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News and Views for Eighth District Bankers

Subprime Crisis: Is There a Way Out?

By Yuliya Demyanyk

The recent turmoil in the subprime mortgage market reverberated beyond the immediacy of that collapsed market, creating difficulties for borrowers, lenders and securitizers of both subprime and prime mortgages. Borrowers, the media and Congress are asking: What can be done? Unfortunately, that's a question that does not yet have an answer.

Economic research indicates that the 2007 crisis was brewing for six consecutive years before it actually occurred.¹ Between 2001 and 2007, the quality of subprime securitized mortgages deteriorated, and the susceptibility of the subprime mortgage market to economic shocks grew. A housing market slowdown—a big economic shock—stopped

masking the true risky nature of subprime loans and triggered the crisis. Moreover, the crisis was not driven by rate resets and was not confined only to adjustable-rate mortgages (ARMs). Fixed-rate mortgages contributed to the crisis, as well.

With the subprime mortgage market disappearing, another ominous word has started taking the place of subprime in the popular media: foreclosure. The Eighth District, like the rest of the nation, is facing a massive wave of subprime mortgage delinquencies and foreclosures.

In Illinois, for example, almost 60,000 households entered foreclosure between Sept. 30, 2006, and Sept. 30, 2007. In Missouri, about 27,000 foreclosures were initiated during the same time period.

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District Banks Face Challenging Environment

By Michelle Neely

After many years of strong profits and few asset quality problems, Eighth District banks now face a decidedly different banking environment as the economy slows and credit markets tighten. This more challenging backdrop is reflected in recent Call Report (Reports of Condition and Income for Insured Commercial Banks) measures of profitability and asset quality, which have deteriorated over the past year. (See table on Page 4.)

Return on average assets (ROA) at District banks fell in the fourth quarter and was down 17 basis points from its level one year ago. ROA was brought down by a falling net interest margin (NIM) and a rising loan loss provision (LLP) ratio.

While the earnings trends are basically the same at U.S. peer banks (banks with assets of less than \$15 billion), they remained more profitable

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Feditorial

Greatly Strengthened Banking System Aided Economy Since Early 1990s

By Bill Poole, president of the Federal Reserve Bank of St. Louis

This is the last Feditorial by Bill Poole, who retires from the Fed March 31.

Between the end of the brief 1990–91 recession and the fourth quarter of 2007, a span of 67 quarters, the U.S. economy experienced only three quarters of decline in real gross domestic product (GDP). The down quarters were fewer than 5 percent of the total. During the prior 44 years, 19 percent of the quarters (33 out of 176) saw a decline in real GDP. No wonder we call the period since 1991 the Great Moderation.

The general agreement is that during the Great Moderation, improved inventory management among businesses and better Fed monetary policy probably played some role. Some observers believe we also have been lucky because we haven't faced economic shocks like those of the 1970s, including oil embargoes and grain harvest failures.

My view is that good luck flows from good policy. The U.S. economy *has* faced serious financial and economic shocks in recent years, but despite them has been more stable than in the past. Consider some of the shocks: emerging-market debt crises in 1994 (Mexico) and 1997–98 (Asia); financial market turbulence when short-term interest rates rose sharply (1994–95) and when the large hedge fund Long-Term Capital Management imploded (1998); and, of course, the terrorist attacks of Sept. 11. The bursting of the high-tech stock-market bubble (2000–02) caused ripple effects throughout the economy and financial markets. Since late 2001, the oil price has quintupled to nearly \$100 per barrel. Other commodity prices also have risen strongly in recent years. The dollar has been volatile. And, today, we are facing a potentially historic correction in the housing market at the same time that credit markets are experiencing unusual strains from defaults on subprime mortgages.

A notable aspect of the U.S. economy's improved performance since the early 1990s, despite many

shocks, is a greatly strengthened banking system.

As the nation's central bank, we are keenly aware of the importance of strong depository institutions in which the public justifiably can place its confidence.

It was not always so. Failures of banks and thrifts averaged 255 per year between 1982 and 1992—an average of more than 21 every *month*!¹ Many of the banks and thrifts that survived the 1980s and early 1990s were under stress; the economic recovery from the 1990–91 recession was hampered by a credit crunch—reduced credit availability for marginal and even some strong borrowers.

The bank failures themselves weeded out many of the unsound bankers and thrift managers who operated during the 1980s. Those who remained understood that higher ratios of bank capital to assets would be necessary to survive and prosper in the future.

New legislation and bank regulations reinforced this newfound financial discipline. Bank failures during 1997–2007 averaged only four per year. Bank profitability has been consistently strong since the early 1990s, encouraging hundreds of new banks to begin operations. Bank-lending growth has comfortably exceeded and, therefore, supported GDP growth for most of the past 15 years.

There is no reason to expect that we will be any more or less lucky than those who came before. We should expect to face our share of economic and financial challenges. A strong, well-capitalized banking system subject to well-designed prudential supervision increases the economy's resilience. Low inflation from sound monetary policy and sound banking practices will go a long way in creating the good luck the economy needs. ■

ENDNOTE

¹ Data on bank and thrift failures are available at www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30.

Fed Invites Banks To Explore Innovation in Community Development

Fostering innovation in community development among banks and other entities is the goal of the St. Louis Fed's Exploring Innovation Week, April 14–18.

The event stems from last May's Exploring Innovation conference, which concentrated mainly on community development finance. The Bank's Community Development department is planning various activities throughout the District, including speeches, resource fairs and workshops on topics such as innovation in housing finance and new ways to promote entrepreneurship.

For more information, call these Fed staff:

- Missouri/Illinois: Matthew Ashby, 314-444-8891
- Arkansas: Amy Simpkins, 501-324-8268
- Kentucky/Indiana: Faith Weekly, 502-568-9216
- Tennessee/Mississippi: Kathy Moore Cowan, 901-579-4103

Visit www.exploringinnovation.org for more information. ■

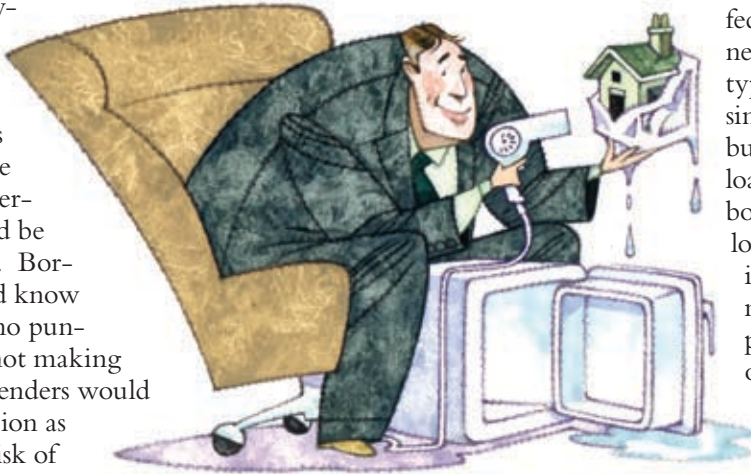
Subprime

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Foreclosures have devastating personal consequences, but they are necessary. Without foreclosures—or more precisely, without the threat of foreclosures—it would be impossible to enforce timely monthly mortgage pay-

ments.

Also, without foreclosure as an option, the mortgage interest rate would be much higher. Borrowers would know that there is no punishment for not making payments. Lenders would see this situation as an elevated risk of mortgage lending and, to be compensated, would raise the mortgage interest rate.



Still, policymakers are analyzing and searching for an ultimate solution to the persisting subprime mess.

To ease the problems with outstanding subprime loans, a dramatic restructuring of the subprime mortgage market—especially the securitized portion—is needed. As an example of a sizable intervention, the federal government may need to provide a new type of loan guarantee—similar to an FHA-type, but applicable to subprime loans. This would let borrowers with subprime loans (re)build equity in their homes. As a more radical proposal, a program similar to the one run by the Home Owners' Loan Corp. (HOLC) during the Great Depression may help stabilize the

market. The HOLC refinanced about 1 million mortgages that were in default. The program did not require public financing other than its initial capitalization. Such a stabilization program—one that would first wipe out subprime debt and then recapitalize existing loans—would most likely be more expensive today than in the 1930s and 1940s because we are in very different economic circumstances.

These potential solutions would take time to work and are costly. In the meantime, modifications on a loan-by-loan basis, timely information to borrowers and mortgage counseling may help many borrowers postpone or avoid foreclosure. If lenders choose to write off some debt, it is critical that money continues to move—in other words, lenders need to keep issuing new loans to be able to absorb any current recapitalization in the future.

The bottom line is that the mortgage market must not freeze up. To prevent the occurrence of such a crisis in the future, more financial education for existing and new borrowers is needed. ■

Yuliya Demyanyk is an economist at the Federal Reserve Bank of St. Louis.

ENDNOTES

¹ Yuliya Demyanyk and Otto Van Hemert, 2007, "Understanding the Subprime Mortgage Crisis," available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1020396.

² See www.americansecuritization.com/uploadedFiles/Final-ASFStatementonStreamlinedServicingProcedures.pdf.

Finding Solutions

Foreclosures are costly. However, renegotiations of mortgage contracts are also costly. Securitization makes renegotiations between a lender (or a servicer) and a borrower almost impossible. The Bush administration has taken steps to ease renegotiations by proposing the American Securitization Forum (ASF) framework to freeze mortgage rates for five years for a number of borrowers with subprime securitized 2/28 and 3/27 hybrid ARMs.² The ASF projects that approximately 1.2 million borrowers would qualify for the fast track loan modifications, but some private forecasters expect as few as one-fifth of that number to benefit.

The government's plan, however, doesn't quite get to the heart of the matter. Among securitized subprime ARMs originated in 2005 and 2006, almost 20 percent were already seriously delinquent (past due more than 60 days) just one year after origination—one to two years before the resets would have occurred. These loans will not qualify for the ASF modifications because they are already seriously delinquent. Most importantly, modifications will not solve the problems because they were not caused by resetting rates.

The government's plan helps illustrate how the depth of the current crisis is yet to be realized.

Challenging Environment

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than District banks in the fourth quarter, with an average ROA of 1.08 percent—a difference of 10 basis points. A higher average NIM and a lower average net noninterest expense margin account for the edge.

Going forward, asset quality will be a paramount concern for District banks, as well as their national counterparts. Loan loss provision ratios are already on the rise in response to higher levels of nonperforming loans.

In the District, all major loan categories showed increases in nonperforming loans in the fourth quarter, with the exception of commercial and industrial loans, which showed a slight decrease. The ratio of nonperforming construction and land development (CLD) loans to total CLD loans more than quadrupled over the past year, jumping from 0.72 percent in the fourth quarter of 2006 to 3.78 percent in the fourth quarter of 2007. Nonperforming 1-4 family home loans have also risen over the past year at District banks, as housing markets weaken, and borrowers and lenders deal with spillovers from the subprime mortgage crisis.

Despite these hits to earnings and asset quality, District banks remain on average well-capitalized. At the end of the fourth quarter, every District bank except one met or exceeded all three regulatory capital ratios. ■

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

Tougher Times for District Earnings and Loan Quality¹

	4th Q 2006	3rd Q 2007	4th Q 2007
RETURN ON AVERAGE ASSETS²			
District Banks	1.15%	1.06%	0.98%
Peer Banks	1.26	1.17	1.08
NET INTEREST MARGIN			
District Banks	4.03	3.91	3.91
Peer Banks	4.06	4.02	4.00
LOAN LOSS PROVISION RATIO			
District Banks	0.17	0.23	0.32
Peer Banks	0.18	0.25	0.32
NONPERFORMING LOANS RATIO³			
District Banks	0.73	1.02	1.40
Peer Banks	0.67	1.00	1.24

SOURCE: Reports of Condition and Income for Insured Commercial Banks

- ¹ Banks with assets of more than \$15 billion have been excluded from the analysis.
- ² All earnings ratios are annualized and use year-to-date average assets in the denominator.
- ³ Nonperforming loans are those 90 days or more past due or in nonaccrual status.

Payments Study: Checks Down, Not Out, While Debit Card Use Rises

You've probably seen the slick ads on TV that show hip people paying for everything with credit or debit cards in a stylishly choreographed routine—until someone stops the music by trying to use cash or check.

So, it's hip to use plastic, right? The numbers, at least, would agree. The 2007 Federal Reserve Payments Study demonstrated that by 2006 more than two-thirds of noncash payments were electronic—debit cards, credit cards, electronic benefits transfer (EBT) and automated clearing house (ACH). A similar study in 2003 showed electronic payments and paper checks running roughly neck and neck.

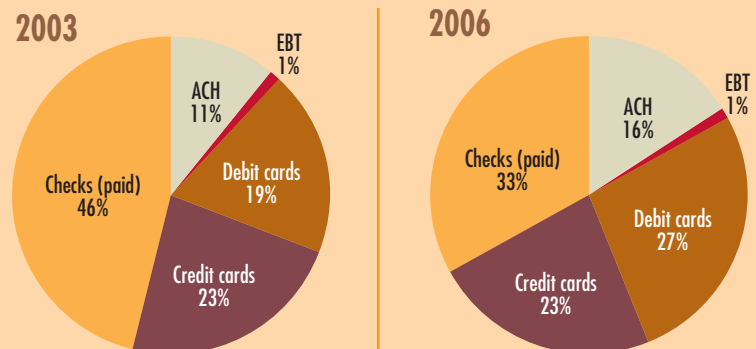
People are still writing checks, as bankers well know—but, of course, in numbers nowhere near as great as they used to be. The number of checks being written is declining at an average rate of 6.4 percent per year since 2003. According to the study, the number of checks paid fell by about 7 billion between 2003 and 2006. In contrast, about 19 billion more electronic payments were made over the same period. Of the 93 billion noncash payments in 2006, about 63 billion were electronic and about 30 billion were checks. The accompanying charts illustrate the changes in forms of payments used over the past four years.

Electronic processing also increased proportionally during the study period.

By 2006, about 40 percent of all interbank checks paid (checks drawn on a different depository institution than the one at which they were deposited) were replaced with electronic information at some point in the collection process. Also, by 2006 almost 3 billion consumer checks were converted and cleared as ACH payments rather than check payments (for a total of 33 billion checks written in 2006).

The Federal Reserve will release further study details later this year on the use of checks by payer, payee and purpose. Read the Payments Study results at www.federalreserve.gov/newsevents/press/other/20071210a.htm. ■

Distribution of the Number of Noncash Payments



SOURCE: 2007 Federal Reserve Payments Study



Recent Changes to the Fed's Communication Strategy: Loud and Clear?

By Kevin L. Kliesen

Kevin L. Kliesen is an associate economist at the Federal Reserve Bank of St. Louis.

The Federal Open Market Committee (FOMC) made several changes in late 2007 to improve the clarity of its actions. The committee is seeking greater transparency in what it does, both to improve its accountability and to help the public better understand monetary policymaking.¹

These changes included: increasing the frequency of the economic projections of the FOMC participants (governors and Reserve bank presidents) to four times per year from two; extending the maximum economic projection horizon to three years from two years; and quantifying, to the extent possible, the degree of uncertainty policymakers attach to their economic projections.

In his remarks describing these changes, Fed Chairman Ben Bernanke said that increased transparency benefits society and the economy in two important ways. First, "Good communications are a prerequisite if central banks are to maintain the democratic legitimacy and independence that are essential to sound monetary policymaking." Second, "Central bank transparency increases the effectiveness of monetary policy and enhances economic and financial performance."²

When making important choices, such as how much to save or how much to spend, households and firms have some expectation of how the economy will perform over, say, the next year or two. But they also rely importantly on current and expected future actions by the central bank. Thus, Fed policymakers can help to reduce one layer of uncertainty facing firms

and households by providing them with some direction about the current stance of monetary policy and its implications for future economic outcomes.

The degree of transparency practiced by the world's central banks varies considerably. For example, the European Central Bank (ECB) has one of the most transparent policies, characterized by the ECB president's press conference held after each policy meeting. While much less transparent than the ECB's practice, the FOMC's decision to release quarterly economic projections is nonetheless a key innovation in helping the private sector form judgments about the FOMC's future actions. For example, when the new economic projections were released Nov. 20, 2007, they indicated that FOMC policymakers had become modestly less optimistic about real GDP growth in 2008 compared with three months earlier.

In view of the recent turbulence associated with developments in the housing and mortgage finance sector, the market's focus on the Fed's changing view of the near-term outlook is consistent with the FOMC's strategy that attempts to discern the degree of risk to economic growth and price stability. If, for example, the risk of weaker economic growth exceeds the risk of higher inflation, former Fed Chairman Alan Greenspan explains that "the appropriate policy gives more weight to a very damaging outcome [weaker economic growth] that has a low probability than to a less damaging outcome [higher inflation] with a greater probability."³

Another key innovation was the decision to extend the projection horizon to three years. Previously, the maximum forecast horizon was slightly less than two years. The extension is a potentially very important development in the monetary policy communication process. For one thing, it reinforces the fact that monetary policy is the main determinant of inflation over longer horizons. It also reinforces the fact that, over time, the overall inflation rate—which households and firms care most about—should be no different from the core inflation rate (minus food and energy), which the FOMC uses as a measure of the underlying inflation rate.

Some economic analysts appear to have interpreted the midpoint of the 2010 central tendency (1.6 percent to 1.9 percent) as the FOMC's long-term inflation preference. However, attaining this outcome may be made more difficult because 1) the composition of the FOMC may change over time and 2) each member, when forming a projection, may have a different view of what an "appropriate" policy stance is. ■

ENDNOTES

¹ See www.federalreserve.gov/newsevents/press/monetary/20071114a.htm.

² See Ben Bernanke, "Federal Reserve Communications," at www.federalreserve.gov/newsevents/speech/bernanke20071114a.htm.

³ See Alan Greenspan, "Risk and Uncertainty in Monetary Policy," at www.federalreserve.gov/boarddocs/speeches/2004/20040103/default.htm.

OutforComment

The following is a Federal Reserve System proposal currently out for comment:

Fed Proposing Changes to Regulation Z (Truth in Lending)

In response to turmoil in the subprime mortgage market, the Federal Reserve is proposing several changes to Regulation Z (Truth in Lending) that would restrict certain practices and require certain mortgage disclosures to be provided earlier in the transaction. The Fed is seeking to adopt these changes under the Home Ownership and Equity Protection Act (HOEPA).

Some of the proposed revisions would apply to all subprime mortgages as well as most prime mortgages. The revisions include limits on yield spread premiums, prohibitions on some loan servicing practices, prohibitions on certain advertising practices for closed-end loans, and requirements that truth-in-lending disclosures must be provided early in the mortgage shopping process.

Comment on the proposal by April 8 at www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm. ■

FedFacts

Treasury Introducing Debit Card for Recurring Federal Benefits

Federal benefit recipients without bank accounts can receive their Social Security and SSI funds more safely with the U.S. Treasury's Direct Express debit card. The Treasury will start issuing the cards in the spring through Comerica Bank.

Direct deposit of benefits into a bank account is still the safest way for people to receive their federal benefits, according to the Treasury, but studies sponsored by the Treasury show that about a third of those receiving checks for Social Security and SSI don't have bank accounts. The debit card provides an alternative to direct deposit for the unbanked and will reduce the cost to taxpayers of providing payments. Read more at www.fms.treas.gov/news/press/financial_agent.html. ■

New \$5 Note Comes Out March 13

The new \$5 bills begin circulating March 13. The redesigned notes include the now-familiar watermark and security thread that have appeared on other new notes since the 1990s. Other new, unique features include subtle changes to the color of the bill, the serial number and the symbol of freedom; visible changes to the Lincoln portrait on the front and Lincoln Memorial vignette on the back; a low-vision feature to aid the vision-impaired; and new microprinting. Old \$5 bills will still be good. Visit www.moneyfactory.gov/newmoney for full details. ■



P.O. Box 442
St. Louis, Mo. 63166-0442

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

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