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CENTRAL Banker

NEWS AND VIEWS FOR EIGHTH DISTRICT BANKERS

FEATURED IN THIS ISSUE
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Community Bank Lending during the Financial Crisis

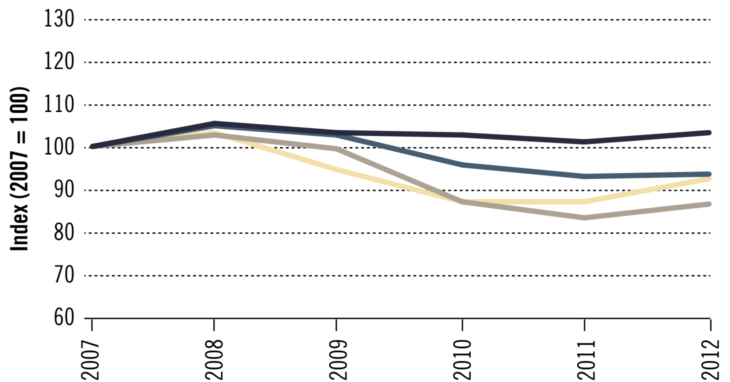
By Gary Corner and Andy Meyer

The total volume of loans held by community banks peaked in 2008 and dropped during the financial crisis and Great Recession. Total loans bottomed out in 2011 and, as of December 2012, have only recovered to a level roughly 10 percent below their 2008 peak.

During this period, both demand and supply factors undoubtedly played roles in the change in bank lending. In the years before the crisis, the perception of ever-rising residential and commercial real estate prices caused loan demand to soar. On the supply side, some (though certainly not all) banks relaxed assorted underwriting standards, accepting applicants with little equity or with overly optimistic property appraisals and income forecasts. During the financial crisis, Great Recession and sluggish economic recovery, business and household loan demand weakened considerably as firms and households cut spending, increased savings and increased balance sheet liquidity. On the supply side, banks that had relaxed some standards naturally raised them to more sustainable levels in an effort to reduce their risk and to limit further losses. Thus, both demand and supply factors contributed to the drop-off in lending, and the relative contribution of each factor is difficult to distinguish.

FIGURE 1

Total Loans



KEY
- Eighth District banks with assets less than $1 billion
- Eighth District banks with assets $1 billion-$10 billion
- U.S. banks with assets less than $1 billion
- U.S. banks with assets $1 billion-$10 billion

Community Bank Lending Trends

Quality loans and local deposit-taking are the foundation of community bank profits and growth. Despite the financial crisis, healthy community banks still had an incentive to maximize profits by lending, as long as risk factors were balanced. As illustrated in Figure 1 above, small community banks across the Eighth Federal

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EDITOR
Scott Kelly
314-444-8593
scott.b.kelly@stls.frb.org

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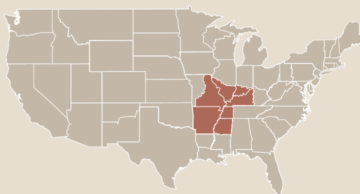
The Eighth Federal Reserve District includes all of Arkansas, eastern Missouri, southern Illinois and Indiana, western Kentucky and Tennessee, and northern Mississippi. The Eighth District offices are in Little Rock, Louisville, Memphis and St. Louis.



Selected St. Louis Fed Sites

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

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

Community Development's Household Financial Stability Initiative
www.stlouisfed.org/HFS

CENTRAL VIEW

The Global Battle Over Central Bank Independence

By James Bullard

James Bullard is president and CEO of the Federal Reserve Bank of St. Louis.

Financial crisis aftershocks have partially broken down the consensus on the wisdom of central bank independence. They have introduced a "creeping politicization" of central banking globally. To the extent that central bank independence is weakened globally, macroeconomic stabilization policy will not be executed as well in the future as it has been since the mid-1980s. "Fiscalization" of monetary policy will tend to complicate the policymaking process substantially.

Consensus on Central Bank Independence

Effective macroeconomic stabilization policy has to be implemented in a timely manner in reaction to macroeconomic shocks. Adjusting fiscal policy—taxation, appropriations and public debt—as a means for stabilization tends to be slow and must be carefully negotiated, while monetary policy can be implemented in a timely and technocratic manner. Hence the conventional wisdom: Focus fiscal policy decisions on the medium and longer run and delegate monetary policy to an independent authority.

If monetary policy is not delegated to an independent authority, then it too becomes part of the slow and complicated negotiations associated with fiscal policy. The society would be left without a way to make timely policy adjustments in reaction to macroeconomic shocks, and the result would be more macroeconomic volatility. The consensus therefore suggests that macroeconomic outcomes will be better with an independent central bank.

Fiscal Responses

In recent years, the central banks in the G-7 countries encountered the zero lower bound on nominal interest rates. In my view, central banks have conducted stabilization policy effectively even while at the zero bound, primarily through the use of quantitative easing programs and forward guidance. Nevertheless, many see fiscal stabilization policy as desirable in the current context.

One idea suggested by some is that the central bank take actions that are cumbersome to accomplish through a democratically elected body, which may be seen as one way to get the relatively speedy monetary policy decision-making into a fiscal policy context. However, this is a creeping politicization of monetary policy. In such a case, some central bank independence is lost since the monetary authority is taking actions at the behest of other policy actors. Furthermore, monetary policy decisions then become wrapped

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Fourth-Quarter 2012 Banking Performance[1]

Earnings Performance

	2011: 4Q	2012: 3Q	2012: 4Q
RETURN ON AVERAGE ASSETS[2]			
All U.S. Banks	0.67%	1.00%	0.97%
All Eighth District States	0.57	0.89	0.87
Arkansas Banks	1.08	1.13	1.18
Illinois Banks	0.34	0.67	0.64
Indiana Banks	0.90	1.12	1.12
Kentucky Banks	0.65	1.10	1.03
Mississippi Banks	0.73	0.91	0.89
Missouri Banks	0.66	0.91	0.89
Tennessee Banks	0.04	0.84	0.80
NET INTEREST MARGIN			
All U.S. Banks	3.96%	3.86%	3.87%
All Eighth District States	3.91	3.84	3.84
Arkansas Banks	4.31	4.19	4.19
Illinois Banks	3.75	3.62	3.61
Indiana Banks	3.97	3.90	3.92
Kentucky Banks	4.08	4.05	4.01
Mississippi Banks	4.01	4.05	4.03
Missouri Banks	3.79	3.71	3.77
Tennessee Banks	3.89	3.92	3.89
LOAN LOSS PROVISION RATIO			
All U.S. Banks	0.61%	0.35%	0.35%
All Eighth District States	0.73	0.41	0.40
Arkansas Banks	0.51	0.36	0.31
Illinois Banks	1.00	0.58	0.55
Indiana Banks	0.45	0.22	0.23
Kentucky Banks	0.58	0.40	0.40
Mississippi Banks	0.55	0.25	0.26
Missouri Banks	0.58	0.38	0.37
Tennessee Banks	0.95	0.36	0.39

Asset Quality Measures

	2011: 4Q	2012: 3Q	2012: 4Q
NONPERFORMING ASSETS RATIO[3]			
All U.S. Banks	4.71%	4.09%	3.73%
All Eighth District States	5.17	4.48	4.09
Arkansas Banks	5.67	5.04	4.76
Illinois Banks	6.19	5.35	4.74
Indiana Banks	3.64	3.18	2.85
Kentucky Banks	3.70	3.69	3.48
Mississippi Banks	4.52	3.80	4.01
Missouri Banks	4.81	4.09	3.53
Tennessee Banks	5.65	4.70	4.32
LOAN LOSS COVERAGE RATIO[4]			
All U.S. Banks	61.57%	67.07%	71.78%
All Eighth District States	58.95	66.55	71.13
Arkansas Banks	60.23	69.12	71.40
Illinois Banks	50.33	55.99	63.16
Indiana Banks	64.11	69.23	75.06
Kentucky Banks	69.40	71.63	75.12
Mississippi Banks	69.12	78.26	66.30
Missouri Banks	67.18	83.23	90.75
Tennessee Banks	61.14	68.73	74.36

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 earnings assets in the denominator.
3 Nonperforming loans plus OREO are those 90 days past due or in nonaccrual status or other real estate owned.
4 The loan loss coverage ratio is defined as the loan loss reserve (ALLL) divided by nonperforming loans.

Can FASB Get Loan Loss Accounting Just Right?

By Michelle Neely and Gary Corner

The Financial Accounting Standards Board (FASB) recently released a proposal that would change the way financial institutions set aside funds to cover losses on loans, debt securities and other assets. Under current accounting rules, the allowance for loan and lease losses (ALLL) is based on incurred losses; the new model, if adopted, would require the allowance to be established for losses expected over the life of the loan based on current and future economic conditions, historical losses, and other factors. The change was prompted by the global financial crisis, when stakeholders were blindsided by the tremendous credit risk that had built up in many institutions' loan portfolios.

Under FASB's new Current Expected Credit Loss model, nonaccrual loans would be treated as before. For unimpaired loans and other credit instruments, the institution would estimate expected credit losses at every reporting period.

Financial institutions follow generally accepted accounting principles (GAAP) when reporting financial information. Under GAAP, funding for the ALLL is determined by what an institution thinks it will lose on loans based on events that have already occurred; this method is referred to as the "incurred loss" method. There are a number of problems with this method, the most significant of which is that it is not forward-looking. Credit losses aren't recognized until they are probable or have already occurred, thus making it difficult for investors to be forewarned of imbedded losses, as in the most recent financial crisis. Many bankers knew that their portfolios of subprime loans, for example, were in trouble long before homeowners started defaulting, but their financial statements did not (and could not, under GAAP) communicate that to investors.

Out with the Old

The push to revamp accounting for credit losses began in 2009 when FASB and the International Accounting Standards Board (IASB) launched a joint project to improve loss accounting and mitigate differences in U.S. (GAAP) and international (IFRS, or international financial reporting standards) accounting systems. By the summer of 2012, the project had broken down as the two accounting bodies could not agree on some significant matters. FASB's concerns were that the agencies' joint proposed impairment method was too complicated and only allowed for a one-year projection period. Bankers had also argued that the joint proposal didn't take into account the diverse nature of banking institutions in the U.S.

Under FASB's new Current Expected Credit Loss (CECL) model, unveiled in December, nonaccrual loans would be treated as before. For unimpaired loans and other credit instruments, the institution would estimate expected credit losses at every reporting period.[1] That estimate would capture all contractual cash flows that the institution does not expect to collect and would be based on "past events, current conditions, and reasonable and supportable forecasts about the future."[2] Importantly, the estimated losses would not be limited to those expected over a specific period of time, leaving most observers to conclude that estimated losses should be based on the life of the credit instrument.

Will New Model Satisfy Stakeholders?

Reaction to the FASB proposal has been mixed. On the positive side, an

accounting expert at the American Bankers Association says the CECL model would be "operationally simpler as well as making the ALLL balance easier to understand and to explain to investors and management."[3] The model would allow ALLL balances to increase during periods of economic growth, if information suggests banks are taking on greater credit risk or future economic conditions are expected to deteriorate. This practice has historically been discouraged by the Securities and Exchange Commission, which is concerned about earnings smoothing.

A recent report by the Government Accountability Office (GAO) highlighting the work of the U.S. Treasury's Financial Stability Working Group on Loss Provisioning is also supportive.[4] The working group asserts that earlier recognition of potential loan losses could have lessened the impact of the financial crisis since banks ultimately had to recognize their credit loss exposures pro-cyclically through a sudden series of provisions to the loan loss reserve, thus depleting their earnings and regulatory capital.

Bankers do have some concerns about the proposal though. The biggest objection is that FASB has not specified a time period over which losses are to be estimated, leaving most to interpret the time period to be the life of a loan or debt security. Most observers objected to an arbitrary one-year time horizon that the IASB has floated, but they argue that the FASB proposal goes to the other extreme. A "life of the loan" loss projection would require information and forecasts that most bankers currently do not have the expertise to generate. Estimating losses on debt securities that are not government-guaranteed, like municipal bonds, would be difficult. Still others worry that the CECL model moves bank accounting more toward a market-value framework. It is also unclear how—if at all—the new model would affect capital requirements and the regulatory treatment of both the ALLL and bank capital.

The FASB proposal is out for comment until May 31. FASB chair Leslie Seidman has said that a final standard will likely be in place by early 2015.

Michelle Neely is an economist and Gary Corner is a senior examiner at the Federal Reserve Bank of St. Louis.

ENDNOTES

1. More specifically, the CECL model covers loans held for investment; held-to-maturity and available-for-sale debt securities; loan commitments; trade, lease and reinsurance receivables; and any other receivables with contractual rights to receive cash.
2. "Proposed Accounting Standards Update—Financial Instruments—Credit Losses (Subtopic 825-15)," *In Focus*, FASB, Dec. 20, 2012.
3. "FASB Impairment Exposure Draft: Frequently Asked Questions (as of 1/4/2013)," American Bankers Association, www.aba.com/Solutions/Acct/Documents/ABAimpairmentEDFAQsJan2013.pdf
4. "Causes and Consequences of Recent Bank Failures: GAO-13-71," Jan. 3, 2013, www.gao.gov/products/GAO-13-71

More on the FASB Proposal and Credit Loss Accounting

To comment on the FASB proposal, visit www.fasb.org and navigate to Exposure Documents > Exposure Documents Open for Comment and scroll down to Proposed Accounting Standards Update—Financial Instruments—Credit Losses. Comments are due by May 31.

For technical details and project updates on the proposal, visit www.fasb.org and navigate to News Center > News Releases Archive and scroll down to "FASB Extends Comment Deadline on Proposal for Accounting for Credit Losses on Financial Assets."

For related St. Louis Fed analysis and data on allowance for loan and lease losses, see the following:

- "ALLL Best Practices: Keep the Appropriate Allowance for Loan and Lease Losses Reserve" by Salvatore Ciluffo and Timothy A. Bosch, which appeared in the Spring 2012 Central Banker as an update to a piece that first ran in the summer of 2009. Go to www.stlouisfed.org/publications/cb/articles/?id=2230 to read this piece.
- FRED (Federal Reserve Economic Data) has more than 50 economic time series related to aspects of the ALLL. Visit http://research.stlouisfed.org/fred2/tags/series?t=alll

FIGURE 2

Commercial Real Estate Loans

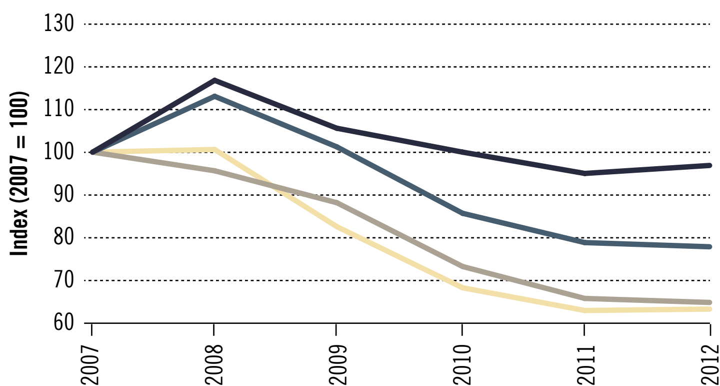


FIGURE 3

1- to 4-Family First Mortgages

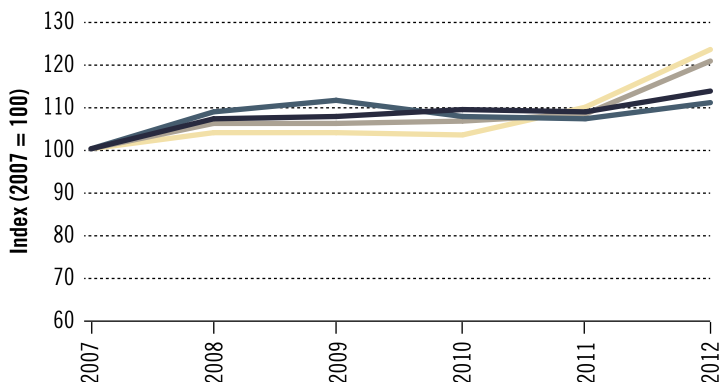
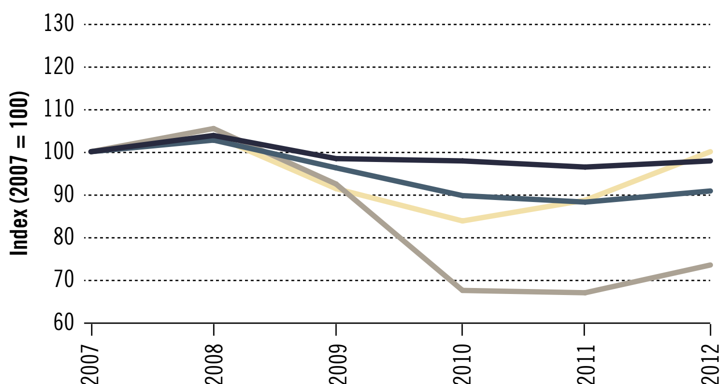


FIGURE 4

Commercial and Industrial Loans



KEY

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- Eighth District banks with assets $1 billion-$10 billion
- U.S. banks with assets less than $1 billion
- U.S. banks with assets $1 billion-$10 billion

Community Bank Lending

continued from Page 1

Reserve District did increase the size of their total loan portfolios compared to their 2007 levels.[1]

The story is different for the other groups of community banks, however, as their total loans experienced a notable decline relative to their 2007 levels. In fact, across the loan categories we reviewed—commercial real estate, 1- to 4-family first-lien loans, and commercial and industrial loans—the data suggest that small Eighth District community banks collectively experienced more stability in lending volume than large Eighth District community banks and community banks nationwide.

One example is in **commercial real estate lending**. From 2008 onward, commercial real estate lending dropped in all four groups of banks, as seen in Figure 2 to the left. A major factor in this decrease was the fall in commercial real estate prices across the nation. Lending has increased somewhat in small Eighth District community banks and appears to have leveled off in the other bank categories.

In reviewing **1- to 4-family loan volumes**, more stability is shown across community banks both nationally and District-wide, as seen in Figure 3 to the left. For all four groups, total loan volume was higher in 2012 than in 2007. It is important to note that these mortgages are the ones that community banks have kept in their own portfolios, as opposed to the ones that they have sold in secondary markets. During this period, the default rate on loans in banks' own portfolios was lower than those in the securitized secondary market.

Next we turn to **commercial and industrial lending**. Across all groups, commercial and industrial lending volume largely declined relative to 2007 levels, as seen in Figure 4 to the left. But again, the lending pattern for small Eighth District banks was the most consistent. In a push to diversify away from the hard-hit commercial real estate sector, many lenders are emphasizing commercial and industrial lending. Anecdotally, community bank lenders report that they increasingly find themselves competing with

regional-sized institutions for the same customers.

Loans as a Percentage of Community Bank Balance Sheets

The data suggest that growth in community bank total assets has outpaced the growth in community bank total loans, as seen in Table 1 to the right. As the returns on other personal investment vehicles fell dramatically, customers flooded banks with deposits, causing a huge increase in liquidity. Loan demand could not absorb all of the funds; so, the banks funneled many of them into investment securities and cash balances. Of course, this surge in deposits may quickly dissipate as depositors' economic opportunities change.

Small community banks across the Eighth Federal Reserve District did increase the size of their total loan portfolios compared to their 2007 levels.

In terms of earnings, the opportunity cost of holding excess liquidity is significant. Consequently, community banks' profitability is unlikely to reach historical norms with their current balance sheet mix. Of course, community bankers are cognizant of their high levels of liquidity and are generally poised and eager to lend.

Conclusion

Community bank lending has apparently turned a corner and is rising again after a prolonged decrease during the financial crisis. Although demand and supply factors play difficult-to-measure roles, one factor that stands firm is that community banks have a strong profit motive to pursue quality lending relationships and are not presently constrained by balance sheet liquidity needs.

Gary Corner is a senior examiner and Andy Meyer is a senior economist at the Federal Reserve Bank of St. Louis.

TABLE 1

Growth in Community Bank Total Assets

Year	Number of Community Banks	Average Assets of Community Banks	Total Loans/ Total Assets
2007 – District	717	$267.2 million	69.7%
2012 – District	645	$332.6 million	60.3%
2007 – U.S.	7,139	$319.9 million	68.9%
2012 – U.S.	5,949	$384.4 million	60.7%

NOTE: Community banks are those that averaged less than $10 billion in total assets over the six-year period.

ENDNOTE

1 Small community banks are defined in this article as institutions with less than $1 billion in assets, while large community banks have between $1 billion and $10 billion in assets. In all of the figures, banks are assigned to a size class based on their average assets over the full six-year period; so, no banks move between size classes. To facilitate comparisons across size classes and geographic regions, each time series is indexed to 100 at the beginning of the period (December 2007).

Upcoming Annual Report Looks at Household Balance Sheets

The net worth of many U.S. households was severely impacted by the financial crisis and ensuing recession. Severe declines in home values and stock prices, together with many job losses and weak income growth among those who held on to their jobs, exposed the precarious debt-laden balance sheets many families had created.

In the upcoming annual report of the Federal Reserve Bank of St. Louis, find out which groups of people lost the most wealth because of the downturn in the economy, why it's important for those households to rebuild their balance sheets and what the latest research has to say about the impact of household financial stability on the broader economy. Many of the families with weak balance sheets going into the crisis have yet to recover financially, while others who were better diversified and had less debt have benefited from rising stock prices and low interest rates. Thus, the economic recovery to date has been bifurcated among households of varying balance-sheet strength and remains weak overall.

To sign up for an e-mail alert when the annual report is published this spring, or to subscribe to the paper version (U.S. addresses only), see www.stlouisfed.org/subscribe

Also, for more information on St. Louis Fed efforts concerning household balance sheets, visit the Household Financial Stability web site at www.stlouisfed.org/HFS, which has articles, speeches, presentations, video and audio clips, and other materials.

Is the Fed Monetizing Government Debt?

The financial crisis and Great Recession have magnified public scrutiny of the Federal Reserve, a consequence of the extraordinary actions the Fed has taken since 2008.

Among the Fed's actions—specifically those by the FOMC (Federal Open Market Committee), the Fed's monetary policymaking body—has been the increase of the U.S. monetary base. Since August 2008 the Fed has tripled the monetary base from about $0.8 trillion to $2.7 trillion, of which $1.2 trillion was used to purchase U.S. government bonds (i.e., Treasury debt).[1]

As St. Louis Fed economist David Andolfatto and research associate Li Li explore in a recent *Economic Synopses*, this has led some commentators to argue that the Fed is "monetizing government debt."[2] Essentially, the concern is that the Fed is somehow enabling excessive government borrowing and possibly risking future inflation.

Under [one] scenario, the Fed is not monetizing government debt—it is simply managing the supply of the monetary base in accordance with the goals set by its dual mandate.

Defining "Monetizing Debt"

To be clear about what "monetizing the debt" means, Andolfatto and Li review some basic principles. The Fed is required by mandate to keep inflation low and stable and to stabilize the business cycle to the best of its ability. The Fed fulfills its mandate primarily by open market sales and purchases of (mainly government) securities. If the Fed wants to lower interest rates, it creates money and uses it to purchase Treasury debt. If the Fed wants to raise interest rates, it destroys the money collected through sales of Treasury debt. Consequently, there is a sense in which the Fed is "monetizing" and "demonetizing" government debt over the course of the typical business cycle.

However, what is usually meant by "monetizing the debt," Andolfatto and Li write, is the use of money creation as a *permanent* source of financing for government spending. Therefore, whether the Fed is *truly* monetizing government debt depends on what the Fed intends to do with its portfolio in the long run.

Is It a Permanent or Temporary Increase?

In an October 2012 speech to the Economic Club of Indiana, Fed Chairman Ben Bernanke explained that ultimately what the Fed is doing is little different than what it has always done. "The Fed's basic strategy for strengthening the economy—reducing interest rates and easing financial conditions more generally—is the same as it has always been. The difference is that, with the short-term interest rate nearly at zero, we have shifted to tools aimed at reducing longer-term interest rates more directly."[3]

For example, the FOMC has made unusually large acquisitions of longer-term securities, including Treasury debt. But is this debt a permanent acquisition? Or will its stay on the Fed's balance sheet be temporary? Andolfatto and Li address these questions:

- **Permanent** – If this accumulated Treasury debt is supposed to be *permanent*, then it is reasonable to expect that the corresponding supply of new money would also be permanent and would remain in the economy as either cash in circulation or bank reserves, Andolfatto and Li write. As the interest earned on the securities is remitted to the Treasury, the federal government essentially can borrow and spend this new money for free. Thus, under this scenario, money creation becomes a permanent source of financing for government spending.
- **Temporary** – On the other hand, if the Fed's recent increase in Trea-

sury debt holdings is only *temporary* (an unusually large acquisition in response to an unusually large recession), then the public must expect that the monetary base at some point will return to a more normal level—with the Fed selling the securities or letting them mature without replacing them. Under this scenario, the Fed is not monetizing government debt—it is simply managing the supply of the monetary base in accordance with the goals set by its dual mandate. Some means other than money creation will be needed to finance the Treasury debt returned to the public through open market sales.

Bernanke has repeatedly propounded the latter view, for instance in his aforementioned speech, Andolfatto and Li explain. They also write that the credibility of Fed policy is arguably reflected in the course of inflation and inflation expectations. Since 2008, inflation has averaged less than the Fed's official long-run inflation target of 2 percent per year. Moreover, market-based measures of inflation expectations remain well-anchored. So, it seems that to this point, at least, the Fed's credibility is passing the market test.

Meanwhile, Andolfatto and Li write that the claim that Fed policy is exerting downward pressure on interest rates, especially at the short end of the yield curve, has some merit. The quantitative impact of Fed policy on longer rates, however, is debatable. The reason for this is because an elevated worldwide demand for U.S. Treasury securities is keeping yields low independently of Fed policy. The possibility that forces outside the Fed have a large impact on yields is suggested by the data in Figure 1 below. As the figure shows, the vast majority (85 percent) of marketable U.S. Treasury debt is held outside the Fed and is close to the average ratio held over the past 20 years.

Conclusion

So, is the Fed monetizing debt—using money creation as a permanent source of financing for government spending? The answer is no, according to the Fed's stated intent. In a November 2010 speech, St. Louis Fed President James Bullard said: "The (FOMC) has often stated its intention to return the Fed balance sheet to normal, pre-crisis levels over time. Once that occurs, the Treasury will be left with just as much debt held by the public as before the Fed took any of these actions."[4] When that happens, it will be clear that the Fed has not been using money creation as a permanent source for financing government spending.

ENDNOTES

1 Most of the remaining new money has been used to purchase mortgage-backed securities.

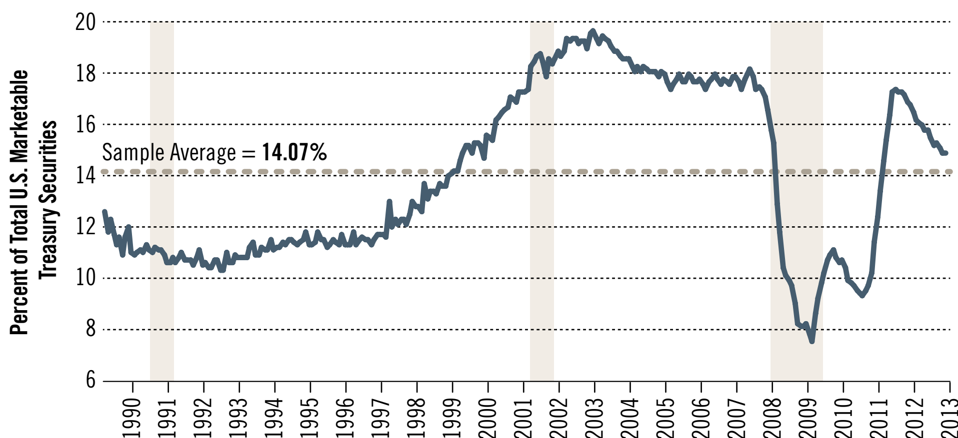
2 "Is the Fed Monetizing Government Debt?" by David Andolfatto and Li Li, Federal Reserve Bank of St. Louis *Economic Synopses*, 2013, No. 5.

3 "Five Questions about the Federal Reserve and Monetary Policy," speech by Ben Bernanke delivered to the Economic Club of Indiana, Indianapolis, Oct. 1, 2012.

4 "QE2 in Five Easy Pieces," speech by James Bullard delivered at the High Profile Speaker Series, New York Society of Security Analysts, New York City, Nov. 8, 2010.

FIGURE 1

Federal Reserve Holdings of U.S. Marketable Securities



SOURCE: Federal Reserve Board

NOTE: Shaded areas indicate U.S. recessions.

Central View

continued from Page 2

up with fiscal policy decisions, slowing down the process through negotiation and making it considerably more complicated.

ECB's OMT Program

An example of this creeping politicization trend is the European Central Bank's (ECB's) outright monetary transactions (OMT) program, which has been widely interpreted as a promise to buy the sovereign debt of individual nations. Should purchases occur, they are conditional on the nation meeting certain fiscal targets.

This is fiscalization of monetary policy: asking the central bank to take actions far outside the remit of monetary policy. Assistance like this from a central authority to a region is best brokered through the political process in democratically elected bodies. The ECB is in essence substituting for a weak pan-European central government.

By nearly all accounts, the European monetary policy process has been bogged down by political wrangling over the OMT and other programs. Ordinary monetary policy provides or removes monetary accommodation in response to macroeconomic developments. Yet the ECB has taken little direct action in response to the European recession.

By conducting a fiscal action, the central bank has been pulled away from its ordinary macroeconomic stabilization policy. Standard monetary policy has become wrapped up in the fiscal policy package and subject to the negotiations that surround that package. This defeats one of the original purposes of central bank independence: having a monetary authority that can react to macroeconomic shocks quickly and effectively.

This article was based on Bullard's presentation on Jan. 4, 2013, at the AEA/ASSA annual meeting in San Diego. See the presentation slides on Bullard's web page at http://research.stlouisfed.org/econ/bullard/jbotherspeeches.html

Follow Regional Agricultural Finance Conditions with Quarterly Survey

Learn about agricultural credit conditions in the Eighth District with the St. Louis Fed's quarterly *Agricultural Finance Monitor*. Each issue surveys District bankers on various aspects of credit conditions, such as:

- farm income and spending,
- bankers' expectations of farmland values,
- farmland sales trends,
- farm loan repayment rates,
- required collateral,
- farm loan interest rates, and
- credit supply and demand.

Agricultural ***FINANCE Monitor***

agricultural credit conditions in the Eighth Federal Reserve District

2012 ■ Fourth Quarter

The third quarterly survey of agricultural credit conditions was conducted by the Federal Reserve Bank of St. Louis from December 17 through December 31; the results presented here are based on the responses from 61 agricultural banks within the boundaries of the Eighth Federal Reserve District.[1] The Eighth District includes all or parts of seven Midwest and Mid-South states. Because these initial data are not adjusted for any seasonal irregularities (should they exist), users are cautioned to interpret the results carefully. In particular, users are cautioned against drawing firm conclusions about longer-run trends in farmland values and agricultural lending conditions.[2]

In addition to our standard survey questions, we asked four special questions on farmland sale trends for this edition of the *Agricultural Finance Monitor*. In particular, we were interested in knowing (i) how the volume of farmland sales in 2012 compared with that in 2011, (ii) the share of farmland purchased by farmers, (iii) the motives for land purchases by non-farmers, and (iv) how the majority of farmland buyers financed their purchase.

Survey Results

On net, respondents reported that fourth-quarter District farm income and spending were higher than one year ago (see Table 1). Bankers indicated that farm income in the St. Louis and Louisville zones was on pace with a year earlier (fourth quarter of 2011), while the southern portion of the District (i.e., the Little Rock and Memphis zones) reported a notable increase in income and spending. Importantly, income in the Memphis zone in the fourth quarter was higher than a year earlier because corn and soybean yields in the southern portion of the District were significantly higher than in northern areas. Farmers in the south were thus able to profit from the rise in commodity prices stemming from last year's drought.

The District's relatively strong performance in the fourth quarter contrasts sharply with the widespread anticipation in the previous survey that last summer's drought would significantly lower income and capital spending in the St. Louis and Louisville zones (see Table 2). In the aggregate, bankers in the current survey indicated no decrease in income and spending and outcomes were a bit better than expected in all zones.[3] Many bankers cited the effect of crop insurance in alleviating the expected negative impact of the drought. Regarding this development, see the boxed insert of selected quotes from survey participants. According to the U.S. Department of Agriculture, estimated crop insurance claims will reach $21 billion nationwide for 2012—more than any other year by far. Missouri and

Selected Quotes from Banker Respondents Across the Eighth Federal Reserve District

An influx of unplanned income arising from crop insurance payments due to the drought increased capital spending. Cattle prices are high, but herd numbers are down in our area. (Arkansas)

The 2012 drought greatly reduced production, but all of our bank's borrowers carried crop insurance, and many had higher levels of coverage. This has resulted in good income for most, and most will carry that income into 2013. (Illinois)

We see land values trending higher. Recently farmers have been borrowing more to purchase real estate as some banks have loosened their down-payment requirements due to lack of loan demand. (Missouri)

The majority of farmers are now leaving the banks and refinancing their farm debt with the Farm Credit agencies. They are taking advantage of the long-term fixed rates that Farm Credit services provide. (Missouri)

NOTE: These are generally verbatim quotes, but some were lightly edited to improve readability.

The survey is produced by staff at the Federal Reserve Bank of St. Louis: Gary Corner, Senior Examiner, Bank Supervision and Regulation Division; and Brett Fawley, Senior Research Associate, and Kevin L. Kliesen, Business Economist and Research Officer, Research Division. We thank staff at the Federal Reserve Bank of Kansas City for initial and ongoing assistance with the agricultural credit survey.

If you have comments or questions, please contact Kevin Kliesen at kevin.l.kliesen@stls.frb.org.

The Eighth Federal Reserve District is headquartered in St. Louis and includes branch offices in Little Rock, Louisville, and Memphis; the District includes the state of Arkansas and portions of Illinois, Indiana, Kentucky, Mississippi, Missouri, and Tennessee.

For more information, see http://research.stlouisfed.org/publications/afm/

St. Louis Fed's CDIAC Holds First Meeting of 2013

The St. Louis Fed's 2013 Community Depository Institutions Advisory Council (CDIAC) met March 5 and 6 at the Bank's headquarters in St. Louis. The council members meet twice a year to advise St. Louis Fed President James Bullard and senior Bank management on the credit, banking and economic conditions facing their institutions and their communities.

This year's council is led by the group's new chair, Glenn D. Barks, president and CEO of First Community Credit Union, based in Chesterfield, Mo. Barks took over the leadership of the council from outgoing chair Dennis M. Terry, president and CEO of First Clover Leaf Bank, Edwardsville, Ill.

It was also the first meeting for four new members: Carolyn "Betsy" Flynn, president and CEO, Community Financial Services Bank, Benton, Ky.; Larry W. Myers, president and CEO, First Savings Bank, Clarksville, Ind.; Frank M. Padak, president, CEO and treasurer, Scott Credit Union, Collinsville, Ill.; and Steve Stafford, president and CEO, First National Bank in Green Forest, Green Forest, Ark. Each was appointed to a three-year term. Council members serve staggered terms and are senior executives of banks, thrift institutions and credit unions from across the Eighth District.

Barks, who has served on the St. Louis Fed's council since its inception in 2011, was appointed to a four-year term as chairman. In this role, he represents the Eighth District at the Federal Reserve Board of Governors' CDIAC meetings, which are held twice yearly in Washington, D.C. The Board established CDIAC in 2010 as a mechanism for community banks, thrift institutions and credit unions with assets of $10 billion or less to provide the Board with input on the economy, lending conditions and other issues. Each of the Fed's 12 Reserve banks established an advisory council, with one representative to serve on the Board's CDIAC.

Other Outgoing Council Members

In addition to Terry, the three other outgoing members of the St. Louis Fed's inaugural CDIAC council were D. Keith Hefner, president and CEO, Citizens Bank & Trust Co., Van Buren, Ark.; William J. Rissel, president and CEO, Fort Knox Federal Credit Union, Radcliff, Ky.; and Larry Ziglar, president, First National Bank in Staunton, Staunton, Ill.

For more information, see the St. Louis Fed's CDIAC web site (www.stlouisfed.org/about_us/cdiac.cfm). For more information and background about all of the Federal Reserve CDIACs, see the Federal Reserve Board of Governors' web site (www.federalreserve.gov/aboutthefed/cdiac.htm) or "Community Banks, Fed Connect Through the Community Depository Institutions Advisory Council" on the Federal Reserve's Community Banking Connections web site (www.communitybankingconnections.org/articles/2012/Q3/Community-Banks-Connect-with-CDIAC.cfm).

2013 St. Louis Fed Community Depository Institutions Advisory Council

Glenn D. Barks (Chair)
President and CEO, First Community Credit Union | Chesterfield, Mo.

Kirk P. Bailey
CEO, Magna Bank | Memphis, Tenn.

Carolyn "Betsy" Flynn
President and CEO, Community Financial Services Bank | Benton, Ky.

H. David Hale
Chairman, President and CEO, First Capital Bank of Kentucky | Louisville, Ky.

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

Larry W. Myers
President and CEO, First Savings Bank | Clarksville, Ind.

Frank M. Padak
President, CEO and Treasurer, Scott Credit Union | Collinsville, Ill.

Mark A. Schroeder
Chairman and CEO, German American Bancorp | Jasper, Ind.

Steve Stafford
President and CEO, First National Bank in Green Forest | Green Forest, Ark.

Gordon Waller
President and CEO, First State Bank & Trust | Caruthersville, Mo.

Larry T. Wilson
President and CEO, First Arkansas Bank & Trust | Jacksonville, Ark.

Vance Witt
Chairman and CEO, BNA Bank | New Albany, Miss.

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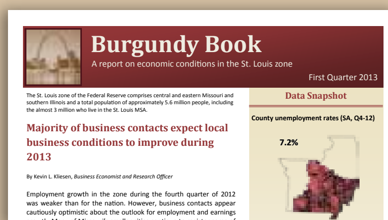
NEW BANKING AND ECONOMIC RESEARCH

- Latest St. Louis Fed *Burgundy Books* Quarterly Economic Data
- *Agricultural Finance Monitor* Looks at Farmland Sale Trends
- Job Polarization Leaves Middle-Skilled Workers Out in the Cold
- Why Are Corporations Holding So Much Cash?
- Residential Real Estate: Rent or Buy?
- Measuring the Contribution of Construction to the Slow Recovery

RULES AND REGULATIONS

- Comment on Fed's Proposed Rules
- CFPB Releases Final Rules Related to Mortgage Servicing and Other Standards



NEW & EXPANDED *BURGUNDY BOOKS*

The St. Louis Fed's quarterly *Burgundy Books* now offer more comprehensive data and information for the Eighth District's four zones.

New or expanded sections include labor markets, manufacturing, real estate and construction, the household sector, banking and finance, agriculture and natural resources, and the public sector.

Download the current reports and listen to MP3 audio clips in English and Spanish at www.stlouisfed.org/newsroom/multimedia/audio

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https://www.stlouisfed.org/publications/central-banker/spring-2013/upcoming-annual-report-looks-at-household-balance-sheets

Upcoming Annual Report Looks at Household Balance Sheets

The net worth of many U.S. households was severely impacted by the financial crisis and ensuing recession. Severe declines in home values and stock prices, together with many job losses and weak income growth among those who held on to their jobs, exposed the precarious debt-laden balance sheets many families had created.

In the upcoming annual report of the Federal Reserve Bank of St. Louis, find out which groups of people lost the most wealth because of the downturn in the economy, why it's important for those households to rebuild their balance sheets and what the latest research has to say about the impact of household financial stability on the broader economy. Many of the families with weak balance sheets going into the crisis have yet to recover financially, while others who were better diversified and had less debt have benefited from rising stock prices and low interest rates. Thus, the economic recovery to date has been bifurcated among households of varying balance-sheet strength and remains weak overall.

To sign up for an e-mail alert when the annual report is published this spring, or to subscribe to the paper version (U.S. addresses only), see www.stlouisfed.org/subscriptionspage.

Also, for more information on St. Louis Fed efforts concerning household balance sheets, visit the Household Financial Stability web site at www.stlouisfed.org/household-financial-stability, which has articles, speeches, presentations, video and audio clips, and other materials.

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https://www.stlouisfed.org/publications/central-banker/spring-2013/recent-st-louis-fed-banking-and-economic-research

Recent St. Louis Fed Banking and Economic Research

Latest St. Louis Fed *Burgundy Books* Quarterly Economic Data

The first quarter 2013 edition of the *Burgundy Books* features more comprehensive data and information on the economic conditions in the Eighth District's four zones (St. Louis, Little Rock, Louisville and Memphis) with the following new or expanded sections: labor markets, manufacturing, real estate and construction, the household sector, banking and finance, agriculture and natural resources, and the public sector.

Published March 14, the latest *Burgundy Books* indicate the following related to banking and finance:

St. Louis – Commercial bank performance in both Illinois and Missouri continued to trail both Eighth District and U.S. peer banks during the fourth quarter. In contrast, southern Illinois banks outperformed their Illinois and Missouri counterparts. Agricultural banks in the zone have been helped by large crop insurance payments paid to farmers in the aftermath of last year's drought.

Little Rock – Arkansas banks generally outperformed their Eighth District and U.S. peers during the fourth quarter of 2012. Still, nonperforming loans of Arkansas banks are relatively high compared with other Eighth District banks and the nation, and some contacts expressed concern about the recent easing in lending standards.

Louisville – Key performance measures suggested that Kentucky and Indiana banks outperformed their Eighth District counterparts and U.S. peers during the fourth quarter of 2012. While significant improvements in asset quality (falling loan delinquency rates) bolstered earnings in the fourth quarter, bankers in the zone still generally reported soft loan demand.

Memphis – Loan delinquency rates for banks in the Memphis zone were similar to other U.S. peer banks, though there was healthy improvement in asset quality reported by Arkansas and Tennessee banks. For the most part, bankers in the zone continued to see soft loan demand.

Read the full reports at https://research.stlouisfed.org/publications/regional/burgundy-book/.

The St. Louis Fed's *Burgundy Books* are quarterly summaries of data on economic conditions in the Eighth District. The *Burgundy Books* serve as a region-specific complement to the Federal Open Market Committee's (FOMC) *Beige Book*, which is a collection of anecdotal data the Federal Reserve uses to help it assess current and future economic conditions. It is published eight times a year, before each FOMC meeting.

The remaining *Burgundy Books* for 2013 will be released on June 13, Sept. 12 and Dec. 12.

Agricultural Finance Monitor Looks at Farmland Sale Trends in 2012

Given the strong growth in farmland values over the past few years, the latest *Agricultural Finance Monitor* gives an indication of the nature of lending activity in this market, based on survey responses from Eighth District bankers. The issue also looks at farm spending and income, demand for loans, availability of funds and more.

The *Agricultural Finance Monitor* is the St. Louis Fed's quarterly survey of agricultural credit conditions in the Eighth District.

Job Polarization Leaves Middle-Skilled Workers Out in the Cold

The economy has increased its demand for high-skilled (high-wage) workers, while opportunities for middle-skilled (middle-wage) jobs have declined. St. Louis Fed economist Maria E. Canon and research analyst Elise Marifian explore how this "job polarization" may require a shift in the sort of training that is encouraged for American workers. Read more in the January 2013 *The Regional Economist*.

Why Are Corporations Holding So Much Cash?

U.S. corporations are holding record-high amounts of cash. St. Louis Fed economist Juan M. Sánchez and research analyst Emircan Yurdagul explore the reasons why in the January 2013 *The Regional Economist*. One reason has to do with taxes—both the uncertainty about future taxes and the reality of today's tax rules. The second reason has to do with the rise of research and development; because of its uncertain nature, this sort of work requires access to high levels of cash.

Residential Real Estate: Rent or Buy?

The residential real estate market showed additional signs of improvement in 2012, though the recovery has been quite different for single-family compared with multifamily markets. As one realtor in the Eighth Federal Reserve District recently said, "Yesterday's buyer is today's tenant." Read more in this *Economic Synopses* by St. Louis Fed economist Silvio Contessi and research associate Li Li.

Measuring the Contribution of Construction to the Slow Recovery

Construction not only has been important during the recession but also is still potentially dragging down the overall economy. As St. Louis Fed economist Carlos Garriga explores in a recent *Economic Synopses*, recovery of the construction sector seems a necessary ingredient for a strong and sustained recovery of economic activity and a reduction in the unemployment rate.

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https://www.stlouisfed.org/publications/central-banker/spring-2013/financial-market-utilities-mortgage-servicing-among-latest-doddfrank-act-proposed-and-final-rules

Rules and Regulations: Financial Market Utilities, Mortgage Servicing among Latest Dodd-Frank Act Proposed and Final Rules

Fed Requests Comments on the Following Proposed Rules

Comment by April 30 on enhanced prudential standards, early remediation requirements for foreign banking organizations and foreign nonbank financial companies

The proposed Fed rule requests comment on specified enhanced prudential standards for companies that the Financial Stability Oversight Council (FSOC) has determined pose a grave threat to financial stability. Additionally, certain foreign banking organizations would be required to form a U.S. intermediate holding company, which would generally serve as a U.S. top-tier holding company for the U.S. subsidiaries of the company. The proposed rule would affect foreign banking organizations with total consolidated assets of $50 billion or more and foreign nonbank financial companies supervised by the Federal Reserve Board. The Board extended the comment period to allow interested persons more time to analyze the issues and prepare their comments. Originally, comments were due by March 31.

Comment by May 3 on notice of proposed rulemaking regarding financial market utilities

The Federal Reserve Board seeks comment by May 3 on proposed rules regarding accounts for financial market utilities (FMU) as permitted by Regulation HH. The proposed rules set out conditions and requirements for a Reserve bank to establish and maintain an account for an FMU as well as the minimum safety and soundness conditions a designated FMU must meet for an account to be opened and maintained. The proposed rules also address a Reserve bank's authority to pay interest on any balance maintained by a FMU.

Consumer Financial Protection Agency (CFPB) Releases Final Rules Related to Mortgage Servicing and other Standards

CFPB implements loan originator compensation requirements under the Truth in Lending Act

The CFPB rule implements amendments to the Truth in Lending Act as it relates to loan originators. The amendments include:

- requirements and restrictions concerning loan originator compensation;
- the qualifications, registration and licensing of loan originators;
- compliance procedures for depository institutions;
- mandatory arbitration; and

- the financing of single-premium credit insurance.

Amendments to Sections 1026.36(h) and (i)—Prohibited Acts or Practices and Certain Requirements for Credit Secured by a Dwelling—take effect on June 1, 2013. All other provisions of the rule become effective on Jan. 10, 2014.

CFPB establishes guidelines for requesting confidential information

This CFBP final rule establishes guidelines for the protection and disclosure of confidential information as well as procedures for serving the CFPB with legal documents and prohibiting employees from disclosing confidential information. The final rule also implements provisions of the Freedom of Information Act and Privacy Act. The rule is effective as of March 18, 2013.

CFPB implements, modifies several mortgage servicing rules under the Truth in Lending Act

This CFPB final rule implements and modifies several mortgage servicing rules under the Truth in Lending Act. The rule requires servicers to provide certain notices for adjustable-rate mortgages, periodic statements for residential mortgage loans and prompt crediting of mortgage payments and responses to requests for payoff amounts. The rule also amends current Truth in Lending provisions related to the scope, timing, content and format of disclosures to consumers regarding interest rate adjustments to variable-rate transactions. Amendments to Sections 1026.36(h) and (i)—Prohibited Acts or Practices and Certain Requirements for Credit Secured by a Dwelling—take effect on June 1, 2013. All other provisions of the rule become effective on Jan. 10, 2014.

CFPB sets mortgage servicing rules under the Real Estate Settlement Procedures Act

This CFPB final rule implements and modifies several mortgage servicing rules under the Real Estate Settlement Procedures Act (RESPA). Mortgage servicers are obligated to correct errors asserted by borrowers, provide certain information to borrowers and provide protections to borrowers in connection with forced-placed insurance. Servicers are also required to establish certain policies and procedures and evaluate borrowers' applications for loss mitigation options. The final rule also modifies and streamlines existing servicing related provisions of RESPA. This rule takes effect on Jan. 10, 2014.

Rule requires disclosure and delivery of appraisals and other written valuations under the Equal Credit Opportunity Act

The CFPB revised Regulation B to implement the Equal Credit Opportunity Act (ECOA). The revisions require creditors to provide all applicants with free copies of all appraisals and other written valuations developed in connection with an application for a loan to be secured by a first lien on a dwelling. Creditors are also required to notify applicants in writing that copies of appraisals will be promptly provided. The rule takes effect on Jan. 18, 2014.

CFPB rule expands HOEPA coverage, sets home ownership counseling requirements

The CFPB amended the Truth in Lending Act (Regulation Z) and the Real Estate Settlement Procedures Act (Regulation X) to:

- expand the universe of loans covered by the Home Ownership & Equity Protections Act (HOEPA),
- revise HOEPA's tests for coverage and
- offer guidance on how to determine HOEPA coverage.

The final rule also implements restrictions and requirements concerning loan terms and origination practices for mortgages that fall within HOEPA's coverage. In connection with certain loans, lenders are required to

provide a list of homeownership counseling organizations to consumers and obtain confirmation that a first-time borrower received such counseling. The rule takes effect on Jan. 10, 2014.

Final rule amends ability-to-repay and qualified mortgage standards under the Truth in Lending Act

This CFPB final rule requires creditors to make a reasonable, good faith determination of a consumer's ability to repay any consumer credit transaction secured by a dwelling and also establishes certain protections from liability under this requirement for qualified mortgages. The final rule contains special rules to encourage creditors to refinance nonstandard mortgages into standard mortgages with a fixed rate for at least five years to reduce consumers' monthly payments. The rule also limits prepayment penalties for certain fixed-rate, qualified mortgages and requires creditors to retain evidence of compliance with the rule for three years after a covered loan is consummated. This rule takes effect Jan. 10, 2014.