SPRING 2012
CENTRAL Banker
NEWS AND VIEWS FOR EIGHTH DISTRICT BANKERS

FEATURED IN THIS ISSUE: ALLL Best Practices | Bank Performance Continues on Meandering Path

Will Community Bank Returns on Equity Return to Precrisis Levels?

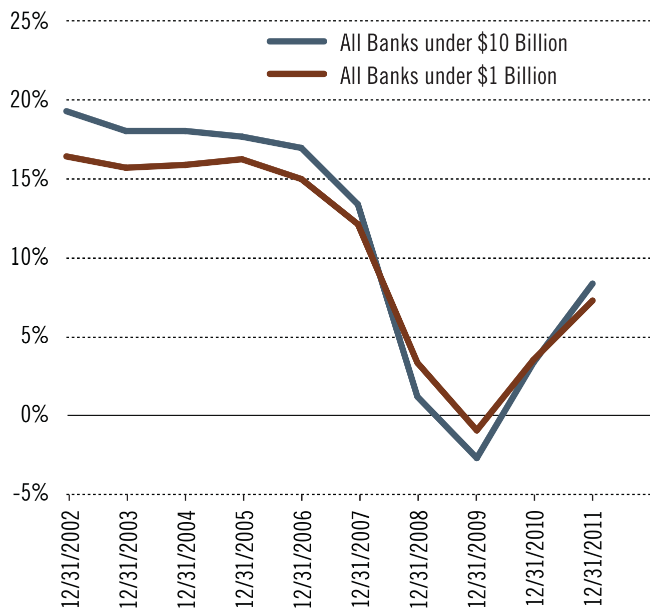
By Gary Corner

In the wake of the financial crisis, the "value" of a community bank is generally discussed in the context of the community: the relationship bankers have with their customers and community and their understanding of local economic conditions and opaque credit opportunities. In many cases, the community bank also stands as an important small business in the community, albeit as a credit provider and employer.

While these factors are important, another gauge of the "value" of a community bank is its ability to earn a fair return for its stakeholders. Without an adequate return to investors, retaining or even attracting new investment could become more difficult for community banks. This article examines the historical trend in community bank returns on equity (ROE) over the last 10 years and highlights the gap between current and historical pretax returns.

FIGURE 1

Historical Pretax Return on Equity



SOURCE: Reports of Condition and Income for Insured Commercial Banks

Decomposing Return on Equity

Return on equity is more than simply net income divided by average equity. It can be more completely expressed as return on assets (ROA) relative to an equity multiplier or, more simply, the degree of financial leverage at a bank. Return on equity can be further understood by employing a DuPont analysis technique. This technique dissects ROA into the subcomponents that drive asset utilization, or total revenue/average total assets.[1] From here a bank's expense ratio can be segregated into the components that encompass total operating expenses/average total assets.[2]

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CENTRAL
Banker

News and Views for Eighth District Bankers
Vol. 22 | No. 1
www.stlouisfed.org/cb

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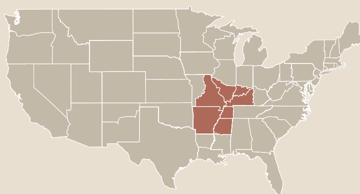
The Eighth Federal Reserve District includes all of Arkansas, eastern Missouri, southern Illinois and Indiana, western Kentucky and Tennessee, and northern Mississippi. The Eighth District offices are in Little Rock, Louisville, Memphis and St. Louis.



Useful St. Louis Fed Sites

Dodd-Frank Regulatory Reform Rules
www.stlouisfed.org/rrr

FOMC Speak
www.stlouisfed.org/fomcspeak

FRED (Federal Reserve Economic Data)
www.research.stlouisfed.org/fred2

St. Louis Fed Research
www.research.stlouisfed.org

CENTRAL VIEW

Many Community Banks Must Make Tough ROE Choices

By Timothy A. Bosch

Timothy A. Bosch is a vice president in Banking Supervision and Regulation at the Federal Reserve Bank of St. Louis.

At year-end 2007, before the reverberations of the global financial crisis began to be felt across most business sectors, there were 7,139 community banks in the U.S. By the end of 2011, that number had slipped to 6,155. More than one-third of the decline, or 342 charters, occurred because of institutions that failed. The 642 other banking organizations found strategic partners to bolster their financial strength or improve operating efficiencies.

The 14 percent decline in charters in just four years is reflective of the challenges facing banks over that time, especially community banks. And headwinds prevail: Revenue opportunities continue to be limited, operating costs are climbing and the uncertainty of added regulation remains a concern.

To be fair, some of the recent data on community bank performance have been positive. Problem asset ratios have declined, and earnings performance has improved. Moreover, banks facing asset quality difficulties are working hard to improve their balance sheets through prudent loan restructures, asset disposals and the redeployment of funds into less concentrated market sectors.

I am often asked, "What lies ahead?" No one has a crystal ball, but one area of the balance sheet that may not recover to precrisis levels is return on equity (ROE).

Community banks consistently express concerns about profit opportunities, given current weak loan demand and the possibility of growing regulation. Community bank managers are going to have to make some tough choices over the next few years. They will need to identify areas where they can reduce costs. They might eliminate business lines that are no longer profitable (even if they are legacy businesses) and focus on their core areas of expertise and profitability. All of this uncertainty only underscores the importance of having a strong management team at the bank.

If the bank cannot make such adjustments, investors in community banks may need to adjust their expectations for returns on equity. Depending on the length and depth of low returns, some investors may turn elsewhere, requiring some additional consolidation of the industry to scale growing costs.

The community bank model in the U.S. has withstood numerous challenges throughout its history. Despite some recent positive signs, bank managers can't ignore the headwinds they're facing. The next few years will be crucial in understanding what it will take for community banks to return to historic profitability.

Bank Performance Continues on Meandering Path

By Michelle Neely

The slight uptick in bank earnings experienced by District banks and their U.S. peers in the third quarter did not carry over into the final quarter of 2011. Asset quality measures did continue to improve, however. Real estate loans—especially those backed by commercial properties—remain the primary source of nonperforming assets.

Return on average assets (ROA) at District banks fell 3 basis points in the fourth quarter to 0.79 percent, but the ratio was still 29 basis points above its year-ago level. ROA also declined at U.S. peer banks—those with average assets of less than $15 billion—but by a smaller amount, to 0.70 percent. Although earnings ratios at U.S. peers still fall below those of District banks, the gap between the two sets of banks has narrowed in recent quarters. Two years ago, District banks outperformed their U.S. peers by 45 basis points when measured by ROA; by year-end 2011, that gap had fallen to 9 basis points. A more dramatic decline in funds set aside to cover nonperforming assets by U.S. peers than those by District banks explains the closing of this difference.

In the District, the decline in ROA can be traced to a slight increase in loan loss provisions that is typical of the fourth quarter and a slightly larger increase in noninterest expenses, primarily personnel expenses. The net interest margin (NIM) increased 1 basis point in the fourth quarter to 4.03 percent. The margin is up 17 basis points from a year ago thanks to a much larger decline in interest expenses than in interest income.

For U.S. peer banks, ROA declined a bit because a small increase (2 basis points) in the average NIM was offset by a larger increase (4 basis points) in noninterest expenses. An uptick in personnel expenses was responsible for half the increase in overall noninterest expenses. The loan loss provision ratio rose just 1 basis point in the final quarter to 0.60 percent. The ratio is about half its year-ago level of 1.10 percent, reflecting in part the steady improvement in asset quality since year-end 2010.

Earnings Zig, Asset Quality Zags[1]

	2010: Q4	2011: Q3	2011: Q4
RETURN ON AVERAGE ASSETS[2]			
District Banks	0.50%	0.82%	0.79%
U.S. Peer Banks	0.22	0.72	0.70
NET INTEREST MARGIN			
District Banks	3.86	4.02	4.03
U.S. Peer Banks	3.90	3.94	3.96
LOAN LOSS PROVISION RATIO			
District Banks	0.88	0.54	0.55
U.S. Peer Banks	1.10	0.59	0.60
PROBLEM ASSETS RATIO[3]			
District Banks	4.84	4.88	4.66
U.S. Peer Banks	5.27	4.95	4.68

SOURCE: Reports of Condition and Income for Insured Commercial Banks

NOTES: 1 Because all District banks except one have assets of less than $15 billion, banks larger than $15 billion have been excluded from the analysis.
2 All earnings ratios are annualized and use year-to-date average assets or average earning assets in the denominator.
3 Problem assets are loans 90 days or more past due or in nonaccrual status plus other real estate owned (OREO). The ratio is computed by dividing problem assets by total loans plus OREO.

Asset Quality Picks Up in District and Nation

Asset quality improved somewhat in the final quarter of 2011 at both sets of banks, with nonperforming loans and other real estate owned (OREO) declining from the third quarter. The problem assets ratio—nonperforming loans plus OREO divided by total loans plus OREO—fell 22 basis points to 4.66 percent in the District. The chief reason for the decline in this ratio was the sharp drop in nonperforming construction and land development (CLD) loans, which make up more than a quarter of the District's total nonperforming loans. The nonperforming CLD loan ratio fell below 10 percent for

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Quarterly Report

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the first time since late 2009, hitting 9.73 percent at year-end 2011. Nonperforming rates also fell in other parts of the real estate portfolio, as well as in the consumer loan and the commercial and industrial (C & I) loan categories.

The asset quality picture is much the same at U.S. peer banks. Declines in nonperforming real estate loans, especially CLD loans, brought down the aggregate problem asset and nonperforming loan ratios. Nonperforming C & I loans also fell, though nonperforming consumer loans—credit card and other consumer loans—rose. Nonperforming ratios for all categories of loans are higher at U.S. peers than at District banks, in part reflecting less volatile real estate markets and a predominant "lending local" lending strategy in this region of the country.

Coverage Ratios Are Up and Capital Ratios Are Steady

Although loan loss reserves declined at year-end at both sets of banks, loan loss reserve coverage ratios actually rose because nonperforming loans fell more. The coverage ratio at District banks increased by 310 basis points to 65.01 percent, meaning District banks had on average 65 cents in reserves for every dollar of nonperforming loans. The coverage ratio rose 144 basis points to 61.63 percent at U.S. peer banks.

Capital ratios stayed basically flat in the fourth quarter, and the average tier 1 leverage ratio was well above the regulatory minimum at 9.46 percent for District banks and 9.90 percent for U.S. peer banks.

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

Statewide Bank Conditions for Fourth Quarter 2011[1]

Compiled by Daigo Gubo

	2010: 4Q	2011: 3Q	2011: 4Q
RETURN ON AVERAGE ASSETS[2]			
All Eighth District States	0.34%	0.64%	0.65%
Arkansas Banks	0.77	1.11	1.09
Illinois Banks	0.06	0.44	0.46
Indiana Banks	0.48	0.89	0.90
Kentucky Banks	0.80	0.82	0.71
Mississippi Banks	0.55	0.72	0.72
Missouri Banks	0.37	0.70	0.66
Tennessee Banks	-0.04	0.12	0.42
NET INTEREST MARGIN			
All Eighth District States	3.80	3.89	3.91
Arkansas Banks	4.13	4.31	4.32
Illinois Banks	3.67	3.73	3.75
Indiana Banks	3.78	3.94	3.97
Kentucky Banks	4.00	4.12	4.08
Mississippi Banks	3.92	3.98	4.01
Missouri Banks	3.67	3.73	3.78
Tennessee Banks	3.80	3.89	3.92
LOAN LOSS PROVISION RATIO			
All Eighth District States	1.01	0.69	0.67
Arkansas Banks	0.88	0.50	0.50
Illinois Banks	1.34	0.93	0.92
Indiana Banks	0.90	0.47	0.44
Kentucky Banks	0.60	0.52	0.55
Mississippi Banks	0.80	0.56	0.55
Missouri Banks	0.87	0.57	0.58
Tennessee Banks	1.02	0.88	0.64
NONPERFORMING LOAN RATIO[3]			
All Eighth District States	3.76	3.64	3.50
Arkansas Banks	3.48	3.78	3.57
Illinois Banks	5.04	4.78	4.53
Indiana Banks	3.10	3.14	2.94
Kentucky Banks	2.38	2.43	2.42
Mississippi Banks	2.97	2.70	2.62
Missouri Banks	3.18	2.96	3.06
Tennessee Banks	3.64	3.70	3.43
NONPERFORMING LOAN + OREO RATIO[4]			
All Eighth District States	5.27	5.32	5.14
Arkansas Banks	5.46	5.83	5.65
Illinois Banks	6.55	6.56	6.21
Indiana Banks	3.83	3.89	3.64
Kentucky Banks	3.55	3.69	3.65
Mississippi Banks	4.61	4.50	4.47
Missouri Banks	4.73	4.78	4.85
Tennessee Banks	5.60	5.71	5.42

SOURCE: Reports of Condition and Income for Insured Commercial Banks

NOTES:
[1] Because all District banks except one have assets of less than $15 billion, banks larger than $15 billion have been excluded from the analysis.
[2] All earnings ratios are annualized and use year-to-date average assets or average earning assets in the denominator.
[3] Nonperforming loans are those 90 days or more past due or in nonaccrual status.
[4] Nonperforming loans plus OREO are those 90 days past due or in nonaccrual status or other real estate owned.

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

By Timothy A. Bosch and 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).

Examiners Expect Higher ASC Adjustments

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 Accounting Standard Codification (ASC) 450 portion of the ALLL.[1]

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** — These 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** — These 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 ASC 450 adjustments when the bank is experiencing larger losses and the economy is weak.

Requirements under ASC 310

In addition, ASC 310 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

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Junior Liens for Certain Residential Properties Covered in New ALLL Guidance

Federal agencies in January reiterated supervisory guidance on allowance for loan and lease losses (ALLL) estimation practices associated with loans and lines of credit secured by junior liens on one- to four-family residential properties.

This ALLL guidance, given in SR 12-3, applies to all banking organizations with junior lien loans, including institutions with $10 billion or less in consolidated assets.

The interagency guidance also reminds institutions to monitor all credit quality indicators relevant to credit portfolios, including junior liens. Examples of junior liens include second mortgages and home equity lines of credit taken out by mortgage borrowers. For more information on SR 12-3, go to Banking Information & Regulation > Supervision and Regulation Letters on the Board of Governors' web site (www.federalreserve.gov).

Where Housing Markets Lead in 2012, Eighth District Economies Are Likely to Follow

By William Emmons

Housing markets generally have served as reliable bellwethers of economic conditions during recent decades. But while some measures of Eighth District housing-market activity recently showed signs of life, it's not clear yet if it is cause for cautious optimism in the economic outlook.

Historically, home-building activity usually declines a year or two in advance of a broad economic slowdown or recession, while inflation-adjusted house prices often stagnate or decline during the months preceding the economic downturn. When the economy eventually stabilizes and begins to grow again, home building, home sales and house prices usually pick up before other economic vital signs, such as employment, have shown meaningful improvement. The 2001 recession was a rare exception to this rule, as Figure 1 on Page 7 shows. In that instance, home building and house prices remained strong even as the overall economy weakened.[1,2]

Housing markets usually are key economic indicators in the Eighth District too. Home-building activity in most parts of our District reached a peak in late 2005. Eighth District home prices, adjusted for inflation, reached peaks as early as the first quarter of 2005 in Indiana, with all other district states hitting their high points between the first quarter of 2006 and the first quarter of 2007. (See Table 1 below.)

In turn, economic conditions in states in the District reached their peaks in the last quarter of 2007 or the first quarter of 2008, as the middle column of data in the table indicates. Across our District and the nation, a peak in inflation-adjusted house prices gave between four and 11 quarters advance warning of the deep recession that hit in late 2007.[3]

2012 Housing Market Indications

If housing markets serve as bellwethers for local economies heading into as well as out of a downturn, what do current housing-market indicators suggest for Eighth District economies as 2012 gets underway? Figure 2 on Page 7 shows that an average of Eighth District inflation-adjusted house-price indexes appeared to be trending downward through the first half of 2011, although the last data point, for

TABLE 1

Real House-Price and Economic Activity Index Peaks

	Peak Quarter for Inflation-Adjusted (Real) FHFA House-Price Index	Peak Quarter for the Philadelphia Fed Coincident Economic Activity Index	Quarters between Real House-Price Peak and Economic Activity Index Peak
U.S.	2006: Q2	2008: Q1	7
Eighth District States Average	2007: Q1	2008: Q1	4
Arkansas	2006: Q4	2008: Q1	5
Illinois	2007: Q1	2008: Q1	4
Indiana	2005: Q1	2007: Q4	11
Kentucky	2006: Q1	2007: Q4	7
Mississippi	2007: Q1	2008: Q1	4
Missouri	2006: Q1	2007: Q4	7
Tennessee	2007: Q1	2008: Q1	4

SOURCES: Federal Housing Finance Agency, Bureau of Economic Analysis, Federal Reserve Bank of Philadelphia

the third quarter of 2011, showed an uptick.

Likewise, home-building activity showed some signs of life near the end of 2011, albeit from an historically depressed level. Based on the weak housing market data alone, the economic recovery that has been underway since mid-2009 is surprising. Housing market problems may well help explain why the recovery has been weak, both in our District and nationwide.

In Conclusion

Housing market indicators suggest challenges for the 2012 economic outlook for Eighth District states. Moreover, even if housing markets begin to show strength as 2012 unfolds, the broader economic vigor they might be anticipating could take some time to materialize.

William Emmons is an economist at the Federal Reserve Bank of St. Louis.

ENDNOTES

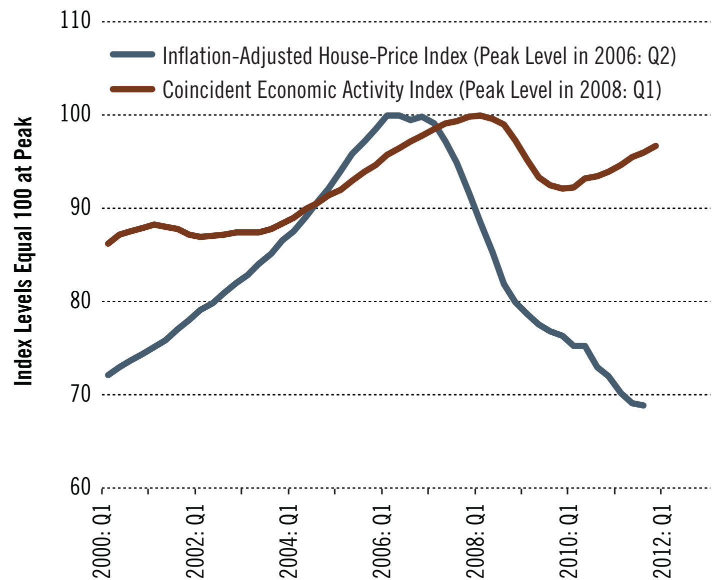
1 The surprising strength of housing probably was due to several unusual factors, including the brief and mild nature of the recession, strong demand for housing as a "safe asset" in the wake of a large stock market decline, and falling mortgage rates after mid-2000. The 30-year fixed-rate mortgage fell from 8.5 percent in May 2000 to 5.25 percent by June 2003.

2 The Federal Reserve Bank of Philadelphia's Coincident Economic Activity Indexes are statistically derived measures of overall economic strength for the nation and each of the 50 states. Each index is based on four economic indicators for a particular state: nonfarm payroll employment, average hours worked in manufacturing, the unemployment rate, and wage and salary disbursements deflated by the consumer price index. See www.philadelphiafed.org/research-and-data/regional-economy/indexes/leading/ for more details and historical data for the indexes.

3 Nationally, the recession began in December 2007 and continued until June 2009, as determined by the National Bureau of Economic Research. Arkansas and Mississippi experienced somewhat milder downturns than the nation as a whole, per the Philadelphia Fed's Coincident Economic Activity Indexes. Tennessee tracked the nation very closely through the recession, while Illinois, Indiana, Kentucky and Missouri suffered noticeably deeper recessions than the national average.

FIGURE 1

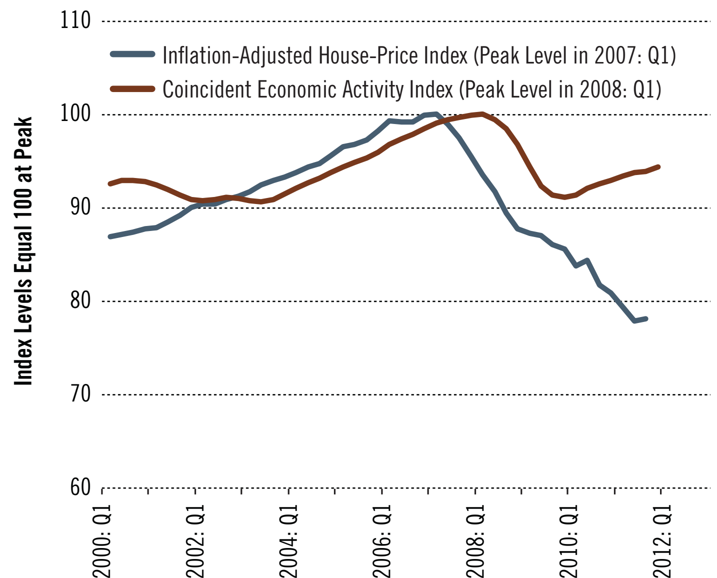
U.S. House-Price Index and Coincident Economic Activity Index



SOURCES: Federal Housing Finance Agency, Bureau of Economic Analysis, Federal Reserve Bank of Philadelphia. Inflation-adjusted house prices are quarterly through 2011: Q3. The Coincident Economic Activity Index is quarterly through 2011: Q4.

FIGURE 2

Eighth District House-Price Index and Coincident Economic Activity Index



SOURCES: Federal Housing Finance Agency, Bureau of Economic Analysis, Federal Reserve Bank of Philadelphia. Inflation-adjusted house prices are quarterly through 2011: Q3. The Coincident Economic Activity Index is quarterly through 2011: Q4.

St. Louis Fed President James Bullard Explores the "Death of a Theory"

More than three years ago, St. Louis Fed President James Bullard discussed "Three Funerals and a Wedding"—ideas about how the financial crisis (up to that point) had changed the conventional wisdom on some critically important macroeconomic issues facing the nation.

Bullard's "funeral" category had several items, but the "wedding" category had just one rising idea: fiscal policy as a business cycle stabilization tool. Now, in his new research paper titled "Death of a Theory," Bullard concludes that the turn in recent years toward fiscal approaches to stabilization policy has run its course and that the conventional wisdom of the past several decades is reasserting itself. (See the brief description on Page 9 of fiscal vs. monetary stabilization policy.)

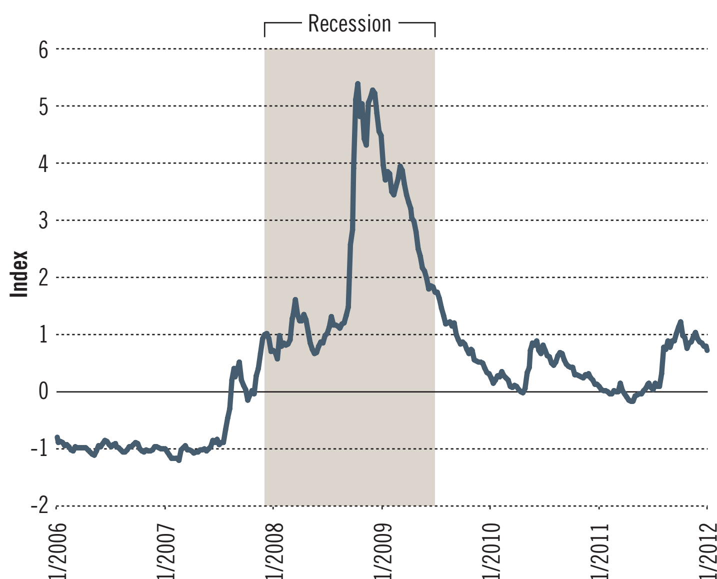
Over the two decades leading up to the financial crisis, the conventional wisdom was that fiscal policy was not a good tool for macroeconomic stabilization—that is, not a good way to attempt to react to shocks that buffet the economy, says Bullard. Conventional wisdom suggested that shorter-run stabilization issues should be handled by the monetary authority (e.g., the Federal Reserve) and that fiscal authorities (e.g., the president and the Congress) should focus on a stable taxing and spending regime to achieve economic and political goals over the medium and longer run. This state of affairs lasted, broadly speaking, until the fall of 2008.

At that point, the short-term nominal interest rate targeted by the FOMC (Federal Open Market Committee) was pushed nearly to zero, where it remains to this day. This led many to conclude that the burden for short-term macroeconomic stabilization had, as a result, shifted to fiscal policy. Indeed, over the past three years, we have seen numerous attempts at stabilization policy by fiscal authorities in the U.S. and around the globe, Bullard says.

However, Bullard argues that the net effect of these attempts has been to confirm much of the conventional wisdom regarding fiscal stabilization policy that existed prior to the financial crisis.

FIGURE 1

The St. Louis Financial Stress Index



SOURCE: Federal Reserve Bank of St. Louis

The St. Louis Financial Stress Index was essentially off the charts during the winter of 2008-2009. A reading of zero would mean normal stress levels and a reading of 2 would be exceptionally high by historical standards; during the crisis, readings of 5 or higher were observed. By 2010, however, stress had returned to more normal levels, and so the case for continued increases in government spending at that point had diminished, says St. Louis Fed President James Bullard in "Death of a Theory." See more on the St. Louis Financial Stress Index at http://research.stlouisfed.org/fred2/series/STLFSI on FRED (Federal Reserve Economic Data).

Addressing the Case for the Fiscal Approach

Much research has been published on when the fiscal approach to business cycle stabilization would be useful and effective. In "Death of a Theory," Bullard cites a paper by economist Michael Woodford in which Woodford notes that "while a case for

aggressive fiscal stimulus can be made under certain circumstances, such policy must be designed with care if it is to have the desired effect."[1]

This line of research assumes that monetary business cycle stabilization policy is ineffective and unable to influence real interest rates once the policy rate is near zero. In addition, the types of policy experiments considered in this research involve extra government spending and taxation only during the period when the policy rate is near zero and financial markets are in considerable turmoil, and not any longer than that. (See Figure 1 on Page 8 for a measure of financial stress during the crisis.)

Three key issues related to the assumptions in Woodford's paper lead Bullard to doubt the merits of possible fiscal stabilization programs for the present circumstances:

First, the types of fiscal policy interventions recommended in the research are fairly intricate and must be designed carefully if they are to have the desired effect. However, the conventional wisdom on fiscal stabilization policy emphasizes that political processes in the U.S. and elsewhere are not well-suited to make timely and subtle decisions like these.

Second, monetary stabilization policy has been quite effective, even while the policy rate has been near zero, Bullard emphasizes. This is because the monetary policy authority can use many other tools to influence inflation and inflation expectations. Thus, a turn toward fiscal stabilization policy is not necessary.

Third, although the research says that taxes should be collected simultaneously with the increase in government spending, the actual fiscal stabilization policy for many countries has involved heavy reliance on government borrowing. This increased debt would be interpreted as promised future taxes. However, shifting the taxes into the future can undo most or all of the benefits that might otherwise come from the fiscal stabilization program, Bullard explains.

In Summary

Bullard concludes that the conventional wisdom on stabilization policy is being re-established in the U.S. Stabilization policy should be left to the monetary authority, which can operate effectively even with a near-zero policy rate. Fiscal authorities should set the tax and spending programs in a way that makes economic and political sense for the medium to longer term. In particular, a stable tax code that is aligned with a stable plan of government spending would allow businesses and households to plan for the future in the most effective way, Bullard says.

ENDNOTE

1 Michael Woodford, "Simple Analytics of the Government Expenditure Multiplier," *American Economic Journal: Macroeconomics* 3: 1-35, 2011.

Stabilization Policy: Fiscal vs. Monetary

Macroeconomic stabilization policy means reacting in a timely manner to aggregate shocks that hit the economy and in a way that smoothes out an otherwise rocky ride for the economy's businesses and households:

Fiscal policy, which is controlled by the president and the Congress, attempts to do this through changes in taxes and government spending.

Monetary policy, which is the charge of the Federal Reserve, attempts to do this by targeting the nominal interest rate or, when the interest rate is near zero, by influencing inflation and inflation expectations primarily through quantitative easing.

"Death of a Theory" and Other James Bullard Resources

This article was based on the paper, presentation and summary of "Death of a Theory," which was originally released in January 2012. President Bullard presented the paper to members of various financial institutions and business leaders on Jan. 13, 2012, at the Edward Jones Annual Meeting in St. Louis.

Visit www.stlouisfed.org/theory to read the presentation and summary or read the paper in the March/April 2012 issue of the St. Louis Fed's *Review* (http://research.stlouisfed.org/publications/review).

Other key policy papers by President Bullard are also available on his web page, http://research.stlouisfed.org/econ/bullard, including:

- "Measuring Inflation: The Core Is Rotten"
- "Seven Faces of 'The Peril'"
- "Three Funerals and a Wedding"

Community Bank Returns

continued from Page 1

More succinctly, this analysis breaks down bank or industry performance into revenue management and cost management.

Given the complication posed by the U.S. tax code, which drives many small, closely held banks to elect Subchapter S status, it may be preferable to consider ROE on a pretax basis. While pretax results do not eliminate all biases, they may help improve the comparability of community bank results.[3]

Historically, a well-run community bank offered a predictable pretax ROE. As shown in Figure 1 on Page 1, average pretax ROE for banks $10 billion and under from 2002 through 2006 was an attractive 17.9 percent (and within a predictable range of 16.9 percent to 19.2 percent). A balance of revenue-collecting opportunities, a modest cost structure and appropriate leverage were the hallmarks of this performance.

The next five years proved more turbulent. From 2007 through 2011, the average pretax return on equity for community banks nationwide deteriorated to 13.3 percent at year-end 2007, turned negative in 2009 at -2.8 percent, and rebounded to a low but positive 8.4 percent by year-end 2011. This precipitous decline in pretax ROE is understandable given that the five-year average for provision expenses more than tripled to 0.91 percent of average assets, up from 0.29 percent during the previous five years. Of course, this adjustment was necessary to replenish loan loss reserves as commercial real estate and residential real estate loan losses skyrocketed.

An important but somewhat disguised trend, interrupted by the financial crisis, was that community bank returns on equity (excluding securities gains) were in a decadelong period of decline. The trend is illustrated in Figure 2. The decline was driven by a narrowing in the spread between asset utilization and operating expenses.

In Conclusion

As bank health nationwide continues to recover after the financial crisis, it is possible ROE will settle in at a lower-than-precrisis historical rate, leading to a resetting of performance expectations by community bank stakeholders. This could be a transitional adjustment or may represent a structural change for the industry.

In either scenario, there may be important repercussions. For example, a lower return expectation might encourage consolidation between healthy institutions in order to gain greater scale and spread out operating

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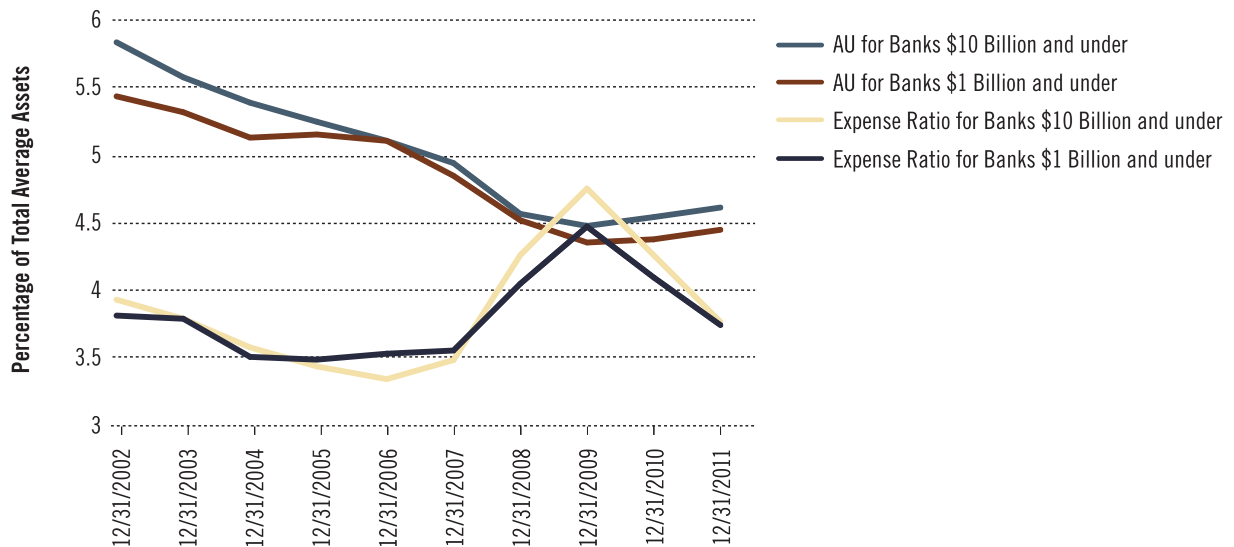
FIGURE 2

Asset Utilization Rate and Expense Ratio



SOURCE: Reports of Condition and Income for Insured Commercial Banks

The "Dialogue" Resumes this Spring with the European Sovereign Debt Crisis

Go beyond the headlines again this year with the St. Louis Fed's public discussion series, "Dialogue with the Fed." The series, which began last fall, focuses on critical issues facing the economy and financial markets. Each session featured presentations by St. Louis Fed officials followed by an open discussion.

DIALOGUE WITH THE FED

Beyond Today's Financial Headlines

The first session for 2012 will be held on **May 8** at the St. Louis Fed in downtown St. Louis. Christopher Waller, senior vice president and director of Research, will lead the presentation and discussion on the European sovereign debt crisis. The discussion, which will be held from 7-8:30 p.m. CT, will also be webcast live on the St. Louis Fed's web site.

Registration for the on-site event and other information will be available in April at **www.stlouisfed.org/dialogue**.

Watch for Dialogue announcements on Twitter, Facebook, RSS feeds and e-mail (visit www.stlouisfed.org/followthefed for more). Also visit the Dialogue web page for video and presentations from the fall sessions.

Community Bank Returns

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costs. Alternatively, changing expectations may reshape the thinking of bank management on fixed investments, such as facilities, and further shift the emphasis to electronic delivery mechanisms. Only time will tell whether community banks will be able to return to precrisis levels of profitability.

Gary Corner is a senior examiner at the Federal Reserve Bank of St. Louis. The author thanks Daigo Gubo, policy analyst in the Supervisory Policy and Risk Analysis Unit, for contributing to this article.

ENDNOTES

1 Total revenue for purposes of this analysis is net interest income and noninterest income combined. The author chose to exclude ad hoc securities gains from the revenue total, believing most investors do not consider community bank securities gains a valuable ongoing revenue source.

2 Total operating expense is noninterest expense plus provision for loan and lease losses.

3 Banks that elect Subchapter S tax status are not subject to federal corporate taxes. Rather, the shareholders are subject to personal income taxes on their pro rata share of the bank's entire earnings. Gilbert, R. Alton and Wheelock, David C., "Measuring Commercial Bank Profitability: Proceed with Caution," November/December 2007 Federal Reserve Bank of St. Louis *Review*.

ALLL Best Practices

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be tested for impairment, such as all loans over a certain size, all classified loans or all nonaccrual 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 an ASC 310 analysis indicating the amount of impairment for each loan tested.

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

Timothy A. Bosch is a vice president in Banking Supervision and Regulation and Salvatore Ciluffo is a senior examiner at the Federal Reserve Bank of St. Louis.

ENDNOTE

1 A version of this article first appeared in the summer 2009 *Central Banker*. Since that time, the Financial Accounting Standards Board restructured accounting and reporting standards as Accounting Standard Codifications (ASC). FAS 5 is found under ASC 450 and FAS 114 is found under ASC 310.

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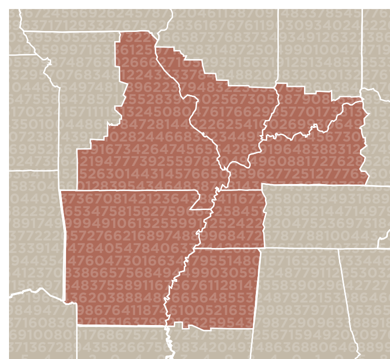
- Federal Reserve Lending to Troubled Banks During the Financial Crisis

RULES AND REGULATIONS

- What the Changes to the Home Affordability Refinance Program Mean for Lenders
- New Fed Guidance Addresses Rating Upgrades Standards
- Comment by April 30 on Dodd-Frank Enhanced Prudential Standards and Early Remediation Requirements
- Consumers Can Submit Foreclosure Review Requests by July 31

CDIAC UPDATE

- The St. Louis Fed's 2012 Community Depository Institution Advisory Council Meets



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St. Louis Fed's 2012 Community Depository Institutions Advisory Council Meets

The St. Louis Fed's Community Depository Institutions Advisory Council (CDIAC) met March 5 and 6, 2012, for the first of its bi-annual meetings at the Bank with President James Bullard. The St. Louis council, comprised of 12 executives of smaller financial institutions from communities across the Eighth District, was established in 2011 to advise Bullard on local credit, banking and economic conditions. The chairman of the council then reports twice a year, along with counterparts from the Federal Reserve System's 11 other districts, to the Federal Reserve Board of Governors' Community Depository Institutions Advisory Council.

Four of the members whose original one-year terms expired in 2011 were re-appointed to three-year terms beginning in 2012. For more information, see the St. Louis Fed's CDIAC page, or for more information about all of the Federal Reserve System CDIAC councils, see the Federal Reserve Board of Governors' site.

The St. Louis council next meets Sept. 17 and 18, 2012.

2012 St. Louis Fed Community Depository Institutions Advisory Council

Dennis M. Terry (Chairman)
President and CEO, First Clover Leaf Bank FSB, Edwardsville, Ill.
Term expiration: 2012

Kirk P. Bailey
CEO, Magna Bank, Memphis, Tenn.
Term expiration: 2014

Glenn D. Barks
President and CEO, First Community Credit Union, Chesterfield, Mo.
Term expiration: 2013

H. David Hale
Chairman, President and CEO, First Capital Bank of Kentucky, Louisville, Ky.
Term expiration: 2014

D. Keith Hefner
President and CEO, Citizens Bank & Trust Company, Van Buren, Ark.
Term expiration: 2012

Gary E. Metzger
President, Liberty Bank, Springfield, Mo.

Term expiration: 2013

William J. Rissel
President and CEO, Fort Knox Federal Credit Union, Radcliff, Ky.
Term expiration: 2012

Mark A. Schroeder
Chairman and CEO, German American Bancorp, Jasper, Ind.
Term expiration: 2014

Gordon Waller
President and CEO, First State Bank & Trust, Caruthersville, Mo.
Term expiration: 2013

Larry T. Wilson
President and CEO, First Arkansas Bank & Trust, Jacksonville, Ark.
Term expiration: 2014

Vance Witt
CEO & Chairman, BNA Bank, New Albany, Miss.
Term expiration: 2013

Larry Ziglar
President, First National Bank in Staunton, Staunton, Ill.
Term expiration: 2012

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Recent St. Louis Fed Banking and Economic Research

Wanted: A New Engine for Economic Growth

Don't expect consumer spending to be the engine of economic growth it once was, argues St. Louis Fed economist William Emmons. "Can American consumers continue to serve as the engine of U.S. and global economic growth as they did during recent decades? Several powerful trends suggest not, at least for a while," Emmons writes.

"Instead, new sources of demand, both domestic and foreign, are needed if we are to maintain healthy rates of growth. Unfortunately, this won't be easy because consumer spending constitutes the largest part of our economy, and replacements for it—more investment, more government spending or more exports—either can't be increased rapidly or might create unwanted consequences of their own," Emmons writes. Read the full article in the January *Regional Economist*.

New Economic Synopses Essays from St. Louis Fed Economists

Identifying Structural and Cyclical Shocks Across U.S. Regions

The statistical relationship between vacancies and unemployment is not always a stable one, as unemployment remains high even while job vacancy rates are returning to pre-financial crisis levels. A February Economic Synopsis briefly explores why it is not clear how monetary policy might be used to reduce local unemployment rates where recruiting intensity is high but the right kind of worker is hard to find.

Unemployment Dynamics During Economic Recoveries

Employment turnover was significantly lower following the Great Recession than it was after the previous two recessions. A January Economic Synopsis briefly explores slow employment growth and low turnover, and speculates that a decrease in labor reallocation may be caused by higher rigidity and regulations in the labor market as well as more generous unemployment welfare.

Speculation in the Oil Market

When oil prices jump, is speculation in the oil markets truly to blame? A March *Economic Synopsis* identifies and assesses four components that contribute to the price of oil—which is a critical first step for allocating resources efficiently and designing good policy.

This *Economic Synopsis* is based on the working paper of the same name co-authored by St. Louis Fed economist Luciana Juvenal.

How Home Loan Modification through the 60/40 Plan Can Save the Housing Sector

Many well-respected economists have suggested plans for mortgage restructuring built on the idea of share appreciation mortgages, which generate rather complex transactions with conflicting interests between the lender and the homeowner. The 60/40 Plan, however, combines several economic principles adapted to the nature of home loans and appears to provide all the benefits but fewer of the drawbacks of many of these programs, including current government programs such as the Home Affordable Refinance (HARP) and Home Affordable Modification (HAMP) programs. Read the full article in the St. Louis Fed's March/April 2012 *Review*.

Federal Reserve Lending to Troubled Banks During the Financial Crisis, 2007-2010

Numerous commentaries have questioned both the legality and appropriateness of Federal Reserve lending to banks during the recent financial crisis. This working paper by St. Louis Fed economists addresses two questions motivated by such commentary: Did the Federal Reserve violate either the letter or spirit of the law by lending to undercapitalized banks, and 2) did Federal Reserve credit constitute a large fraction of the deposit liabilities of failed banks during their last year prior to failure. The authors found no evidence that the Federal Reserve ever exceeded statutory limits during the recent financial crisis, recession and recovery periods, and conclude that Federal Reserve lending to depository institutions during the recent episode was consistent with the intentions of the U.S. Congress.

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Rules and Regulations

What the Changes to the Home Affordability Refinance Program Mean for Lenders

Among the most significant of the recent changes to the Home Affordable Refinance Program (HARP) are the elimination of risk-based fees for borrowers who finance into shorter-term mortgages; removal of the loan-to-value ceiling for some fixed-rate mortgages backed by GSEs (government-sponsored enterprises); and a program extension. Read more in the latest issue of *Bridges*.

New Fed Guidance Addresses Rating Upgrades Standards

The Federal Reserve Board issued guidance in March to ensure that supervisors apply consistent standards as they evaluate whether banking organizations with $10 billion or less in assets are eligible for upgrades of supervisory ratings.

The guidance is being issued to ensure that upgrades occur in a timely manner when the banking organizations have made the requisite progress in addressing any supervisory concerns that had prompted lower ratings. To be eligible for an upgrade, banks are expected to demonstrate, among other things, improvement in financial condition and risk management, as well as show that such improvement is likely to continue.

Comment by April 30 on Enhanced Prudential Standards, Early Remediation Requirements

Interested persons now have until April 30 to comment on a proposed rule to implement the enhanced prudential standards and early remediation requirements in the Dodd-Frank Act for bank holding companies with consolidated assets of $50 billion or more and nonbank financial companies supervised by the Federal Reserve Board.

The proposal includes a wide range of measures addressing issues such as capital, liquidity, single counterparty credit limits, stress testing, risk management, and early remediation requirements. They are designed to reduce the probability of failure of systemically important companies and minimize damage in the event that such a company fails. The Board extended the comment period (originally ending March 21) to allow interested persons more time to analyze the issues and prepare their comments.

Certain Consumers Can Submit Foreclosure Review Requests by July 31

People seeking a review of their mortgage foreclosures under the Federal banking agencies' Independent Foreclosure Review now have until July 31, 2012, to submit their requests.

The new deadline provides an additional three months for borrowers to request a review if they believe they suffered financial injury as a result of errors in foreclosure actions on their homes in 2009 or 2010 by one of the servicers covered by enforcement actions issued in April 2011.

The actions required 14 large mortgage servicers to retain independent consultants to conduct a comprehensive review of foreclosure activity in 2009 and 2010 to identify borrowers who may have been financially injured due to errors, misrepresentations, or other deficiencies in the foreclosure process. If the review finds that financial injury occurred, the borrower may receive compensation or other remedy.

Borrowers are eligible for an Independent Foreclosure Review if they meet the following basic criteria:

1. The mortgage loan was active in the foreclosure process between Jan. 1, 2009, and Dec. 31, 2010.
2. The property securing the mortgage loan was the borrower's primary residence.
3. The mortgage loan was serviced by one of the participating mortgage servicers. Those include: America's Servicing Company, Aurora Loan Services, BAC Home Loans Servicing, Bank of America, Beneficial, Chase, Citibank, CitiFinancial, CitiMortgage, Countrywide, EMC, Everbank/Everhome Mortgage Company, Financial Freedom, GMAC Mortgage, HFC, HSBC, IndyMac Mortgage Services, MetLife Bank, National City Mortgage, PNC Mortgage, Sovereign Bank, U.S. Bank, Wachovia Mortgage, Washington Mutual, Wells Fargo, and Wilshire Credit Corporation.