

WINTER 2010

CENTRAL Banker

NEWS AND VIEWS FOR EIGHTH DISTRICT BANKERS

FEATURED IN THIS ISSUE: Reaching the Unbanked and Underbanked | Underwriting for Subprime Mortgages

Asset Quality: Are We There Yet?

By Gary Corner

While still significantly elevated, the volume of nonperforming loans—those loans 90 days or more past due or in nonaccrual status—has declined for many banks across the country. The largest banks in the United States are signaling they have turned the corner on asset quality issues, evidenced by their shrinking provision expenses (or charges against earnings to build loan loss reserves) and rising profits.

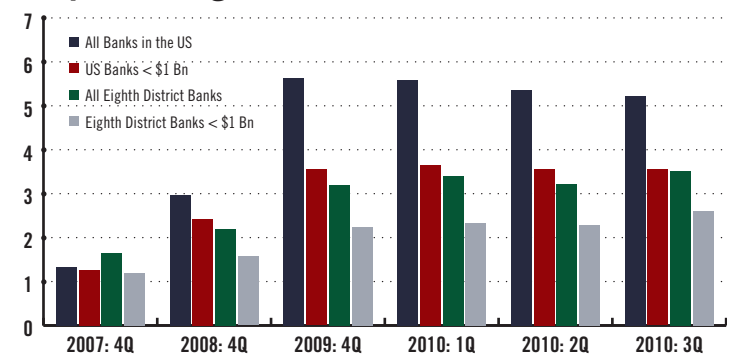
Unfortunately, this improving national trend is not emerging across the Eighth District. As illustrated in Chart 1, nonperforming loans appear to have peaked in volume at year-end 2009 across all banks in the U.S. and seemingly one quarter later for all U.S. banks with less than \$1 billion in total assets. For Eighth District institutions, however, the ratio climbed after a modest decline in the second quarter.

The reversal in trend is magnified when the growth in banks' other real estate owned accounts (OREO) is considered. Chart 2 combines bank nonperforming loans with the nonearning assets that have migrated into banks' other real estate owned accounts. As shown by the chart, the ratio of nonperforming loans plus OREO to total loans plus OREO continues to increase. For the District's smallest banks, the change has been the most dramatic since year-end 2009.

In contrast, the same ratio declines slightly for all banks in the U.S. This composite, however, is dominated by

CHART 1

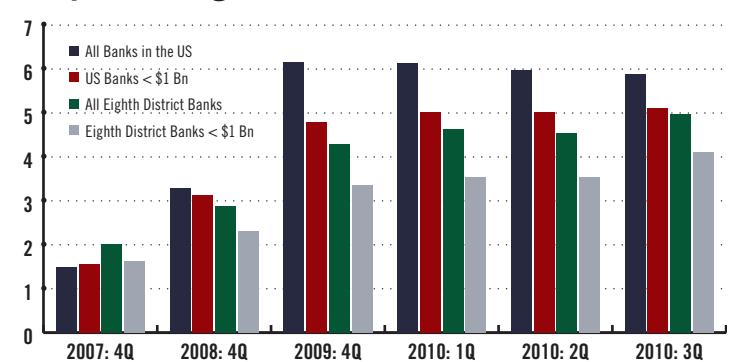
Nonperforming Loans / Total Loans



SOURCE: Call Reports.

CHART 2

Nonperforming Loans + OREO / Total Loans + OREO



SOURCE: Call Reports.

a handful of very large, diversified institutions that are less reliant on commercial real estate lending. Their performance is generally not representative of Eighth District institutions.

The exposure of Eighth District and community banks to commercial

continued on Page 5

CENTRAL Banker

News and Views for Eighth District Bankers
Vol. 20 | No. 4
www.stlouisfed.org/publications/cb

EDITOR

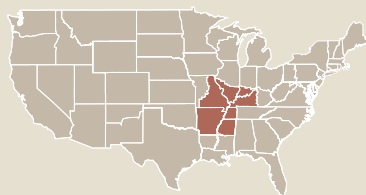
Scott Kelly
314-444-8593
scott.b.kelly@stls.frb.org

Central Banker is published quarterly by the Public Affairs department of the Federal Reserve Bank of St. Louis. Views expressed are not necessarily official opinions of the Federal Reserve System or the Federal Reserve Bank of St. Louis.

Sign up for *Central Banker* e-mail notices at www.stlouisfed.org/publications/cb/. Follow the Fed on Facebook, Twitter and more at stlouisfed.org/followthefed.

To subscribe for free to *Central Banker* or any St. Louis Fed publication, go online to www.stlouisfed.org/publications/subscribe.cfm. To subscribe by mail, send your name, address, city, state and ZIP code to: Central Banker, P.O. Box 442, St. Louis, MO 63166-0442.

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



CENTRAL VIEW

Another Tough Year for Community Banks: What Lies Ahead?

By Julie Stackhouse

About this time last year, banking conditions in the Eighth District were very weak. September 2009 call report data showed a return on average assets for District banks under \$10 billion in assets of just 0.38 percent. Nonperforming loans and other real estate owned (OREO) to total loans approached 3.46 percent. It appeared that 2010 would be a year of significant challenges and many bank failures. But we also hoped it would be a watershed year, with a strengthening economy serving to lessen some of the challenges.

As we approach the end of 2010, we now know that the rate of economic growth has been disappointing. Construction remains the economy's soft spot. In a typical economic recovery, housing construction is a key driver pulling the economy out of the recession. This time, however, there is a sizable inventory overhang of houses. In addition, vacancy rates on commercial and industrial properties are quite high.

So, what does this portend for 2011? For the 829 banks on the FDIC's watch list (as of the second quarter of 2010), much could depend on the pace of economic growth and recovery in real estate sectors. Bank failures will continue (2010 failures surpassed the 2009 total in early November), with the pace dependent on the ability of distressed banks to find merger partners or other forms of capital. And all banks will closely watch the growth in regulatory costs resulting from the new regulations issued as a result of the Dodd-Frank Act.

The challenges will also bring opportunity to some banking organizations as they grow through acquisitions. But with so much uncertainty still ahead, I expect that 2011 will be another year of transition for the banking industry as we begin to understand the full impact of the regulatory changes and adjust to the structural changes that continue to take place in the U.S. economy.



Julie Stackhouse is senior vice president of the St. Louis Fed's division of Banking Supervision, Credit and the Center for Online Learning.

A Mixed Bag for District, Peer Banks

By Michelle Neely

Profitability rose at the District's banks in the third quarter, although average asset quality worsened after showing some improvement at mid-year 2010. Return on average assets (ROA) at District banks increased 6 basis points to 0.58 percent in the second quarter (see table), putting ROA 33 basis points above its year-ago level. For U.S. peer banks—banks with assets of less than \$15 billion—ROA advanced 7 basis points to 0.33 percent in the third quarter. Average ROA for smaller institutions showed a similar trend at both District and peer banks; ROA increased 2 basis points to 0.80 percent at District banks with assets of less than \$1 billion, and rose 4 basis points to 0.42 percent at U.S. peers of the same size.

At District banks, a boost of 6 basis points in the net interest margin (NIM) to 3.84 percent was the primary determinant for the increase in profits. The increase was split evenly between a rise in interest income and a decline in interest expense. Loan loss provisions also declined while net noninterest expense rose just one basis point. For U.S. peers, the increase in net income was due to a 4 basis point rise in the NIM and an equivalent drop in loan loss provisions. Profit ratios also increased because of shrinking balance sheets; average assets declined somewhat at both District and U.S. peer banks.

The drop in loan loss provisions at District banks is surprising given the sharp rise in nonperforming loans in the third quarter. Nonperforming loans as a percent of total loans climbed 32 basis points to 3.30 percent at District banks after a drop of 11 basis points in the second quarter. Nonperforming loans also rose at U.S. peer banks, but by a more modest 7 basis points to 4.09 percent. All major categories of loans at District banks posted increases in nonperforming

Profits, Asset Quality Diverge¹

	2009: 3Q	2010: 2Q	2010: 3Q
RETURN ON AVERAGE ASSETS²			
District Banks	0.25%	0.52%	0.58%
U.S. Peer Banks	-0.30	0.26	0.33
NET INTEREST MARGIN			
District Banks	3.67	3.78	3.84
U.S. Peer Banks	3.61	3.83	3.87
LOAN LOSS PROVISION RATIO			
District Banks	0.95	0.83	0.81
U.S. Peer Banks	1.51	1.09	1.05
NONPERFORMING LOAN RATIO³			
District Banks	2.62	2.98	3.30
U.S. Peer Banks	4.03	4.02	4.09

SOURCE: Reports of Condition and Income for Insured Commercial Banks

NOTES: ¹ Because all District banks but one have assets of less than \$15 billion, banks larger than \$15 billion have been excluded from the analysis.

² All earnings ratios are annualized and use year-to-date average assets or average earning assets in the denominator.

³ Nonperforming loans are those 90 days or more past due or in nonaccrual status.

rates, but once again, deterioration in the real estate portfolio drove the overall results. The nonperforming construction and land development loan and nonfarm nonresidential real estate loan ratios were both up substantially over second quarter levels. Although the deterioration in loan performance was less significant at U.S. peer banks, overall nonperforming rates remain higher than those of District banks across all asset categories.

The combination of rising nonperforming loans and falling loan loss provisions led to declines in the average loan loss reserves coverage ratio at both sets of banks. The ratio of loan loss reserves to nonperforming loans fell 544 basis points to 60.57 percent in the District, meaning about 60 cents was reserved for every dollar of nonperforming loans. The coverage ratio at U.S. peer banks also fell in the third quarter, but by a more modest

continued on Page 5

Underwriting on Subprime Mortgages: What Really Happened?

By Rajdeep Sengupta and Bryan Noeth

The subprime mortgage was developed to accommodate borrowers who would otherwise not have access to more conventional mortgages. Almost by definition, the creation of a subprime mortgage implies a deterioration of underwriting standards. In addition, the phenomenal growth of the subprime mortgage market naturally implies a significant decline of underwriting standards in the overall mortgage market. It is widely believed that a secular deterioration of underwriting standards starting around the latter half of 2004 led to the collapse of the subprime mortgage market. In light of this, some questions arise: How did poor underwriting bring about the collapse of the subprime market? More importantly, how would subprime mortgages perform if underwriting standards did not deteriorate?

The subprime market is largely defined as one meant for borrowers of modest credit quality. Naturally, it is widely believed that in order for this market to grow, it had to lower its standards and serve borrowers of even poorer credit quality. However, a recent study of more than nine million mortgages securitized and sold as subprime has found just the opposite.¹ It reveals that minimum credit quality—as measured by their credit (FICO) scores—on subprime originations actually improved during 2000-2006. In particular, the percentage of loans with origination FICO not greater than 500 dropped from 2.45 percent of total originations during 2000-2002 to 0.31 percent during 2004-2006. But how did the bottom segment of the mortgage market record such high growth and still show an improvement in credit quality? The answer may lie in the fact that more than 70 percent of originations for every year during 2000-2006 were refinances. Over half of these mortgages were cash-out refinances; that is, households refinanced an existing mortgage into a subprime

mortgage and in the process cashed out on their home equity.

An important feature of the subprime market during 2000-2006 was the significant growth in the proportion of originations with lower documentation and higher loan-to-value ratios (LTV). There is a clear trend of a decline in underwriting standards along these dimensions. However, a multidimensional view of underwriting reveals a less-known trend: Over the years, lenders increasingly relied on FICO scores to offset other riskier attributes of borrowers. As a result, average FICO scores were significantly higher for originations whose other attributes (such as lower documentation or higher loan-to-value ratios) were riskier. In particular, the percentage of loans with origination FICO less than 500 and LTV greater than 80 percent dropped from 0.8 percent of total originations during 2000-2002 to 0.06 percent during 2004-2006. Moreover, the percentage of low-documentation loans with origination FICO less than 500 dropped from 0.34 percent of total originations during 2000-2002 to 0.07 percent during 2004-2006. These figures seem to suggest that the minimum criteria for obtaining a subprime loan actually tightened over this period.

Emphasis on FICO Scores

The patterns of underwriting suggest that lenders placed emphasis on FICO scores not just as an adequate indicator of credit risk, but also as a means to adjust for other riskier attributes on the origination. With the benefit of hindsight, some industry experts have faulted originators on this account arguing that FICO scores failed as predictors of default. In contrast, the recent study finds that the performance of FICO scores as indicators of default did not deteriorate over this period. In particular, they show that on average, the decrease in the probability of default in moving from

a lower FICO score to a higher FICO score does not deteriorate over this period. Moreover, after controlling for other attributes on the loan origination, the increase in survival probability for a given improvement in FICO increases over the years. In sum, their results suggest that the overall trend of emphasis on FICO scores at the time of origination was not misplaced.

How would ex post facto default rates change if a “representative” origination of 2005 vintage had been originated in 2001? The study’s conclusion is that representative subprime originations for later vintages (namely, 2005, 2006 and 2007) would perform significantly better in 2001 and 2002 than representative originations of the same vintages (namely, 2001 and 2002). In light of this evidence, it is difficult to conclude that underwriting was central to the collapse of the subprime mortgage market. This non-result is a significant departure from conventional wisdom on the subprime crisis. Still, it is not difficult to see why a discerning reader may not find this result implausible. The argument that a significant deterioration in underwriting after 2004 triggered the collapse of the subprime market implicitly suggests that originations of earlier vintages had relatively robust underwriting. Taken to its logical conclusion, it could also suggest that the underwriting framework for earlier vintages could help provide a sustainable framework for future subprime originations. In contrast, their results do not rule out the possibility that the design of subprime contracts could have been fundamentally flawed since the inception of this market.²

1 Bhardwaj, Geetesh and Sengupta, Rajdeep, “Where’s the Smoking Gun? A Study of Underwriting Standards for U.S. Subprime Mortgages” (March 11, 2010). Federal Reserve Bank of St. Louis Working Paper No. 2008-036D.

2 “Why HARM the subprime borrower?” *The Regional Economist*, Federal Reserve Bank of St. Louis, April 2010.

Rajdeep Sengupta is an economist and Bryan Noeth is a research analyst at the Federal Reserve Bank of St. Louis.

Asset Quality: Are We There Yet?

continued from Page 1

real estate and related loan losses remains high. Weakness in economic factors that underlie commercial real estate fundamentals, such as employment and income growth, also remain elusive. In some cases, the passage of time could force further recognition of difficult lending relationships as borrowers exhaust their remaining options and collateral cash flows weaken.

As such, without clear, sustained improvement in the present and future quarters, it appears that many community and Eighth District banks will continue to experience significant asset quality problems well into 2011.

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

A Mixed Bag for District, Peer Banks

continued from Page 3

120 basis points. U.S. peer banks have about 55 cents set aside for every dollar of nonperforming loans.

Capital ratios improved at both sets of banks in the third quarter. The average tier 1 leverage ratio jumped 12 basis points to 9.07 percent at District banks, and 18 basis points to 9.45 percent at U.S. peer banks. Rising capital ratios were the result of increased profits and a smaller asset base.

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

Reaching the Unbanked and Underbanked

By *Martha Perine Beard*

The word unbanked is an umbrella term used to describe diverse groups of individuals who do not use banks or credit unions for their financial transactions. They have neither a checking nor savings account. As bankers, you may find the following data useful when exploring the unbanked and underbanked in your community.

Some consumers are unbanked for a variety of reasons. These include: a poor credit history or outstanding issue from a prior banking relationship, a lack of understanding about the U.S. banking system, a negative prior experience with a bank, language barriers for immigrant residents, a lack of appropriate identification needed to open a bank account, or living paycheck to paycheck due to limited and unstable income.

Underbanked consumers have either a checking or savings account, but also rely on alternative financial services. The FDIC estimates that the underbanked population includes about 43 million adults and 21 million households. These households use non-bank money orders or non-bank check-cashing services, payday loan institutions, rent-to-own agreements or pawn shops on a regular basis. Blacks, Hispanics and Native Americans are the most likely Americans to be underbanked.

The most common groups of unbanked persons include low-income individuals and families, those who are less-educated, households headed by women, young adults and immigrants. As part of the Census Population Survey sent nationwide in 2009, the FDIC asked finance-related queries to help build the database on household banking habits. Responses showed that almost one in 10 households do not use a bank at all. When compared with the 9 percent estimate gathered in the 2001 Federal Reserve Survey of Consumer Finances, the

percentage of unbanked consumers appears to have remained relatively stable. The survey further estimated that nearly 9 million households (approximately 7.7 percent of the population) are unbanked. The unbanked population includes about 17 million adults, with 21.7 percent blacks, 19.3 percent Hispanics and 15.5 percent Native Americans.

Encouraging the unbanked to handle payments through the financial mainstream is important for a number of reasons. Having a checking and savings account is an important first step in establishing that the consumer has the financial acumen to apply for credit for a car or home. It also permits a consumer's payroll check to be automatically deposited into a checking account, and lets the consumer arrange to have a specified amount automatically transferred to the savings account each pay period.

But, the key advantage to consumers having bank accounts is avoiding costly alternative financial services and enabling families to build and protect their wealth. Unbanked consumers spend approximately 2.5 to 3 percent of a government benefits check and between 4 percent and 5 percent of payroll check just to cash them. Additional dollars are spent to purchase money orders to pay routine monthly expenses. When you consider the cost for cashing a bi-weekly payroll check and buying about six money orders each month, a household with a net income of \$20,000 may pay as much as \$1,200 annually for alternative service fees—substantially more than the expense of a monthly checking account fee.

The direct cost of being unbanked will vary based upon the number and type of checks cashed and the number of money orders purchased. There are indirect costs as well, according to a Boston Fed study. Unbanked individuals frequently lack sufficient credit histories to satisfy the requirements of traditional lenders, whereas a bank

account helps build a credit history.

Still, more expensive, check-cashing outlets remain popular for a number of reasons. They are frequently located in low- to moderate-income areas and transportation to them is less difficult. In many cities and towns, the number of alternative financial service providers (check cashers, title lenders and payday lenders) far exceeds the number of bank and credit union branches in these areas. In addition to convenience, alternative financial service providers offer a range of convenient payment services in one location: They cash paychecks, sell money orders with stamped envelopes, serve as agents for utility bill payments and can transmit funds electronically for money transfers.

Addressing the Memphis Area Unbanked and Underbanked

The FDIC estimates 96,000 unbanked households in the Memphis MSA. To address this issue, the Memphis Branch is partnering with the City of Memphis and the nonprofit RISE Foundation to launch Bank on Memphis this December. This community-wide effort is intended to decrease the number of unbanked residents in Memphis through gaining 5,000 new customers in the first year. The campaign is based on successful models in San Francisco, Seattle and Evansville, Ind.

Banks and credit unions will be asked to develop checking accounts and savings accounts targeted towards low-income households. After these products are developed, the banks will work closely with non-profits and community groups to promote them. This is in addition to what some banks already do, such as locating branches in grocery stores and hiring multilingual staff.

Martha Perine Beard is senior branch executive of the Memphis Branch of the Federal Reserve Bank of St. Louis.

Unbanked and Underbanked Households

Percentage by State ¹	Unbanked	Underbanked	Banked	Status unclear ²
Arkansas	10.1%	22.3%	69%	3.4%
Illinois	6.2	15.7	75.4	2.7
Indiana	7.4	16.8	71.3	2.8
Kentucky	11.9	23.7	62.7	1.8
Mississippi	16.4	25.2	55.1	3.3
Missouri	8.2	19.3	69	3.4
Tennessee	9.9	17.5	69.4	3.2
United States	7.7	17.9	70.3	4.1

Eighth District Zones ³	Unbanked	Underbanked	Banked	Status unclear ²
Little Rock	7.3%	25%	69.3%	3.9%
Louisville	7.6	17.5	74.2	0.6
Memphis	17.3	17.4	59.1	6.2
St. Louis	7.5	22.4	65.9	4.2

SOURCE: 2009 FDIC National Survey of Unbanked and Underbanked Households.

- ¹ State figures encompass entire states and thus are not limited to Eighth District counties.
- ² Status unclear means that respondents may be banked, but their use of alternative services is not known.
- ³ Due to the nature of the data, percentages may not equal 100.

Treasury Will Stop FTD Coupon Processing after Dec. 31, 2010

Information below outlines the operational impact to your financial institution if it participates in the Treasury Tax and Loan (TT&L) program and submits FTD coupons via an Advice of Credit (AOC) on behalf of business customers.

Dec. 31, 2010: Last day to accept FTD coupons from your customers

Jan. 3, 2011: Last day to submit an AOC representing the dollars collected from FTD coupon payments

Please start assisting your customers in transitioning to alternate payment methods today. For more information visit http://fms.treas.gov/eftps/transition_materials.html or contact the Treasury Support Center at 888-568-7343 or TTL_Plus@stls.frb.org.



FEDERAL RESERVE BANK *of* ST. LOUIS

CENTRAL to AMERICA'S ECONOMY®

P.O. Box 442
St. Louis, MO 63166

STLOUISFED.ORG

FIRST-CLASS
US POSTAGE
PAID
PERMIT NO 444
ST LOUIS, MO

Central Banker Online

SEE THE ONLINE VERSION OF THE FALL 2010 *CENTRAL BANKER* FOR MORE INSIGHTS, REGULATORY SPOTLIGHTS AND FED NEWS.

THIRD QUARTER BANK CONDITIONS DISTRICT-WIDE

RULES AND REGULATIONS

- Guidance Issued for Managing Reverse Mortgage Compliance and Reputation Risks
- Enhanced Consumer Protections and Disclosures Proposed for Home Mortgage Transactions

- Fed Issues Interim Rule Revising Disclosure Requirements for Closed-End Mortgages
- New Escrow Requirement Proposed for Jumbo Mortgage Loans

ONLINE VIEWS

- St. Louis Fed, Bankers and Economists Explore Facts and Uncertainties of the Dodd-Frank Act
- Federal Reserve Offers Homeowners MORE

>> ONLY ONLINE

Read these features at www.stlouisfed.org/publications/cb/

Reader Poll

Do you think that the resolution authority in the Dodd-Frank Act will prevent “too big to fail” for non-banking financial companies?

- No, because this will actually institutionalize bailouts
- Only partially because the resolution authority is not global for multi-national corporations
- Yes, because it creates orderly dissolution of large companies before they utterly collapse
- No, because it doesn't apply to insurance companies and GSEs such as Freddie Mac and Fannie Mae

Take the poll at www.stlouisfed.org/publications/cb/. Results are not scientific and are for informational purposes only.

In the fall issue's poll, we asked what is the main concern for community banks as the nation emerges from the financial crisis and Great Recession? Based on 167 responses:

- 38 percent said unusually high numbers of residential and commercial real estate loan delinquencies
- 33 percent said negative public perception toward large banks, which unfairly stigmatizes small banks
- 19 percent said high unemployment and low consumer spending
- 10 percent said effects of the recently passed financial reforms