SUMMER 2009

CENTRAL Banker

NEWS AND VIEWS FOR EIGHTH DISTRICT BANKERS

FEATURED IN THIS ISSUE: Stress-Testing Large Banks | Re-establishing Connections

Not Normal Times

What Is the Future of CRA?

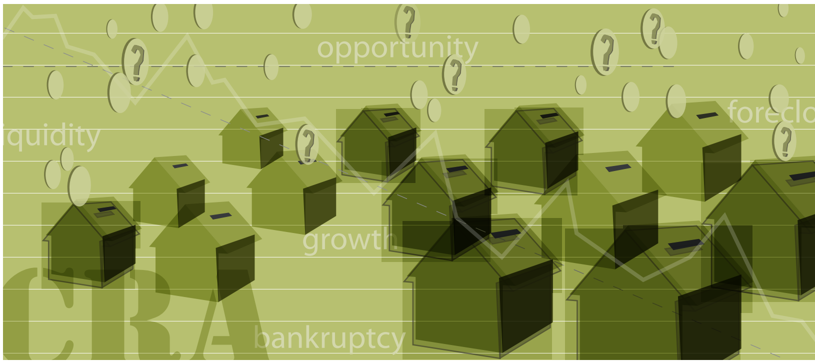
Since the financial crisis began, many bankers have wondered how the Community Reinvestment Act (CRA) will be updated to fit the changing financial landscape.

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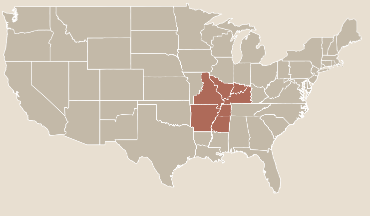
The Eighth Federal Reserve District includes all of Arkansas, eastern Missouri, southern Illinois and Indiana, western Kentucky and Tennessee, and northern Mississippi. The Eighth District offices are in Little Rock, Louisville, Memphis and St. Louis.



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.

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www.stlouisfed.org/littlerock/

Louisville Branch:
www.stlouisfed.org/louisville/

Memphis Branch:
www.stlouisfed.org/memphis/

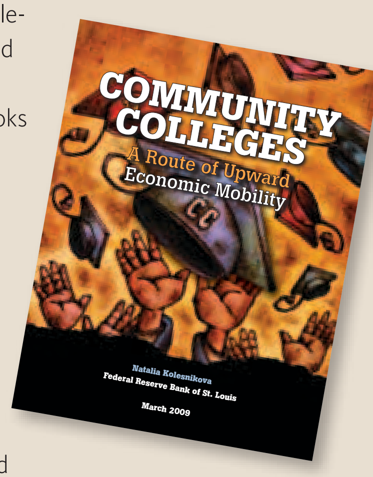
Robert Hopkins is the senior branch executive of the St. Louis Fed's Little Rock Branch.

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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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.

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https://www.stlouisfed.org/publications/central-banker/summer-2009/fairvalue-accounting-dont-shoot-the-messenger

Views: Fair-Value Accounting: Don't Shoot the Messenger!

William R. Emmons

A long-standing criticism of historical-cost accounting (HCA) is that, while it may provide good information about things that already have happened, it may not tell us much about what has happened in the recent past or what is likely to happen in the future.

For example, a bank may have acquired a bond some time ago at a price of $100, but it might be possible to sell the security today for only $80. If the bank classifies the security as "held to maturity" and believes that it will pay off in full at maturity, it is allowed to carry the security at $100 and need not recognize any loss when reporting its earnings and capital.

Fair-value accounting (FVA) is a framework for assigning current values to assets and liabilities. In the example above, a loss of $20 would be recognized both in the bank's earnings and its capital as soon as it occurred. The bank would have no choice, even though it might believe there has been no permanent impairment of the security's value.

Many academics, policymakers and others have applauded FVA as a vast improvement over HCA, because it is likely to accelerate the recognition and (hopefully) resolution of troubled banks and other financial firms. At the same time, some bankers, politicians and others have derided FVA as a principal cause of the financial turmoil we are experiencing because it translates financial-market volatility into wild and largely unjustified fluctuations in banks' earnings and capital.

In fact, both extreme positions are wide of the mark. FVA is neither perfect nor pernicious in its own right. There are many difficult conceptual and practical issues surrounding FVA that remain to be resolved. In the meantime, all concerned parties should learn more about FVA and work toward a more effective implementation. Fair-value accounting is just the messenger and it wouldn't be wise to "shoot it down" just because the message it is bringing today is unpleasant.

Fair-value Accounting in the United States

U.S. GAAP (generally accepted accounting principles) has been moving toward FVA principles for a number of years, but GAAP remains a hybrid system. That is, it is an evolving mixture of historical-cost, LOCOM (lower-of-cost-or-market) and fair-value accounting principles.

As of late 2007, banks and other firms may choose to apply fair-value principles to any financial asset or liability, but they need not do so in some cases. Certain items, such as derivatives, always must be reported at fair value. Others, such as loans, rarely are. Liabilities may be marked up or down to reflect changes in fair value, giving rise to the paradoxical implication that a firm's financial difficulties actually may increase its earnings and capital. For example, a bank that has issued $100 million of debt may increase its earnings and capital by $10 million if its debt is trading at 90 percent of par in the secondary market.

The "fair-value option" is explained in FAS (Financial Accounting Standards) 159. If choosing FVA for a loan, security or liability, a bank applies the "fair-value hierarchy" spelled out in FAS 157. In particular, an asset or liability is reported at market value, if a price is available (a level-one valuation); at a value derived from a closely related market price or prices (a level-two valuation); or at a value determined by a valuation model, such as an estimate of the values of the asset's discounted cash flows (a level-three valuation).

What Fair-value Accounting Does and Does Not Do

As currently implemented in U.S. GAAP, relevant FVA standards are intended to answer how much a competent liquidator would receive for this asset, and how much it would have to pay to extinguish that liability, in a non-distress transaction under normal market conditions.

This statement of its intent shows that application of FVA struggles with at least three difficult problems:

First: The "exit-price notion" of fair value is a liquidation value, which may differ significantly from an asset's or liability's "value in use." It disregards any "going-concern value" that may be attached to a particular asset or liability, such as the value of a bank-borrower relationship, market-specific knowledge, or a core-deposit franchise. Thus, FVA may materially misrepresent the economic value of a viable bank, as distinct from the sum of its component assets and liabilities if transferred (hypothetically) to another bank. Note, however, that historical-cost accounting also may report an enterprise value far from the total market values of a viable bank's debt and equity.

Second: FVA is highly subjective whenever there is no deep and liquid market for one of the bank's assets or liabilities. In these situations—much more common today during the financial turmoil than in years past—FAS 157 details valuation techniques based on "close substitutes" (a level-two valuation) or a discounted-cash-flow or other model-based valuation (a level-three valuation). These valuations require expert judgment and are likely to differ significantly across banks and from day to day when financial markets are volatile.

Third: In important respects, application of FVA under GAAP is voluntary, and thus makes comparisons across banks more difficult. Some banks will report a larger proportion of their assets and liabilities at fair values than others, making standard accounting ratios difficult to interpret.

The Fog of War

The financial crisis has demonstrated a key advantage of FVA in providing relatively prompt updates on the financial conditions of some banks and other financial firms. But it also has highlighted some of FVA's weaknesses. Moreover, the Financial Accounting Standards Board in early April issued clarifications of several FVA statements. FASB said the clarifications would make the fair-value framework "more flexible" by encouraging banks to use their own judgments more often about whether the markets used for valuation purposes were "not orderly." This will increase the frequency of level-three valuations, in particular.

While FASB was criticized by many for "compromising" or "weakening" FVA, it's more accurate to say that FASB merely has altered the elaborate compromise represented by GAAP's incorporation of fair-value principles. A similar controversy is raging around accounting standards outside the U.S.

Fair value is neither a perfect accounting framework nor more inherently flawed than any other approach. Ironically, the prominence of fair-value accounting principles in U.S. GAAP increased just as the financial crisis was unfolding. It would be a mistake to blame FVA for the crisis, but we also should learn from recent experience that its application has been problematic.

ABOUT THE AUTHOR

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https://www.stlouisfed.org/publications/central-banker/summer-2009/alll-best-practices-keep-the-appropriate-allowance-for-loan-and-lease-losses-reserve

Views: ALLL Best Practices: Keep the Appropriate Allowance for Loan and Lease Losses Reserve

Timothy A. Bosch , Salvatore Ciluffo

During these uncertain economic times, lenders must continually actively assess the quality of their loans. It seems like a simple statement; however, a bank can hurt itself without such diligence.

For example, many banks with high concentrations of commercial real estate loans have incurred extraordinary losses. Therefore, it is imperative to document the rationale behind all quantitative and qualitative factors, and be vigilant, proactive and realistic. Examiners will view favorably banks that are quick to self-identify problem assets and that apply a solid reserve against those loans that will likely result in some loss.

To help your institution explore the quality of your loans, pay attention to your allowances for loan and lease losses (ALLL). For several years, the banking industry enjoyed low loan loss rates. Normally, during periods of economic stability, most ALLL methodologies use a three- to five-year-average net loss history to determine the loss factors for the homogeneous loan pools for the Financial Accounting Standard (FAS) 5 portion of the ALLL. However, during periods of significant economic contraction—such as now—banks should adjust for their recent loss experience, which they should expect to more accurately estimate their inherent losses.

Accounting rules require consideration of external and internal factors affecting the adequacy of the ALLL. Banks should modify their qualitative and environmental factors to ensure that allowance estimates place appropriate emphasis on current market information and events in a bank's lending area:

- External factors include the direction of national and local economies, changes in bankruptcy rates, changes in unemployment rates, and levels of national and local foreclosures.
- Internal factors include asset quality trends, trends in nonperforming loans and charge-offs, portfolio concentrations, refinance risk, and the strength of the bank's credit administration practices.

Simply stated, examiners expect higher FAS 5 adjustments when the bank is experiencing larger losses and the economy is weak.

In addition, FAS 114 requires an individual credit impairment analysis. A loan is impaired if it's probable that all principal and interest payments will not be received according to the contractual terms of the loan agreement. Banks should define, in their loan policies, which loans will be tested for impairment, such as all loans over a certain size, all classified loans or all non-accrual loans.

Once the loan is determined to be impaired, the amount of the impairment needs to be measured using one of the three methods, the most common of which is fair value of collateral less selling and carrying costs. The challenge in today's economic environment is obtaining a realistic appraisal. Bank management is encouraged to maintain a FAS 114 analysis indicating the amount of impairment for each loan tested.

Don't hesitate to contact your examiners if you have questions on ALLL methodology.

>> More Online

Bank Directors Desktop

Federal Agencies' Q&A on ALLL

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https://www.stlouisfed.org/publications/central-banker/summer-2009/bankers-explore-innovation-in-a-difficult-economy

Views: Bankers Explore Innovation in a Difficult Economy

In this economy, can you be innovative and create sustainable economic opportunities and still meet obligations and customer expectations?

The Federal Reserve Bank of St. Louis helped bankers and other community leaders from 21 states answer that nagging question during the springtime *Exploring Innovation: A Conference on Community Development.* The St. Louis Fed holds the conference every other year.

Among those who attended was Ben Steinberg of Southern Bancorp Inc., who complimented the closing address by Bill Strickland, president and CEO of
Manchester Bidwell Corp. "In my mind, Strickland was able to connect what he was doing in Pittsburgh with the successful programs like KIPP Delta Public School in Helena, Ark. Both programs raise the bar of expectations. Both programs provide high quality space to their participants. Both have a much wider impact and extend far beyond the expected movement in one set of benchmarks."

Bobby Culler of First Bank & Trust Co. Inc. in Caruthersville, Mo., said during the conference that it's good to network and collaborate with people who have some of the same kinds of situations and problems that his organization faces. Patricia Avery of Old National Bank in Evansville, Ind., said that the conference exposed participants to a wide variety of successful programs and models that she's now considering.

"But perhaps most importantly, the message that 'now is the time to innovate' came through loud and clear," said Avery, who serves as Old National's director of community innovation. "We know what's worked in the past. But if we're going to succeed in strengthening our communities, we've got to move beyond what we're comfortable with now and develop 21st century strategies and tools that can change the future of our communities."

Avery and Culler were among the bankers and other participants who were interviewed during the conference for the Exploring Innovation YouTube channel.

Before the conference, the majority of attendees were not optimistic about community development opportunities in their areas, but by the end, their attitudes had changed.

For more information on exploring innovation in community development, see the St. Louis Fed's Community Development web page or visit the conference page.

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https://www.stlouisfed.org/publications/central-banker/summer-2009/shape-of-effective-reform-not-yet-clear

Views: Shape of Effective Reform Not Yet Clear

While history shows important financial crises have resulted in new reform-oriented legislation—and that the current crisis is likely to follow this pattern—the design of an effective reform is far from clear at this point, said St. Louis Fed President James Bullard.

Bullard spoke May 1 at the 119th annual Arkansas Bankers Association convention in Hot Springs. In his presentation, "The U.S. Financial System and Macroeconomic Performance," Bullard said that parts of the regulatory system have proven to work well, such as the monitoring practices and fairly clear rating system currently in place for smaller banks.

"Deposit insurance and prudential regulation have proven to be successful in avoiding small bank panics," he said. "Supervision allows the regulator to anticipate potential bank failures and prepare accordingly."

He also pointed out that with smaller banks "a clear resolution regime is in place," and that the U.S. has a system for closing banks in a way that does not damage others in the industry.

The problem areas in the crisis have centered on large banks and especially large non-bank financial firms, which makes monitoring far more difficult and the resolution regime unclear. Thus, two of the elements that make smaller bank regulation successful are missing for larger financial firms, he said.

These firms are often thought to be too big to fail, but Bullard said that they are only too big to fail quickly. He argued that one goal of a successful reform should be to find a method to allow failure, but in a way that does not cause significant market disruption. He stressed that a good resolution regime for these firms must be credible, so that all market participants understand what will happen in the event of failure.

Bullard also discussed the Federal Reserve's role in a new regulatory landscape. He said that the Fed is the nation's lender of last resort, and so, needs to be involved in the regulation of firms that have access to the discount window. He also said that the Fed needs to know the condition of the financial system to run an effective monetary policy, and that this also argues for a substantial Fed role in the regulatory structure. Both of these needs have been underscored in the current crisis.

Bullard said that the Fed has been the nation's de facto systemic risk regulator. He named three important systemic risk calls made by Fed officials in recent years. He argued that systemic risk regulation has come to mean many things to many people and that the debate needs to be sharpened substantially before progress can be made.

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https://www.stlouisfed.org/publications/central-banker/summer-2009/is-it-time-for-you-to-ask-the-fed

Tools: Is It Time for You To Ask the Fed?

Since November 2008, the St. Louis Fed has offered an exclusive communications channel between Fed officials and the leaders of state member banks and bank holding companies in the Eighth District.

Ask the Fed is an hour-long conference call/program offered once a month, featuring candid discussions on topics of the day. If you're a senior officer of a state member bank or bank holding company and haven't yet joined an *Ask the Fed* session, here's what you've missed so far:

- The mortgage crisis: Root causes and consequences for the economy (November 2008)
- What's new in the federal funds market? (December 2008)
- Changes to the Fed's payments system risk policy: What does it mean for your bank? (January 2009)
- Remarks on the U.S. economy with St. Louis Fed President Jim Bullard (February 2009)
- A panel discussion on the Federal Reserve discount window, with additional comments on liquidity implications that face financially troubled institutions and understanding the impact of the OTTI impairment affecting FHLB securities portfolios (March 2009)
- Discussion and Q&A with Elizabeth Duke, member of the Federal Reserve Board of Governors (April 2009)
- From the examiner's perspective: Challenges facing community banks (May 2009)

If you sign up to participate in any subsequent *Ask the Fed,* you can access previous program materials. If you would like to participate, contact the St. Louis Fed's Patrick Pahl, Banking Supervision & Regulation, at 314-444-8858 or askthefed@stls.frb.org. Remember, participation is limited to senior officers of state member banks and bank holding companies in the Eighth District.

The St. Louis Fed's web site has been revamped with a fresh, new design and streamlined navigation. Located at www.stlouisfed.org, the site also offers several new features and tools. These features include easy-to-use economic charts and data, including charts from the Fed's Little Rock, Louisville and Memphis zones; region-specific news and events; more multimedia features; RSS feeds and an expanded menu of e-mail alert choices. Watch for even more features and functionalities to be launched in the coming months.

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https://www.stlouisfed.org/publications/central-banker/summer-2009/st-louis-fed-joins-pbs-on-youtube

Tools: St. Louis Fed Joins PBS on YouTube

The St. Louis Fed has been working with KETC (Channel 9), the St. Louis PBS station, since the summer of 2008 in an effort to educate St. Louis-area residents about the mortgage and financial crises. KETC created a web site called Facing the Mortgage Crisis and an accompanying YouTube channel, which highlights videos of economists and other experts speaking on related topics.

Among the experts is St. Louis Fed economist Bill Emmons, who appeared on the national PBS program "NewsHour with Jim Lehrer" as part of a week-long spotlight on the St. Louis region. Emmons addressed the regional employment situation as part of a panel discussion moderated by PBS correspondent Gwen Ifill. Other participants included Tony Thompson, CEO of the Kwame Building Group; Ellen Sherberg, publisher of the St. Louis Business Journal, and Michael Holmes, executive director of the St. Louis Agency on Training and Employment. Watch the broadcast segment or read the transcript. Emmons is also featured in 12 segments on the KETC YouTube channel discussing a variety topics related to the financial crisis and the St. Louis region.

In another spotlight episode the same week, St. Louis economist Howard Wall joined a forum of St. Louis business leaders at a St. Louis Fed economic forum filmed for the April 29 "The Newshour with Jim Leher" program. The topic was the importance of downtown St. Louis. Gwen Ifill, PBS' senior national correspondent for "The NewsHour with Jim Lehrer," hosted the forum, which also included Jim Alexander, vice president of business recruitment for the Regional Commerce and Growth Association; Rodney Crim, executive director of the St. Louis Development Corporation; and Kitty Ratcliffe, president of the St. Louis Convention and Visitors Commission. The video appears below:

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Regulatory Roundup

New Final Truth in Lending Rules Issued

The Federal Reserve Board issued on May 12 the final rules for Regulation Z (Truth in Lending) that revise disclosure requirements for mortgage loans. The final rules implement the Mortgage Disclosure Improvement Act (MDIA), which was enacted in July 2008 as an amendment to the Truth in Lending Act.

The new final rules are similar to the Reg Z rules finalized in July 2008, except the MDIA is broader and includes more. The new rules are designed to ensure that consumers receive cost disclosures earlier in the mortgage process. Under the MDIA, creditors must comply with the new provisions starting on July 30, 2009. The regulations apply to dwelling-secured consumer loans for which a creditor receives an application on or after July 30, 2009.

Among the requirements, creditors must:

- give good faith estimates of mortgage loan costs ("early disclosures") within three business days after receiving a consumer's application for a mortgage loan and before any fees are collected from the consumer, other than a reasonable fee for obtaining the consumer's credit history;
- give early disclosures for loans secured by dwellings other than the consumer's principal dwelling, such as a second home;
- wait seven business days after providing the early disclosures before closing the loan; and
- provide new disclosures with a revised annual percentage rate (APR) and wait an additional three business days before closing the loan, if a change occurs that makes the APR in the early disclosures inaccurate beyond a specified tolerance.

The rules would permit a consumer to expedite the closing to address a personal financial emergency, such as a foreclosure.

Changes Made to Tier 1 Capital Rules

Bank holding companies can now include in their Tier 1 capital, without restriction, senior perpetual preferred stock issued to the U.S. Treasury Department under the Troubled Asset Relief Program (TARP). The Federal Reserve Board issued the final rule on May 22, after adopting the interim final rule in October 2008.

In addition, the Board announced the adoption of an interim final rule that will let bank holding companies that are S-Corps or that are organized in mutual form to:

- include in Tier 1 capital all subordinated debt issued to Treasury under TARP, provided that the subordinated debt has to count toward the limit on the amount of other restricted core capital elements includable in Tier 1 capital; and

- exclude subordinated debt issued to Treasury under TARP from treatment as "debt" for purposes of the debt-to-equity standard under the Board's Small Bank Holding Company Policy Statement.

Reminder: New Limits on Trust Preferred Securities Delayed until 2011

The Federal Reserve Board decided in March to delay full implementation of final rules that place new limits on the inclusion of trust preferred securities and other restricted core capital elements in tier 1 capital of bank holding companies. The Board did this because of stress on the financial markets and efforts of bank holding companies to increase their capital levels. Because of the delay, all bank holding companies may include cumulative perpetual preferred stock and trust preferred securities in tier 1 capital up to 25 percent of total core capital elements. Read the final rules.

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https://www.stlouisfed.org/publications/central-banker/summer-2009/understand-the-financial-climate-with-the-fed

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.

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https://www.stlouisfed.org/publications/central-banker/summer-2009/tell-your-staff

Tell Your Staff

Food Coupons Officially Going Away

After Sept. 17, the Federal Reserve will no longer accept paper food coupons from banks. Last year, as part of the 2008 farm bill (Food, Conservation and Energy Act of 2008), Congress mandated that all benefits for the Supplemental Nutrition Assistance Program (formerly the food stamp program) be issued electronically.

States were ordered to stop issuing paper coupons for food last June. This year, retailers are to stop accepting stamps and RCs on June 17, and all banks are to stop accepting paper coupons from retailers on July 18. All outstanding paper coupons and RCs will be de-obligated as of June 18. For more information on food coupon redemption procedures, see http://www.frbservices.org/operations/currency/food_coupons.html

Memphis Branch Transitioning to Currency Strap Imaging

If your institution used cash services at the St. Louis Fed, be aware that the Memphis Branch of the St. Louis Fed will begin switching over to currency strap imaging for currency processing on Aug. 24.

Make sure your appropriate staff members know that they may see a delay in receiving cash difference advices. Currently, your depository institution receives original currency straps for differences found in your deposits. During the transition, your DI may receive original currency straps, printed images of original currency straps or a combination of the two.

The depositor information required on the strap remains unchanged; however, this information must be readable if printed images from the straps are sent. Currency strap imaging is being implemented throughout the Fed System as part of the Fed's re-engineering of manual paper-based processes.