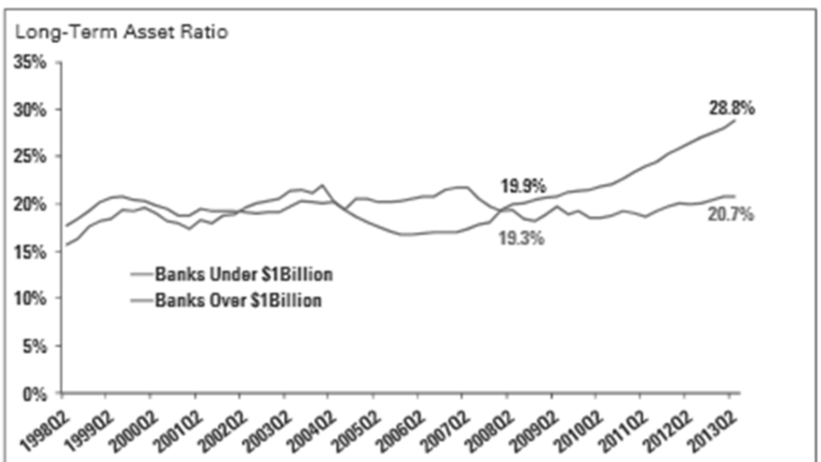
Supervisory Insights Winter 2013 - Overview

Topics:

- Industry Trends Highlight Importance of Effective Interest-Rate Risk Management
- Lending Trends: Results from the FDIC's Credit and Consumer Products/Services Survey
- Then New BASEL III Definition of Capital: Understanding the Deductions for Investments in Unconsolidated Financial Institutions

Industry Trends Highlight Importance of Effective Interest-Rate Risk Management

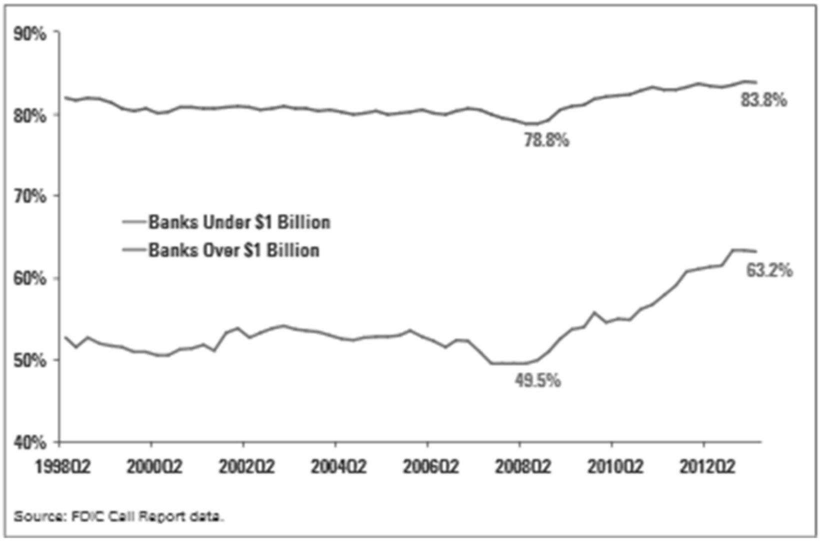
- Emphasizes the importance of banks preparing for rising interest rates
- Concerns are that lengthened asset maturities and a potentially more rate-sensitive mix of liabilities may expose banks to securities depreciation and pressure the net interest margin in a rising rate environment
- Asset Expansion has primarily been in securities portfolios over the last 5 years increasing the risk of portfolio depreciation in a rising rate environment
- Management should also remember that variable rate loans at their floors may not increase for some time as interest rates climb back to the loan's floor
- In Smaller banks securities have moved to longer durations, as have loans, resulting in an increased long-term asset ratio



Note: Excludes former Thrift Financial Report filers. The long-term asset ratio for all banks, including former TFR filers, at June 30, 2013 was 29.8% for banks under $1 billion and 21.1% for banks over $1 billion.
Source: FDIC Call Report data.

- The lower rates and longer duration of these securities could result in depreciation in a rising rate environment
- Amount of assets funded by deposits at highest level in 15 years

Chart 3: The proportion of assets funded by deposits has increased to the highest levels in the past 15 years for both large and small banks.



- While many of these deposits are core, the extended low rate scenario may cause traditionally core deposits to have higher than historical rate sensitivity
    - Management should also consider that early termination fees for time deposits may not be sufficient to deter deposit runoff and repricing when interest rates begin to increase
- Management should measure IRR exposure in a variety of Interest Rate Scenarios, including substantial rate increases to ensure a successful risk management framework
- Banks which experienced significant changes to their asset or funding mix should implement risk mitigation strategies to reduce IRR exposure
- Prudent Limits should be established to help determine when risk mitigation strategies should be implemented

Lending Trends: Results from the FDIC's Credit and Consumer Products/Services Survey

- FDIC completed this survey at the end of all risk management examinations since October 2009.
    - Nearly all FDIC insured institutions have had completed surveys
- Survey solicits examiner assessment about the level of risk and quality of underwriting on nine credit products
    - Also gathered information on new and evolving baking activities and products, local CRE market conditions, and funding practices
- Survey results indicate continued improvement in overall credit risk policies and underwriting practices
    - Three causes:
        - Changes in Economic Conditions
        - Changes in the financial conditions of the Institution

        - Responses to Regulatory Observations

- There is a gradual strengthening in asset quality
- Percentage of respondents designating one or more loan portfolios as high risk declined for all portfolios but agricultural loans
- The respondents seem to be indicating a general tightening of or consistency in underwriting standards
    - Even in banks experiencing loan growth
- Although declining, high risk practices continue to exist most frequently in ADC lending

Table 1: Frequency of Risky ADC Practices Continues to Decline

Higher-Risk Acquisition, Development, and Construction Practices	2010	2011	2012	Jan-Jun 2013
Funding projects on a speculative basis (i.e. without meaningful pre-sale, pre-lease, or take-out commitments)	35%	25%	16%	9%
Funding loans without consideration of repayment sources other than sale of the collateral	33%	27%	16%	11%
Failing to verify the quality of alternative repayment sources	38%	31%	23%	17%
Use of unrealistic appraisal values relative to the current economic conditions and/or the performance observed in similar credits	30%	25%	16%	10%
Liberal use of interest reserves or deferral of interest payments to an extent that may mask rising delinquency levels	19%	12%	6%	3%

Source: FDIC Credit and Consumer Products/Services Survey.

- Texas has the greatest percentage of banks with ADC concentrations
- Banks have continued to reduce Out-of-area lending
- Lending activity is rebounding, though at a modest pace
    - More than 300 surveyed banks were experiencing growth in concentrated portfolios

The New Basel III Definition of Capital: Understanding the Deductions for Investments in Unconsolidated Financial Institutions

- Beginning March 31, 2015 community banks will report a new capital measure called Common Equity Tier 1 Capital (CET1)
- A series of deductions, adjustments, and threshold deductions are applied to get to CET1 Capital (see below)

Table 2 – Regulatory Capital Deductions and Adjustments

Deduction or Adjustment	Common Items for Community Banks*
Regulatory Capital **Deductions** from CET1 capital	Goodwill
	Intangible assets (other than mortgage servicing assets (MSAs))
	Deferred Tax Assets (DTAs) that arise from Net Operating Losses and tax credit carryforwards
Regulatory **Adjustments** to CET1 capital	Unrealized Gains and Losses included in Accumulated Other Comprehensive Income (if the opt-out election is not chosen)
Threshold Deductions to CET1 capital	Non-significant investments in the capital of unconsolidated financial institutions exceeding 10% of the bank's CET1, after regulatory capital deductions and adjustments
	Items subject to the 10% and 15% CET1 capital deduction thresholds: DTAs arising from temporary differences that could not be realized through net operating loss carrybacks MSAs Significant investments in the capital of unconsolidated financial institutions in the form of common stock

* This chart does not include all the deductions or adjustments a community bank may be required to make and only includes a few of the more common deductions or adjustments for illustrative purposes. See 12 CFR § 324.22(a)-(d) for a complete list of items subject to deduction or adjustment.

- The threshold deduction for unconsolidated investments in financial institutions is used to prevent double counting of capital in the financial system
- The Threshold deduction for financial institutions is made after regulatory deductions and adjustments
- "Financial institutions" are defined in the BASEL III regulation, with a predominately engaged test used for all non-listed financial institutions
    - If the bank owns greater than 10% of a potential unconsolidated financial institution's stock, apply this test (see BASEL III regulations for more information)
- Steps for calculating threshold Deduction:
    - Determine amount of investment in unconsolidated institution
    - Determine if Investment is significant or non-significant
        - All investments in capital of the unconsolidated financial institution are significant if the bank owns more than 10% of its common stock
        - All capital investments of the unconsolidated financial institution are Non-Significant if the bank owns less than 10% of its common stock
    - Aggregate the significant and non-significant investments into 2 separate buckets
    - Calculate the threshold for non-significant investments & Deduct the excess
        - Threshold is 10% of adjusted CET1 capital (CET1 after deductions and adjustments)
        - Deduct the amount of non-significant investments that exceeds the threshold from CET1 Capital, Additional CET1 Capital, or Tier 2 capital

depending on the proportion of each type of capital investment held (CET1, Additional Tier 1 capital, etc.)
    - The amount not deducted is risk weighted according to the new standardized approach
- Calculate the threshold for significant investments and deduct the excess
    - Calculated after making deductions for non-significant investments in capital of unconsolidated institutions
    - Uses a 10% and 15% threshold
    - The thresholds are applied individually and collectively to significant investments in common stock of unconsolidated financial institutions, MSAs, and DTA that arise from temporary timing differences not subject to carryback
    - Any amount of each of the 3 categories held individually that exceeds 10% are deducted from CET1 Capital first
    - The remaining amount of the three categories are then aggregated, and the portion that exceeds 15% of CET1 capital is then deducted
    - The amounts not deducted in these 3 categories are risk weighted at 250%
    - The calculation is adjusted for phase ins of the new Capital Rules through 2018