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C&I Lending Presents Challenges, Risks, and Rewards

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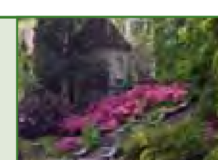
FEDERAL RESERVE BANK OF PHILADELPHIA

In this Issue...

ON THE COVER:

Winterthur Estate, Winterthur, Delaware



Supervision Spotlight

William W. Lang, Senior Vice President

C&I Lending Presents Challenges, Risks, and Rewards

by William W. Lang, Senior Vice President

Commercial and industrial (C&I) lending—especially to small businesses—has become increasingly attractive to community bankers. When managed properly, C&I lending offers a lucrative earnings opportunity for banks, while providing constructive benefits to the broader economy.

C&I portfolios have grown moderately over the past year, during a time when demand for other loan types has remained relatively weak. However, competition for C&I loans also has intensified. Larger banks that reduced their C&I lending are once again aggressively competing for C&I loans. As competition grows more aggressive and banks continue to suffer from weak earnings, supervisors will be concerned that some bankers may respond by expanding their C&I portfolios without putting sound risk management practices into place, resulting in unduly relaxed loan covenants, overly thin loan spreads, or excessive concessions to attract new and retain existing clients.

In a recent speech, Federal Reserve Governor Elizabeth Duke emphasized the need for a balanced approach, but expressed concerns as well, stating, "Moreover, to generate loan volume without increasing real estate lending, many banks are now targeting growth in commercial and industrial (C&I) loans, a type of lending with which they may have less expertise. In fact, banks have generally experienced higher loss rates on C&I loans than on commercial real estate secured loans (excluding construction loan losses), even through the crisis. So this portfolio shift has the potential to increase rather than decrease expected losses."[1]

Community bankers have worked hard to make inroads into C&I lending, and many view it as an area with future growth potential. It is important that bankers, particularly those who are newly entering or expanding C&I lending programs, understand the inherent risks in this lending niche and possess the expertise to ensure long-term success.

Defining C&I Lending

The term "commercial and industrial (C&I) loan" is commonly used to designate loans to a corporation, commercial enterprise, or joint venture that are not ordinarily main-

[1] Elizabeth A. Duke (2012), "Opportunities to Reduce Regulatory Burden and Improve Credit Availability," speech delivered at the 2012 Bank Presidents Seminar, California Bankers Association, Santa Barbara, California, January 13, available online at www.federalreserve.gov/newsevents/speech/duke20120113a.htm.

tained in either the real estate or consumer installment loan portfolios. According to the Federal Reserve's *Commercial Bank Examination Manual* (the examination manual), commercial loans are typically a state member bank's largest asset concentration. They offer banks the most complexity and require the greatest commitment from bank management to monitor and control risks. The examination manual defines such loans, stating, "Commercial loans are extended on a secured or unsecured basis with a wide range of purposes, terms, and maturities. While the types of commercial and industrial loans can vary widely depending on the purpose of loans made and market characteristics where the bank operates, most commercial and industrial loans will primarily be made in the form of a seasonal or working-capital loan, term business loan, or loan to an individual for a business purpose."[2]

Recent Growth

Analysis of balance sheet data of commercial banks indicates that in December 2011, C&I loans were more than 10% higher than in December 2010. A monthly breakdown of the data shows that the recent pace of year-over-year percentage change at the largest 25 banks was higher (15%) than at the smaller domestic banks (5%). (See Fig. 1—C&I Loans in Bank Credit)

The overall C&I loan portfolios at Third District commercial banks and state savings banks increased during 2011 as well. Notably, the growth was stronger among banks with less than $1b in assets than at their larger counterparts, a trend that was evident in the District throughout the financial crisis.

[2] *Commercial Bank Examination Manual*, Federal Reserve Board of Governors, Division of Banking Supervision and Regulation, March 1994, available online at www.federalreserve.gov/boarddocs/supmanual/cbem/cbem.pdf.

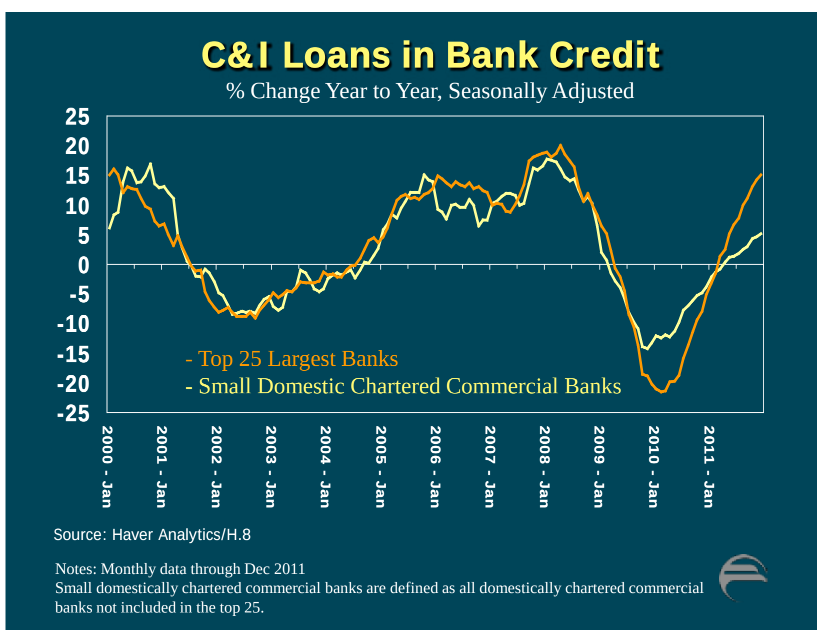
Demand for C&I Loans

The Federal Reserve's January 2012 Senior Loan Officer Opinion Survey suggests continued growth in C&I lending.[3] About 15 percent of domestic banks, on net, reported increased demand for C&I loans from small firms, the largest net percentage that has been reported since 2005. Survey respondents reported a general increase in the number of potential borrowers, and respondents attributed this increase to a more optimistic business outlook. However, while the outlook is improving, confidence levels remain low, and plans for hiring and capital expansion remain modest.

Although banks are making more C&I loan commitments, line utilization remains relatively low. Many businesses are flush with cash, and operating efficiency levels are strong. The National Federation of Independent Business's (NFIB's) December 2011 survey of more than 900 small-

[3] "The January 2012 Senior Loan Officer Opinion Survey on Bank Lending Practices," available online at www.federalreserve.gov/boarddocs/snloansurvey/201201/default.htm.

Figure 1



business owners showed that nearly 93% said their credit needs were either met, or they weren't interested in borrowing. This survey also determined that "Money is available, but most owners are not interested in a loan to finance the purchase of equipment they don't need."[4]

Today's C&I Underwriting Conditions

Regulators encourage prudent lending to creditworthy borrowers. As outlined in the *Interagency Statement on Meeting the Needs of Creditworthy Borrowers*, the regulatory agencies "expect all banking organizations to fulfill their fundamental role in the economy as intermediaries of credit to businesses, consumers, and other creditworthy borrowers. It is essential that banking organizations provide credit in a manner consistent with prudent lending practices and continue to ensure that they consider new lending opportunities on the basis of realistic asset valuations and a balanced assessment of borrowers' repayment capacities."[5]

> **"It is essential that banking organizations provide credit in a manner consistent with prudent lending practices and continue to ensure that they consider new lending opportunities on the basis of realistic asset valuations and a balanced assessment of borrowers' repayment capacities."**

The Federal Reserve's July 2011 Senior Loan Officer Opinion Survey shed some light on current lending standards in the industry.[6] One question asked respondents to report how their current lending stance stood, relative to the range defined by the easiest and tightest standards applied by their bank since 2005. This survey noted that, "For different types of C&I loans, between 25 and 50 percent of domestic respondents indicated that their bank's current lending standards were near the middle of that range. Of the remaining domestic respondents, more indicated that their current levels of standards on C&I loans were tighter than the middle of the range, compared with the number that indicated that standards were easier than the middle of the range."

The 2011 survey also found that a large net fraction of domestic banks reportedly eased pricing terms on C&I loans to firms of all sizes over the past three months. A moderate net fraction of banks also indicated a reduction in their use of interest rate floors. Domestic banks that reported having eased terms on C&I loans unanimously cited increased competition from other banks and nonbank lenders as a reason for doing this.

Mitigating Risks

Banks must understand the potential risks of C&I lending and monitor those risks at both the borrower and the portfolio level. Examiner expectations pertaining to C&I lending are outlined in section 2080 of the examination manual.

Supervisors will seek to ensure that appropriate due diligence is performed, that effective ongoing monitoring takes place, and that prompt actions are taken to mitigate risks. While this article is not meant to provide an all-encompassing list, below are some general principles and best practices to consider.

Lending Expertise

C&I lending can present challenges to loan officers unfamiliar with this business line and can heighten the risk of loss to a bank's portfolio. The skills required for commercial

[4] Dunkelberg, W. and Wade, H., "NFIB Small Business Economic Trends," February 2012, available online at www.nfib.com/Portals/0/PDF/sbet/sbet201202.pdf.

[5] *Interagency Statement on Meeting the Needs of Creditworthy Borrowers*, joint press release, November 12, 2008, available online at www.federalreserve.gov/newsevents/press/bcreg/20081112a.htm.

[6] "The July 2011 Senior Loan Officer Opinion Survey on Bank Lending Practices," available online at www.federalreserve.gov/boarddocs/snloansurvey/201108/default.htm.

real estate lending may not equate fully with C&I lending. The lenders and support teams need to have expertise in the nuances of C&I. Formally trained and experienced professionals in the C&I niche can be scarce. Suitable talent is sometimes times hard to find, expensive to develop, and difficult to retain. Banks should take necessary actions to ensure that lending and credit administration functions have both the experience and resources needed to successfully conduct C&I lending business.

A bank's loan policy should be critically evaluated for suitability with C&I lending, and exceptions should be monitored closely.

Sound Underwriting and Fundamentals

Upholding the basic principles behind sound underwriting standards is crucial for ensuring superior long-term performance and maintaining safety and soundness. There should be reasonable assurance of repayment in a timely manner. Prudent underwriting practices should reflect many credit factors, including the borrower's overall creditworthiness, the capacity of business income to service the debt, and the value and quality of the collateral. The lender should know when a business has systematic peaks and contractions so that loans are suitably structured with regard to funding needs and the timing of cash flows. A bank should also adhere to SBA guaranty requirements when applicable.

The basics still matter. Common contributors to loss include the failure to perfect liens, value collateral properly, or understand the value of guarantees. A bank should analyze the secondary sources of repayment, such as the guarantor or collateral strength, and the ability of the borrower to provide additional capital support.

Relevant Loan Policy

C&I growth should be defined and approved by the board of directors and management and should be well-documented in the loan policy. A bank's loan policy should be critically evaluated for suitability with C&I lending, and exceptions should be monitored closely. Internal controls on limits should be adequate to ensure that loan quality is not being compromised in favor of growth. The policy should cover prudent diversification through measurements of loan types, collateral support, and borrower types as a percentage of capital. For example, bank management should monitor credit concentrations by North American Industry Classification System (NAICS) codes. Ongoing credit review and monitoring with useful and timely data are essential. Concise and useful information should be conveyed periodically to board members. In addition, an engaged and well-informed board of directors is crucial to ensuring that the activity remains aligned with the organization's risk appetite.

Monitoring Cash Flow

It is well-known in the industry that cash flow is the single most important element in determining whether a business has the ability to repay debt. Section 3050 of the examination manual states that, "The accrual conversion method is the preferred method because it is the most reliable. The second and less reliable method is the supplemental or traditional cash-flow analysis; however, the information needed for this analysis is usually easier to obtain." Analysis of cash flow should be balanced and reflect expectations for the borrower's performance over a reasonable range of future conditions.

Borrowers should provide current, complete, and accurate financial statements at least annually. Management should also request personal tax returns. Knowledge and understanding of the borrower's business is essential.

Bankers must pay close attention for potential signs of trouble. The examination manual outlines some symptoms to watch for, including the following:

- **Slowdown in the receivables collection period.** This symptom often reveals that the borrower has become more liberal in establishing credit policies, has softened collection practices, or is encountering an increase in uncollected accounts.

- **Noticeably rising inventory levels in both dollar amount and percentage of total assets.** Increases in inventory levels are usually supported by trade suppliers, and financing these increases can be extremely risky, particularly if turnover ratios are declining.
- **Slowdown in inventory turnover.** This symptom may indicate overbuying or some other imbalance in the company's purchasing policies and may indicate that inventory is slow-moving.

Internal Stress Analysis

Bankers should ask themselves what would happen to C&I performance and capital levels if various adverse scenarios were to unfold. There should be an appropriate level of capital. A variety of stress factors should be considered, and a variety of analytical techniques can be applied. The important element is that senior management and the board of directors understand the risk to the portfolio and their bank under unexpectedly stressful conditions.[7]

Conclusion

As the recovery gains traction, greater opportunities for business lending will arise. Banks of all sizes should be well prepared to serve the credit needs of their communities. While C&I lending can provide potential earnings opportunities for banks, it should be conducted in a balanced manner with a prudent decisionmaking process and proper credit risk management practices in place.

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[7] Buczinski, R., "Stress-Testing a C&I Loan Portfolio: A Top-Down Approach to Assessing Downside Economic Risks," *The RMA Journal*, November 2008, available online at www.ibisworld.com/Common/MediaCenter/StressTesting.pdf.

From the Examiner's Desk

The Road to Higher Rates Could Be Rocky

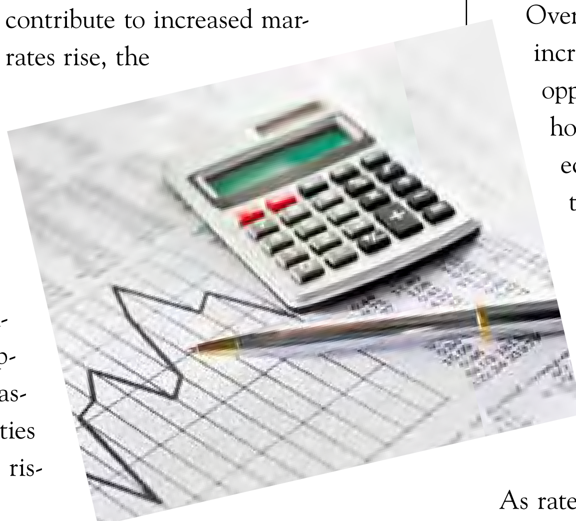
by Atul Dholakia, Senior Analyst

Atul Dholakia, Senior Analyst

Rates have been low for an extended period of time now; it was back in December 2008 when the target fed funds rate was lowered to a range of 0–25 basis points. As this period of low rates has continued for over three years, a sense of resignation seems to have set in due to the pressure on the net interest margin from the flood of liquidity, combined with low loan demand and historically low investment yields. On the other hand, there is a sense of cautious optimism about the future, with the view that rates will either stay at current levels or rise, with a corresponding increase in loan rates. This article will discuss the potential challenges to the return to higher rates.

Assumptions

While loan rates may rise, deposit rates will lag in both timing and amount. The thinking, therefore, is that interest rates on loans will increase faster than interest rates on deposits, which will contribute to increased margins. However, as rates rise, the road to higher margins could be a rocky one that should be navigated with care. To begin, one should examine the assumptions that both assets and liabilities will benefit from rising rates.



A major plank underlying this view is that rising rates will be accompanied by, if not actually caused by, an economic recovery. Loan rates have been low for a long time. As rates begin to rise, the expectation is that loan pricing will also improve, resulting in higher than current spreads over cost of funds. For example, consider a loan priced at prime plus 100 basis points. As prime increases from the current 3 percent to 3.50 percent, there would be a 50 basis point increase in the loan rate as well, so the new loan rate would be 4.50 percent. In addition, an institution's management may be able to increase the spread, since economic conditions have improved, and borrowers are eager to borrow and take advantage of opportunities. Thus, the market could bear an increase of 10 basis points in the spread, so that the new yield on the loan would be 4.60 percent.

Overall loan demand is also expected to rise because of increased economic activity. Businesses have identified opportunities for investment, but they are currently holding back because of the slowdown. Once the economy picks up, borrowers will be enthused about the prospects and eager to start projects that have been on hold, driving up loan demand for financing such projects. Increased loan yields and higher loan demand together will result in higher interest income, helping the margin as well as net income; this is the expectation.

Consider the deposit side of the balance sheet. As rates rise, bank management becomes reasonably confident that it will be able to lag deposit rate increases to a pace slower than increases in loan rates. In addition, it is possible that management will pass on only a portion of the rate increase to deposit holders, with the balance remaining to boost the margin. Thus, if loan rates increase by 50 basis points, deposit rates may actually rise only a fraction, perhaps 20 basis points. In case the deposit rate increase can be delayed up to 90 days beyond the increase in loan yields, an additional boost to the margin and income would be realized.

Based on this reasoning, it would appear that banks should anticipate rising rates. In fact, some managers have informally expressed that they are now waiting for rates to start rising so that they can see their margins and performance improve. These conclusions are based on a very plausible set of assumptions and reasoning. However, prudence requires a look at some additional facts and alternative assumptions.

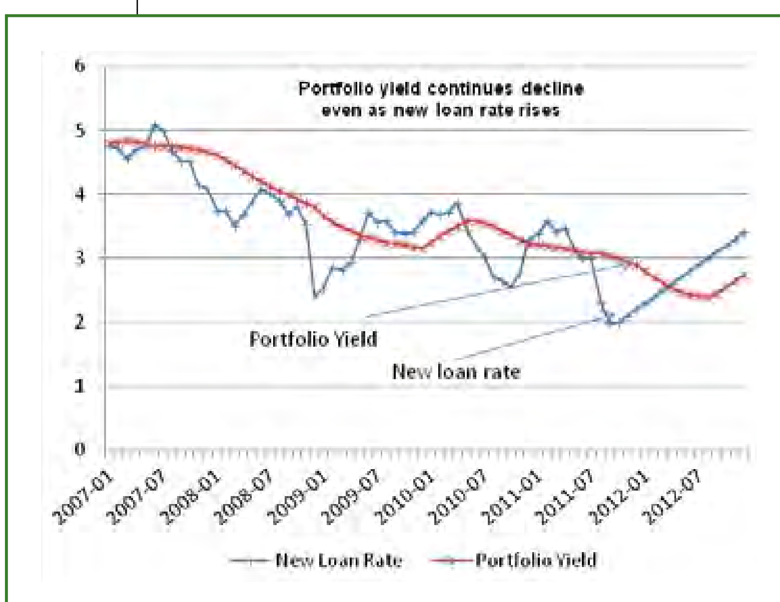
Additional Facts and Alternative Scenarios

Loans

Consider loan yields first. The line of thinking outlined above applies to rates for new loan originations and to portfolio loans that are floating rate. In these situations, the new loans are booked at the new (higher) pricing, and the floating rate portfolio reprices immediately to the higher rates. However, fixed rate loans will behave differently. Even though *new* fixed rate loans are originated at the new, higher rates, the portfolio of loans on the books will not reprice. In fact, since there has been an extended period of declining and low rates, the older (and higher priced) loans will run off before the newer, lower-rate loans as illustrated in the chart to the right. For instance, a loan booked in the second quarter of 2009 (when the 10-year bond averaged 3.52 percent) will run off before a loan booked in the third quarter of 2011, when the 10-year bond averaged 2.43 percent.

A second factor that may restrict even floating rate loan yields from rising immediately is the very factor that prevented them from falling too far: floors. As rates continued to decline over the last three years, bank managers began to modify loan terms to be, for example, prime plus 100 basis points *with a floor of 5 percent*. Floors were not common prior to this extended period of declining rates. The floors served their purpose, since these loans continued to yield 5 percent when the terms without the floors would have dropped the yield to 4 percent (current prime rate of 3 percent plus 100 basis points). Looking forward to a rising rate environment, however, these floors will prevent an increase in loan yields, since the yields already are higher than the index plus spread. For loans with those terms, a 100 basis point increase in prime would translate to a *zero* increase in loan yields. Prime would have to increase more than 100 basis points for these yields to start increasing.

Finally, the scenario of higher loan demand also may not play out quite as quickly as anticipated. Loan demand may remain weak, as borrowers are wary of incurring debt with the experience of recession still fresh in their minds. It is true that as rates and economic activity increase, loan demand should eventually increase as well. However, the economy has been in an extended downturn. It may take three or four quarters of sustained growth before borrowers feel comfortable taking on debt and before loan demand shows a robust and sustained increase.



Deposits

As described above, loan portfolio yields may take a few quarters to start reflecting the increase in market rates. Traditionally, one of the tools bank management uses in more "normal" (higher) rate environments to help the margin for two or three quarters is to slightly reduce deposit rates, for example 15–20 basis points. This action can provide some breathing room as other initiatives (in this case, increased loan demand and rates) with longer lead times kick in. Deposit rates can be boosted back up once the new initiatives start making a contribution. The hope is that the temporary nature of the reduction will not jeopardize depositor relationships. This option is not available in the current environment. Most industry observers and participants are in agreement that deposit rates have no further room to fall. Not being able to use this tool reduces the options management has to keep margins steady.

The impact on a specific institution will depend on the institution's balance sheet dynamics and local market conditions.

Another assumption in the view that rising rates will help margins is that management will be able to not only delay (lag) increasing deposit rates while loan rates increase, but will also be able to keep deposit rate increases significantly lower than loan rate increases. In practice, this strategy has some limitations. As noted above, it may take a few quarters for sustained loan demand to take root, especially if loan rates are also higher. This effectively translates to an unplanned lag in benefit derived from higher loan rates and volumes. This lag could partially offset the benefit expected from the planned lag in deposit rate increases as deposit customers see increases in market rates and expect to see those increases passed on to them without too much delay.

An additional factor is that rising rates may be accompanied by a rapid evaporation of liquidity in the system. This scenario is very plausible. Rising rates in an environment of recovery could lead to the liquidity currently parked in bank deposits flowing back into the stock market and other asset classes. This flow could lead to more competition for the liquidity that remains in bank deposits, eroding management's capacity to lag deposit rates.

Measuring and Managing Risk

It is clear that many factors are at play in this environment. Some factors point in the direction of higher loan rates, better spreads, and better overall interest income. Other factors could dampen, or even overwhelm, the effect of these beneficial factors—effects of the extended low rate environment and cautious borrower behavior. On the interest expense side, the positive effects of traditional tools like managing deposit rates may offset liquidity drying up and competition for remaining liquidity. The impact on a specific institution will depend on the institution's balance sheet dynamics and local market conditions.

It is possible for management to quantify the probable effects of these scenarios. ALCO meetings are a good forum to develop a set of alternative assumptions regarding loan growth, loan pricing, and deposit pricing. Once management is comfortable with the specifics of the assumptions, these scenarios can be run through the simulation models to determine possible results. This exercise can more precisely quantify what otherwise remains only an educated guess about the impact different scenarios can have. Results from this simulation can be discussed at ALCO meetings to develop strategies to address institution-specific exposures.

Conclusion

Scenario planning and analysis can be done without an inordinate amount of effort, but they can provide very valuable insights and help navigate the rocky road to higher margins. If management keeps a cautiously optimistic view and considers the assumptions discussed here, that road might feel just a bit smoother.

If you have any questions regarding this article, please contact Senior Analyst Atul Dholakia (atul.dholakia@phil.frb.org) at (215) 574-4360.

DFA Today

Bob Rell,
Senior Specialist

The Dodd-Frank Act's Progress, Priorities, and Challenges

by Bob Rell, Senior Specialist

The critical rulemaking process associated with the implementation of the Dodd-Frank Act (DFA or the act) continues. According to Davis Polk's year-end 2011 progress report, "of the 400 total rulemaking requirements, 86 (21.5%) have been finalized and 155 (38.75%) have been proposed. 159 (39.75%) rulemaking requirements have not yet been proposed."[1]

This is also likely to be a period of reflection and assessment for some existing DFA rules that were implemented during the earliest phases. Enough time has now elapsed to perform meaningful analysis and measure the tangible impact that particular regulations have had on the banking industry to date.

This recurring feature of *SRC Insights* highlights key events associated with the DFA that have transpired since the last issue. Reference links to more detailed information on the subject matter 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

January 17, 2012
FDIC Board Proposes Stress Testing Regulation for Large Banks
The FDIC approved a notice of proposed rulemaking (NPR) that would require certain large insured depository institutions to conduct annual capital-adequacy stress tests. The proposal would apply to FDIC-insured state nonmember banks and FDIC-insured state-chartered savings associations with total consolidated assets of more than $10 billion.
http://www.fdic.gov/news/news/press/2012/pr12004.html

December 20, 2011
Federal Reserve Board Proposes Steps to Strengthen Regulation and Supervision of Large Bank Holding Companies and Systemically Important Nonbank Financial Firms
The Federal Reserve Board proposed steps to strengthen regulation and supervision of large bank holding companies and systemically important nonbank financial firms. The proposal, which includes a wide range of measures addressing issues such as capital, liquidity, credit exposure, stress testing, risk

[1] *Dodd-Frank Progress Report*, Davis Polk, January 2012, available online at http://www.davispolk.com/files/Publication/0070db24-e562-4666-832c-03ad96defd42/Presentation/PublicationAttachment/b1836732-9b89-46be-a9e5-07c77a08d62a/Jan2012_Dodd.Frank.Progress.Report.pdf.

management, and early remediation requirements, is mandated by the DFA.
http://www.federalreserve.gov/newsevents/press/bcreg/20111220a.htm

December 20, 2011
Regulation YY—Enhanced Prudential Standards and Early Remediation Requirement for Covered Companies
This is a request for comment on proposed rules that would implement the enhanced prudential standards required to be established under section 165 of the DFA and the early remediation requirements established under section 166 of the act. The enhanced standards include risk-based capital and leverage requirements, liquidity standards, requirements for overall risk management (including establishing a risk committee), single-counterparty credit limits, stress test requirements, and a debt-to-equity limit for companies that the Financial Stability Oversight Council (FSOC) has determined pose a grave threat to financial stability.
http://www.federalreserve.gov/newsevents/press/bcreg/20111220a.htm

December 7, 2011
Agencies Seek Comment on Additional Revisions to the Market Risk Capital Rules
The federal bank regulatory agencies announced that they are seeking comment on a notice of proposed rulemaking (NPR) that would amend an earlier NPR announced in December 2010. The initial NPR proposed modifications to the agencies' market risk capital rules for banking organizations with significant trading activities.
http://www.federalreserve.gov/newsevents/press/bcreg/20111207a.htm

FINAL NOTICES

January 17, 2012
FDIC Board Approves Final Rule Requiring Resolution Plans for Insured Depository Institutions over $50 Billion
The FDIC approved a final rule requiring an insured depository institution with $50 billion or more in total assets to submit to the FDIC periodic contingency plans for resolution in the event of an institution's failure.
http://www.fdic.gov/news/news/press/2012/pr12003.html

December 23, 2011
Two-Year Phase-in Period for Most Savings and Loan Holding Companies to File Federal Reserve Regulatory Reports
The Federal Reserve Board issued a final notice for a two-year phase-in period for most savings and loan holding companies (SLHCs) to file Federal Reserve regulatory reports and an exemption for some SLHCs from initially filing Federal Reserve regulatory reports.
http://www.federalreserve.gov/newsevents/press/bcreg/20111223a.htm

November 17, 2011
Agencies Issue Statement to Clarify Supervisory and Enforcement Responsibilities for Federal Consumer Financial Laws
Five federal financial supervisory agencies issued this statement, which explains how the total assets of an insured bank, thrift, or credit union will be measured for purposes of determining supervisory and enforcement responsibilities under the DFA.
http://www.federalreserve.gov/newsevents/press/bcreg/20111117a.htm

LEGISLATIVE ACTIONS, HEARINGS, AND LEGAL PROCEEDINGS

February 1, 2012
Hearing Entitled "H.R. 3461: the Financial Institutions Examination Fairness and Reform Act"
Committee on Financial Services
http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=276487

January 18, 2012
The Volcker Rule
Testimony was given by Governor Daniel K. Tarullo before the Subcommittee on Capital Markets and Government-Sponsored Enterprises and the Subcommittee on Financial Institutions and Consumer Credit.
http://www.federalreserve.gov/newsevents/testimony/tarullo20120118a.htm

December 7, 2011
Enhanced Supervision: A New Regime for Regulating Large, Complex Financial Institutions
U.S. Senate Committee on Banking, Housing, and Urban Affairs
http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=6ee66e38-fcc3-4128-b69f-7c2d923c2216

December 6, 2011
Continued Oversight of the Implementation of the Wall Street Reform Act
U.S. Senate Committee on Banking, Housing, and Urban Affairs
http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=77971a67-b8f7-4e14-a837-892a065b7201

November 2, 2011
The Consumer Financial Protection Bureau: The First 100 Days
Committee on Financial Services
http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=266367

October 31, 2011
Regulatory Reform: Examining How New Regulations are Impacting Financial Institutions, Small Businesses, and Consumers
Committee on Financial Services
http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=265044

GAO AND OTHER NOTABLE REPORT RELEASES SPEECHES, TESTIMONY, AND EVENTS OF INTEREST

February 2, 2012
Remarks by Treasury Secretary Tim Geithner on the State of Financial Reform
As the FSOC convened for its first meeting of 2012, Treasury Secretary Tim Geithner delivered remarks on the state of financial reform at the U.S. Department of the Treasury. Secretary Geithner reviewed the progress made to date and outlined priorities and challenges for the year ahead.
http://www.treasury.gov/press-center/press-releases/Pages/tg1408.aspx

January 13, 2012
Opportunities to Reduce Regulatory Burden and Improve Credit Availability
Remarks were made by Federal Reserve Governor Elizabeth A. Duke at the 2012 Bank Presidents Seminar, California Bankers Association, Santa Barbara, California.
http://www.federalreserve.gov/newsevents/speech/duke20120113a.htm

GAO Reports

January 19, 2012

Bank Holding Company Act Characteristics and Regulation of Exempt Institutions and the Implications of Removing the Exemptions (GAO-12-160)

The DFA directs GAO to study the implications of removing the exemptions. This report examines (1) the number and general characteristics of certain institutions in the U.S. banking system that are exempt from the definition of bank in the BHC Act, (2) the federal regulatory system for exempt financial institutions, and (3) potential implications of subjecting the holding companies of exempt institutions to BHC Act requirements.

http://www.gao.gov/products/GAO-12-160

January 18, 2012

Hybrid Capital Instruments and Small Institution Access to Capital

Responding to concerns that these instruments did not perform well during the 2007–2009 financial crisis, in 2010 the DFA required regulators to establish rules that will exclude the instruments from tier 1 capital and required GAO to study the possible effects of this provision. This report addresses (1) the use, benefits, and risks of hybrid instruments as tier 1 capital; (2) the potential effects of the exclusion on banking institutions and the economy; and (3) options for smaller banking institutions to access regulatory capital.

http://www.gao.gov/products/GAO-12-237

January 18, 2012

Real Estate Appraisals—Appraisal Subcommittee Needs to Improve Monitoring Procedures

The DFA expanded ASC's Title XI role and required GAO to examine ASC's activities and exemptions to federal appraisal requirements. This report discusses: (1) how ASC is carrying out its original Title XI responsibilities, (2) ASC's actions and plans to implement DFA provisions, and (3) regulatory dollar thresholds for determining when an appraisal is required.

http://www.gao.gov/products/GAO-12-147

January 17, 2012

Bank Capital Requirements—Potential Effects of New Changes on Foreign Holding Companies and U.S. Banks Abroad

During the 2007–2009 financial crisis, many U.S. and international financial institutions lacked capital of sufficient quality and quantity to absorb substantial losses. In 2010, the DFA introduced new minimum capital requirements for bank and savings and loan (thrift) holding companies—including intermediate holding companies of foreign banks. Intermediate holding companies are the entities located between foreign parent banks and their U.S. subsidiary banks. These companies held about 9 percent of total U.S. bank holding companies' assets as of September 2011. The DFA also required GAO to examine (1) regulation of foreign-owned intermediate holding companies in the United States, (2) potential effects of changes in U.S. capital requirements on foreign-owned intermediate holding companies, and (3) banks' views on the potential effects of changes in U.S. capital requirements on U.S. banks operating abroad.

http://www.gao.gov/products/GAO-12-235

January 17, 2012

Municipal Securities—Overview of Market Structure, Pricing, and Regulation

The DFA required GAO to review several aspects of the municipal securities market, including the mechanisms for trading, price discovery, and price transparency. This report examines (1) municipal security trading in the secondary market and the factors that affect the prices investors receive and (2) the Securities and Exchange Commission's (SEC's) and self-regulatory organizations' (SROs') enforcement of rules on fair pricing and timely reporting.

http://www.gao.gov/products/GAO-12-265

January 12, 2012

Securities Research—Additional Actions Could Improve Regulatory Oversight of Analyst Conflicts of Interest

In 2003 and 2004, the SEC, SROs, and others settled with 12 broker-dealers to address conflicts of interest between the firms' research and investment banking personnel. The regulators alleged that the firms

allowed their investment bankers to pressure equity research analysts in ways that could cause them to issue misleading research to the harm of investors. Under the Global Research Analyst Settlement (global settlement), the firms had to undertake reforms designed to sever links between research and investment banking. The SROs also adopted equity research rules to address analyst conflicts across the industry, but these rules were not as stringent in some areas as the global settlement. The DFA required GAO to study these issues.
http://www.gao.gov/products/GAO-12-209

November 10, 2011
Dodd-Frank Act Regulations—Implementation Could Benefit from Additional Analysis and Coordination
This report examines (1) the regulatory analysis, including cost-benefit analysis, financial regulators have performed to assess the impact of selected final rules issued pursuant to the DFA; (2) how financial regulators consulted with each other in implementing the selected final rules to avoid duplication or conflicts; and (3) what is known about the impact of the final rules.
http://www.gao.gov/products/GAO-12-151

OTHER REPORTS

January 2012
Davis Polk Dodd-Frank Progress Report
http://www.davispolk.com/files/uploads/FIG/Jan2012_Dodd.Frank.Progress.Report.pdf

December 2011
Thrift Institutions After Dodd-Frank: The New Regulatory Framework
Morrison & Foerster
http://www.mofo.com/files/Uploads/Images/111208-Thrift-Institutions-User-Guide.pdf

November 15, 2011
Regulatory Burden Reduction
This is a discussion of Federal Reserve efforts to minimize regulatory burden, both in the ordinary course of carrying out regulatory responsibilities generally and, more specifically, in implementing the DFA.
http://www.federalreserve.gov/generalinfo/foia/regulatory-burden-reduction-111115.pdf

UPDATES ON NEW AGENCIES

Consumer Financial Protection Bureau (CFPB)

January 30, 2012
Semiannual Report of the CFPB
This report summarizes the CFPB's activities and accomplishments over the period from its launch on July 21 through December 31, 2011, and provides information required by the DFA.
http://www.consumerfinance.gov/wp-content/uploads/2012/01/Congressional_Report_Jan2012.pdf

January 20, 2012
CFPB Adopts Rule to Protect Consumers Sending Money Internationally
The CFPB adopted a rule that will increase protections for consumers who transfer money internationally. Under the new rule, remittance transfer providers will generally be required to disclose the exchange rate and all fees associated with a transfer so that consumers know exactly how much money will be received on the other end. The rule also requires remittance transfer providers to investigate disputes and remedy errors.
http://www.consumerfinance.gov/pressrelease/consumer-financial-protection-bureau-adopts-rule-to-protect-consumers-sending-money-internationally/

January 19, 2012
CFPB Examines Payday Lending
The CFPB convened the agency's first-ever field hearing to gather information and input on the

payday lending market. The hearing coincided with the publication of the Bureau's "Short-Term, Small-Dollar Lending Procedures," a field guide CFPB examiners will use to ensure that payday lenders—banks and nonbanks—are following federal consumer financial laws.
http://www.consumerfinance.gov/pressrelease/consumer-financial-protection-bureau-examines-payday-lending/

January 11, 2012
CFPB Releases Mortgage Origination Examination Procedures
The CFPB announced a key initial step in implementing its Nonbank Supervision program—the publication of the "Mortgage Origination Examination Procedures." These procedures are a field guide for CFPB examiners looking at mortgage originators in both the bank and nonbank sectors of the industry.
http://www.consumerfinance.gov/pressrelease/consumer-financial-protection-bureau-releases-mortgage-origination-examination-procedures/

January 6, 2012
Raj Date named Deputy Director of the Consumer Financial Protection Bureau
CFPB Director Richard Cordray named Raj Date the agency's first deputy director. Date has been leading the day-to-day operations of the CFPB since it launched in July 2011.
http://www.consumerfinance.gov/pressrelease/raj-date-named-deputy-director-of-the-consumer-financial-protection-bureau/

January 5, 2012
CFPB Launches Nonbank Supervision Program
The CFPB launched the nation's first federal nonbank supervision program, one of the central new responsibilities the agency acquired with a director. This will be an extension of the CFPB's bank supervision program that began last July and will ensure that banks and nonbanks follow federal consumer financial laws.
http://www.consumerfinance.gov/pressrelease/consumer-financial-protection-bureau-launches-nonbank-supervision-program/

January 4, 2012
Bulletin Regarding the Bureau's Supervision Authority and Treatment of Confidential Supervisory Information
The CFPB issued Bulletin 12-01 to clarify its practices on collecting and safeguarding information obtained through the supervisory process.
http://www.consumerfinance.gov/wp-content/uploads/2012/01/GC_bulletin_12-01.pdf

January 4, 2012
Richard Cordray Serves as the First Director of the CFPB
http://www.consumerfinance.gov/the-bureau/about-rich-cordray/

November 17, 2011
Interagency Statement for Determining Asset Size of Institutions for Federal Consumer Financial Law Supervisory and Enforcement Purposes
The statement explains how the total assets of an insured depository institution or insured credit union ("institution") will be measured for purposes of determining supervisory and enforcement responsibilities under sections 1025 and 1026 of the DFA.
http://www.consumerfinance.gov/wp-content/uploads/2012/01/CFPB_Institutions_Size_Letter_11-17-2011.pdf

October 13, 2011
Supervision and Examination Manual
The CFPB's *Supervision and Examination Manual*, issued on October 13, 2011, is a guide to how the CFPB will supervise and examine consumer financial service providers under its jurisdiction for compliance with federal consumer financial law.
http://www.consumerfinance.gov/guidance/supervision/manual/

Federal Insurance Office (FIO)

January 10, 2012
Remarks by Federal Insurance Office Director Michael McRaith at Property/Casualty Insurance Joint Industry Forum
http://www.treasury.gov/press-center/press-releases/Pages/tg1393.aspx

December 9, 2011
Remarks by Deputy Secretary Neal Wolin at Federal Insurance Office Conference
http://www.treasury.gov/press-center/press-releases/Pages/tg1382.aspx

Financial Stability Oversight Council (FSOC)

December 23, 2011
Report to the Congress on Prompt Corrective Action
The DFA requires the FSOC to submit a report to Congress regarding the implementation of prompt corrective action (PCA) by the federal banking agencies. More specifically, section 202(g)(4) of the act requires the council to issue a report on actions taken in response to the GAO study required by section 202(g)(1) of the act. This report discusses the existing PCA framework and the findings and recommendations of the GAO study. It also highlights some lessons learned from the financial crisis and outlines actions taken that could affect PCA, as well as additional steps to modify the PCA framework that could be considered.
http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%20PCA%20Report%20FINAL.PDF

November 11, 2011
Minutes of the FSOC
http://www.treasury.gov/initiatives/Documents/5a3%20DRAFT%20Minutes%20of%20the%20FSOC%2011%2011%202011.pdf

Office of Financial Research (OFR)

Assessment of Fees on Large Bank Holding Companies and Nonbank Financial Companies Supervised by the Federal Reserve Board to Cover the Expenses of the Financial Research Fund
The Treasury Department has proposed a rule that would determine the fee large banks and other major financial institutions would have to pay to help finance new regulatory powers created by the DFA financial reform law.
http://www.treasury.gov/initiatives/wsr/Documents/View%20the%20NPR.pdf

67th Annual Field Meetings 2012

Presented by the Federal Reserve Bank of Philadelphia

The Federal Reserve Bank of Philadelphia (FRBP) will be hosting its 67th annual Field Meetings for institutions throughout the Third District in March, April, and May. There is no cost to attend, but registration is required.

These dinner meetings provide an excellent opportunity for institution senior management and directors to hear presentations from FRBP leaders regarding the Payment Cards Center, an economic outlook, and a discussion on current supervisory issues and banking trends. Our format is designed to provide deeper insights into the issues we face and to facilitate the exchange of information. In addition, FRBP President Charles I. Plosser will provide remarks at each session.

Bank presidents should have received an invitation to attend. If you would like to find a meeting location in your area, or if you have questions, please email fieldmeetings@phil.frb.org or contact Tony Scafide at (215) 574-6546, Bond Kraemer at (215) 574-6536, or Janet Rizzo at (215) 574-6471.

Outreach Matters

Staff members in the Supervision, Regulation and Credit (SRC) Department of the Federal Reserve Bank of Philadelphia have a long tradition of presenting at financial trade group conferences, in academic settings, and at individual outreach engagements. In addition, SRC hosts periodic outreach events and provides other resources to Third District institutions through Federal Reserve System programs. Following is an overview of some of these outreach programs, with web addresses to access more information or to subscribe.

Bank Directors' Desktop — This online course is a primer on the duties, responsibilities, and key roles of bank directors. It is an excellent tool for new directors who want to learn more about what is expected of them in their new role, and it is also useful for seasoned directors, who want to refresh themselves on different elements of their role. This resource is designed to provide insight into current supervisory expectations, promote proper risk management practices and internal controls, and build core skills needed to fulfill the obligations of a bank director in a rapidly-changing industry. It is available at www.bankdirectorsdesktop.org.

Bankers' Forums — The forums were developed to convey key supervision and regulation issues relevant to community and regional bankers and to frame these issues within an open, information-sharing venue. The periodic events provide an opportunity to exchange insights with bank management on banking conditions, regulatory topics, and emerging issues; to gain perspective of local market conditions; and to address prominent concerns. This year's bankers' forums will be held in the fall; more information will be provided in the coming months.

CFO/CPA Roundtable — The roundtable fosters discussion between representatives of the Board of Governors, the Federal Reserve Bank of Philadelphia, and Third District bankers and accountants regarding accounting and specialized knowledge issues.

Consumer Compliance Outlook® and Outlook Live — Consumer Compliance Outlook is a quarterly Federal Reserve System publication dedicated to consumer compliance issues. The online version of the publication is available at www.consumercomplianceoutlook.org. In addition to the publication, the System hosts "Outlook Live," a popular webinar series that digs deeper into consumer compliance topics of interest. Each webinar is archived for future reference.

Partnership for Progress — Launched in June 2008, P4P is the Federal Reserve's outreach and technical assistance program for minority-owned and de novo banking institutions. This program helps these institutions confront their unique challenges, cultivate safe and sound practices, and compete more effectively in today's marketplace. It combines one-on-one guidance, workshops, and an extensive interactive web-based resource and information center at www.fedpartnership.gov.

SRC Insights® — This quarterly newsletter for Third District institutions highlights current supervisory and regulatory topics and is available in print or online at www.srcinsights.org.

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