's liquidity became strained.

News reports asserted that ANB lacked the capital to withstand a high level of nonperforming loans. ANB had approximately $1.9 billion in total assets, roughly 90 percent funded with brokered deposits, which are more volatile than core deposits. According to published reports, ANB's past due and nonaccrual loans more than tripled during the six months preceding closure.

The FDIC estimates that the failure of IndyMac will result in a material loss to the deposit insurance fund of approximately $8 billion, while ANB's failure will amount to a $214 million loss to the fund.

In light of these failures, let's look at issues that affect a bank's financial condition and what lessons can be learned. The problems typically fall into one or more of the following categories:

- Management forgets/ignores the principle of risk and return.
- Management fails to properly diversify.
- Bank personnel engage in activities that they do not fully understand.
- Management is incompetent, or a fraud is committed.

Banks can often achieve impressive returns—which far exceed peer levels—by employing aggressive growth strategies, such as expanding into unfamiliar markets, lowering overall credit quality or exposing the bank to high-risk commercial real estate concentrations. Often, funding strategies involve more costly and less stable wholesale funding in the form of brokered deposits. The volatile combination of aggressive asset growth funded with wholesale sources can create tremendous strains on liquidity and increase the bank's sensitivity to interest rate fluctuations.

A better means of achieving growth is a measured approach with an appropriate funding and risk management strategy established prior to any significant growth.

Boards of directors should give close attention to the time-proven fundamentals of lending during good economic times. Otherwise, issues will inevitably arise when credit conditions deteriorate.

Additionally, boards should pay close attention to the liability side of the bank's balance sheets. Brokered deposits, used within prudent levels, can serve as a legitimate source of funding. However, if asset quality deteriorates and capital ratios fall, prompt corrective action triggers can restrict the renewal of brokered deposits. (For more, see "Prompt Corrective Action: What Does It Mean for a Bank's Liquidity?" in this issue's online-only content at www.stlouisfed.org/publications/cb.)

Boards of all banks should also consider contingent funding plans. Where appropriate, these plans should include completing the required documents and pledging collateral for contingency access to the discount window. (See www.frbdiscountwindow.org for more.) ■

*Allen North is an assistant vice president in the St. Louis Fed's Banking Regulation and Supervision division.*

# Regional Roundup

## Foreclosure Forum Set for St. Louis

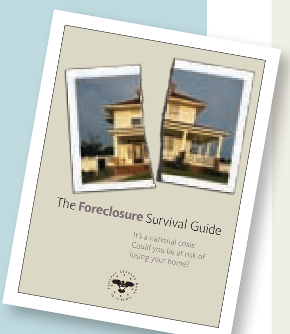
As part of its Homeownership and Mortgage Initiative, the Federal Reserve is sponsoring a series of foreclosure forums across the country, including one in St. Louis. Called "Recovery, Renewal, Rebuilding," the series is designed to generate discussion on the aftereffects of the foreclosure crisis among business and community leaders, government officials and policymakers.

The forums examine the current state of communities that are experiencing significant foreclosures. Creative solutions for recovering and preparing for the future are explored. National experts discuss the challenges that foreclosures present and engage participants in finding solutions.

The Homeownership and Mortgage Initiative is a comprehensive Federal Reserve strategy to provide information to help prevent unnecessary foreclosures and to stabilize communities affected by the crisis.

The forum scheduled for St. Louis on Sept. 24 and 25, called Strengthening Neighborhoods in Weak Markets, is open to all interested parties. See www.stlouisfed.org/RRRseries to register.

## Banks Can Offer New Foreclosure Survival Guide




Homeowners who are having difficulty making their mortgage payments can get helpful information from *The Foreclosure Survival Guide,* new from the Federal Reserve Bank of St. Louis.

This brochure provides basic information on who is at risk for foreclosure, where to find help and pitfalls to avoid when seeking help. The free publication includes a national hot line number (1-888-995-HOPE) and a list of local counseling agencies that homeowners can call for advice.

Bankers who would like copies of the guide to distribute can call Cynthia Davis of the St. Louis Fed at 314-444-8761 or e-mail communitydevelopment@stls.frb.org.

## Tough Times

*continued from Page 1*

Profitability ratios at both sets of banks were brought down by small increases in net noninterest expense and more substantial boosts in loan loss provisions. Loan loss provisions as a percent of average assets (LLP ratio) rose nine basis points to 0.52 percent in the District—almost triple the level of a year ago. At national peer banks, the increase was more pronounced (to 0.71 percent).

Loan loss provision increases reflect, of course, asset quality problems that continue to mount in the District and nation. The ratio of nonperforming loans to total loans was 1.53 percent at District banks and 1.92 percent at U.S. peer banks at the end of the second quarter. The proportion of nonperforming loans has nearly doubled at District banks and has more than doubled at peer banks over the past year.

Problems in the real estate portfolio are primarily responsible for the overall increase: At the end of the second quarter, 1.77 percent of real estate loans were nonperforming at District banks. Within the real estate portfolio, delinquency ratios were most pronounced in construction and land development loans (4.25 percent) and multifamily loans (1.60 percent). Delinquency rates have risen in C&I and consumer portfolios, too. The trends are identical at peer banks.

District banks remain on average well-capitalized. At the end of the second quarter, just one bank (out of 713) failed to meet one of the three regulatory capital ratios. District banks averaged a leverage ratio of 9.11 percent. ■

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

### Tougher Times for District Earnings and Loan Quality[1]

| | 2nd Q 2007 | 1st Q 2008 | 2nd Q 2008 |
|---|---|---|---|
| **RETURN ON AVERAGE ASSETS[2]** | | | |
| District Banks | 1.06% | 0.93% | 0.81% |
| Peer Banks | 1.18 | 0.81 | 0.61 |
| **NET INTEREST MARGIN** | | | |
| District Banks | 3.87 | 3.79 | 3.79 |
| Peer Banks | 3.96 | 3.85 | 3.83 |
| **LOAN LOSS PROVISION RATIO** | | | |
| District Banks | 0.19 | 0.43 | 0.52 |
| Peer Banks | 0.22 | 0.57 | 0.71 |
| **NONPERFORMING LOANS RATIO[3]** | | | |
| District Banks | 0.89 | 1.71[4] | 1.53 |
| Peer Banks | 0.83 | 1.63 | 1.92 |

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 earning average assets in the denominator.
3 Nonperforming loans are those 90 days or more past due or in nonaccrual status.
4 Excluding data of ANB Financial brings the 1st quarter NPL ratio down to 1.54 percent.

# What Can Be Done about the Widening Income Gap?

By Christopher H. Wheeler

*Christopher H. Wheeler is a former Research officer at the Federal Reserve Bank of St. Louis. Access more of his research at http://research.stlouisfed.org/econ/wheeler/index.html.*

A common mantra among politicians is that the rich are getting richer while the poor are getting poorer. Data point to a dramatic rise in income inequality in the United States between 1980 and 2006.

The findings were published this summer in *Earnings Inequality within the Urban United States: 2000-2006,* which examines hourly labor earnings for 298 U.S. metropolitan areas—including St. Louis, Little Rock, Louisville and Memphis. The full report is available at www.stlouisfed.org/community/assets/pdf/Income_Inequality_report.pdf.

The data on the whole indicate that there is an ever-widening wage gap between those at the top end of the pay scale and workers at the low end. The rise in wage inequality has been driven by such factors as educational attainment, e.g., high school versus post-baccalaureate degrees. Based on an analysis of inequality, some of the most important correlates of rising inequality between 2000 and 2006 were found to be:

- decreasing manufacturing,
- rising fractions of foreign-born workers (which are possibly associated with increased numbers of low-skill workers),
- rising rates of unemployment and
- increased fractions of workers with advanced degrees.

These findings generally support theories that the wage gap is widening because of changes in industrial structure, rising low-skill labor supply and skill-biased technological change.

### What Can Policymakers Do?

Evidently, since much of the rise in inequality is associated with the supply of and demand for workers with high levels of skills, inequality is probably best handled by increasing the fraction of workers with high levels of education.

Of course, while helping workers at the bottom end of the distribution acquire human capital would undoubtedly help raise the lower end of the wage distribution, increasing the total supply of highly skilled workers may exacerbate inequality, at least in the short run. An increase in the number of workers with advanced degrees may create even greater bias for the highly skilled and enhance their earnings—while leaving behind those with lesser education.

Over time, however, as workers with high levels of schooling become the majority of the American labor force, the degree of homogeneity among workers increases. In addition, the extent to which employers are forced to bid for relatively few high-skill employees will decrease, dampening growth at the top end of the earnings scale.

Policies aimed at influencing skills are probably more desirable than those attempting to affect what types of industries employ American workers, e.g., subsidizing certain sectors, strengthening trade barriers. Indeed, the decline of jobs in manufacturing represents the confluence of forces well beyond the control of government, forces such as the evolution of technology, the decline of transportation costs and the growing integration of markets around the world.

Therefore, falling wages and the problems associated with workers who have been displaced from this sector are probably most effectively addressed through programs that provide workers with job skills that the American economy now demands, as discussed in the report. Moreover, by augmenting the human capital of all workers in the United States, the ability of individuals to make the transition from one line of work to another is enhanced, with relatively modest losses in earnings. ■

## *Central Banker* Online Looks at Liquidity

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

- The Fed's Julie Stackhouse looks at what prompt corrective action means for a bank's liquidity.
- A new Fed web site supports minority-owned institutions and de novo banks.
- The Fed's Community Development Advisory Council is ready to serve.
- Christopher Waller to become St. Louis Fed's director of Research.
- New rules are coming in 2009 for Fed ACH international transactions.
- Innovation Exploration continues in the Eighth District.

# Calendar Events

UPCOMING FED-SPONSORED EVENTS FOR EIGHTH DISTRICT DEPOSITORY INSTITUTIONS

### Local Business Cycles and Crime Rates

ST. LOUIS—OCT. 29
LITTLE ROCK—NOV. 20
LOUISVILLE—DEC. 3
MEMPHIS—DEC. 9

Fed economist Thomas A. Garrett will discuss his new study on local business cycles and their effect on crime rates. The report includes information on four urban areas in the Bank's district: St. Louis, Little Rock, Louisville and Memphis. Register online at www.stlouisfed.org/community or by contacting the Fed's Cynthia Davis in St. Louis at 314-444-8761, Julie Kerr in Little Rock at 501-324-8296, Lisa Locke in Louisville at 502-568-9292 or Cathy Martin in Memphis at 901-579-4102.

### Child Development Accounts: A Research and Policy Symposium

ST. LOUIS—NOV. 12-14

Scholars from around the country will present papers on the national potential of child development accounts, a rapidly emerging idea in the United States. For information, call or e-mail Washington University's Gena Gunn at 314-935-9651 or ggunn@wustl.edu.

### Economics of Ethanol: Costs, Benefits and Future Prospects of Biofuels

ST. LOUIS—NOV. 14

Members of financial institutions and other business leaders are among those invited to a nontechnical conference on the economics of ethanol. Session topics include the profitability of ethanol processing, the impact of ethanol subsidies on rural economies, and the effects on food prices and farm production decisions. The St. Louis Fed's Research division is among the hosts for the conference, which will be held at Washington University in St. Louis. For more information, see http://research.stlouisfed.org/conferences/ethanol/index.html, or e-mail the Fed's Tom Garrett at tom.a.garrett@stls.frb.org or Washington University's Melinda Warren at warren@wustl.edu.

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https://www.stlouisfed.org/publications/central-banker/fall-2008/prompt-corrective-action-what-does-it-mean-for-a-banks-liquidity

# Views: Prompt Corrective Action: What Does It Mean for a Bank's Liquidity?

**Julie L. Stackhouse**

Allen North's article, "Arkansas Bank Failure Teaches Lessons in Missed Fundamentals," in this issue of *Central Banker* points out the challenges of managing bank liquidity when asset quality issues arise.

Section 38 of the Federal Deposit Insurance Act requires insured depository institutions and federal banking regulators to take "prompt corrective action" to resolve capital deficiencies at insured depository institutions. What are the relevant prompt corrective action provisions that can affect liquidity, and what should a bank's board of directors consider when setting a bank's liquidity tolerances? Key provisions for different capital categories include the following:

## Adequately capitalized institutions

Such institutions must receive a waiver from the FDIC to accept, renew or roll over brokered deposits (banks sell these large-denomination deposits to brokerages). A waiver is granted on a case-by-case basis, upon a finding that acceptance of such deposits does not constitute an unsafe and unsound practice.

If granted, an institution may not pay an effective yield that exceeds by more than 75 basis points the effective yield paid on deposits of comparable size and maturity.

Institutions that are undercapitalized to varying degrees must take additional actions and have additional requirements:

## Undercapitalized institutions

- must file an acceptable capital restoration plan;
- cannot pay dividends or management fees;
- may not accept, renew or roll over any brokered deposit; and
- may not solicit *any other deposits* by offering an effective yield that exceeds by more than 75 basis points the effective yield paid on deposits of comparable size and maturity.

## Significantly undercapitalized institutions

- are subject to the same actions as an undercapitalized bank;
- cannot pay bonuses to, or increase compensation of, senior executive officers without prior regulator approval; and
- are subject to other restrictions and actions as noted in the Federal Deposit Insurance Corporation Improvement Act (FDICIA).

## Critically undercapitalized institutions

- are subject to the same provisions as an undercapitalized bank and a significantly undercapitalized bank; and
- cannot pay interest or principal on subordinated debt (without FDIC waiver) after 60 days of becoming critically undercapitalized.

In addition, within 90 days of the bank becoming critically undercapitalized the chartering authority must:

- appoint a receiver; or
- take other such actions that the primary regulator, with the concurrence of the FDIC, determines would better serve the purposes of prompt corrective action (and review such determination every 90 days).

What does this all mean? As capital ratios deteriorate, the ability to generate high-rate deposits can become restricted. Moreover, Section 142 of the Federal Deposit Insurance Act places limits on Federal Reserve discount window lending in these situations.

The best solution to liquidity strains during times of financial stress is to prevent them. Therefore, boards of directors should consider:

- setting liquidity risk tolerances for the bank and maintaining diversified funding sources;
- establishing policies, procedures, limits and internal controls;
- maintaining standards to identify, measure, monitor, control and report liquidity risk; and
- periodically conducting scenario analysis and contingency planning exercises.

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## Capital Categories for Financial Institutions

| Capital Category | Total Risk-based | Tier 1 Risk-based | Leverage | Other |
|---|---|---|---|---|
| **Well-capitalized** | 10% or more | 6% or more | 5% or more | not subject to formal action to maintain a specific capital level |
| **Adequately capitalized** | 8% or more | 4% or more | 4% or more | leverage ratio of 3% or more if bank is 1 rated and not growing |
| **Undercapitalized** | less than 8% | less than 4% | less than 4% | leverage ratio of 3% or more if bank is 1 rated and not growing |
| **Significantly undercapitalized** | less than 6% | less than 3% | less than 3% | N/A |
| **Critically undercapitalized** | N/A | N/A | N/A | tangible equity to total assets ratio of 2% or less |

SOURCE: Section 38 of the Federal Deposit Insurance Act

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https://www.stlouisfed.org/publications/central-banker/fall-2008/check-out-exploring-innovation-resources

# Tools: Check Out “Exploring Innovation” Resources

Earlier this year, the St. Louis Fed held receptions, seminars and tours in Arkansas, Kentucky, Mississippi, Missouri and Tennessee related to exploring innovation in community development.

The Fed held Innovation in Community Development Week in April to raise awareness of financial possibilities and honor those who search for new ways to improve life in low- to moderate-income areas.

Many of the articles and resources used for the week's events are available at the Exploring Innovation web site. Next year's Exploring Innovation Week is scheduled for April 22–29.

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https://www.stlouisfed.org/publications/central-banker/fall-2008/new-rules-coming-in-2009-for-fed-ach-international-transactions

# Tools: New Rules Coming in 2009 for Fed ACH International Transactions

By March 20, 2009, all international transactions made via the ACH network will be required to use the IAT (International ACH Transaction) SEC (Securities and Exchange Commission) code.

It's a new rule that applies to all ACH participants. The rule will simplify the process of identifying international transactions by requiring that IAT entries include specific data elements defined by the Bank Secrecy Act's travel rule.

The change will make it easier for depository financial institutions to comply with U.S. laws, such as requirements by the Office of Foreign Assets Control (OFAC). It will also define new parties to the IAT entry and enhance processing efficiencies for all ACH participants.

Read more at www.frbservices.org, including preparation instructions.

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https://www.stlouisfed.org/publications/central-banker/fall-2008/fedfacts

# FedFacts

## New Fed Web Site Supports Minority-Owned Institutions and De Novo Banks

Minority-owned depository institutions and de novo banks can receive support from a new Federal Reserve web site, www.fedpartnership.gov. The site is part of the Fed's Partnership for Progress program, which was created to preserve and promote minority institutions and enhance their ability to thrive in a competitive banking environment. The Philadelphia Fed coordinates the program.

The site provides resources related to the three cycles of a bank's development: starting a bank, managing its transition and growing its shareholder value. The site also provides diverse data sets bankers may use as benchmarks, a directory of Federal Reserve contacts and a timeline illustrating milestones in minority banking.

## Meet the Fed's Community Development Advisory Council

The St. Louis Fed formed the Community Development Advisory Council late last year to keep the Fed president and Community Affairs staff informed of the District's community development issues and to suggest ways the Bank might support local development efforts.

Bankers have a formal voice on the council through the participation of Marita Willis, assistant vice president and community consultant of PNC Bank in Louisville, and of Tom Reeves, president of Pulaski Bank in St. Louis.

## Christopher Waller To Become St. Louis Fed's Director of Research

Christopher J. Waller, professor and Gilbert F. Schaefer Chair of Economics at the University of Notre Dame, will be joining the St. Louis Fed as director of Research in approximately July 2009.

The current director of Research, Robert Rasche, will become executive vice president and senior policy adviser at that time.

Waller's research interests include monetary theory, political economy and macroeconomic theory. He has been extensively published in peer-reviewed journals, including the *American Economic Review,* the *Quarterly Journal of Economics* and the *Journal of Monetary Economics*. View some of his working papers.

A visiting scholar at the St. Louis Fed in 1994-95, he will be returning to the Bank monthly between now and the start of his appointment to ensure a smooth transition.

In announcing Waller's selection, St. Louis Fed President Jim Bullard said, "I am very excited that we have been able to attract Chris Waller to the Bank. … I expect that Chris will provide outstanding leadership for the Research division and will push the Bank to continue to achieve our strategic objective of System and national leadership in this area."