Interagency Minority Depository Institutions National Conference

Minority Depository Institutions: A Bridge to Community Stabilization

Remarks at the PLENARY SESSION: REGULATORY OVERVIEW

Discussion of primary agency concerns relative to the banking industry

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Good Afternoon.

It is a pleasure to be here. The Federal Reserve is committed to fostering the strength and vitality of the nation's minority banks, which play a key role in providing credit to small businesses and consumers, creating jobs, and promoting financial literacy by working closely with customers.

Over the last 18 months, the operating environment for all banks has been extremely challenging. The problems in financial markets have migrated into a more traditional credit cycle and a lengthy recession. Past periods of financial crises have shown that restoring the banking system to normal operations takes several years and recessions tend to be deeper and longer lasting when associated with financial crises.

Recent events have resulted in unprecedented Government intervention and aggressive actions by the Federal Reserve to stabilize markets and restore confidence in the financial system. The increased presence of government in financial markets has resulted in the introduction of the most sweeping proposal for reforming the financial services sector since the 1930's. Legislation is coming, but what eventually gets implemented can be affected by you, so I urge you to make your voices heard. Two other recommendations I would make to you in the current environment are to make sure you have extensive and ongoing communication with bank

supervisors and get out in front of regulations by being realistic and identifying credit problems early.

The result of the financial crisis has increased the emphasis on capital and liquidity planning. I'd like to comment specifically on these two areas. During the period leading up to the financial crisis there was a view that excess liquidity was prevalent in the marketplace. However, the poor functioning of financial markets and failure of some high profile firms revealed excessive leverage and weaknesses in liquidity management. Consequently, as a result of these events credit markets seized up and there is a renewed supervisory focus on liquidity and funds management at banks of all sizes. While the impacts of liquidity risk during the crisis on large institutions has been well reported, supervisors are particularly focused on its management at regional and community banks given their growing asset quality problems, particularly commercial real estate. This focus reflects the fact that liquidity risk generally arises as a consequence of other risks. Bankers should expect examiners to place more emphasis on liquidity risk management going forward.

On July 6, interagency guidance was issued on liquidity risk management which is out for comment for 60 days. The goal of the guidance is to more clearly articulate supervisory expectations on risk management. In addition, supervisors will enhance oversight and enforcement to ensure that expectations are met by supervised institutions. The guidance not only summarizes the principles of sound liquidity risk management that the agencies issued in the past, but also addresses deficiencies which became evident as a result of recent events. The guidance re-emphasizes the importance of cash flow projections, diversified funding sources, stress testing, holding a cushion of liquid assets, and a formal well-developed contingency funding plan as primary tools for monitoring and measuring liquidity risk. The contingency plan

should cover adverse scenarios as well as normal operations and should include the Discount Window as a liquidity source. The agencies expect all financial institutions including holding companies to manage liquidity risk using processes and systems that are commensurate with the organization's complexity, risk profile, and scope of operations.

As you think about liquidity risk management, you should ensure that adequate liquidity is maintained at the parent holding company and each of its subsidiaries. This is important in light of real or potential constraints on the transfer of funds among subsidiaries and between subsidiaries and the parent holding company, including legal and regulatory restrictions.

Finally, credit problems and margin pressure may be leading some banks to yield chase, moving further out on the yield curve. With market rates low and the yield curve steep, bankers need to be careful not to set the stage for problems in the future since rates have no where to go but up. On the positive side, liquidity ratios for the banking industry improved in the first quarter as FHLB advances fell back and consumers saved more increasing core deposits. However, in aggregate banks continued to expand their reliance on brokered deposits. In summary, managing liquidity and liquidity risk are critical functions of bank management which examiners will focus on more closely going forward. Effective management of this activity will allow minority banks to promote economic growth and fulfill their missions.

Another area of focus for bank supervisors is capital adequacy and planning. In a February 2009 supervisory letter, the Federal Reserve provided direction to supervisory staff that re-emphasized the importance of capital planning and prudent dividend policies for bank holding companies and their bank subsidiaries. This guidance, which was directed to all BHCs – both large and small – reminded them to ensure that they remain sources of strength to their bank subsidiaries and to curtail dividends when their financial condition is under stress. In addition to

evaluating the appropriateness of a BHCs capital level given its overall risk profile, supervisory staff will focus on the quality of a BHCs capital and trends in its capital composition. The Board's risk based capital rules state that voting common stockholders equity should be the dominant element of Tier 1 capital and banking organizations should avoid over-reliance on non-common equity capital elements. It should be noted that in the first quarter industry capital levels improved as BHCs down-streamed proceeds from the Treasury's TARP CCP, cut dividends, and de-leveraged.

In light of the recent events, the use of stress testing has gained greater prominence as a key element of effective management which should be employed in both liquidity and capital planning at financial institutions. Stress tests do not require sophisticated models, but should be commensurate with the size, complexity, and risk profile of the institution. Forward looking stress tests can enhance liquidity and capital planning and risk management by providing an assessment of the firm's condition under severe, but plausible scenarios. You can expect examiners to inquire about this type of analysis in these two key areas.

Thank You. At this time I'll be happy to address any questions from the audience.