TEXAS BANK REPORT

Texas Department of Banking, Commissioner, Charles G. Cooper

Data as of June 30, 2012

Commissioner's Comments

The banking industry is being flooded with a variety of regulatory and economic issues keeping both regulators and bankers fully engaged. Recognizing how difficult it is to keep up with this fluid environment, it seems fitting to dedicate this edition to the matters being closely monitored by both the Department and our banks.

The latest industry hot button is Basel III and the impact these proposed capital changes could have on our banks and local economies throughout Texas. Many bankers and several federal and state regulators, including myself, oppose the approach and implementation of the capital rules. The complexity and widespread reach of this proposal merits a thorough review. I believe it is important for all bankers to be familiar with the proposal and its potential impact.

Emerging from the economic downturn, and wading through compliance issues leaves little time for the daily operations; however, they remain no less important and can lead to future problems if overlooked. For this reason we offer some insight into succession planning and risk management in the areas of lending and cyber-crime.

Continually dealing with the future and the foresight of what may be ahead is not only a banker's concern, it's an issue the Department faces as well. For several years, financial examiner turnover has been a problem. Over the last several years we have worked diligently to improve staffing tenure at all levels to allow us to offer you and the citizens of Texas the best service possible. Our efforts have paid off and examiner retention within the 5-9 and 10-14 year ranges has gradually improved.

Our bankers enjoy the working relationship with the Department, and we pride ourselves on our accessibility. We hope to continue to cultivate this relationship. If you have any questions or want to provide a comment on any of the topics included in this report, please contact us.

Charles G. Cooper
Banking Commissioner

Agencies Seek Comment on Regulatory Capital Rules

Gayla Hugghins

U.S. Basel III Capital Initiative

In early June 2012, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, published for comment three notices of proposed rulemaking (NPRs) intended to revise and replace the agencies' current capital rules. Taken together, the agencies intend that the proposals would establish an integrated regulatory capital framework that addresses shortcomings in regulatory capital requirements that became apparent during the recent financial crisis. The proposed rules would implement in the U.S. the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision (BCBS), along with changes required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The original deadline for comments regarding the proposed capital regulations was extended from mid-September to October 22, 2012.

The proposed Basel III risk-based capital weights and credit conversion factors could materially affect the relative attractiveness of different asset classes going forward. As such, if implemented as currently presented, the new rules are likely to have significant impacts on the pricing, mix, and maturity of bank assets and off-balance sheet activities.

History of the Basel Committee

The BCBS was established by a group of central-bank Governors from ten International Monetary Fund (IMF) members (Belgium, Canada, France, Italy, Japan, the Netherlands, the United Kingdom, the United States, Germany and Switzerland, known as the "Group of Ten" or "G10") at the end of 1974 in the aftermath of serious disturbances in international currency and banking markets. Over the years, the Committee was expanded to twenty-seven member countries, which are represented by their central banks and/or the bank-regulatory authorities in each country. The Committee's Secretariat is provided by the Bank for International Settlements (BIS) in Basel, Switzerland, from which the BCBS takes its name, and where nearly all the Committee's meetings take place.

The Committee does not possess any formal supranational supervisory authority, and its conclusions do not have legal force. Rather, it formulates broad supervisory standards and guidelines and recommends statements of best practice. To achieve this, the Committee has issued a long series of documents since 1975.

In 1988, the Committee decided to introduce a capital measurement system commonly referred to as the Basel Capital Accord. This system provided for the implementation of a credit risk measurement framework with a minimum risk-based capital standard of 8% by year-end 1992. In June of 1999, the Committee issued a proposal for a revised Capital Adequacy Framework. The revised framework, issued in June 2004, served as a basis for national rule-making and for banks to complete their preparations for the new framework's implementation.

Over the past few years, the Committee has moved more aggressively to promote sound supervisory standards worldwide. In response to the financial crisis of 2008, the Committee developed a reform program to address the lessons of the crisis, which delivers on the mandates for banking sector reforms established by a group of 20 Finance Ministers and Central Bank Governors from 20 major world economies at their 2009 Pittsburgh summit. Collectively, the new global standards to address both firm-specific and broader systemic risks have been referred to as "Basel III."

Basel III

"Basel III" is a comprehensive set of reform measures, developed by the BCBS to strengthen the regulation, supervision and risk management of the global banking sector. These measures aim to improve the banking sector's ability to absorb shocks arising from financial and economic stress, improve risk management and governance, and strengthen banks' transparency and disclosures.

The reforms target both bank-level and system-wide risks. The BCBS states that these two approaches to supervision are complementary, as greater resilience at the individual bank level reduces the risk of system wide shocks.

Basel III is part of the Committee's effort to enhance the banking regulatory framework. It builds on the "International Convergence of Capital Measurement and Capital Standards" document (Basel II). A summary table of the Basel III framework provides an overview of the various measures taken by the Committee.

The 2012 U.S. Proposals – Notices of Proposed Rulemaking (NPRs)

In the first capital document, referred to as the "Basel III NPR," the agencies proposed to revise their risk-based and leverage capital requirements consistent with agreements reached by the BCBS on Banking Supervision (Basel III). The Basel III NPR would apply to all insured banks and savings associations, top-tier bank holding companies domiciled in the U.S. with more than $500 million in assets, and savings and loan holding companies that are domiciled in the U.S. Provisions of this NPR would include implementation of a new Common Equity Tier 1 minimum capital requirement (CET1), a higher minimum Tier 1 capital requirement, and, for the very largest and most complex banking organizations, a sup-

plementary leverage ratio that incorporates a broader set of exposures. Additionally, consistent with Basel III, the agencies proposed to apply limits on a banking organization's capital distributions and certain discretionary bonus payments if the banking organization does not hold a specified "buffer" of common equity Tier 1 capital in addition to the minimum risk-based capital requirements. The revisions set forth in this NPR are consistent with section 171 of Dodd-Frank, which requires the agencies to establish minimum risk-based and leverage capital requirements.

The Basel III NPR also revised the agencies' Prompt Corrective Action (PCA) framework by incorporating the new regulatory capital minimums and updating the definition of tangible common equity. PCA is an enforcement framework that constrains the activities of insured deposit institutions based on their level of regulatory capital.

In the second capital document, referred to as the "Standardized Approach NPR," the agencies proposed to revise and harmonize rules for calculating risk-weighted assets to enhance credit and counterparty risk sensitivity and address weaknesses identified over recent years, including incorporating aspects of the Basel II standardized framework, and alternatives to credit ratings, consistent with section 939A of Dodd-Frank. The revisions included methods for determining risk-weighted assets for residential mortgages, securitization exposures, and counterparty credit risk. The NPR also introduced disclosure requirements that apply to U.S. banking organizations with $50 billion or more in total assets. The Standardized Approach NPR applies to the same set of institutions as the Basel III NPR.

The third capital document, referred to as the "Advanced Approaches and Market Risk NPR," generally applies to institutions with $250 billion or more in consolidated assets or $10 billion or more in foreign exposure (as reported on FFIEC 009 Country Exposure Report), and to companies with significant trading activity. The Advanced Approaches and Market Risk NPR would revise the existing advanced approaches risk-based capital rules consistent with Basel III and with other changes by the BCBS to its "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (Basel II), as revised by the BCBS between 2006 and 2009, and recent consultative papers published by the BCBS. The agencies' proposed rules would also revise the existing advanced approaches risk-based capital rules to be consistent with section 939A and section 171 of Dodd-Frank.

The Basel III NPR

The proposed changes to the federal banking agencies' current capital rules are intended to strengthen the quality and loss-absorbance safeguards provided by regulatory capital and enhance banks' abilities to continue functioning as financial intermediaries, including during periods of financial stress. Most notably, the Basel III NPR provides for a new calculation of Tier 1 Capital that is based upon CET1. CET1 includes the net unrealized gains/losses on available-for-sale (AFS) debt and equity securities, which differs from the previous treatment of gains/losses on AFS securities that were largely excluded from capital calculations. It is widely believed that the inclusion of gains/losses on securities from quarter to quarter will introduce significant volatility that has not been present before into capital calculations. Some commenters have suggested that a way to avoid the volatility of including gains/losses on AFS securities in capital would be to reclassify all of an institution's securities into Held-To-Maturity (HTM). This solution, however, could have the effect of severely limiting an institution's ability to react to unexpected liquidity demands. Other commenters have suggested that institutions shorten the duration of their current bond purchases in order to lower the volatility of price movements in their holdings. This solution, however, would likely have the effect of lowering profitability, as shorter term holdings usually carry lower yields.

In addition, the Basel III NPR contains new definitions of Tier 1 Capital, Total Capital, and the Leverage Ratio. The agencies have also added the new CET1 Risk-Based Capital ratio to their PCA guidelines, and have revised the PCA ratios upward, effective January 1, 2015. Additionally, a new category of "Tangible Equity Capital" has been added. The PCA guidelines will require that banks with less than 2% "Tangible Equity Capital" to Total Assets be designated as "Critically Undercapitalized."

Another aspect of the Basel III NPR is a required "Capital Conservation Buffer" that must be satisfied before banks can make capital distributions and certain discretionary bonus payments. The target capital levels for banks under Basel III that do not want to face limitations on capital distributions and discretionary payouts are a Tier 1 ratio of 8.5%, a Total Capital ratio of 10.5% and a CET1 ratio of 7%.

Another controversial feature of the Basel III NPR is the 10-year phase-out of capital instruments that were previously defined in some cases as Tier 1 capital instruments. Beginning in 2013, these include cumulative perpetual preferred stock and trust preferred securities (TruPS). Bank holding companies with $15 billion or more in assets must comply with a quicker three-year phase-out consistent with section 171 of Dodd-Frank or the Collins Amendment. Many institutions with less than $15 billion in assets believed that their TruPS had been "grandfathered" by the Collins Amendment, and they would be allowed to count TruPS as Tier 1 Capital until they matured or were paid-off. However, the federal banking agencies took a more conservative position. Although banking organizations with less than $15 billion in assets enjoy a longer 10-year phase-out, many were hopeful that the agencies would read the Collins Amendment exemption to permanently grandfather their trust preferred and other newly non-eligible capital instruments. That is not the case in the Basel III NPR.

The Standardized Approach NPR

With the proposed Standardized Approach NPR, the agencies intend to revise rules for calculating risk-weighted assets to enhance risk sensitivity and address weaknesses identified over recent years, including incorporating elements of the Basel II Standardized Approach. The proposed effective date is January 1, 2015, with an option for early adoption. This NPR includes changes to the general risk-based capital requirements that address the calculation of risk-weighted assets, including:

1. Changing the denominator of the risk-based capital ratios by revising the asset risk weights;

2. Revising the treatment of counterparty credit risk;

3. Replacing references to credit ratings for calculating risk-weighted assets for certain assets with alternative measures of creditworthiness, consistent with section 939A of Dodd-Frank;

4. Providing more comprehensive recognition of collateral and guarantees; and

5. Providing a more favorable capital treatment for transactions cleared through qualify-

ing central counterparties.

Some of the main effects on community banks will be:

1. 1-4 Family Residential Real Estate loans will be categorized and assigned risk-weights from 35% to 200%, based on contractual terms, loan-to-value ratios, and performance;

2. "High Volatility" Commercial Real Estate (HVCRE) loans, generally defined as all Acquisition, Development and Construction (ADC) loans, will be assigned a risk-weight of 150%;

3. Past Due Assets (loans and securities), excluding 1-4 family residential and HVCRE, will be assigned risk-weights of 150%;

4. Structured Securities will be assigned risk–weights up to 1,250%, based upon the application of three approaches, eliminating the current ratings-based approach; and

5. Equity Holdings will be assigned risk-weights from the current 0% up to 600%, based upon how the exposures are classified.

In addition, under the Standardized Approach NPR, off-balance sheet items will be assigned different treatments:

- Certain commitments will be assigned higher credit conversion factors.

- 1-4 Family Mortgage loans sold will lose the current 120-day recourse exclusion for early payment default or premium refund clauses, and will be assigned a 100% credit conversion factor, with risk-weights from 35% to 200% based on category classification and loan-to-value.

The loss of the 120-day recourse exclusion has the potential to negatively impact many banks that originate and sell mortgage loans into the secondary market by significantly increasing their capital requirements to cover loans sold to correspondents. However, there has been very little discussion in the financial press and industry trade publications about this impact.

Regulatory Capital Estimation Tool

On September 24, 2012, the agencies released a spreadsheet calculator that banking organizations can use to estimate the potential effects on their capital ratios of the agencies' Basel III and Standardized Approach NPRs. The estimation tool is designed primarily for use by smaller, non-complex banking organizations and provides a general estimate of a banking organization's leverage and risk-based capital ratios under the NPRs. Because the estimation tool was designed as a standardized mechanism for banking organizations to broadly understand the potential impact of the NPRs, it has certain inherent limitations and contains some simplifying assumptions to facilitate its widespread use. It can however be used to give a "ballpark" estimate of a bank's potential capital ratios under the proposed NPRs.

Summary

Given the broad coverage of banking activities by the Basel III and Standardized Approach NPRs, it is likely that all banks will be affected by the proposed changes, some to a greater extent than others. Regulators have said that the vast majority of banks would have met the fully phased-in requirements as of June 30, 2012. Although an analysis conducted by SNL Financial (SNL) found that most of the industry was prepared from a capital standpoint to weather the change, the study determined that institutions above $15 billion in assets seemed better equipped to achieve the capital requirements under the proposals. SNL found that 603 U.S.-based banks with less than $15 billion in assets, excluding foreign-owned entities and banks with adjusted Texas Ratios over 100%, would fall short of the minimum Basel III requirements under their conservative scenario. Under their moderate scenario 202 banks would fall short.

Given the significant impact of the changes included in the proposals, the agencies encouraged bankers to submit their comments about the NPRs. The extension of the comment period deadline appeared to be an indication that the agencies recognized the potential these proposals pose for unintended consequences, and that they may have been looking for support for making changes that lessen the impact on community banks and those with noncomplex activities.

There have been several speeches and articles in the financial press that indicate increasing concern that the Basel III Accord may breakdown, as some countries are working towards compliance, while others are not. In prepared remarks in September 2012, FDIC Board Member Thomas Hoenig said that the rules as proposed are too complex and should be replaced by simpler ones that rely primarily on a bank's ratio of tangible equity to tangible assets. He also suggested that if international regulators do not return to the drawing board, then U.S. regulators should reject Basel III standards and "go back to basics."

Greg Gonzales, Chairman of Conference of State Bank Supervisors (CSBS) and Commissioner of the Tennessee Department of Financial Institutions, issued a public statement on the federal banking agencies' proposed capital rules on October 3, 2012. The statement outlined CSBS's opposition to the proposed approach to implement the Basel III Capital Accord and to incorporate a standardized approach for risk-weighted assets. CSBS filed comment letters with the federal agencies expressing its concerns about the impact on the industry and the economy.

Clearly, the final chapter has not been written in this Basel III NPR story. There may be more proposals and changes to come before the final regulations are promulgated. But banks will need to stay abreast of the changes and accompanying commentary, and be prepared to factor in future changes in their calculations of capital adequacy until the regulations are finalized and published. Above all else, bankers should voice their concerns to federal regulators and congressional representatives on how Basel III will affect their bank and the communities it serves.

Tips to Help Make an Examination Go Smoothly:

1. When providing requested documents prior to the start of the examination, label the items using the item number on the request list as a reference.

2. Provide all the items from the request list. If there are questions about items on the list, call or email the examiner-in-charge rather than waiting until the examiners are on-site to ask about it.

3. The initial request list asks for contact information. Providing the proper contact person for the items in the request packet along with the location or phone number of the contact person is helpful when examiners need to discuss the item.

4. Provide documents in electronic format whenever possible (via CD, flash drive, or through secure email).

5. Email documents using a secure email system such as Zix. There is a link on the Department's website under the Secure Talk section: Zix email will allow up to ten files not to exceed 45MB. Multiple emails may need to be sent.

6. When providing the information on the loans selected for review, include new information that has not made it into the file, such as new financial statements. Also, if some of the loan items such as property taxes and insurance are maintained on a separate system, provide examiners with access to the system or provide copies of those items.

7. Prior to the start of the examination, update the loan files in order to reduce loan documentation exception items.

IT Security: Corporate Account Takeovers Continues with New Twists

Phillip Hinkle

Earlier this year the Texas Department of Banking issued Supervisory Memorandum (SM) 1029 which outlines minimum requirements of a risk mitigation plan for Corporate Account Takeovers (CATO). It is supported by extensive optional risk mitigation practices developed by the Texas Bankers Electronic Crimes Task Force (Task Force) in cooperation with the U.S. Secret Service. The extensive practices developed by bankers have been recognized as strong guidance to the entire banking industry and are being prepared for national distribution through the Conference of State Bank Supervisors (CSBS) and the Financial Services – Information Sharing and Analysis Center (FS-ISAC).

But unfortunately, the work does not stop there. As the SM states, the techniques of the thieves are continually evolving and therefore continued vigilance is needed.

In June 2012, McAfee and Guardian Analytics released their report titled Dissecting Operation High Roller. They reported uncovering a highly sophisticated, global financial services fraud campaign that had reached American banks. But, unlike standard CATO attacks that typically feature live (manual) interventions; they discovered at least a dozen groups using heavy automation that required no human participation. The study found 60 servers processing thousands of attempted thefts from high-value commercial accounts. The research documented attacks at every class of financial institution, debunking popular wisdom that only big banks are affected.

In September 2012, the FS-ISAC, FBI, and Internet Crime Compliance Center (IC3) released a Fraud Alert outlining a new trend in which cyber criminals compromise bank networks and obtain employee login credentials. The stolen credentials are then used to initiate unauthorized wire transfers. Essentially, the bank itself is the targeted corporation for the takeover. Further disconcerting, the Fraud Alert notes that small-to-medium sized banks or credit unions have been targeted in most of the reported incidents.

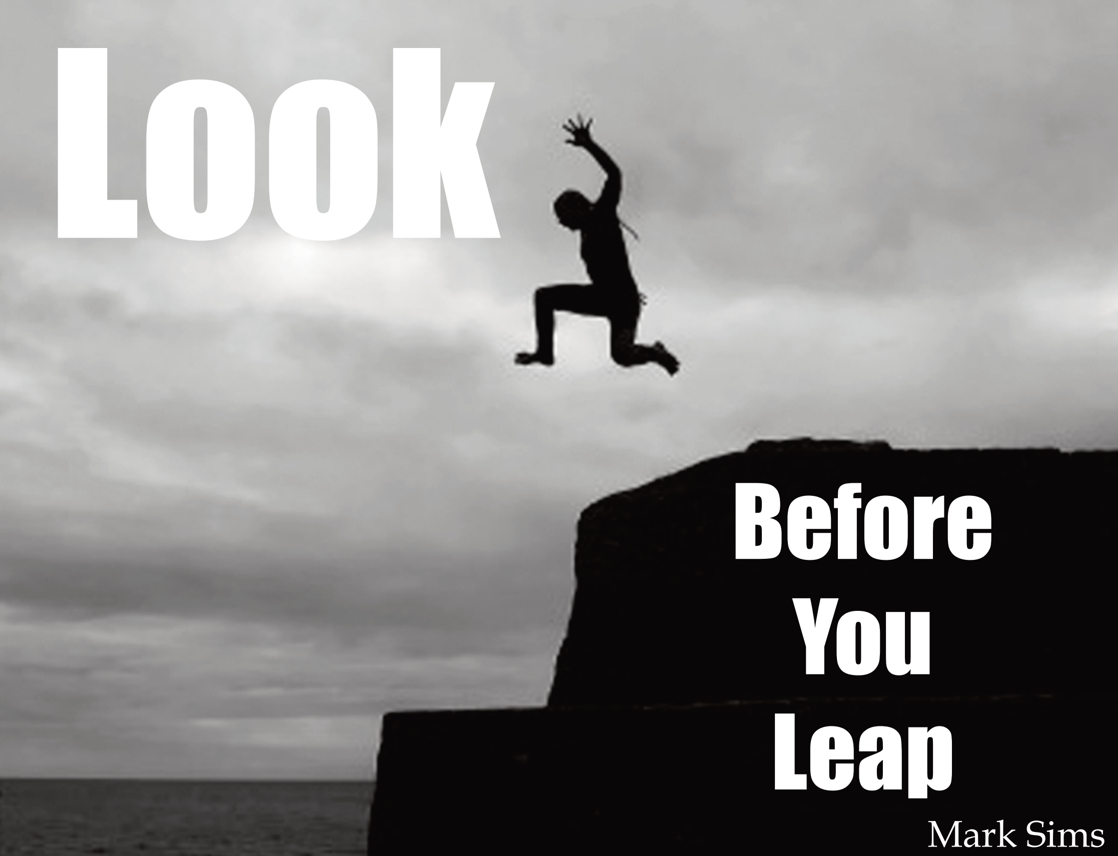
To address the reports of compromised credentials of wire transfer personnel, the Department will be meeting with the Task Force to obtain banker supported recommendations. Once these are developed, they will be shared with the industry.

What this year is showing us is that cyber thefts are not going to diminish or stay the same. As a bank manager, how comfortable are you with technology and technological threats? Human nature is to focus on what we are comfortable with. If IT Security issues are only reviewed and discussed once a year with staff and the Board, the financial institution is probably not prepared for managing the potential fraud.

The Department encourages you to develop a corporate culture of information security. Bank staff and the bank's Board should be receiving periodic briefings throughout the year regarding changing threats and mitigation strategies.

State-chartered banks and trust companies having questions regarding this topic or other IT security issues may contact Phillip Hinkle, Chief IT Security Examiner, at (817) 640-4050.

Look Before You Leap



Mark Sims

Given the highly competitive banking environment and low growth economy, bankers are looking for ways to boost the bottom line. One approach to growing earnings is to expand lending activities into new markets or business lines. In considering new opportunities, the old adage “look before you leap” makes more sense than ever. Lending in a market or product line that your institution is not experienced has obvious dangers. Sound due diligence at the onset, including appropriate investments in systems and personnel, can save grief and profits in the long run.

Leveraging off existing knowledge and expertise is a good place to start. Senior management and the Board have a strong knowledge of the economy and prominent business sectors in the bank’s local community. For example, if your goal is to diversify the loan portfolio by expanding into commercial lending, the Board and senior managers would likely have a good idea of potential new clients or existing clients that could benefit from expanded products. Consultations and networking with your customer base and community leadership could also generate ideas about new lending alternatives.

Research into the new lending source is essential. This may consist of reviewing economic and business activity reports on a new geographic region or researching a specific industry. In addition to brainstorming with banking peers or civic leaders, accessing other resources may be helpful. For example, tapping a consultant’s expertise could allow the bank to better understand the dynamics of an industry being considered for expansion.

The Board of Directors should establish and articulate the bank’s risk appetite. Expanding the loan universe, either in terms of geographic markets, new industries, or new lending types should be incorporated into strategic planning, budgeting, and capital planning and receive the Board’s approval. Capital adequacy is also a consideration. If capital ratios are on the low end of the preferred range, then a capital injection may be necessary to offset the changing risk profile. Part of articulating the risk appetite is adoption of policy guidelines for the new lending sector. Updated loan policy guidelines can establish limits on how much new credit exposure should exist in relation to capital. Given that new lending sectors are risky, conservative growth targets at inception may be appropriate, with increases occurring based on the credit experience and learning curve.

Considerations in deciding on a new lending sector should include the organization’s strengths and technical capacity. A review of staffing is a necessary prelude to a new lending program. Depending on existing staff capacity and growth plans, the bank may need to hire the expertise and staff support to successfully participate in a new lending sector. If the plan is to expand into a new geographic market, recruiting a senior lender with strong connections to the market is a sound move. If the plan is to expand into a specific industry such as energy, manufacturing, agriculture, etc., likewise recruiting a senior lender with extensive industry experience is essential. For a lending sector that is labor intensive, hiring sufficient staff and providing necessary training is also essential.

Some lending sectors require a specific infrastructure or monitoring function that may be new to the bank. For example, expanding into revolving lines of credit for working capital, collateralized by a customer’s accounts receivable and inventory necessitates ongoing monitoring in the form of field audits, reviews of aging reports and compliance with loan covenants. Expansion into interim construction lending requires frequent inspections of construction progress and reviews of draw requests. Entry into energy production lending requires analysis of engineering reports and production data. If existing credit administration staff performs these duties, they should receive the resources and training necessary to carry out this responsibility. Management has the option of outsourcing some of these functions. If so, then standard vendor management due diligence and oversight is essential. Overreliance on one vendor is discouraged. Contracting with a group of quality vendors could prevent problems due to occasional unavailability of a single vendor or belatedly discovering technical competence problems with a specific provider. The Board should at least annually review and approve the list of service providers. Federal regulatory authorities have also published extensive guidance on the management of third-party service providers, which should be reviewed.

Sound credit underwriting is a crucial element of managing the risk in new markets or industries. If the bank is successful in obtaining a customer from another lender, you need to know the complete story on the existing banking relationship. It is important to understand why another lender is willing to part with the customer you are trying so hard to acquire. As always, the character component of the "C's" of credit is paramount. Conducting due diligence on your new customer is essential to know who you are lending to. Onsite visits to meet key management and visually inspect facilities are imperative. Standard credit analysis is needed based on recent year's fiscal statements of the business under consideration in order to ensure the customer has supportive cash flow, net worth, and liquidity. However, do not neglect trend analysis over a minimum five-year period to determine patterns and tendencies, specifically earnings improvement and capital strengthening. Stick to lending basics such as obtaining personal guaranties and financial data to support the quality of guarantor support. Discipline in negotiating repayment programs and collateral margin is warranted, especially in a new and unfamiliar portfolio. Approval of policy exceptions in order to grow the new portfolio may be tempting, however exercising caution in granting policy exceptions will benefit the bank in the long run. Credit stress testing for significant customers is helpful. This can help determine what adverse event or combination of economic events or industry factors could change a good loan to a problem loan. Also, pricing for the risk in newer potentially riskier credits is merited as the bank is incurring a degree of additional risk.

As the portfolio grows, monitoring is essential. The new portfolio should be tracked to determine if asset quality anomalies appear. This could include a disproportionately high volume of past dues or losses as compared to the aggregate

loan portfolio. Rapid loan growth is also a potential red flag. Thorough management and Board reporting is a crucial part of the risk management framework. Part of monitoring is inclusion of the new portfolio in the loan review scope. Whether you maintain this function internally or contract with a third party, the bank wants loan review to opine on credit quality and policy compliance.

Part of monitoring includes concentrations of credit. The growth caused by expanding into new territories or business lines can result in increasing an existing concentration or the creation of a new one. Effective management information systems and appropriate monitoring is needed to evaluate concentration risk. The extent of reporting will vary based on the bank size and complexity. Report format alternatives include reporting of loans by industry, geography, loan-to-value exceptions, or property types. To ensure the quality and accuracy of reporting systems, periodic reviews should be performed by an independent party.

Maintaining and expanding your knowledge base is important. Initial success can lead to complacency and neglect of pending dangers. If a bubble or unsustainable growth trend is developing, customer insights can be an indication that market conditions are changing. Attention should be paid when valued and successful customers note that an area is overbuilt, that industry profit margins are contracting, or competition is intense. This feedback can motivate the bank to underwrite new loans in that industry more conservatively or be more selective in accepting new loan requests. Other sources of knowledge maintenance include participation in industry groups, review of trade journals, or attendance at seminars or webinars.

Inevitably some of the new loans will deteriorate or become non-performing. A corporate culture that values open communication will help in conducting a post mortem review to determine exactly what went wrong. The occasional mistake and lessons learned can be painful but they also provide insights to help avoid future headaches.

Expanding the loan customer base has the capacity to benefit the bottom line and increase shareholder value. Sound planning, internal controls, underwriting, and oversight are obvious and necessary components of risk management needed to better the prospects and rewards that can accompany the risk being incurred by the bank. Sticking to the basics that have served you well in your banking career is invaluable in managing the risk associated with new lending areas.

SUCCESSION Planning

Kurt Purdom & Melissa Dvoracek

Succession planning is an often overlooked issue for community bank boards, but it is a topic that is vitally important for the long term well-being of the bank and its shareholders. The board of directors has the responsibility for governance over the bank's affairs, and the development and execution of a thoughtful succession plan should also receive the board's full consideration. Between establishing and monitoring policies and procedures, keeping up with regulatory changes, and monitoring overall performance, bank directors have significant responsibilities and may not have taken the time to address succession planning. However, good succession planning can help the bank avoid future problems as experienced directors and officers either retire or simply leave the bank.

Both inside and outside directors should be taken into account when considering succession planning for directors. As a matter of practice, inside directors are those who are also officers of the bank, and outside directors are those who are not officers of the bank. This article will focus only on the issue of succession planning for outside directors.

We all know the importance of business diversity within the outside board members, and as a general rule, we find that most bank boards are well diversified when it comes to outside directors' occupations and knowledge. The directors are often attorneys, entrepreneurs, oil and real estate professionals, insurance agents, farmers and ranchers. The spectrum of knowledge adds strength to the board which in turn benefits the bank and its shareholders. An important dimension for community bank boards that is often missing is diversity in the ages of board members. Many of the directors are of similar age and experience. Just as boards seek to diversify the business backgrounds of their members, benefits can stem from age diversification as well. A board that is age diversified may be able to better relate to differing age groups of bank customers, may bring added dimensions of expertise to the board, and can allow for the transfer of customer familiarity and practical experience from one generation of board members to the next.

It may be a challenge to find suitable replacements for outside directors. In the past, outside directors were usually business owners within the community who had local ties. Being elected to the board of the local bank was often considered a status symbol. Now, it seems that people are less likely to agree to hold a position on the local bank board because of the fear of liability. In addition, increasing regulatory requirements and more complex business transactions make it difficult for even successful business people to understand the decisions that impact regulatory compliance. Finding qualified individuals within the community who understand the complex banking industry may also be a challenge.

A tool that can be used to ease board member transition is to invite individuals in the community to be advisory directors. This allows them to learn the banking industry to determine if they have time available to devote to the bank, and to see if they enjoy board service. This approach can also allow the existing board to determine if the candidate might make a good director for the institution.

Banks are reminded that confidential information may not be disclosed to an advisory director unless the board minutes reflect an appropriate business need for such disclosure and the disclosure is made pursuant to a written confidentiality agreement between the bank and the advisory director.

When searching for potential successors, it is important to remember the desired characteristics of a strong board member. Key characteristics of good directors include:

- Independence - being free of conflicts;
- Time to devote to the job - including time to gain knowledge of the industry, to prepare for board meetings and to participate in committees;
- Attention - being fully engaged and proactive as a board member;
- Independent, sound judgment - solid character with the ability to think on their own;
- Courage - having a willingness to deal with tough issues; and,
- Curiosity - possessing an intellectual curiosity about the bank, the financial services industry, and the trends impacting both.

A fully developed succession plan may take time to draft. Developing the right strategy for your institution may take multiple discussions with board members and time to seek out the right individuals as prospective board members. Start discussing succession planning and make it a priority on the board's agenda.

Then vs. Now
Five Year Look Back

Mark Sims & Adam Akins

Although the number of Texas state-chartered banks has declined in the last five years, the industry experienced steady growth over the same period. A comparison of footings from June 30, 2007, and June 30, 2012, reflects a significant increase in total assets from $86.7 billion at June 30, 2007, to $196.3 billion at June 30, 2012. The main reason for the increase is the conversion of Comerica Bank to a Texas state-charter in the fourth quarter of 2007 and five years later, the conversion of Frost Bank in June 2012. Although it was perceived that brick and mortar facilities would diminish overtime, branches have steadily increased. In June 2007, there were 1,406 branches in the state system, and by June 2012 the number grew to over 2,000 branches.

At June 30, 2007, the average Texas state-chartered bank had 25.6% of assets in securities and 58.8% of assets in total loans. The average equity capital to assets ratio was 12.4%. Fast forward to June 30, 2012, and the average balance sheet is similar. At June 30, 2012, the average Texas state-chartered bank had 27.7% of assets in securities and 56.6% in total loans. So on average, there was a slight reduction of lending activity with the proceeds invested in securities. The average equity capital to assets ratio declined to a still robust 11.4%.

Securities increased from $22.2 billion at June 30, 2007, to $54.3 billion at June 30, 2012. The growth in dollars was driven by general asset growth in the five year time period. As noted, the ratio of securities to assets increased slightly. There was more change within the composition of the average security portfolio. Mortgage-backed securities (MBS) increased from 13.4% of total assets at June 30, 2007, to 18.2% at June 30, 2012. These holdings have been predominantly issued or guaranteed by the U.S. government with minimal holdings of private label MBS. Municipal bonds as a percentage of total assets increased from 2.9% to 4.3% during the same time period.

Total loans increased from $51 billion at June 30, 2007, to $111.2 billion at June 30, 2012. As noted, the ratio of total loans to assets declined slightly. The most significant change is the reduction in real estate loans from 39.3% of total assets at June 30, 2007, to 29.9% of total assets at June 30, 2012. The largest area of reduction within real estate was diminished construction and land development lending. This factor contributed to total commercial real estate loans declining from 21.3% of total assets at June 30, 2007, to 12.6% of total assets at June 30, 2012. The reduction in commercial real estate lending was offset by an increase in commercial and industrial loans from 12.2% of total state banking assets to 20.5% in this five year time period. While the commercial and industrial loan increase is skewed by the portfolios of larger banks, the data reveals that Texas state banks have reduced exposure to more problematic lending assets in recent years.

Overall, state-chartered banks weathered the challenges of the financial crisis well. Today the improving Texas economy is allowing our bankers to improve their respective balance sheets and continue with their growth plans.

Announcements

Pursuant to SB 249 of the 82nd Legislature, one new member has been appointed by the Governor to the Finance Commission. The new member is:

Public Member
Victor E. Leal
Amarillo, Texas
Term Expires February 1, 2018

Effective	Type	Subject Matter	Applicable Entitles
10/15/12	SM - Supervisory Memorandum	SM 1008 Policy on Other Real Estate Owned	Bank
10/15/12	SM - Supervisory Memorandum	SM 1032 Policy on Other Real Estate Owned	TC

Revision of Supervisory Memorandums

Revised Supervisory Memorandum for Commercial Banks
Supervisory Memorandum 1008 (SM 1008) regarding Other Real Estate Owned (OREO) was revised as of October 15, 2012. Revisions include a clarification of appraisal requirements and disposal of OREO. The forms related to Extending the Holding Period for OREO and Holding Mineral Interests have also been updated and are included in SM 1008. To view SM 1008 and the related forms, go to the New Actions table on the Law and Guidance Manual.

New Supervisory Memorandum for Trust Companies
The Department issued a new Supervisory Memorandum regarding Other Real Estate Owned (OREO) specific to Trust Companies. Supervisory Memorandum 1032 was effective on October 15, 2012. Prior to issuing SM 1032, the policy for trust companies with OREO was included in SM 1008. To view SM 1032, go to the New Actions table on the Law and Guidance Manual.

TABLE I

Quarterly Balance Sheet and Operating Performance Ratios

for Texas State-Chartered Banks 6/30/12 Through 6/30/11

ACCOUNT DESCRIPTIONS (IN MILLIONS OF $)	6/30/12	3/31/12	12/31/11	9/30/11	6/30/11
Number of State-Chartered Banks	300	301	302	305	309
Total Assets of State-Chartered Banks	196,322	175,482	170,401	168,477	164,639
Number of Out-of-State, State-Chartered Banks Operating in Texas	26	25	25	25	21
Total Texas Assets of Out-of-State, State-Chartered Banks Operating in Texas	36,061	35,985	35,985	35,985	35,520
Subtotal	232,383	211,467	206,386	204,462	200,159
Less: Out-of-State Branch Assets/Deposits	-37,987	-37,987	-37,987	-37,987	-37,127
**Total State Banks Operating in Texas	194,396	173,480	168,399	166,475	163,032
BALANCE SHEET (Tx. State-Chartered Banks)					
Interest-Bearing Balances	12,942	12,083	10,307	12,557	10,197
Federal Funds Sold	1,229	1,523	1,492	1,601	1,348
Trading Accounts	707	575	1,176	554	442
Securities Held-To-Maturity	9,531	9,868	8,853	8,255	8,666
Securities Available-for-Sale	44,798	35,918	34,512	33,480	31,863
Total Securities	55,036	46,361	44,541	42,289	40,971
Total Loans	111,193	100,387	99,779	97,459	98,035
Total Earning Assets	180,400	160,354	156,119	153,906	150,551
Premises and Fixed Assets	3,274	2,945	2,901	2,895	2,912
Total Assets	196,322	175,481	170,390	168,477	164,639
Demand Deposits	20,255	18,617	18,067	17,399	16,601
MMDAs	81,164	67,197	64,009	60,956	57,992
Other Savings Deposits	12,762	12,193	11,576	12,417	11,961
Total Time Deposits	37,390	36,813	36,741	37,383	38,142
Brokered Deposits	1,526	1,681	1,865	2,188	2,490
Total Deposits	159,793	143,014	138,509	136,248	132,451
Federal Funds Purchased	3,841	3,002	2,882	3,037	2,971
Other Borrowed Funds	5,535	5,405	5,355	5,395	6,534
Total Liabilities	174,043	155,875	151,194	149,116	146,041
Total Equity Capital	22,279	19,606	19,196	19,360	18,598
Loan Valuation Reserves	1,725	1,637	1,650	1,670	1,811
Total Primary Capital	24,004	21,243	20,846	21,030	20,409
Past Due Loans > 90 Days	436	499	512	579	518
Total Nonaccrual Loans	1,731	1,848	1,826	1,840	2,073
Total Other Real Estate	827	855	860	926	900
Total Charge-Offs	265	122	788	582	422
Total Recoveries	72	31	155	114	89
Net Charge-Offs	193	91	633	468	333
INCOME STATEMENT					
Total Interest Income	3,401	1,548	6,148	4,599	3,146
Total Interest Expense	384	193	892	691	487
Net Interest Income	3,017	1,355	5,256	3,908	2,659
Total Noninterest Income	1,370	598	2,204	1,619	1,062
Loan Provisions	124	74	460	315	226
Salary and Employee Benefits	1,632	727	2,723	2,002	1,345
Premises and Fixed Assets Expenses (Net)	378	168	681	502	342
All Other Noninterest Expenses	950	423	1,637	1,221	848
Total Overhead Expenses	2,960	1,318	5,041	3,725	2,535
Securities Gains (Losses)	101	32	75	67	31
Net Extraordinary Items	0	0	4	4	0
Net Income	1,068	454	1,562	1,202	755
Cash Dividends	557	173	767	494	307
RATIO ANALYSIS					
Loan/Deposit	69.59%	70.19%	72.04%	71.53%	74.02%
Securities/Total Assets	28.03%	26.42%	26.14%	25.10%	24.89%
Total Loans/Total Assets	56.64%	57.21%	58.56%	57.85%	59.55%
Loan Provisions/Total Loans	0.22%	0.29%	0.46%	0.42%	0.46%
LVR/Total Loans	1.55%	1.63%	1.65%	1.71%	1.85%
Net Charge-Offs/Total Loans	0.17%	0.09%	0.63%	0.48%	0.34%
Nonperforming+ORE/Total Assets	1.53%	1.82%	1.88%	1.99%	2.12%
Nonperforming+ORE/Primary Capital	12.47%	15.07%	15.34%	15.91%	17.11%
Net Interest Margin	3.34%	3.38%	3.37%	3.30%	3.53%
Gross Yield	4.86%	4.89%	4.90%	4.80%	5.11%
Return on Assets	1.09%	1.03%	0.92%	0.93%	0.92%
Return on Equity	9.59%	9.26%	8.14%	8.07%	8.12%
Overhead Exp/TA	3.02%	3.00%	2.96%	2.87%	3.08%
Equity/Total Assets	11.35%	11.17%	11.27%	11.49%	11.30%
Primary Capital/Total Assets+LVR	12.12%	11.99%	12.12%	12.36%	12.26%

*Unrealized gains/losses are already included in equity capital figures.

**Total State Banks Operating in Texas includes branches of out-of-state, state-chartered banks.

Data was derived from the FDIC website.

Financial data does not include one state-chartered bank that has fiduciary activities only and does not have the power to accept or pay deposits.

TABLE II

COMPARATIVE STATEMENT OF CONDITION

COMMERCIAL BANKS DOMICILED IN TEXAS

JUNE 30, 2012 AND JUNE 30, 2011

ACCOUNT DESCRIPTIONS (In Millions of $)	6/30/2012 STATE CHARTERED		6/30/2012 NATIONAL CHARTERED		6/30/2012 ALL BANKS		6/30/2011 ALL BANKS	
Number of banks	300	% TA	244	% TA	544	% TA	559	% TA
BALANCE SHEET								
Interest-Bearing Balances	12,942	6.6%	9,399	6.6%	22,341	6.6%	20,307	6.7%
Federal Funds Sold	1,229	0.6%	5,780	4.1%	7,009	2.1%	2,618	0.9%
Trading Accounts	707	0.4%	44	0.0%	751	0.2%	553	0.2%
Securities Held-To-Maturity	9,531	4.9%	2,657	1.9%	12,188	3.6%	10,751	3.5%
Securities Available-For-Sale	44,798	22.8%	21,255	15.0%	66,053	19.5%	56,948	18.7%
Total Securities	55,036	28.0%	23,956	16.9%	78,992	23.3%	68,252	22.4%
Total Loans	111,193	56.6%	94,778	66.7%	205,971	60.9%	189,103	61.9%
Total Earning Assets	180,400	91.9%	133,913	94.2%	314,313	92.9%	280,280	91.8%
Premises & Equipment	3,274	1.7%	1,971	1.4%	5,245	1.5%	5,138	1.7%
TOTAL ASSETS	196,322	100.0%	142,136	100.0%	338,458	100.0%	305,255	100.0%
Demand Deposits	20,255	10.3%	13,306	9.4%	33,561	9.9%	29,443	9.6%
MMDAs	81,164	41.3%	42,837	30.1%	124,001	36.6%	106,879	35.0%
Other Savings Deposits	12,762	6.5%	32,206	22.7%	44,968	13.3%	30,186	9.9%
Total Time Deposits	37,390	19.0%	23,792	16.7%	61,182	18.1%	64,813	21.2%
Brokered Deposits	1,526	0.8%	2,515	1.8%	4,041	1.2%	5,228	1.7%
Total Deposits	159,793	81.4%	117,541	82.7%	277,334	81.9%	245,229	80.3%
Fed Funds Purchased	3,841	2.0%	1,626	1.1%	5,467	1.6%	8,944	2.9%
Other Borrowed Funds	5,535	2.8%	5,354	3.8%	10,889	3.2%	10,474	3.4%
TOTAL LIABILITIES	174,043	88.7%	126,449	89.0%	300,492	88.8%	269,852	88.4%
Equity Capital	22,279	11.3%	15,686	11.0%	37,965	11.2%	35,403	11.6%
Allowance for Loan/Lease Losses	1,725	0.9%	1,827	1.3%	3,552	1.0%	3,963	1.3%
Total Primary Capital	24,004	12.2%	17,513	12.3%	41,517	12.3%	39,366	12.9%
Past due >90 Days	436		419		855		851	
Nonaccrual	1,731		1,678		3,409		4,425	
Total Other Real Estate	827		714		1,541		1,583	
Total Charge-Offs	265		295		560		940	
Total Recoveries	72		44		116		204	
INCOME STATEMENT	Y-T-D		Y-T-D		Y-T-D		Y-T-D	
Total Interest Income	4,599	100.0%	2,725	100.0%	7,324	100.0%	6,166	100.0%
Total Interest Expense	691	15.0%	254	9.3%	945	12.9%	826	13.4%
Net Interest Income	3,908	85.0%	2,471	90.7%	6,379	87.1%	5,340	86.6%
Total Noninterest Income	1,619	35.2%	760	27.9%	2,379	32.5%	1,865	30.2%
Loan Provisions	315	6.8%	199	7.3%	514	7.0%	523	8.5%
Salary & Employee Benefits	2,002	43.5%	927	34.0%	2,929	40.0%	2,342	38.0%
Premises & Fixed Assets (Net)	502	10.9%	235	8.6%	737	10.1%	606	9.8%
All Other Noninterest Expenses	1,221	26.5%	1,815	66.6%	3,036	41.5%	1,555	25.2%
Total Overhead Expenses	3,725	81.0%	2,977	109.2%	6,702	91.5%	4,503	73.0%
Securities Gains(losses)	67	1.5%	32	1.2%	99	1.4%	36	0.6%
Net Extraordinary Items	4	0.1%	0	0.0%	4	0.1%	0	0.0%
NET INCOME	1,195	26.0%	921	33.8%	2,116	28.9%	1,663	27.0%
Cash Dividends	494		515		1,009		1,024	
Average ROA	1.22%		1.30%		1.25%		1.09%	
Average ROE	10.73%		11.74%		11.15%		9.39%	
Average TA ($ Millions)	654		583		622		546	
Average Leverage	11.35%		11.04%		11.22%		11.60%	
Dividends/Net Income	41.34%		55.92%		47.68%		61.58%	

*Unrealized gains/losses are already included in equity capital figures.

TABLE INCLUDES ONLY BANKS DOMICILED IN TEXAS. BRANCHES OF OUT-OF-STATE BANKS ARE NOT INCLUDED.

Data was derived from the FDIC website.

Financial data does not include one state-chartered bank that has fiduciary activities only and does not have the power to accept or pay deposits.