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Pg. 4 Balancing Risk and Profitability in Today's Dynamic Environment

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Editor...........Julie D'Aversa
Editor...........Katrina Johnston
Designer......Ashlan Taylor

FEDERAL RESERVE BANK OF PHILADELPHIA

In this Issue...

ON THE COVER:

Barnegat Lighthouse, nicknamed "Old Barney," at Long Beach Island, New Jersey.

Letter from the Editors

Katrina Johnston and Julie D'Aversa, Editors

Fresh Insights

In marking our 16th year of publication, we are excited to introduce not just this new *SRC Insights* design, but also SRC's new senior vice president, Bill Lang. Bill has been a strong leader in SRC since he joined the Federal Reserve Bank of Philadelphia in 2002. He brings a fresh perspective to his new role, while staying rooted in the Fed's commitment to transparent and balanced supervision. In his first column, Bill discusses the challenges of balancing risk with profitability in today's financial environment.

The new design of the publication incorporates some modern elements that we hope you will enjoy, while we remain focused on providing important information to help you and your institutions maintain safety and soundness in today's environment. The first and most obvious new design is the cover, which will change with each quarter and highlight a scene from different parts of our beautiful Third District, including New Jersey, Pennsylvania, Delaware, and the city of Philadelphia. You'll certainly see some places you recognize or may even want to visit! Through this quarterly publication, SRC remains committed to providing our banks and holding companies with useful information on emerging supervisory and regulatory topics.

It seems 2011 has been a very dynamic year for many of us, but here at *SRC Insights*, we see change as a time for refreshment. We hope you enjoy our refreshed look, and we continue to welcome any comments and suggestions you have!

Sincerely,

Katrina Johnston and Julie D'Aversa

Katrina Johnston and Julie D'Aversa, Editors

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Supervision Spotlight

Balancing Risk and Profitability in Today's Dynamic Environment

by William W. Lang, Senior Vice President

William W. Lang, Senior Vice President

Current business conditions continue to present substantial challenges to growth in the banking industry. Yet, this is also a time of opportunity for banks with strong balance sheets and sound risk cultures. Properly balancing risk and reward is always important, but it is particularly important in a stressful macroeconomic environment. Decisions made in these critical times can have important lasting effects, both positive and negative, on a bank's performance. Moreover, the decisions made by the banking industry more generally will be central for the future prosperity of the nation.

Are there prevalent influences in today's environment that might impair sound judgment? There certainly are aspects of the current environment that may encourage a bank to be excessively risk-averse and to fail to seize opportunities to lend. This is why the banking agencies have issued guidance on promoting lending to creditworthy borrowers and on making prudent loan workouts. Alternatively, there are also some specific current conditions that could potentially tempt bankers to unduly relax standards, reach for earnings, or otherwise temporarily set aside solid risk management principles.

Defining Risk

For a bank, financial risk is defined as "the possibility that the outcome of an action or event could bring up adverse impacts. Such outcomes could either result in a direct loss of earnings/capital or may result in imposition of constraints on a bank's ability to meet its business objectives. Such constraints pose a risk as these could hinder a bank's ability to conduct its ongoing business or to take benefit of opportunities to enhance its business."[1]

A bank's risk appetite reflects how much risk an organization is willing to take in order to attain desired results. Determining a bank's risk appetite is a central responsibility of the bank's board of directors. Bank management is responsible for executing its strategy consistent with the firm's risk appetite and for obtaining an adequate rate of return for the amount of uncertainty assumed.

By necessity, banks must take on risks if they are to adequately serve the financial needs of their community. The goal of risk management is not to eliminate all risk, but rather to better understand, measure, and manage risk. The key is applying appropriate techniques to obtain an acceptable tolerance level of risk associated with unanticipated events. These techniques include risk measurement, risk avoidance, risk acceptance, risk mitigation, and risk transfer, as well as the maintenance of a sufficient capital buffer to absorb the impact of unexpected events.

[1] "Banking Supervision Department FAQs," State Bank of Pakistan, available at http://www.sbp.org.pk/bsd/BSD_FAQs.pdf.

Managing Risk

Past and present financial crises highlight the fact that risk management challenges will always exist. While "risk" is typically associated with negative events, risky situations can often result in positive outcomes. During good times, growing risk may be shrouded by positive results. As economic problems began to materialize in recent years, it became apparent that many financial institutions underestimated or devalued their emerging risks, possibly driven by their overconfidence in how risk and opportunity were being managed. This was most clearly evident in the residential mortgage market, where "risky bets" on subprime mortgages produced high returns as long as house prices continued to rise.

A bank should be able to demonstrate that exceptional short-term results are being derived using sound underlying banking practices and principles, not being driven by unreasonable risk-taking that creates longer-term vulnerabilities. It's a difficult balance, but bankers and regulators must exhibit sufficient discipline to draw the line and intervene proactively when the risks no longer align with the rewards.

> **While "risk" is typically associated with negative events, risky situations can often result in positive outcomes.**

Success going forward will continue to be centered on superior risk management practices, including establishing a risk appetite that is well understood and actionable. It is natural to be optimistic about potential results, but prudent bankers also ensure that risk concentrations do not become excessive, consider alternative outcomes under adverse scenarios, and ensure that risk exposure is properly aligned with long-term objectives.

Motivations for Assuming Additional Risk in Today's Environment

What are the current environmental or sectoral factors that could motivate a bank to take on excessive risk? When formulating a strategic approach in today's environment, bankers should be mindful of the potential influences on their decision-making process. Several external factors might override a banker's logic and lead to unwanted consequences, including the following:

- Searching for sustainable top-line earnings growth
- Slack loan demand and fewer creditworthy borrowers
- Reluctance to take hits to capital and earnings by promptly recognizing problem loans
- Higher compliance costs
- Interest rate risk
- Curtailed investment and staffing cutbacks
- Inadequate MIS infrastructure
- Opportunities for rapid growth through acquisition

Sustainable Top-Line Earnings Growth

Recent improvements in banking industry earnings have been largely driven by reduced provisioning made possible by improving credit quality. However, since this is not a sustainable earnings contributor over the long run, banks have begun pursuing other strategies to stimulate future earnings.

The FDIC reported that positive contributions from reduced provisions outweighed the negative effect of lower revenues at many institutions. This is only the second time in the 27 years for which data are available that the industry has reported a year-over-year decline in quarterly net operating revenue. When earnings prospects dampen, some banks may pursue higher-yielding, but potentially riskier, lending to compensate. Others could be tempted to relax underwriting standards to sustain loan volume or attract new borrowers. During this time, it is important for bankers to ensure that strategies are properly aligned with both short-term objectives and the longer-term health of the bank.

Slack Loan Demand and Fewer Creditworthy Borrowers

Bankers commonly say "You have to make loans to make money." One of the key challenges facing bankers in today's environment is slack loan demand. Recent borrowers have generally demanded less credit, as expansion plans are put on hold, business activity slows, and cash flows tighten. Regulators understand the important role banks have in maintaining a healthy financial system and promoting a vibrant economy, and they encourage lending to creditworthy borrowers.

> **Regulators understand the important role banks have in maintaining a healthy financial system and promoting a vibrant economy, and they encourage lending to creditworthy borrowers.**

Heightened competition resulting from an extended period of tepid loan demand can also be a catalyst for taking on greater risk. As banks pursue a limited number of high-quality opportunities, there is a greater tendency to compromise on structure. Ambitious goals for loan growth, particularly when fueled by misaligned incentives, can quickly exacerbate the problem. Stretching for yields and relaxing underwriting standards can lead to poor lending decisions that ultimately translate into credit problems as portfolios season.

Compensation and incentive practices may also serve as obstacles to effective risk management by inappropriately incenting excessive risk-taking in the short-term at the expense of long-term sustained financial health. In the quest to boost yield, a bank may justify expanding into less familiar, but potentially lucrative, territories or loan types. For example, a number of institutions have recently entered or expanded C&I lending, a niche market that carries considerable risks if not executed properly. Banks must ensure that their lenders have sufficient knowledge and expertise to support the new endeavor and properly mitigate the associated risks.

Other recommendations include establishing and reinforcing a strong loan underwriting culture, creating a long-term strategic vision and turning away riskier deals when warranted, maintaining ongoing awareness of evolving market conditions, and including credit cycle fluctuation scenarios in the management of both credit exposures and lending policies. Focusing on portfolio performance and performing stress testing are also warranted.

Reluctance to Promptly Recognize Problem Loans

Experience has shown that bank lending mistakes tend to be more prevalent in good times when borrowers and lenders are overconfident about the prospects for repayment. Recessionary macroeconomic conditions and a sluggish housing market have been the key drivers behind bank failures over the last few years. This can be seen by the geographic clustering of bank failures in distressed regions. However, while the external economic environment certainly was influential, it was hardly the standalone factor in a bank's demise, and most banks, even in distressed regions, are weathering the storm. The root causes of bank failures can often be traced to inherent risk exposures or management weaknesses that become more pronounced under stressful conditions and ultimately impair an institution's ability to withstand adverse conditions.

A key factor in overcoming adverse conditions is promptly recognizing problem loans and strengthening balance sheets when troubles arise. Unless written down, poor quality legacy loans can clutter a bank's balance sheet and tie up capital that is needed for future lending and growth. Given the current pressures on earnings and the relatively high cost of capital, there is a natural reluctance to promptly write down troubled loans. However, a sluggish approach to recognizing problems will ultimately prolong problems and hamper a firm's ability to seize current market opportunities.

Higher Compliance Costs and Adjustment to the "New Normal"

While banks are subject to comprehensive and continually evolving regulations and requirements, they still need to leverage limited resources and take new risks in order to be competitive. A key objective as reforms are implemented will be to ensure that the regime allows for innovation—an important engine for growth—while employing a prudent and flexible regulatory system.

Bankers assert that fee generation and future earnings potential have been significantly reduced by enhanced overdraft protection rules, increased compliance costs, interchange rules, and other recently implemented regulations. In response, some banks have resorted to raising customer fees to make up for the lost revenues. This approach must be weighed carefully, as it is not without consequence. Customer attrition and heightened scrutiny from consumer advocates could be damaging to a bank's reputation.

Interest Rate Risk

Historically low rates have prevailed for a considerable time now, but bankers cannot be lulled into complacency. Although rising rates normally correspond with other encouraging events in the economy, they can also expose a liability-sensitive institution to adverse shifts in the level of net interest income or other rate-sensitive income sources and impair the underlying value of its assets and liabilities. Keith Ligon, chief of the FDIC's Capital Markets Branch, notes that, "Examiners consider the strength of the institution's interest rate risk measurement and management program and conduct a review in light of that institution's risk profile, earnings, and capital levels. When a review reveals material weaknesses in risk management processes or a level of exposure to interest rate risk that is high relative to capital or earnings, a remedial response can be required."[2] The effect that rising rates have on the borrower's ability to service their loans must also be considered at a time when household finances remain strained.

Obtaining and retaining core deposits may have seemed relatively easier for bankers in recent years. Driven primarily by inflows into money

[2] Ligon, Keith, "A Changing Rate Environment Challenges Bank Interest Rate Risk Management," *Supervisory Insights*, FDIC, available at: www.fdic.gov/regulations/examinations/supervisory/insights/sisum05/article01_risk_management.html.

market deposit accounts and other savings deposit products, the aggregate deposit levels of Third District banks have grown at a healthy pace. Depositors appear to have preferred the liquidity of these accounts during a time of sustained low interest rates, financial uncertainty, and lackluster performance in alternative investment products. However, when interest rates become more meaningful, the stickiness of these deposits will be tested. Some customers will likely shift money to higher-yielding certificates of deposit. Competition will rise, and NIMs at liability-sensitive banks will come under pressure.

Curtailed Expenses and Staffing Cutbacks

As bank earnings were influenced by rising levels of nonperforming loans, increased provisions for loan losses, and declining collateral values, more emphasis was placed on internal cost control and greater tendency toward spending conservatism. Many institutions pared back staff or postponed new investments, particularly in non-revenue-generating areas, to boost earnings. Initially beneficial to the bottom line, this had potential to increase an organization's risk in other ways. While seeking efficiency gains is admirable, unjustifiable cutbacks can be counterproductive when they result in coverage lapses or draw resources from risk-susceptible areas, such as BSA monitoring.

Inadequate MIS Infrastructure

Governance and risk management processes and associated management information, collection, analysis, and reporting systems (MIS) continue to exhibit weaknesses and may be inadequate to support effective decision-making. In general, today's bankers and boards are seeking more concise, meaningful, and timely reports. They want the right data at the right time. Data volume does not diminish the need and importance of judgment and accountability in decision-making. Banks that cannot generate the right information to identify, measure, monitor, and control risk are likely to face bigger troubles. As a result, companies are looking to gain efficiencies and improve performance by aggregating initiatives and consolidating system processes.

Rapid Growth Through Acquisition

Many banks weakened during the financial crisis, creating potential for greater industry consolidation. Careful consideration and thorough due diligence should precede any planned expansion efforts. Management can greatly reduce the potential for operational and reputational risk through preparation to ensure that a seamless operational conversion occurs. Rapid growth can quickly make an existing risk management infrastructure ineffective or obsolete. Risk practices should be reevaluated to ensure that they are commensurate with the size and complexity of the new consolidated entity. Pursuing too many acquisitions in a short period requires considerable time and may divert management's attention away from critical core issues.

The acquisition and integration of failed institutions present a unique set of challenges, including the concern over whether institutions with a high number of assisted transactions have the capacity to work through the credit problems they are taking on and to effectively assimilate the institutions they have acquired.

Conclusion

Despite the turbulence the industry has endured, the financial system is likely to emerge stronger and more resilient as a result of the crisis. Banks will return to fundamentals, and businesses and consumers are likely to exhibit less leverage. Banks should reinforce strong operational practices, improve information management, and emphasize balance sheet transparency to restore confidence. Effective enterprise risk management should enable management to handle any uncertainty or risk through strategies and objectives that strike a proper balance of return and risk.

To remain strong, bankers should be conscious of underlying factors and pressures that could be motivating their decisions today. And they should strive for a consistent way to incorporate governance, risk management, and integrity into their everyday activities to mitigate risk tomorrow. ■

From the **Examiner's Desk**

Brent Kreiser,
Assistant Examiner

Interest Rate Risk: The Importance of Understanding Deposit Assumptions

by Brent Kreiser, Assistant Examiner

The economic recovery is gaining traction, and one likely result is interest rates eventually returning to "typical" levels. Under normal circumstances, it is difficult to predict when rate changes will occur, but today's environment makes it even more difficult. As financial markets emerge from recent challenges, financial instrument behavior will continue to be unpredictable, and, as rates change, banks may not be able to rely on past experiences to determine the behavior of their financial instruments. This will create big challenges for asset and liability management, highlighting the importance of sound interest rate risk (IRR) management practices and management's need to understand model assumptions and their impact on model results.

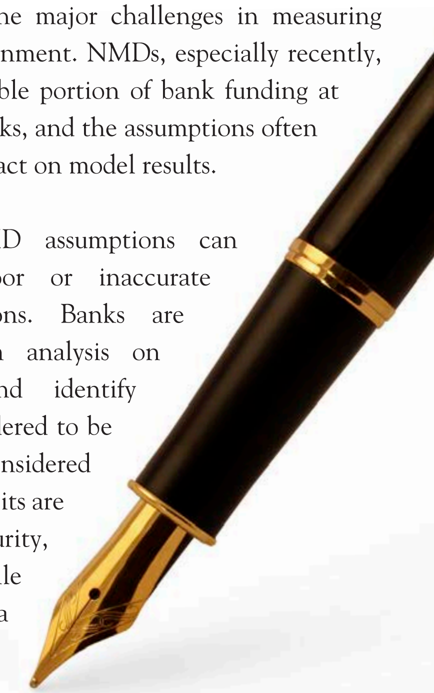
The Result of an Uncertain Market

With so many unknowns, SR Letter 11-7, *Supervisory Guidance on Model Risk Management*, is increasingly important, and understanding deposit assumptions is critical in planning for the future. Uncertain financial markets caused many small business owners and consumers to increase cash reserves; as a result, many community banks experienced increases in low-cost deposits over the past several years. Banks have benefitted from improved net interest margins and earnings performance, enabling them to increase cash and short-term investment reserves, while bolstering their liquidity positions. Institutions with excess liquidity reserves may believe they will benefit from short-term rate increases; however, an institution's ability to redeploy these reserves may be limited due to the need to maintain higher levels of balance sheet liquidity. Accordingly, institutions may overstate the impact of being asset-sensitive and the related benefit of rising short-term interest rates.

Correct Model Assumptions

IRR models require banks to input assumptions about customer behavior under different rate scenarios. These assumptions are typically based upon historical experiences and current strategies, but the unique nature of this current environment may negate the benefit of historical experience. Correctly modeling nonmaturity deposits (NMDs) is one of the major challenges in measuring IRR in today's environment. NMDs, especially recently, represent a considerable portion of bank funding at many community banks, and the assumptions often have the greatest impact on model results.

Poorly-modeled NMD assumptions can contribute to poor or inaccurate management decisions. Banks are required to perform analysis on NMD accounts and identify those accounts considered to be volatile and those considered to be core. Core deposits are assigned a longer maturity, while the volatile portion is assigned a short-term maturity.

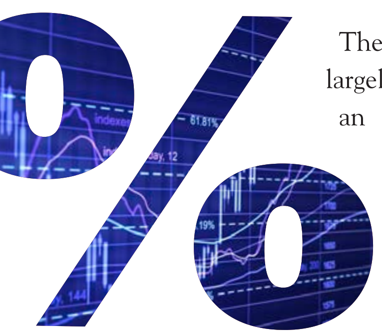


The size and stability of core deposits have a significant impact on the bank's overall risk profile. Banks may need to reassess the portion of NMD they consider to be core deposits, especially as customer behavior in the current environment may not be consistent with the institution's historical experience.

As the economy emerges from the recession, it is likely that NMDs will seek higher yields, and competition for these accounts will increase, resulting in an increased cost of funds for banks. Customers can be sensitive to rates and the increased competition for funds, especially as the economy recovers and customers reduce the cash reserves they are willing to hold. This increased competition may also cause banks to look to other wholesale funding sources and change the IRR profile of the overall organization. Banks should exercise caution, since the stickiness of core deposits may be impacted by customer behavior as cash reserves are reduced.

Earnings at Risk and Economic Value of Equity

The uncertainty of these assumptions highlights the importance of a balanced approach to IRR, including both earnings at risk and the economic value of equity, as well as the sensitivity testing of key model assumptions. Earnings at risk are impacted by the customer's response to rates offered on other deposit products and increases in competition. Generally, changes in bank deposit rates lag changes in interest rates, reacting faster to falling rates and slower to rising rates. Banks typically incorporate rate floors, which represent the base rate necessary to ensure that funding sources are not withdrawn. These factors will determine the impact on earnings at risk and must be considered for effective earnings at risk modeling.



The economic value of equity is largely impacted by determining an average life of NMD and applying an appropriate discount rate. The average life of NMD should be determined by calculating the average life of every deposit on the balance sheet; however, this requires extensive analysis of data that banks do not often retain. Most community banks analyze NMD at the account level and perform ongoing analysis of the maturity of these accounts.

Organization Profile

Consideration should also be given to the size and overall complexity of an organization in determining the adequacy of model assumptions; however, most organizations are expected to have adequate systems and resources to effectively model NMD assumptions. Due to inherent limitations of basic models and the impact of unknown variables, management is expected to have a thorough understanding of the IRR profile of the organization. Management's knowledge of its customer base is not adequate to effectively determine customer behavior; additionally, merely utilizing conservative assumptions may have the impact of underestimating the bank's sensitivity position.

Accurate IRR models not only provide a true picture of the risk profile of the organization, but also enable a bank to more effectively price and market loan and deposit products to its customers. Model assumptions, especially in the current rate environment, require both management and the board of directors to obtain a greater understanding of the assumptions and the impact on the IRR profile of the organization.

SR Letter 11-7

The Federal Reserve and the Office of the Comptroller of the Currency have issued SR 11-7, *Supervisory Guidance on Model Risk Management*. The guidance highlights the importance of assessing an organization's management of model risk. Key aspects of model risk management include robust model development, implementation, effective validation, sound governance, and appropriate policies and procedures. The guidance notes one of the keys to effective model risk management is to critically assess model objectives, limitations, and model assumptions on an ongoing basis. Effective modeling and validation do not eliminate model risk, but rather encourage establishing model limitations, monitoring model performance, and adjusting model assumptions as necessary to further control model risk.

No "Right" Answer

There is no "right" answer for modeling NMD assumptions, so it critical that banks test a range of assumptions and evaluate the results relative to IRR limits. One approach for stressing model assumptions is simply applying various factors to decay rates of NMD. The outcome of these assumptions should be reviewed by both management and the board of directors. By stress testing assumptions, banks can better understand which model assumptions most influence the outcome of model results. Significantly changing model assumptions will enable banks to identify those assumptions that most heavily impact the model.

Banks should scrutinize these critical assumptions to determine their overall reasonableness and accuracy. While history can often be a great teacher, in this case, it is especially important to stress test assumptions that are not supported by historical experiences and to use more reliable modeling practices to ensure proper interest rate risk management. ■

WHO TO CALL

Your institution may need to contact an officer, manager, or staff member in the Supervision, Regulation, and Credit Department, but you may not know whom to contact. The following list should help you find the correct contact person to call. Financial institutions that have an appointed central point of contact should generally contact that individual directly.

Contact names appearing in **bold** are the primary contacts for their areas.

Community Regional Supervision

William W. Lang, SVP	215-574-7225
Constance H. Wallgren, VP	215-574-6217
Elisabeth V. Levins, AVP	215-574-3438
Eric A. Sonnheim, AVP	215-574-4116
William T. Wisser, AVP	215-574-7267
Becky Goodwin, Manager	**215-574-4324**
Stephen J. Harter, Manager	**215-574-4385**
Adina A. Himes, Manager	**215-574-6443**
Jacqueline Fenton, Manager	**215-574-6234**
Lorraine Lopez, Manager	**215-574-6596**

Consumer Compliance & CRA Examinations

William W. Lang, SVP	215-574-7225
Robin P. Myers, AVP	215-574-4182
Robert Snarr, Manager	**215-574-3918**

Consumer Complaints

Federal Reserve Consumer Help Center	**888-851-1920**

Regulations Assistance

Regulations Assistance Line	**215-574-6568**

Enforcement

A. Reed Raymond, VP	215-574-6483
Joseph J. Willcox, Manager	**215-574-4327**

Regulatory Applications

A. Reed Raymond, VP	215-574-6483
H. Robert Tillman, AVP	215-574-4155
James D. DePowell, Manager	**215-574-4153**

Retail Risk Analysis

Christopher C. Henderson, Retail Risk Officer	**215-574-4139**

Discount Window and Reserve Analysis

Vish P. Viswanathan, VP	215-574-6403
Gail L. Todd, Credit Officer	**215-574-3886**

Despite National Declines in Mergers and Acquisitions, Third District Valuations Improve

by William Lenney, Regulatory Applications Specialist, and David Schwartz, Regulatory Applications Intern

William Lenney and David Schwartz, Regulatory Applications

This is the fifth installment in a recurring series on national and Third District trends in bank mergers and acquisitions. For this article, the study was updated for the period July 2010 to June 30, 2011, and data[1] on 1007 U.S. commercial banks acquired from January 2002 to June 30, 2011 were reviewed and analyzed. The same analytic factors used in the four previous analyses were also applied to this most recent time period.

In general, the analysis found that the pace of bank mergers and acquisitions slowed, while price-to-book valuations declined slightly in the second half of 2010 and the first six months of 2011 (Figure 1). There were 87 acquisitions from July 1, 2010, to June 30, 2011, compared to 149 acquisitions from July 1, 2009, to June 30, 2010.[2] The factors from the 2002–June 30, 2010 analysis were reevaluated to include the bank mergers and acquisitions completed from July 1, 2010, to June 30, 2011.

Interstate vs. Intrastate

The nature of transactions as interstate or intrastate continues to play an important role in determining average price-to-book valuations. Intrastate bank targets received a higher price-to-book value during the July 1, 2010–June 30, 2011 time period. For this most recent period, intrastate targets received a 1.07 average price-to-book value, compared to interstate targets that received a 0.92 average price-to-book value. This was consistent with the

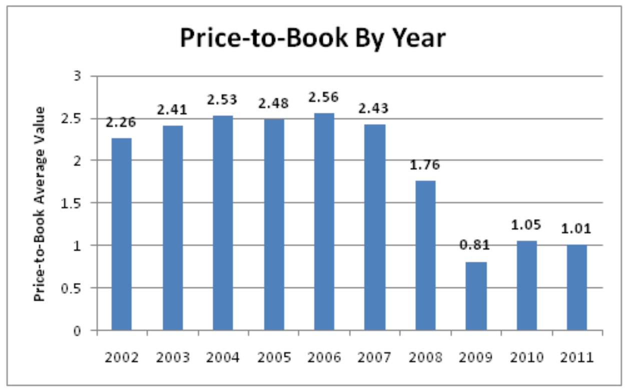


Figure 1: Price-to-Book by Year

July 1, 2008– June 30, 2009 time period, a slow period for bank mergers and acquisitions, but reversed the trend seen in the July 2009–June 30, 2010 period. During the July 2008–June 20, 2009 period, intrastate bank targets received a 1.34 average price-to-book value, while interstate targets received only 1.17.

The data indicate that when merger and acquisition activity is low, it is likely that acquirers are more willing to stay near home, but when the pace accelerates, there is a propensity to pay a premium to expand into new markets and other geographic locations.

Total Asset Size of Targets

During the 2002–June 30, 2008 period, the total asset size of target financial institutions had an impact on the acquisition price, as the price-to-book value appeared to increase with the total asset size of the acquired institution. However, from July 1, 2008–June 30, 2010, large target institutions received a lower price-to-book value than the smaller target institutions. This trend continued from July 1, 2010–June 30, 2011, as banks with assets exceeding $1 billion received a 0.84 average price-to-book value, while banks with less than $1 billion received an average 1.06 price-to-book value. This valuation cycle is consistent with the deleveraging theme that has been occurring in the past three years.

CAMELS and RFI/C Rating

Strong composite CAMELS and RFI/C ratings and core deposits continue to demonstrate a solid relationship to higher price-to-book values. In theory, financial institutions that have solid overall performance should expect to receive a higher price-to-book value. As solid overall performance commonly results in composite CAMELS or RFI/C ratings of strong or satisfactory, it is not surprising that examination and inspection ratings correlate and correspond to price-to-book premiums paid. This fact was evident in the 2002–June 30, 2010 analysis and again proved to be the case with the recent data.

The average price-to-book values paid during the January 1, 2002–June 30, 2010 time period for 1- and 2-rated banks were 2.55 and 2.37, respectively, while 3- and 4-rated banks received 1.69 and 1.06, respectively (Figure 2). During the last 12 months, 1-rated banks received an average price-to-book valuation of 1.35, while 2-rated banks received 1.26. The average price-to-book value for 3-and 4-rated targets were 1.01 and 0.66, respectively. Targets rated 5 received an average 0.71 times book value. Although the values paid were consistently lower during

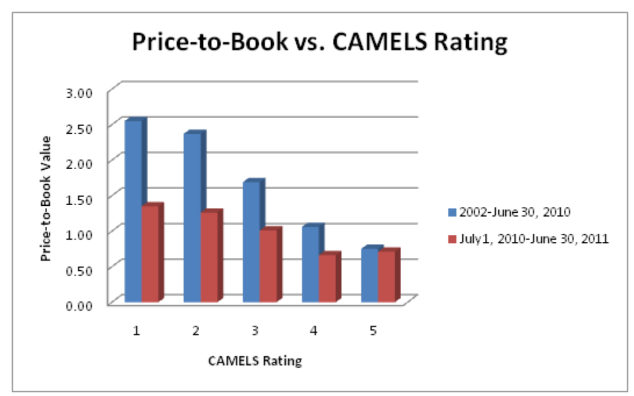


Figure 2: Price-to-Book vs. CAMELS Rating

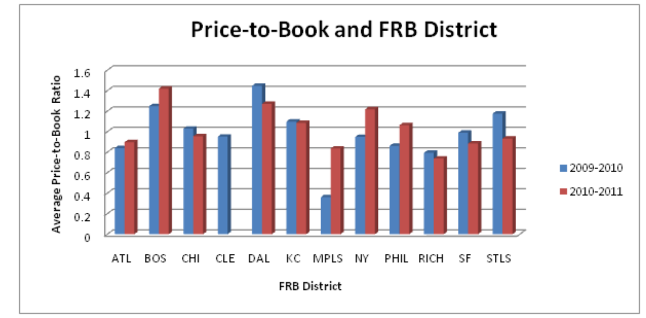


Figure 3: Price-to-Book and FRB District

the past 12 months versus the historical average, higher-rated banks continued to consistently receive a higher price-to-book value than lower-rated banks.

Valuations by District

Geography still plays an obvious role in price-to-book values as well, but the ratios in each region have changed noticeably. The targets in the Boston, Dallas, and New York Districts received the highest average price-to-book ratios—1.42, 1.27, and 1.22, respectively, during the July 1, 2010–June 30, 2011 (Figure 3) period. The most significant valuation deterioration occurred in the San Francisco District during the same period when compared to the July 1, 2009–June 30, 2010 period, when the average price-to-book valuation declined from 0.99 to 0.88. Although targets in the Dallas District received a high average price-to-book value, they also experienced a significant decline.

Some Districts showed improvement. Average price-to-book values increased in the Atlanta, Boston, Minneapolis, New York, and Philadelphia Districts during the July 1, 2010–June 30, 2011 period. Minneapolis had the most significant increase, as the average price-to-book values in the District improved from 0.36 to 0.84 from the July 2009–June 30, 2010 period to the July 2010–June 30, 2011 period.

The highest price-to-book value paid in the nation over the last 12 months was Round Top Bancshares, Inc.'s purchase of Eagle Bank in the Dallas District for 1.91 times book value. The lowest price-to-book value over that period was North American Financial Holdings,

[1] Data obtained through SNL Financial.

[2] In addition to the 87 acquisitions occurring between July 1, 2010, and June 30, 2011, 111 government-assisted acquisitions were not included in this study. Price-to-book data are not available for these transactions.

Is Something Missing?

With each issue of *SRC Insights*, we aim to highlight the supervisory and regulatory issues that affect you and your banking institution the most. But we recognize that you may be interested in topics that we have not covered, and we want to ensure that we address your interests.

What issues arise in your daily operations? What questions concern you in the course of business? What else would like to see in an upcoming issue of *SRC Insights*? We encourage you to contact us with any topic ideas, concerns, or questions.

Please direct any comments and suggestions to Katrina Johnston (Katrina.johnston@phil.frb.org) at (215) 574-6633.

Inc.'s purchase of Green Bankshares, Inc. in the Atlanta District for 0.07 times book value.

Institutions acquired in the Third District received a 1.06 average price-to-book value from July 1, 2010–June 30, 2011, which was a significant increase from the 0.86 average during the July 2009–June 30, 2010 period. The highest price-to-book value in the Third District during the July 2010–June 30, 2011 period was the $342 million acquisition of Tower Bancorp, Inc. by Susquehanna Bancshares, Inc., which was priced at 1.35 times book value.

Conclusion

During the past year, the pace of acquisitions has decreased, while price-to-book values paid for targets slightly declined as well. Acquiring institutions were willing to pay a higher price-to-book premium for intrastate targets, as institutions looked for opportunities to expand close to home. Smaller targets commanded a higher value compared to larger targets, as it appears that acquirers wanted to grow in smaller, more conservative increments. Institutions that had strong overall performances and ratings were still considered more valuable.

American investing great, Warren Buffet, once said, "Never count on making a good sale. Have the purchase price be so attractive that even a mediocre sale gives good results." Though banks with certain asset characteristics and favorable CAMELS ratings may yield high price-to-book ratios, the 2010-11 data clearly show that, for banks seeking to expand, a low price is still the dominant factor driving bank mergers and acquisitions. ■

DFA Today

Bob Rell,
Senior Specialist

The Dodd-Frank Act Turns One

by Bob Rell, Senior Specialist

July marked the first anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA or the act) being passed into law. Efforts during the past year were focused heavily on rulemaking and implementation aspects. Many significant accomplishments and numerous historic milestones have already been reached, yet today's DFA implementation process is still very dynamic, and, clearly, considerable debate and effort remain ahead.

This recurring feature of *SRC Insights* provides updates on the latest events associated with the DFA that have transpired since the last issue. Reference links to more detailed information on the topics are also provided. If you have any questions regarding this periodic section, please contact Senior Specialist Bob Rell at bob.rell@phil.frb.org. ■

RULE PROPOSALS AND REQUESTS FOR COMMENT

June 20, 2011
Federal Reserve Proposes Rules Under Regulation B to Clarify Data Collection Compliance Requirements for Motor Vehicle Dealers
This proposed rule under Regulation B aims to clarify that motor vehicle dealers are temporarily not required to comply with certain data collection requirements in the DFA until the Board of Governors issues final regulations to implement the statutory requirements.
http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110620a1.pdf

June 9, 2011
Agencies Seek Comment on Stress Testing Guidance
This is a request for comment on proposed supervisory guidance regarding stress-testing practices at banking organizations with total consolidated assets of more than $10 billion.
http://www.gpo.gov/fdsys/pkg/FR-2011-06-15/pdf/2011-14777.pdf

May 18, 2011
SEC Proposes Rules to Increase Transparency and Improve Integrity of Credit Ratings
The Securities and Exchange Commission voted unanimously to propose new rules and amendments intended to increase transparency and improve the integrity of credit ratings.
http://www.sec.gov/rules/proposed/2011/34-64514.pdf

May 12, 2011
Federal Reserve Proposes Rule Under Regulation E to Create New Consumer Protections for Remittance Transfers
This is a request for comment on a proposed rule that would create new protections for consumers who send remittance transfers to recipients located in a foreign country, by providing consumers with disclosures and error resolution rights. The proposed amendments implement statutory requirements set forth in the DFA.
http://www.federalreserve.gov/newsevents/press/bcreg/20110512a.htm

April 22, 2011
Study Regarding Compliance with Section 404(b) of the Sarbanes-Oxley Act
The SEC is requesting public comment related to a study of how to reduce compliance burden of auditor attestation requirements for companies whose public float is between $75 million and $250 million, while maintaining investor protections.
http://www.sec.gov/rules/other/2010/34-63108.pdf
http://www.sec.gov/news/studies/2011/404bfloat-study.pdf

FINAL RULES ADOPTED

July 14, 2011
Repeal of Regulation Q
The Federal Reserve issued a final rule to repeal Regulation Q, which prohibited the payment of interest on demand deposits by institutions that are member banks of the Federal Reserve System.
http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110714a1.pdf

July 12, 2011
Federal Reserve Releases Lists of Institutions Subject to, and Exempt from, the Debit Card Interchange Fee Standards
These lists are intended to help payment card networks and others determine which issuers qualify for the statutory exemption from interchange fee standards. The statute exempts any debit card issuer that, together with its affiliates, has assets of less than $10 billion.
http://www.federalreserve.gov/paymentsystems/debitfees.htm

July 6, 2011
Federal Reserve and FTC Issue Final Rules to Implement the Credit Score Disclosure Requirements of the Dodd-Frank Act
If a credit score is used in setting material terms of credit or in taking adverse action, the statute requires creditors to disclose credit scores and related information to consumers in notices under the Fair Credit Reporting Act (FCRA).
http://www.federalreserve.gov/newsevents/press/bcreg/20110706a.htm

June 29, 2011
Debit Card Interchange Fees
The Federal Reserve issued a final rule establishing standards for debit card interchange fees and prohibiting network exclusivity arrangements and routing restrictions.
http://www.federalreserve.gov/newsevents/press/bcreg/20110629a.htm

June 14, 2011
Agencies Adopt Final Rule to Establish a Risk-Based Capital Floor
Three federal banking regulatory agencies adopted a final rule that establishes a floor for the risk-based capital requirements applicable to the largest internationally-active banking organizations.
http://www.federalreserve.gov/newsevents/press/bcreg/20110614a.htm

LEGISLATIVE ACTIONS, HEARINGS, AND LEGAL PROCEEDINGS

July 8, 2011
Legislative Proposals Regarding Bank Examination Practices
The Committee on Financial Services held a hearing entitled "Legislative Proposals Regarding Bank Examination Practices."

http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=249608

June 30, 2011
TCF National Bank Suit
TCF National Bank sued to enjoin a portion of the DFA that will limit the rate some financial institutions may charge for processing debit-card transactions. At the outset of the proceedings, TCF moved for a preliminary injunction, and the District Court denied the motion. On June 30, 2011, TCF decided to ask that the U.S. District Court in South Dakota dismiss its case without prejudice.
http://www.leagle.com/xmlResult.aspx?xmldoc=In%20FCO%2020110629000T.xml&docbase=CSLWAR3-2007-CURR

June 16, 2011
The Dodd-Frank Act: Impact on Small Business Lending
The Subcommittee on Economic Growth, Capital Access and Tax held a hearing titled "The Dodd-Frank Act: Impact on Small Business Lending."
http://smbiz.house.gov/Calendar/EventSingle.aspx?EventID=245671

GAO AND OTHER NOTABLE REPORT RELEASES

July 15, 2011
One Year Later: The Consequences of the Dodd-Frank Act
This is a report issued from House Financial Services Committee assessing DFA results at its one-year anniversary.
http://financialservices.house.gov/UploadedFiles/FinancialServices-DoddFrank-REPORT.pdf

July 14, 2011
Dodd-Frank Act: Eleven Agencies' Estimates of Resources for Implementing Regulatory Reform
GAO testimony provides information on selected federal agencies' reported funding and staff resources associated with implementing the DFA in 2010, 2011, and 2012.
http://www.gao.gov/new.items/d11808t.pdf

July 13, 2011
Residential Appraisals: Opportunities to Enhance Oversight of an Evolving Industry
The GAO examined (1) the use of different valuation methods, (2) factors affecting consumer costs for appraisals and appraisal disclosure requirements, and (3) conflict of interest and appraiser selection policies and views on their impact.
http://www.gao.gov/new.items/d11653.pdf

July 13, 2011
Proprietary Trading: Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented
The GAO reviewed (1) what is known about the risks associated with such activities and the potential effects of the restrictions and (2) how regulators oversee such activities.
http://www.gao.gov/new.items/d11529.pdf

July 12, 2011
Dodd-Frank: One Year On
The Pew Charitable Trusts and NYU's Stern School collected an array of prominent experts to provide an interim report of the act's effectiveness.
http://voxeu.org/index.php?q=node/6742

July 1, 2011
Dodd-Frank Progress Report
The *Davis Polk Dodd-Frank Progress Report* is a monthly publication that uses empirical data to help market participants and policymakers assess the progress of the rulemaking and other work that has been performed by regulators under the DFA.
http://www.davispolk.com/files/uploads/FIG//July2011_Dodd.Frank.Progress.Report.pdf

June 23, 2011
Bank Regulation: Modified Prompt Corrective Action Framework Would Improve Effectiveness

This GAO report examines the outcomes of the use of Prompt Corrective Action (PCA) on the Federal Deposit Insurance Corporation's (FDIC's) Deposit Insurance Fund (DIF); the extent to which PCA thresholds, regulatory action, and other financial indicators help address possible bank failure; and options for making PCA a more effective tool.
http://www.gao.gov/new.items/d11612.pdf

June 13, 2011
Response to a Congressional Request Regarding the Economic Analysis Associated with Specified Rulemakings
This is a response to a May 4, 2011, request to assess the economic analysis the Board of Governors of the Federal Reserve System (Board) performed for five specified proposed rulemakings required by the DFA.
http://www.federalreserve.gov/oig/files/Congressional_Response_web.pdf

May 19, 2011
Banking Regulation: Enhanced Guidance on Commercial Real Estate Risks Needed
This GAO report examines, among other issues, (1) how the FDIC, the Board of Governors of the Federal Reserve System (Federal Reserve), and the Office of the Comptroller of the Currency (OCC) responded to trends in CRE markets and the controls they have for helping ensure consistent application of guidance and (2) the relationships between bank supervision practices and lending.
http://www.gao.gov/new.items/d11489.pdf

SPEECHES, TESTIMONY, AND EVENTS OF INTEREST

June 21, 2011
FDIC Systemic Resolution Advisory Committee
The FDIC hosted its first meeting of the Systemic Resolution Advisory Committee. The committee will provide advice and recommendations on a broad range of issues regarding the resolution of systemically-important financial companies pursuant to the DFA.
http://www.fdic.gov/about/srac/index.html

June 16, 2011
Capital and Liquidity Standards
Governor Tarullo testified before the Committee on Financial Services, U.S. House of Representatives, Washington, D.C.
http://www.federalreserve.gov/newsevents/testimony/tarullo20110616a.pdf

June 15, 2011
Banking Supervision
Michael R. Foley, Senior Associate Director, Division of Banking Supervision and Regulation, testified before the Subcommittee on Financial Institutions and Consumer Protection, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C. on banking supervision.
http://www.federalreserve.gov/newsevents/testimony/foley20110615a.pdf

June 3, 2011
Regulating Systemically-Important Financial Firms
These remarks by Governor Tarullo were delivered at the Peter G. Peterson Institute for International Economics, Washington, D.C.
http://www.federalreserve.gov/newsevents/speech/tarullo20110603a.pdf

May 12, 2011
Dodd-Frank Implementation: Monitoring Systemic Risk and Promoting Financial Stability
Chairman Bernanke testified before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C.
http://www.federalreserve.gov/newsevents/testimony/bernanke20110512a.pdf

May 5, 2011
Implementing a Macroprudential Approach to Supervision and Regulation
This speech by Chairman Bernanke was delivered at the 47th Annual Conference on Bank Structure and Competition, Chicago, Illinois.
http://www.federalreserve.gov/newsevents/speech/bernanke20110505a.pdf

UPDATES ON NEW AGENCIES

Consumer Financial Protection Bureau

July 18, 2011
Building the CFPB: A Progress Report
This is a progress update and summary of CFPB activities during the past year.
http://www.consumerfinance.gov/wp-content/uploads/2011/07/Report_BuildingTheCfpb1.pdf

July 17, 2011
Richard Cordray Nominated to be Director of the Consumer Financial Protection Bureau
Richard Cordray, a former Ohio Attorney General and the CFPB's current head of enforcement, is President Obama's nominee to lead the new agency.
http://www.whitehouse.gov/the-press-office/2011/07/17/president-obama-announces-richard-cordray-director-consumer-financial-pr

June 30, 2011
Mark Bialek Appointed Inspector General of Board of Governors and the Bureau of Consumer Financial Protection
Mark Bialek was appointed inspector general of the Board of Governors of the Federal Reserve System and the Bureau of Consumer Financial Protection, effective July 25.
http://www.federalreserve.gov/newsevents/press/other/20110630a.htm

June 23, 2011
Consumer Financial Protection Bureau Seeks Public Input on Key Element of Nonbank Supervision Program
This is a notice and request for comment on statutory requirement to define "larger participant" in certain consumer financial markets.
http://www.consumerfinance.gov/wp-content/uploads/2011/06/Notice-and-Request-for-Comment-Defining-Larger-Participants-in-Nonbank-Supervision.pdf

Financial Stability Oversight Council

July 15, 2011
Financial Stability Oversight Council Announces Upcoming Meeting Details
The U.S. Department of the Treasury announced that the next Financial Stability Oversight Council (FSOC) meeting will be held Monday, July 18. The open session will be focused on the one-year anniversary of the DFA.
http://www.treasury.gov/press-center/media-advisories/Pages/07152011.aspx

June 24, 2011
S. Roy Woodall, Jr. Nominated as Member of the Financial Stability Oversight Council
The White House Office of the Press Secretary announced the nomination of S. Roy Woodall, Jr., of Kentucky, to be a member of the Financial Stability Oversight Council (FSOC) for a term of six years. The nomination was sent to the Senate on June 27, 2011.
http://www.whitehouse.gov/the-press-office/2011/06/24/president-obama-announces-more-key-administration-posts

May 24, 2011
FSOC Meeting Documents
These are documents from the FSOC's May 24, 2011, meeting.
http://www.treasury.gov/initiatives/Pages/FSOC-index.aspx

Office of Financial Research

July 14, 2011
Oversight of the Office of Financial Research and the Financial Stability Oversight Council
This is from a Committee on Financial Services hearing.
http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=250180

FEDERAL RESERVE BANK
OF PHILADELPHIA

Supervision, Regulation and Credit Department
Ten Independence Mall
Philadelphia, PA 19106

www.philadelphiafed.org

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