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VIEW FROM THE DISTRICT *A Fourth District Perspective — Cleveland*

Back to the Future: Personal Reflections on the Evolution of Community Bank Supervision

by Stephen Jenkins, Senior Vice President, Supervision & Regulation, Federal Reserve Bank of Cleveland

In many aspects, how we view our role in an organization often determines how we approach our activities and responsibilities. And as with most things, it's a good practice to take a step back periodically and assess our role and the manner in which we approach our responsibilities. This practice helps ensure that we not only evolve relative to the environment

around us, but that we grow in a direction that contributes to our success in fulfilling those responsibilities.



Stephen Jenkins

Such is the case in our professional roles. For me, that role is as a supervisor of banking organizations in the Fourth Federal Reserve District. When I take a step back and assess my current role, I can't help but recall the start of my career 32 years ago and all the changes that have taken place in both the banking industry and in the bank supervision profession.

One of my earliest and most poignant professional recollections relates to my first bank examination assignment. In preparation for this assignment, I was forewarned by colleagues of the reaction I would likely receive from the bank employees at the start of the examination. This was back in

the days when bank examinations were conducted mostly on a surprise basis, and bank examiners descended upon banks so that the bank's records could be appropriately accessed. My directive, at the time, was to travel to the town in which the bank was located, check into the designated hotel (usually the only one in the town), and wait before going to the bank and entering the building on the cue of our lead examiner. Imagine my surprise when I arrived at the hotel and saw the hotel's marquee, which read, "Welcome Bank Examiners."

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Navigating the Great Deposit Migration Through Interest Rate Risk Modeling

by Ryan Bolig, Senior Analyst, Federal Reserve Bank of Philadelphia; Susan Maxey, Surveillance Manager, Federal Reserve Bank of Richmond; and Donna Thompson, Capital Markets Specialist, Federal Reserve Bank of Richmond

Through the wake of the financial crisis and ensuing post-recession period, deposits at community banks grew significantly, strongly weighted in nonmaturity deposits (NMDs). While increased volumes of NMDs offer low funding costs and additional liquidity, new challenges loom as interest rates begin to inch upward from historical lows.

How will rising interest rates affect funding profiles? Will changing deposit compositions adversely affect profitability? What impact will increasing rates have on interest rate risk (IRR)?

Banks commonly use IRR modeling to help answer these questions. Model results help inform management's tough decisions; however, as mentioned in a previous *Community Banking Connections* article on IRR measurement, inaccurate data inputs or model assumptions, especially those surrounding deposits, can produce unreliable model output that may result in poor decision-making.¹ This article expands on a

¹ See Emily Greenwald and Doug Gray, "Essentials of Interest Rate Risk Measurement," *Community Banking Connections*, Third Quarter 2013, available at www.cbfrs.org/articles/2013/Q3/Essentials-of-Effective-Interest-Rate-Risk-Measurement.

series of IRR articles in previous issues of *Community Banking Connections*² to shed light on some common characteristics of current deposit bases that can affect the reliability of IRR modeling results and, subsequently, management's risk mitigation strategies.

The Importance of Understanding a Deposit Base

Understanding the characteristics of a bank's deposit base is crucial to determining how rate changes may affect the bank's profitability, liquidity, and exposure to interest rate changes. Consider the current postcrisis environment, which

² Three previous issues of *Community Banking Connections* included articles on IRR. The first article, "Interest Rate Risk Management at Community Banks," provided an overview of key elements of an IRR management program; the second, "Effective Asset/Liability Management: A View from the Top," focused specifically on directors' and senior managers' responsibilities, such as implementing sound policies and IRR exposure limits; and the third, "Essentials of Effective Interest Rate Risk Measurement," emphasized risk measurement issues. These articles are available at www.cbfrs.org/articles/2012/Q3/interest-rate-risk-management, www.cbfrs.org/articles/2013/Q1/Effective-Asset-Liability-Management, and www.cbfrs.org/articles/2013/Q3/Essentials-of-Effective-Interest-Rate-Risk-Measurement, respectively.

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is characterized by low interest rates, limited alternative investment opportunities, and general risk aversion. This atmosphere has led many consumers and businesses to hold excess cash in the form of bank deposits. In fact, between 2006 and 2013, community bank³ deposits grew by \$159 billion, or 9 percent. Concurrently, banks also witnessed a noticeable shift in deposit composition, from time deposits into nonmaturity products such as money market and savings accounts. Such rapid growth and changing compositions have led examiners to ask:

- How were these new deposits obtained? Are these new customer accounts or increased balances of established account holders? Did external factors (such as the economic environment) contribute to the deposit growth, or did internal factors (such as banks' deposit pricing being above market) bring about the change?
- Are these new deposits stable or temporary? Will they leave when higher-yielding investment opportunities arise?
- Are these new deposits more price-sensitive? Will they convert to higher-yielding accounts (such as time deposits) or leave the banking system when rates increase?

IRR models rely on assumptions based on deposit characteristics. By researching these characteristics in the context of banks' unique deposit bases and applying the knowledge gained directly to modeling inputs, banks can enhance the reliability of model outcomes. Otherwise, poorly designed models have the potential to produce misleading output and less-than-optimal decisions, perhaps impeding bank management from correctly mitigating risks.

Tips to Better Understand the Deposit Base

IRR modeling output relies heavily on two deposit assumptions:

1. Effective duration (or average life)
2. Price sensitivity (i.e., beta⁴)

³ For the purpose of this article, community banks are defined as those with total assets of \$10 billion or less.

⁴ Beta refers to the price sensitivity of deposit accounts for a given change in interest rates. For example, if rates increase by 100 basis points, a beta of 25 percent means deposit rates will increase 25 basis points.

Traditionally, NMDs are assumed to be less volatile than other funding sources. As such, many IRR models assume that NMDs exhibit longer durations or average lives and lower price sensitivities (betas) to rate changes than other funding sources. However, given that the low rate environment of the past few years has been accompanied by deposit growth and shifts in deposit mix, banks should revisit these assumptions to see if they still hold true today for their deposit bases. Management may need to alter these assumptions because recent deposit inflows may not exhibit the same stable characteristics as traditionally assumed.

“ Given that the low rate environment of the past few years has been accompanied by deposit growth and shifts in deposit mix, banks should revisit these assumptions to see if they still hold true today for their deposit bases. ”

Two strategies to assist bankers in better understanding their institutions' deposit bases include:

1. Historical trend analysis
2. Communication with large depositors

Historical trend analysis of deposit growth rates and deposit mix changes is a good place to begin when evaluating exposure to rising rates. This involves, at a minimum, assessing the current composition of deposits (NMD versus time) compared with a historical composition in order to identify the magnitude of deposit mix shift within the institution. Figure 1 (on page 12) demonstrates this analysis performed on the entire community bank population. Year-end 2013 data show that NMDs represented 69 percent of total deposits compared with a historical average of 56 percent before the recession. This shift may have resulted from consumers reacting to the prolonged low rate environment, risk aversion, or limited alternative investment opportunities. Regardless of the drivers of the deposit shift, when interest rates rise, bank management should consider the extent to which deposit levels and composition may revert closer to historical norms.

The figure uses a 10-year precession average as the basis for

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Successfully Managing Agricultural Credit Risk Regardless of Agricultural Market Conditions

by Nicholas Hatz, Assistant Vice President, Federal Reserve Bank of Kansas City—Omaha Branch, and Sandra Schumacher, Supervisory Examiner and Relationship Manager, Federal Reserve Bank of Minneapolis—Helena Branch

The roughly 1,500 agricultural banks¹ in the United States play a crucial role in the U.S. financial system by helping meet rural producers' credit needs (Figure 1). Asset size comparisons with larger financial institutions understate agricultural banks' important contributions to both their regional economies and to the broader national economy. Market conditions in recent years, including volatile commodity prices, escalated farmland values in certain regions of the country, and rising farm production costs, have elevated the risks in agricultural lending, so much so that the Federal Reserve Board issued supervisory guidance in October 2011 on supervisory expectations for managing agricultural credit risk.²

This article provides a historical perspective on agriculture bank failures, discusses lessons learned about the increased risk in agricultural lending, and reviews aspects of the supervisory guidance on effective risk management policies. Since the Federal Reserve System supervises a large number of agricultural banks, its examiners have the opportunity to observe a wide range of risk management practices. Several proven risk management practices and

¹ Agricultural banks are defined as banks in which farm production and farm real estate loans equal 25 percent or more of total loans.

² See Supervision and Regulation letter 11-14, "Supervisory Expectations for Risk Management of Agricultural Credit Risk," available at www.federalreserve.gov/bankinforeg/srletters/sr1114.htm.

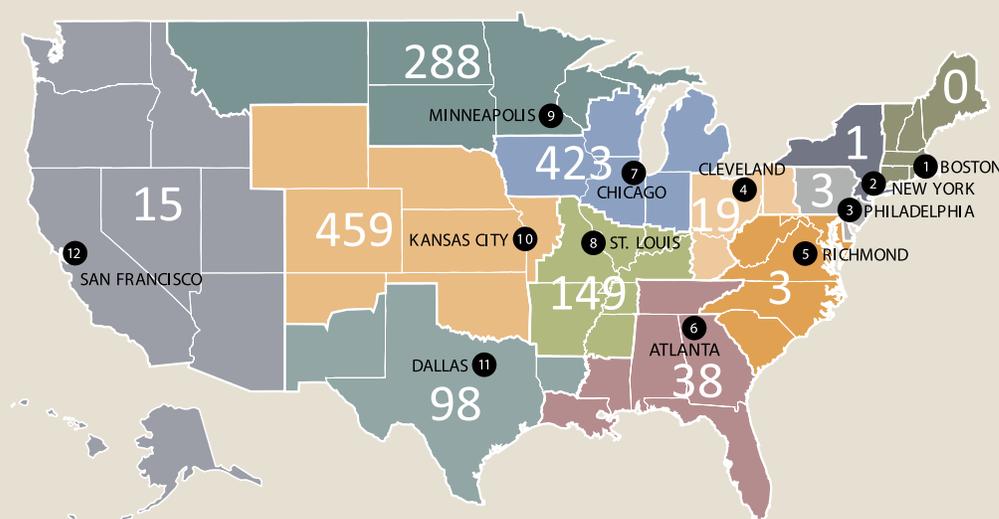
some common mistakes observed during the examinations of these banks are also discussed. This analysis, however, is not all-inclusive.

Lessons Learned from a Past Farm Crisis and Common Mistakes

Agricultural markets deteriorated severely in the 1980s, affecting many agricultural banks. Although a significant number of agriculture banks failed in the 1980s, most survived.³ Those banks that weathered the crisis were characterized as having more conservative and consistent lending strategies, stronger risk management practices, and more formalized capital and strategic planning processes. In fact, the boards of the surviving banks had generally

³ See Federal Deposit Insurance Corporation, "History of the Eighties — Lessons for the Future," available at www.fdic.gov/bank/historical/history/.

Figure 1: Agricultural Banks by Federal Reserve District



Source: Reports of Condition and Income, December 31, 2014

implemented strong risk management frameworks well in advance of adverse global market dynamics. Agricultural bank failures in the 1980s were largely a result of poor lending practices, including incomplete financial and cash flow analysis, overreliance on collateral values, poorly developed lending policies and procedures, poor documentation, and aggressive marketing to customers — with little concern for cash flow. Moreover, many borrowers were accustomed to obtaining credit with minimal financial documentation based on the anticipation that market prices and asset values would only continue to rise. Overall, one of the broad lessons learned from the 1980s farm crisis was that conservative and consistently applied risk management systems employed during both good and bad times enabled most agricultural banks to withstand even the most severe agricultural market downturns.

In looking back at the 1980s and the more recent financial crisis, it is apparent that several common factors contributed to the rise in problem banks. Among those factors were weak risk management practices and ineffective risk controls. Policies or procedures that described the bank’s risk tolerance and provided the parameters for managing those risks were often lacking. There was often a slow response to identifying and downgrading problem loans because lending policies and risk management procedures were outdated, ineffective, or nonexistent. Inadequate training of less-experienced lenders often led to poor loan underwriting, loan structuring, and credit analysis.

With rapidly increasing real estate prices, many agricultural banks relied too heavily on collateral and misjudged farmland values. When conditions worsened, borrower equity positions and, ultimately, the value of collateral available to protect the bank against loss decreased significantly. Examiners often noted that credit decisions were based on collateral values instead of borrowers’ debt service capacity. Weak underwriting can lead to problem loans and loan losses. At many failed banks, competitive pressures led to insufficient pricing for risk and relaxed underwriting standards. Loans were structured primarily to maintain business relationships and were based on management’s previous experience with borrowers rather than on information in financial statements. Cash flow, revenue, and balance sheet forecasts were often unsubstantiated. Lending decisions based on insufficient credit analysis resulted in banks not understanding their borrowers’ full financial condition. When market conditions deteriorated, borrowers were exposed to rising input costs and unstable

prices, and the banks had no forewarning that the borrowers were facing debt repayment problems. The proper balance between managing credit risk and supporting a customer’s needs is critical. A mismatch in amortization periods may strain cash flow and repayment ability, forcing the borrower to become noncompliant with the terms of the loan.

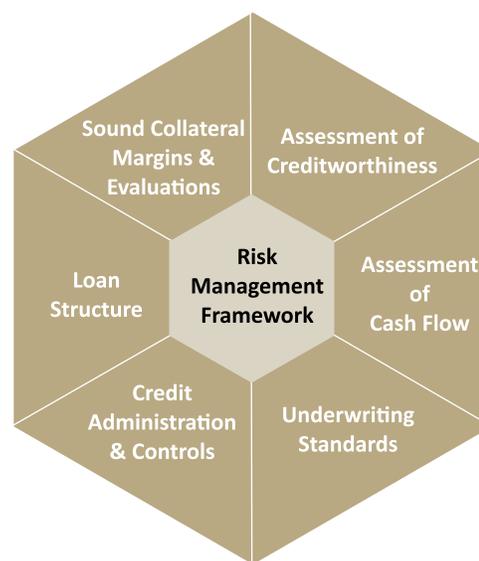
Supervisory Expectations for Effective Risk Management Practices

As outlined in Supervision and Regulation (SR) letter 11-14, a bank’s risk management program should be commensurate with the size and complexity of the bank’s exposure to the agricultural sector. As illustrated in Figure 2, SR letter 11-14 outlines six key risk management practices: assessment of creditworthiness, assessment of cash flow, underwriting standards, credit administration and controls, loan structure, and sound collateral margins and evaluations. Managing risk in these areas does not necessarily involve avoiding the risk; rather, it involves employing a consistent application of practices proven to control risk effectively within a wide range of outcomes.

A sound risk management program includes a board of directors and management team that understand current issues, trends, and overall conditions in agricultural markets. Factors

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Figure 2: Loan-Level Risk Management Requires a Multifaceted Approach



Source: SR letter 11-14, “Supervisory Expectations for Risk Management of Agricultural Credit Risk,” available at www.federalreserve.gov/bankinforeg/srletters/sr1114.htm

Development and Maintenance of an Effective Loan Policy: Part 2*

by James L. Adams, Supervising Examiner, Federal Reserve Bank of Philadelphia

This article explores *how* lending activities can be administered and controlled through appropriate and sound underwriting criteria and practices that are governed by a sound loan policy.¹ A loan policy must establish who is responsible for ensuring that the underwriting criteria (financial capacity, collateral, pricing, and terms) are appropriately structured, analyzed, and monitored. This article also touches upon the incorporation of documentation requirements and the ongoing maintenance of the credit files.

Underwriting Criteria

A loan policy must address key credit decision criteria and underwriting factors such as the purpose of the loan, required financial information, collateral, risk ratings (borrower and facility), pricing, and policy exceptions. It may include metrics that make a particular borrower, industry, or loan type acceptable; for example, the policy may note debt-to-income or specific debt service coverage (DSC) ratios, interest coverage ratios, loan-to-value requirements, or appropriate amortization periods. The policy should also address postorigination activities, such as ongoing monitoring and credit administration, including postorigination monitoring of loan covenants, obtaining financial information, and assessing the borrower's ongoing

ability to service the debt and ultimately repay the loan.

In its simplest form, the underwriting criteria and loan approval process will drive the bank's assessment and determination of a borrower's creditworthiness. When underwriting criteria are strong, the loan portfolio should perform better and credit losses should be minimized. It is not uncommon, especially in larger or more complex banks, to have separate policies, guidelines, and documentation requirements that correspond to different loan types (such as commercial real estate, land acquisition and development, residential tract development, asset-based loans, and commercial and industrial).

Smaller banks or banks offering fewer loan products may wish to include key type-specific underwriting criteria or standards within the general loan policy. No matter where policy underwriting criteria are included, the analysis of any borrowing request should address the basics of extending credit, including character (integrity), capacity (sufficient cash flow to service the obligation), capital (net worth), collateral (assets to secure the debt), and conditions (borrower and the overall economy).

Financial Information

The decision to lend should be based on a borrower's ability to repay an obligation. Obtaining and reviewing loan applications along with the appropriate borrower information, both financial and collateral-related, are a vital part of determining creditworthiness. For lenders to appropriately analyze borrower information and support the loan approval, the information must be accurate and obtained in a timely manner.

The loan policy must establish what financial information is required from a borrower and/or any guarantors both during the application process and while the credit remains outstanding. The frequency (monthly, quarterly, or annually) with which the information will be collected must be established, and the personnel responsible for obtaining the information should be identified.

The information required to make a sound lending deci-

* This article is the second of a three-part series. The first article, which is titled "Development and Maintenance of an Effective Loan Policy: Part 1," appeared in the Third/Fourth Quarter 2014 issue of *Community Banking Connections* and is available at www.cbfrs.org/articles/2014/q3-q4/development-and-maintenance-of-an-effective-loan-policy. The article discussed why it is important for a loan policy to define *what* is permissible and *who* has responsibility for ensuring lending activities are conducted in a safe and sound manner. The article covered loan policy development, policy objectives, permissible and impermissible loans, participations, portfolio mix and limits, lending department structure, and lending authority. It also discussed how each of these policy elements can vary depending on the activities and mission of a banking organization.

The final article in the series, which will appear in a future issue, will discuss several aspects of ongoing credit monitoring and credit file maintenance that need to be included in the loan policy. It will also address management information systems and reporting, loan review, loan workout, and the allowance for loan and lease losses.

¹ See Board of Governors of the Federal Reserve System, *Commercial Bank Examination Manual (CBEM)*, section 2040.1, "Loan Portfolio Management," available at www.federalreserve.gov/boarddocs/supmanual/cbem/2000.pdf.

sion will be dependent upon what type of credit extension is requested and who the borrowing entity is (for example, a corporation or an individual). A corporate borrower will typically be required to supply more information than an individual borrower applying for a personal loan. Key sources of financial information for either party include tax returns, financial statements, and/or cash flow statements. For corporate borrowers, financial documents should typically be prepared by an accountant. For individual borrowers, personal financial statements should be as complete and thorough as possible. The bank may also require additional or more detailed information to assess the borrower's financial condition. Any additional or special reporting requirements should also be articulated in the loan policy. The policy should specifically address the frequency of obtaining and refreshing borrower credit reports from credit reporting agencies. The loan policy should also outline what type of financial information is required for each type of borrower and extension of credit.

Collateral

When extending credit on a secured basis, lenders need to ensure that appropriate collateral valuations are obtained. When collateral is taken to enhance a credit and/or secure the ultimate repayment source of a loan, lenders must ensure that an appropriate lien is filed (perfected) and that the value of the collateral is sufficient to cover the outstanding balance of the loan. Collateral valuation is required at origination and should be repeated on an ongoing basis to ensure that the assets maintain their value. Appropriately trained staff must be available to perform ongoing collateral monitoring. The loan policy should discuss the types of collateral that are acceptable and unacceptable for each loan type. The policy should also discuss documentation requirements for various types of collateral that may support the lender's ability to exercise perfected liens.

Real Estate Collateral

A common form of collateral for many loans is some form of real estate. There are federal regulations and specific supervisory guidance that set standards for real estate lending and the valuation of real estate collateral.² The most important element of managing real estate collateral is obtaining a credible appraisal of the underlying property. The Federal Reserve's

² The Federal Reserve Board's real estate appraisal standards are found in Regulation H, subpart E, 12 CFR 208.50–51 for state member banks. For bank holding companies, the appraisal standards can be found in Regulation Y, subpart G, 12 CFR 225.61–67.

appraisal regulation requires institutions to obtain an appraisal for federally related transactions in excess of \$250,000.³ An evaluation is allowed for transactions of less than \$250,000. The regulation further establishes when appraisals are required, gives minimum standards for acceptable appraisals, and outlines the requirements for appraiser independence. Management must ensure that the regulatory requirements for real estate lending and appraisals are incorporated into their banks' lending policies. Regulatory agencies have also provided comprehensive supervisory guidance with additional detail for managing real estate collateral. The "Interagency Appraisal and Evaluation Guidelines" were issued in December 2010 to assist institutions in establishing safe and sound appraisal programs.⁴

Other Collateral Types

Other common types of collateral that often secure borrowings include accounts receivable, inventory, equipment, and investment securities. In some cases, the loan policy may allow the approval of less-common collateral such as specialty vehicles, boats, or precious metals. Regardless of the type of collateral, the loan policy should outline acceptable procedures for valuing and monitoring the collateral. It should also require that the valuations be performed by individuals with the appropriate skill sets and credentials. As with all collateralized financing, the underlying collateral value serves as the basis for determining how much money should be advanced; therefore, the controls over the preservation and maintenance of the collateral should be outlined within the policy. Lenders should determine the collateral value at the time the loan is originated and then perform periodic inspections to determine

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³ The Interagency Appraisal and Evaluation Guidelines were published on December 2, 2010, and explain real estate transactions that require appraisals and/or evaluations. The guidance provides federally regulated institutions' and examiners' clarification on the agencies' expectations for prudent appraisal and evaluation policies, procedures, and practices.

Appraisal — As defined in the agencies' appraisal regulations, a written statement independently and impartially prepared by a qualified appraiser (state licensed or certified) setting forth an opinion as to the market value of an adequately described property as of a specific date(s), supported by the presentation and analysis of relevant market information.

Evaluation — A valuation permitted by the agencies' appraisal regulations for transactions that qualify for the appraisal threshold exemption, business loan exemption, or subsequent transaction exemption.

⁴ See Supervision and Regulation letter 10-16, "Interagency Appraisal and Evaluation Guidelines," available at www.federalreserve.gov/boarddocs/srletters/2010/sr1016.htm.

Back to the Future: Personal Reflections on the Evolution of Community Bank Supervision *continued from page 1*

Of course, the hotel manager had all the best intentions. But an unintended consequence of this warm hospitality was informing the town — and therefore, the bank — of our impending arrival. As it turns out, the surprise was on the bank examiners, and not on the bank!

Needless to say, these days, surprise bank examinations are not only impractical but also unnecessary. Those examinations were viewed as appropriate when banking was much simpler, and the risks of loss to the bank were mostly related to the cash in the teller drawers and the thickness of the walls of the vault (which, yes, we actually measured as part of a bank examination!). Asset verification was the primary purpose of the examination. As a result, bank examinations were also much simpler and much narrower in scope than they are today. The examiners assessed the condition of that specific bank at that particular point in time, and the examination was completed. If the bank was in reasonably sound condition, the bankers would not hear from the examiner again until the next “surprise” examination, likely in about 12 months.

Technology and Banking Crises: Drivers of Change in Examinations

The bank examiner role was narrowly viewed, and, consequently, the manner in which that responsibility was fulfilled remained unchanged through the mid-1980s. It was around this time that the use of technology in banking became widespread and that the pace of change in the banking industry accelerated significantly. In addition, it was during this period when two significant events — the savings and loan crisis, which originated, in part, here in Ohio,¹ and the failure of Continental Illinois, which for many years was the largest bank failure in U.S. history — rocked the banking industry and, together with the accelerated pace of change in banking, highlighted the inadequacies of “point-in-time” examinations. To effectively respond to these developments in the banking environment, examiners reassessed our approach to evaluating the condition of banks. Rather than relying on just the point-in-time examinations, examiners turned to

technology to aid in monitoring the condition of banks in periods between examinations. Expanded regulatory reports submitted by banks were used as the basis of offsite surveillance so that the financial condition of any particular bank could be determined absent an onsite examination. With the greater use of ongoing monitoring, bank examiners became “bank supervisors” who both examined banks on a point-in-time basis and monitored them on an ongoing basis.

The Role of Regulatory Changes

Beyond technology, much of the increased pace of change in the 1980s and 1990s was fueled by changes in regulations. The elimination of parts of the Federal Reserve Board’s former Regulation Q removed limits on interest rates during the 1980s, which allowed for greater flexibility in product pricing for banks. However, this also increased the complexity of banking. The Riegle–Neal Interstate Banking and Branch-

““ The elimination of parts of the Federal Reserve Board’s former Regulation Q removed limits on interest rates during the 1980s, which allowed for greater flexibility in product pricing for banks. ””

ing Efficiency Act of 1994 relaxed restrictions on interstate banking and branching, resulting in an increase in the numbers of mergers and altering the competitive landscape. Subsequently, the passage of the Gramm–Leach–Bliley Act in 1999 provided even greater flexibility for banks to engage in a wider range of financial activities, such as limited investment and insurance activities. This regulatory change also had an effect on compliance with consumer regulations, as it related to the sale of mutual funds and other investment products by banks. Furthermore, during this period, there was other significant legislation, including the Financial In-

¹ In March 1985, the imminent failure of Home State Savings Bank and related bank runs resulted in the closure of all savings and loans in Ohio. Only those that qualified for federal deposit insurance were allowed to reopen.

stitutions Reform, Recovery, and Enforcement Act (FIRREA) in 1989, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, and the Sarbanes–Oxley Act of 2002, all of which resulted in additional regulatory requirements for banks.

The primary effects on banks from the regulatory changes were twofold. First, banks began to engage in a wider array of financial activities, many of which were not considered traditional banking activities. Second, these new opportunities in banking marked the advent of the divergence between larger, more complex banking organizations and traditional community banks.

With regard to the first effect, banks increasingly engaged in activities and offered products that represented a change from traditional banking. Many banks diversified their longstanding banking services with activities such as investments and insurance brokerage, mutual fund sales, and even merchant banking activities. This broader range of activities prompted bank supervisors, who were still responsible for assessing the condition of banks, to broaden our skills and knowledge to understand the risks associated with these new activities. While still technically chartered as banks, these entities became viewed more broadly as financial institutions to reflect the wider spectrum of products and services they offered. Correspondingly, bank supervisors progressed to become “financial institution supervisors” to reflect the more expansive activities we oversaw.

The other significant effect of the new regulations from that period was the beginning of the marked distinction between large banking organizations and smaller community banks. Because of the relaxed restriction on interstate banking and branching, banking consolidations through mergers and acquisitions increased during that period, resulting in a smaller number of banks nationwide, with a greater concentration of U.S. banking assets held at large banks. In addition, these large banks were more likely to engage in newer, more complex, and less traditional banking activities, due in part to their greater access to resources that helped design new product and service offerings and ensure compliance with the new regulations. Smaller community banks were more limited in their appetite and ability to experiment with newer financial activities.

Correspondingly, supervisors began to approach the supervision of large and small banks differently. Supervision of large banks evolved to having a team of supervisors responsible for

the ongoing monitoring and supervision of a single large bank. This team would maintain constant, close communications with management of the particular large bank and conduct reviews of various activities of the bank throughout the year. On an annual basis, these reviews would be rolled up into an overall comprehensive assessment of the condition of the entire bank.

The supervision of small banks remained generally unchanged. Periodic onsite examinations would take place and were augmented by offsite surveillance activities and periodic communications with bank management.

Value-Added Supervision

Recognizing the challenges faced by banks — particularly smaller community banks — in understanding the requirements of the wide array of new regulations, the Federal Reserve launched initiatives to promote greater outreach to bankers. A primary objective of outreach was to help bankers better understand regulations and to provide education related to various aspects of banking operations. For example, starting in the mid-1990s, the Federal Reserve developed the view that our supervision of banks and financial institutions should not focus solely on identifying deficiencies; rather, to the extent possible given our continued responsibility for assessing banks’ safety and soundness, our supervisory processes should add value to banks. In Cleveland, we referred to initiatives to implement this approach as “value-added supervision.” This initiative emphasized communications and responsiveness to bankers and promoted the principle that a more informed banking sector would result in greater compliance with banking laws and regulations and stronger financial institutions.

Banks’ management and staff were not the only focus of the outreach and education efforts. Banks’ directors were also encouraged to participate in educational outreach sessions. Tailored Director Programs were developed whereby a topic of interest was selected by a particular bank board of directors, and supervisors designed and delivered a presentation to the directors to discuss that topic. The program was particularly valuable in cases in which a directorate was considering a new strategy and wanted to learn more about a particular topic, or those in which a bank was facing a particular challenge and its board needed to develop a greater understanding of that area.

Value-added supervision represented a significant cultural shift in the supervisory process. The “gotcha” approach to examinations of community banks was replaced with a focus

on adding value to the supervisory process without sacrificing the common objective shared by both community bankers and supervisors: the safe and sound condition and long-term value of the banking organization.

This focus also paved the way for supervisors to direct resources more effectively and efficiently. Through an ongoing dialogue with bankers, the Federal Reserve adopted a risk-based approach to establishing the scope of examinations and reviews, whereby examination resources were directed to those banks and activities with the greatest risks. Conversely, areas of lower risk were reviewed less frequently or in less depth. This risk-based approach minimized the burden on bankers whose operations exhibited lower levels of risk and allowed supervisors to be more effective in directing resources to banks with higher-risk profiles.

Impact of the Recent Financial Crisis

The mutual focus on a shared objective served bankers and supervisors well for a number of years. However, the confluence of many factors — including, but not limited to, technological advances and changes in regulations — resulted in a perfect storm that became the financial crisis beginning in 2007–2008. Banks across the industry, both small and large, were adversely affected by the crisis that had its genesis in subprime mortgage loans that were originated by banks and other financial firms, sold to the secondary market, and repackaged into securities ultimately purchased by banks and other investors. This “originate-to-distribute” business model transformed and transferred the risks associated with subprime mortgage loans in a way that masked the significant exposures to loss that returned to the banking industry, albeit in another form. Though few community banks were directly involved in subprime lending, many faced losses as real estate values supporting commercial real estate loans fell. As

supervisors, we maintained our focus on individual financial institutions and paid less attention to risks that were building up across the financial system but had not yet materialized.

In retrospect, supervisors now acknowledge that the previous focus on the soundness of an individual entity such as a bank or financial institution was not enough. Attention must also be paid to risks in the broader financial system and the environment in which banks operate, as those risks have a high likelihood of adversely affecting the condition of banks of all sizes. As such, the focus on supervising individual financial institutions, while still important, is clearly too narrow. Oversight of the broader financial system, including the individual entities, is now necessary. As a result, our role as supervisors has once again evolved as we have become “financial system supervisors” with a broader perspective that considers the financial entities, instruments, and environment within our scope.

In practice, as it relates to the supervision of community banking organizations, supervisors consider a much broader range of factors in addition to the individual community bank and its overall condition. Our financial system supervisors also consider macro risks that may exist in the financial system to which community banks may be exposed. These macro risks may take the form of newer or more complex financial instruments or investments, the risks of which may not be well understood by or apparent to bankers. Supervisors are also including assessments of the macroeconomic environment in which community banks operate to ensure that banks are prepared for potential changes in the economy that may adversely impact the banks. In addition, a greater degree of information sharing and coordination occurs among supervisors of community banks nationwide so that a more holistic view is taken. This broader view allows for trends and emerging risks to be identified in a more timely way, and inter-

Evolution of a Bank Supervisor

BANK EXAMINER

- Point-in-time examination
- Focus on financial condition

BANK SUPERVISOR

- Ongoing supervision
- Focus on risks in banks

FINANCIAL INSTITUTION SUPERVISOR

- Ongoing supervision
- Focus on risks in financial institutions

FINANCIAL SYSTEM SUPERVISOR

- Ongoing supervision
- Focus on risks in financial institutions
- Focus on risks across groups of financial institutions and in the financial system
- Forward-looking risk identification

connections between banks — even smaller community banks and regional banks — can be identified. Lastly, our financial system supervisors are developing various quantitative tools and predictive analytics to aid in the early identification of risks that may originate within or outside of a community banking organization.

As the term implies, our financial system supervisors continuously monitor the condition of individual financial institutions, as well as the financial system in which these institutions operate. This dual focus helps to ensure that the risks that may affect these institutions, regardless of their origin, are identified in a more timely way so that appropriate actions may be taken to mitigate those risks.

Tiered Framework for Regulation and Supervision

As a result of the recent financial crisis, there is greater awareness of the importance of the amount of risk a particular financial institution contributes to the overall financial system. The largest and most complex banking organizations clearly pose the highest level of risk to the financial system. Regional and moderately complex banking organizations individually contribute a modest level of risk to the financial system, and smaller, noncomplex community banking organizations individually pose little risk. Given these distinctions, the Federal Reserve has increasingly adopted an approach to develop regulations and conduct supervision of banks based on such a tiered framework. This can be thought of as a risk-based approach to supervision and regulation, applied across the range of supervised financial institutions. In this framework, banking organizations that pose the highest level of risk to the financial system should be subject to the most restrictive regulations and greatest amount of supervisory scrutiny, and conversely, small, noncomplex community banking organizations that pose little risk to the financial system should be subject to the least restrictive regulations and less intensive supervisory oversight. This tiered framework allows supervisors to direct resources to banking organizations based on their risk and minimize regulatory burden on organizations whose risk profiles are lower.

Future of Supervision

To paraphrase the folksinger Bob Dylan, “There is nothing so stable as change.” As the financial system and banking industry continue to change and evolve, the role and approach of supervisors must also evolve.

Given the significance of technology in transforming both the financial industry and the supervisory process, there is no doubt that technology will continue to be a significant factor in future change. As it relates to examinations, technology will continue to reduce the burden placed on bankers by allowing for a greater portion of examinations to be conducted offsite. Document-sharing technology, data downloads, and videoconferencing all facilitate the ability to conduct reviews offsite and reduce disruptions to a bank’s operations during an examination. An added benefit is the greater efficiency of the examination, which translates into shorter durations of bank examinations and also reduces the burden on bankers.

Technology will also continue to have a significant influence on the manner in which ongoing monitoring and risk identification are conducted. Greater use of quantitative assessments is made possible by more robust software applications, and the greater availability of data combined with advances in technology facilitate the development of advanced analytic tools designed to identify emerging risks.

Notwithstanding the benefits of technology, future supervision will still require a human touch. Onsite presence of supervisors at banking organizations will continue to be valuable as a way of assessing the corporate culture and risk appetite of supervised institutions. Quantitative models are no substitute for personal dialogue and direct interaction with bankers in understanding the strategic initiatives and direction contemplated by bank leadership.

Commensurate with the continued personal interaction, I believe the value-added supervisory approach will remain an emphasis of supervisors. The objective is to ensure that the overall supervisory process adds value through ongoing communications with bankers, responsiveness to concerns and inquiries, and outreach designed to address issues before they become problems.

While the tools and scope of supervisors continue to evolve with the changing financial system, the fundamental approach and objectives remain unchanged. Our mission is to preserve the stability of our nation’s financial system, in large part through the effective supervision of the banking organizations that comprise a significant portion of that system. I believe the principles of value-added supervision and risk-based supervision will continue to guide our processes and help balance our effectiveness and efficiency in achieving this mission. ■

Navigating the Great Deposit Migration Through Interest Rate Risk Modeling continued from page 3

historical comparison. This time frame is chosen to represent a full rate cycle — identified in the figure by the starred rate peak and trough in 1995 and 2004, respectively. Using the appropriate historical comparison time period is crucial to extracting reasonable results. Historical analysis may be misleading if data represent only a short or static time horizon. This is especially true in cases such as the current prolonged rate environment in which data from the most recent few years may produce unreasonable results.

In addition to reviewing historical trend analysis, discussions with large deposit-holding customers can provide invaluable insights into deposit stability and price sensitivity. To supplement rate cycle data (or when rate cycle data are unavailable), management may find it beneficial to make inquiries as to depositors' intentions.

Incorporating the Unique Characteristics of a Bank's Deposit Base to Ensure Reliable Model Results

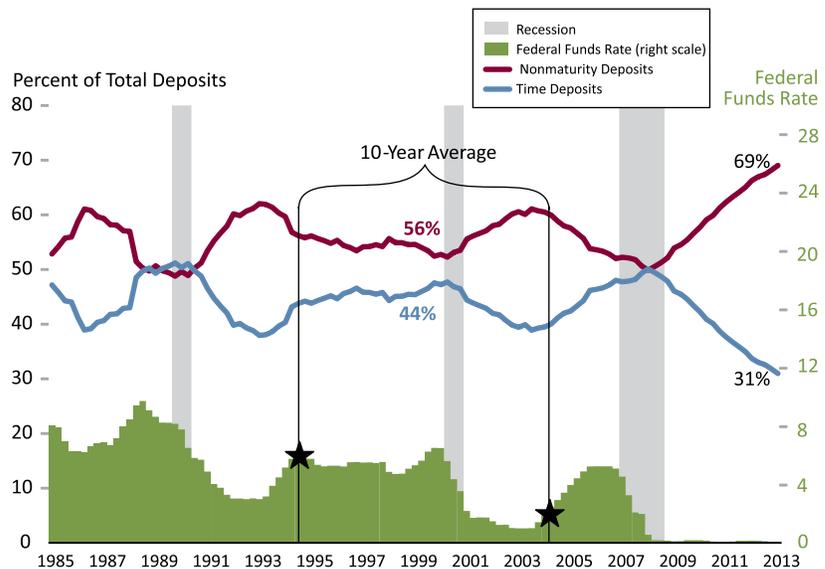
If history is any indication of future depositor behavior, as interest rates rise banks may need to manage the impact to funding costs, liquidity, and IRR. As evidenced in Figure 1, depositors have historically preferred to lock in higher yields through instruments with stated maturities, such as time deposits, during higher-rate environments. As rates rise and time deposits regain attractiveness relative to NMDs, banks may need to decide whether to:

1. compete for NMDs through competition-driven rate increases;
2. face potential composition shifts back into time deposits with higher interest costs;
3. replace currently inexpensive NMD funding with wholesale money; or

4. use a combination of these three options.

Models designed to measure economic value of equity (EVE), earnings at risk (EAR), and liquidity through various rate scenarios can provide valuable forward-looking predictions to inform this type of decision-making. As previously stated, however, model results are only as useful as the embedded assumptions. Because deposits are a key source of funding for most community banks, assumptions related to how deposits respond to changes in interest rates are important drivers of model results. As such, ensuring that these assumptions are reasonable is essential to obtaining reliable output. Absent

Figure 1: Aggregate Community Bank Deposit Mix: Nonmaturity Versus Time Deposits (Banks with Less Than \$10B in Total Assets)



	NMD Percentage	Time Deposits Percentage
December 31, 2013	69%	31%
Average 1995–2004	56%	44%

Notes: The gray areas represent recessions. Brokered deposits are excluded. The Call Report does not report the amount of brokered deposits split between time deposits or NMDs. Given that most brokered deposits are likely reported as time deposits, the entire balance of brokered deposits was subtracted from time deposits for calculation purposes.

Sources: Call Report data and historical federal funds rate data are available on the Board of Governors of the Federal Reserve System's public website at www.federalreserve.gov/releases/h15/data.htm.

rational deposit assumptions, model results may lead management to decisions that could inadvertently worsen the bank's exposure to interest rate changes, thus affecting future profitability and liquidity positions.

Projecting EVE and EAR

Given the heightened level of NMDs in community banks today, it is important that banks apply appropriate effective durations (or average lives) and price sensitivity assumptions (i.e., betas) in IRR modeling. Because newer segments of NMDs acquired during the financial crisis may not behave like typical core deposits, banks should exercise caution when applying behavioral modeling assumptions to this group of deposits. Traditional assumptions associated with NMDs (long average lives and lower price sensitivities) may understate the volatility of some of these newer segments of NMDs, which, in turn, may produce model results that understate the potentially negative impact rising rates could have on earnings and capital. Institutions should update their model assumptions to capture changes in funding mix to ensure any adverse impact is appropriately considered and planned for so that management can make well-informed decisions.

Projecting Liquidity Risk

Although NMDs are classified as core deposits⁵ for regulatory reporting purposes, the influx over the past few years may or may not exhibit the same stable characteristics that traditional core deposits have historically demonstrated. As such, banks should understand and use the factors driving deposit mix changes to estimate potential deposit outflows as well as the increased expense that could occur in upward rate environments. This is particularly important for contingency funding plans, where inaccurate assumptions could overstate the stability of core funding. Such overstatements can lead to unreliable cash flow models and misleading contingency funding scenarios. To mitigate this issue, bank management should reexamine deposit assumptions periodically and exercise caution when relying solely on historical information, as conditions and resulting depositor behavior may change.

Understanding and Reporting Modeling Results

As discussed previously, interest rate and liquidity risk models rely heavily on assumptions, so it is important for management to understand the impact these assumptions can have

on model results. Employing two additional strategies can help add clarity to model outcomes:

1. Simulating multiple scenarios
2. Conducting sensitivity testing

Banks are encouraged to simulate multiple IRR scenarios to better understand how model outcomes differ under various deposit assumptions. This is particularly important in today's environment given the uncertainty surrounding depositor behavior. Scenario analysis surrounding deposit mix projections is particularly important for banks that have experienced significant deposit growth or changes in their deposit composition.

Sensitivity testing can also aid in directors' and senior management's understanding of model results. Sensitivity testing quantifies the impact that key assumptions have on projected levels of earnings and capital in changing rate scenarios. This is an important risk management and measurement tool, as the results of this testing inform management about the potential exposure if actual key indicators were to differ from model assumptions.

Finally, comprehensive communication is critical to the board's and senior management's interpretation of model results. Board and senior management reporting should capture model results related to interest rates, earnings, liquidity, and capital. When appropriate, management may need to make qualitative adjustments to ensure the reasonableness of results. If this is the case, banks should ensure that the rationale for qualitative adjustments is discussed at appropriate committee meetings and is adequately documented. Key model assumptions should be periodically reviewed and discussed, approved, supported, and documented.

Conclusion

A potential change in the interest rate environment introduces challenges for community bank management, and changes to funding compositions and deposit growth over the past few years add to the complexity of these challenges. IRR modeling can provide valuable predictions to inform these decisions, but appropriate assumptions are crucial to delivering reliable model results. As management steers institutions forward, it will be important to consider the unique characteristics of each bank's deposit base in order to derive reliable model results that foster sound decision-making. ■

⁵ Core deposits are the sum of demand deposits, negotiable order of withdrawal, and automatic transfer service accounts; money market deposit and other savings accounts; and time deposits less than \$250,000. Core deposits are generally thought to be more stable sources of funding and less sensitive to interest rate changes.

Successfully Managing Agricultural Credit Risk Regardless of Agricultural Market Conditions continued from page 5

generally used to judge the strength of the farm economy, such as commodity prices, production costs, farmland values, and global markets, are illustrated in Figure 3. Accordingly, assessing emerging trends for each of these factors serves as a solid base to identify, measure, monitor, and control agricultural credit risks. Monitoring market factors and trends helps management and the board to identify sources of potential volatility and mitigate exposure to those various influences.

Assessment of Creditworthiness and Cash Flow

As outlined previously, prudent risk management practices are always relevant, regardless of agricultural market conditions. Insufficient credit analysis and inappropriate loan structure are often observed as precursors to a problem loan. In many cases, overreliance on collateral rather than cash flow as a source of repayment, generous loan terms toward

favored customers, and inadequate real estate appraisals and evaluations are common underwriting pitfalls. Credit quality should take precedence over loan portfolio growth, and a bank should not allow the desire to build revenues to compromise credit standards. Safety of principal and assurance of repayment within agreed-upon terms should be at least as important as profiting from the transaction. A bank cannot charge a high enough interest rate to compensate for a loan that cannot be collected.

Another common mistake is that cash flow, revenue, and balance sheet forecasts are too often accepted at face value based on a borrower's assurances that the numbers are conservative. Such forecasts are assumptions, and the importance of verifying the assumptions' validity cannot be overstated. Consistent application of a cash flow sensitivity analysis is useful in determining an operation's ability to withstand risk and uncertainty. Financial analysis software, which is readily available and easy to use, may help banks assess a borrower's creditworthiness and analyze cash flow. Such software may provide a more thorough analysis of a borrower's repayment capacity and his or her ability to adapt to stressed conditions. Examiners have noted that many agricultural lenders have encouraged their borrowers to use these tools to better understand their own operations and financial conditions.

Underwriting Standards

Reliance on outdated or ineffective policies and procedures could possibly expose the bank to unnecessary risk. A significant number of policy exceptions can indicate that a bank is taking on additional risks and that underwriting standards are no longer in step with the current environment. It is important for banks to adhere to strong, well-developed policies and procedures in the current lending environment, where competition for quality borrowing relationships remains intense. Loosening loan underwriting criteria based on alleged offers from competition should be avoided. While lenders often state that exceptions were granted to meet competitive pressures, frequent contraventions of board-approved policy guidelines may cause examiners to question whether such loans should have been made.

Figure 3: Four Key Metrics Used in Assessing Market Trends and Volatility



Source: SR letter 11-14, "Supervisory Expectations for Risk Management of Agricultural Credit Risk," available at www.federalreserve.gov/bankinfo/reg/srletters/sr1114.htm

A strong practice that examiners have observed during the recent upturn in land values is that many lenders have not used the current market asset valuations for land in lending decisions. Banks with strong credit risk management processes have been observed setting a dollar cap per acre, generally based on historical values, even though recent appraisals would support soaring land values. In this scenario, the borrower is required to provide upfront cash or equity and additional collateral to purchase the land and secure financing, thus creating a cushion if land values decline. By following this practice, these banks have maintained conservative underwriting standards, unlike many lenders in the early 1980s that allowed loan-to-value ratios for loans secured by farmland to exceed 80 percent based on the current, albeit inflated, market values.

Credit Administration and Controls

Clear guidelines should be in place to identify and correct problem loans. Delinquencies are often the first indication of problem loans and usually reflect deterioration in a borrower's financial condition, such as declining profits, decreasing sales, increased dependence on debt, and decreased working capital. Outdated financial statements are also an indication that the borrower may be experiencing financial problems, as the borrower may be reluctant to provide the bank with current financial information. Some aspects are out of the bank's and farmer's control, such as natural disasters (for example, flood, fire, hail, and crop or livestock disease); therefore, it is important for lenders to ensure sufficient insurance is in place to protect assets.

A bank should also have a policy that clearly indicates how carryover debt will be financed and monitored. There are no hard-and-fast rules on whether carryover debt should be adversely classified, but the decision should generally consider the borrower's overall financial condition and trends. In addition, to help identify any sudden material increase in the borrower's indebtedness or deterioration in performance, banks with strong credit risk management processes perform periodic credit bureau checks. Finally, examiners have found internal credit risk ratings to be effective when banks establish loan review programs to further assist in identifying problem loans. When examiners identify problem loans that were previously unknown to the bank, it generally reflects poorly on management's ability to identify and control credit risk.

By nature, a rural community bank's loan portfolio is often highly concentrated in agricultural lending. Recognition of

the potential concentration risk in these banks' capital and strategic planning processes is particularly important. Regulators expect that management or the board will ensure that management information systems and monitoring procedures are formalized and consistently completed. Monitoring of concentration levels should be done on a granular level, meaning that the bank should measure more than a broad agriculture concentration. Banks are encouraged to have a loan portfolio diversification policy and set prudent exposure limits for agricultural loans by commodity type, geographic market, and individual borrowing relationship. Banks also benefit from concentration reports that are tracked in relation to capital at risk, rather than only tracking concentrations by the percentage of total loans.

Loan Structure and Sound Collateral Evaluations

Proper loan structure and terms are critical. Improper structure or terms could lead to inappropriately long amortization periods or even to lender liability issues in the event of a loan default. Furthermore, it is generally inappropriate to finance permanent working capital or other long-term needs using open lines of credit. Loans to fund noncurrent assets carry greater risk when repayment is generated by future cash flow. Instead, repayment terms should be linked to the primary source of repayment for the loan and the useful economic life of the assets being financed.

Structuring a loan to a borrower's business plans and cycles can ensure that payment schedules align with cash flows. For example, a crop operation set up to make monthly payments may have difficulty meeting payment obligations, since its cash flow is typically concentrated in the fall and winter months when the operation sells its grain after harvest. In this case, an annual payment schedule would be more closely aligned to the time when the borrower (in this case, the crop operation) receives income. However, annual repayment terms would likely be inappropriate for a dairy operator, which generally receives more regular weekly or monthly cash flows. Examiners have observed that many banks with strong credit risk management have appropriately structured weaker loans with an enhancement to support the credit (for example, an outside guarantee through the United States Department of Agriculture or Farm Services Administration).

Collateral evaluations should be well documented and performed at a frequency commensurate with the risk characteristics of the account. Frequent inventory reports, borrowing base certifications, and loan officer visitations are strong

processes observed by examiners. For example, livestock operations that have regular turnover and values that fluctuate with the market price, such as feeder operations, require periodic counts and inventory monitoring to ensure that adequate collateral coverage and capital levels are maintained.

Conclusion

The potential always exists in the agricultural sector for reduced profitability and increased borrower stress based on the unknown and uncontrollable volatility in the marketplace. Historical hindsight provides examiners with the opportunity to analyze what has worked and what has not. Lessons learned from past economic downturns in the farm sector show that agricultural banks that pursued more conservative lending strategies and had stronger risk management practices

with formalized capital and strategic planning processes were well positioned for both the up-and-down cycles of volatile agricultural markets.

Prompt identification of risks and appropriate management strategies to control risks are paramount to the success of every bank. Managing risks presents an additional challenge when a bank is dependent on a single sector of the economy — in this case, agriculture. Guiding banks through good and bad times requires proactive and diligent management oversight, as well as effective and informed board governance. It remains essential for the future prosperity of agricultural banking that banks implement prudent and consistent risk management strategies at all times, not only in stressed market conditions. ■

Agricultural Credit Risk Resources

The list below is not comprehensive; however, it includes important links to various available market data research.

Federal Reserve Bank of Chicago — *AgLetter*

www.chicagofed.org/publications/agletter/index
This quarterly publication summarizes survey data for agricultural land values and credit conditions in the Seventh District.

Federal Reserve Bank of Dallas — *Agricultural Survey*

www.dallasfed.org/research/agsurvey/
This survey reports on agricultural credit conditions and farmland values in the Eleventh District.

Federal Reserve Bank of Kansas City — *Survey of Tenth District Agricultural Credit Conditions*

www.kc.frb.org/research/indicatorsdata/agcredit/#issue
This survey reports on agricultural credit conditions and farmland values in the Tenth District.

Federal Reserve Bank of Minneapolis — *Agricultural Credit Conditions Survey*

www.minneapolisfed.org/publications/agricultural-credit-conditions-survey
This survey reports on agricultural credit conditions and farmland values in the Ninth District.

Federal Reserve Bank of St. Louis — *Agricultural Finance Monitor*

<http://research.stlouisfed.org/publications/afm/>
This quarterly survey reports on agricultural credit conditions in the Eighth District.

Federal Reserve Board's *Commercial Bank Examination Manual, Section 2140, "Agricultural Loans"*

www.federalreserve.gov/boarddocs/supmanual/supervision_cbem.htm

FedLinks: "Risk Management Supervisory Expectations for Agricultural Credit Risk," November 2012

www.cbefrs.org/fedlinks/2012/November2012.pdf

Supervision and Regulation Letter 11-14 "Supervisory Expectations for Risk Management of Agricultural Credit Risk"

www.federalreserve.gov/bankinfo/reg/srletters/sr1114.htm

United States Department of Agriculture (USDA)

www.usda.gov/
The USDA provides a wide range of reports and data on market conditions.



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www.clevelandfed.org/2015policysummit

Development and Maintenance of an Effective Loan Policy:

Part 2* continued from page 7

the collateral condition and location, as well as whether any curtailments (reduction or paydown of outstanding advances) are needed to keep the loan balance in line with collateral values.⁵ The policy should also require that borrowers regularly report information about any collateral that is securing a loan (for example, the composition of the collateral as well as its dollar value, location, and compliance with established advance rates). Loan documents should also ensure that banks are able to gain access to collateral at their discretion.

The policy should clearly describe how frequently collateral valuations will be performed. Typically, the frequency of valuations depends on the size of the exposure, the type of collateral, the location, and the established controls over the collateral. The borrower's overall financial condition can also be a key factor in the timing of a collateral valuation. When a borrower's financial condition deteriorates, the borrower may not be adequately maintaining the collateral, or a bank may find that collateral has been sold. This can have a negative impact on the bank's ability to rely on the collateral for repayment.

Perfection of Collateral

When collateral other than real estate is taken to secure a loan, a lien on the collateral is filed with the appropriate local or state authority. Most transactions secured by personal property and fixtures are governed by Article 9 of the Uniform Commercial Code.⁶ The loan policy and procedures should clearly specify the filing requirements, since timing differences and filing locations vary from state to state. Failure to file a financing statement in a timely manner and/or in the proper filing location can compromise the security interest in the collateral.

Unless the collateral is in the possession of the secured party, there must be a written security agreement that describes the collateral, and the agreement must be signed by the debtor. Institutions should regularly monitor lien filings to ensure that lien positions are maintained or that the perfected security interest in the collateral remains intact.

⁵ See CBEM, section 2160, "Asset-Based Lending."

⁶ See CBEM, section 2080, "Commercial and Industrial Loans."

Risk Ratings

Management should establish an accurate and reliable risk rating system to help lenders make appropriate lending decisions and also establish sound monitoring criteria of the borrower's financial and managerial condition. Risk ratings should significantly influence the ultimate lending decision and help management determine if additional covenants and/or controls should be implemented. Risk rating definitions and scales will vary among banks, but the risk rating framework should be sufficiently granular to assist lenders in determining pricing, fees, covenants, provisioning, and specific capital allocation. Risk ratings should also play a vital role in determining overall portfolio administration.

Risk rating systems have evolved significantly over the past few years, including the implementation of dual risk ratings (separate borrower and facility ratings) and the significant increase in the granularity of the pass rating scale. While the details surrounding risk ratings may vary significantly among institutions, the risk rating process and philosophy should be clearly defined and incorporated into the loan policy.

Pricing

Elements of the loan policy may also influence pricing. Final pricing decisions can be complicated by competition from other lenders and the determination of appropriate premiums for default risk. Using a simple cost-plus loan pricing model requires that all related costs associated with extending credit are known before establishing interest rates and fees. A typical cost-plus model will consider the following four components:⁷

- The cost of the funds
- Operating costs associated with servicing the loan(s)
- Risk premium for default risk (considering the borrower risk rating and facility risk rating)
- A reasonable profit margin on capital

Management should be able to establish a pricing baseline

⁷ See Matthew D. Diette, "How Do Lenders Set Interest Rates on Loans?" Federal Reserve Bank of Minneapolis, November 1, 2000, available at www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3030&.

using such a model but will be required to make the appropriate adjustments to be competitive and to receive an appropriate return.

Numerous other variables beyond those previously discussed affect pricing decisions, including loan type, payment structure, and borrowing and deposit relationships. This article does not discuss different pricing strategies but stresses that management must ensure that an appropriate pricing structure is established and implemented for each type of loan product offered. Management should continuously evaluate and adjust rates in response to changes in costs, competitive factors, or risks of a particular product type.⁸

Policy Exceptions

Exceptions to policies and procedures should receive the appropriate level of approval and should be documented in writing.⁹ Even fundamentally sound credits may contain policy exceptions; such credits may not always conform to all aspects of the loan policy, but there may be mitigating circumstances that would justify the loan's approval. The loan policy should establish processes and procedures for presenting nonconforming or exception loan requests received from creditworthy borrowers. After careful analysis, the exceptions that would give the lender comfort to approve the request may be approved or alternative structures may be presented.

To ensure compliance with regulatory guidance,¹⁰ the policy needs to establish review and approval procedures for exception loans, including loans with loan-to-value percentages in excess of supervisory limits. Policy exceptions and any mitigating circumstances should be well documented and presented to the designated committee for approval. All approved exceptions should be appropriately tracked and monitored on an individual and collective basis.

Frequent policy exceptions may indicate a loosening of credit underwriting criteria and/or a policy that is too restrictive. The underlying reasons behind frequently granted exceptions should be assessed and appropriate actions should be taken to ensure the policy is appropriately conveying the desired risk profile.

⁸ See CBEM, section 2040, "Loan Portfolio Management."

⁹ See CBEM, section 2040, "Loan Portfolio Management."

¹⁰ See Regulation H, Appendix C to Part 208 — Interagency Guidelines for Real Estate Lending Policies, available at www.gpo.gov/fdsys/granule/CFR-2012-title12-vol2/CFR-2012-title12-vol2-part208-appC/content-detail.html.

Loan Commitments

Loan approvals should be made in accordance with established underwriting guidelines and should be conveyed to the borrower in a formal commitment letter. While a commitment letter is not a promissory note, it is the document that contains the terms and conditions under which a bank will agree to extend credit. The commitment letter should be based on the approved terms of the loan and should be signed by both parties. It also should include, at a minimum:

- Borrower(s)
- Guarantor(s)
- Amount of credit facility
- Interest rate and methodology used to calculate the interest rate
- Term or tenor
- Security or collateral
- Distribution of proceeds
- Borrower warranties
 - ▶ Financial statements
 - ▶ Appraisals
 - ▶ Inspections
- Covenants
- Expiration or termination of commitment
- Acceptance and closing

Loan Approval and Closing

Once the commitment letter is returned with the borrower's signature and all the necessary negotiations have been completed, formal loan documents can be generated. Borrowers should sign a new commitment letter if any changes that differ from the original approval are negotiated.

The approval may also require the borrower and guarantors to submit (at least annually) financial information during the term of the loan. This will assist in the ongoing monitoring and review of the borrower's financial condition and in determining the continued appropriateness of the credit and whether to grant renewals or extensions.

Once signed, a loan approval or commitment letter can be routed to either the bank's internal loan documentation team or to an outside attorney for the preparation of the formal loan documents. After the loan documents are prepared and the borrower (or the borrower's attorney) has reviewed them, the bank and the borrower will meet for a formal loan closing during which all documents are signed and proceeds are advanced. Institutions should also have policies that govern the

proper procedures for the disbursement of loan proceeds.

Maintaining Appropriate Credit Files and Documentation

The credit file is the repository for all information (financial and collateral) pertinent to the credit extension for the entire period that the credit extension remains outstanding.

Within the credit file, lenders should appropriately document the entire credit relationship and provide internal and external reviewers with all information necessary to analyze the credit during its life. The policy should identify who is responsible for collecting and maintaining all the required information during the life of the loan and specify who is responsible for reviewing the adequacy of the loan documentation. The policy should also contain procedures for identifying, citing, and correcting documentation exceptions and the parties responsible for carrying out these tasks.

The credit file should adequately document and confirm every

aspect of the established underwriting criteria. For example, credit files should include all financial statements, credit reports, collateral inspection documents, past loan applications, memoranda, correspondence, and appraisals. Documentation requirements will vary according to the type of loan, borrower, and collateral.¹¹

Conclusion

Community banks are expected to have and maintain policies and procedures that provide an effective framework to control credit risk through sound underwriting criteria, appropriate credit file management, and sound documentation. While numerous loan policy topics and examples have been presented in this article and the previous one, the importance of tailoring the policy to banks' activities cannot be overstressed. The underwriting criteria along with the credit file maintenance and documentation recommendations presented within this article are by no means all-inclusive. ■

¹¹ See CBEM, section 2040.1, "Loan Portfolio Management."



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The Federal Reserve System and the Conference of State Bank Supervisors invite the submission of papers for their third annual community bank research and policy conference. Federal Reserve Chair Janet Yellen will open the conference, which will be held at the Federal Reserve Bank of St. Louis on September 30 and October 1, 2015. The purpose of the conference is to bring together academics, community bankers, and policymakers to focus on the latest academic research on community banking and the important policy issues that affect community banks.

We invite the submission of papers that explore all aspects of community banking, including but not limited to:

- the role of community banks in the U.S. financial system: past, present, and future;
- the influence of community banks on economic output and the well-being of the businesses and households in the communities they serve;
- advantages and disadvantages of the community bank business model;
- the effects of government policy on community banks;
- significant challenges faced by community banks in the 21st century; and
- new opportunities for community banks in the 21st century.

Theoretical, empirical, and policy-oriented papers are welcome.

The deadline to submit a detailed abstract or completed paper is June 15, 2015. Please send your submissions by e-mail to conference@communitybanking.org.

Authors of accepted papers will be notified by August 1, 2015.

FedLinks: Connecting Policy with Practice is a single-topic bulletin prepared specifically for community banks and bank holding companies with total assets of \$10 billion or less. Each bulletin provides an overview of a key supervisory topic; explains how supervisory staff members typically address that topic; highlights related policies and guidance, if applicable; and discusses examination expectations as appropriate at community banks. *FedLinks* is not intended to establish new supervisory expectations beyond what is already set forth in existing policies or guidance, but rather to connect policy with practice.

These bulletins can be found online at www.cbefrs.org/fedlinks.

By subscribing to *FedLinks* bulletins at www.cbefrs.org/subscribe, you will receive an e-mail notification when new bulletins become available.



Upcoming Webinars: May 13 and June 10

You're invited to participate in the Federal Reserve's "Basics for Bank Directors" program.

Due in large part to the financial crisis and economic recovery in recent years, the need for bank directors to better understand their roles and risks both for themselves and the affiliated banking organization that they serve has become increasingly evident. This program is for new bank directors or existing bank directors who would like a quick review of the basics.

"Basics for Bank Directors" is a virtual course structured around the *Basics for Bank Directors* book and anchored by four one-hour webinars. If you missed any of the earlier sessions, you can still access the archive of each session.

- **Banks, Bank Directors, and Banking 101**
This session was held on March 25. To access the archive, contact Jean Roark (see contact information below).
- **Financial Analysis and the Bank's Condition**
This session was held on April 8. To access the archive, contact Jean Roark (see contact information below).
- Wednesday, May 13, 2:00–3:00 p.m. ET
Bank Capital and Bank Management
www.webcaster4.com/Webcast/Page/583/7800
- Wednesday, June 10, 2:00–3:00 p.m. ET
Bank Ratings, Consumer Protection, Compliance
www.webcaster4.com/Webcast/Page/583/7801

If you have any questions about registering for the program, contact Jean Roark at 314-444-8420 or jean.m.roark@stls.frb.org.

Supervision & Regulation (SR) & Consumer Affairs (CA) Letters

The following SR and CA letters that have been published since the last issue (and are listed by release date) apply to community banking organizations. Letters that contain confidential supervisory information are not included. All SR letters are available by year at www.federalreserve.gov/bankinforeg/srletters/srletters.htm and by topic at www.federalreserve.gov/bankinforeg/topics/topics.htm. A complete list of CA Letters can be found at www.federalreserve.gov/bankinforeg/caletters/caletters.htm.

SR Letter 15-5/CA Letter 15-2, “Guidance to Encourage Financial Institutions’ Youth Savings Programs and Address Related Frequently Asked Questions”

SR Letter 15-4, “Tool for Calculating Capital Requirements Using the Simplified Supervisory Formula Approach”

SR Letter 15-3, “FFIEC Information Technology Examination Handbook”

SR Letter 15-2/CA Letter 15-1, “Guidance on Private Student Loans with Graduated Repayment Terms at Origination”

SR Letter 14-10, “Release of the 2014 Federal Financial Institutions Examination Council’s Bank Secrecy Act/Anti-Money Laundering Examination Manual”

Connecting with You



What banking topics concern you most? What aspects of the supervisory process or the rules and guidance that apply to community banks would you like to see clarified? What topics would you like to see covered in upcoming issues of *Community Banking Connections*?

With each issue of *Community Banking Connections*, we aim to highlight the supervisory and regulatory matters that affect you and your banking institution the most, providing examples from the field, explanations of supervisory policies and guidance, and more. We encourage you to contact us with any ideas for articles so that we can continue to provide you with topical and valuable information.

Please direct any comments and suggestions to www.cbfrs.org/feedback.

The federal bank regulatory agencies announced additional Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) outreach meetings. The EGRPRA requires the federal bank regulatory agencies, as well as the Federal Financial Institutions Examination Council (FFIEC), to conduct a review at least every 10 years to identify outdated or otherwise unnecessary regulations. See also the February 20, 2015, press release on regulatory burden. The Federal Reserve and the other agencies have begun a series of outreach meetings with bankers, consumer groups, and other interested parties to provide them with the opportunity to present their views on the regulations under review. The press release, which was issued on January 14, 2015, is available at www.federalreserve.gov/newsevents/press/bcreg/20150114a.htm.

The Federal Reserve Board is seeking public comment on a proposed rule to expand the applicability of the Board's Small Bank Holding Company Policy Statement for small bank holding companies as well as certain savings and loan holding companies. Additionally, the Board announced a reduction in the reporting requirements for certain bank holding companies and savings and loan holding companies. The press release, which was issued on January 29, 2015, is available at www.federalreserve.gov/newsevents/press/bcreg/20150129b.htm.

Governor Jerome Powell gave welcoming remarks at the EGRPRA outreach meeting in Dallas, TX. The meeting was held on February 4, 2015. His remarks are available at www.federalreserve.gov/newsevents/speech/powell20150204a.htm.

Maryann Hunter, deputy director of the Federal Reserve Board's Division of Banking Supervision and Regulation, testified before the Senate Committee on Banking, Housing, and Urban Affairs at a hearing on "Regulatory Relief for Community Banks and Credit Unions" on February 10, 2015. Her testimony is available at www.federalreserve.gov/newsevents/testimony/hunter20150210a.htm.

The Board and the other federal bank regulatory agencies are seeking comment on an interagency effort to reduce regulatory burden. On February 20, 2015, the federal bank regulatory agencies requested comment on a second set of regulatory categories as part of their review to identify outdated or unnecessary regulations applied to insured depository institutions, as part of the EGRPRA process. The press release is available at www.federalreserve.gov/newsevents/press/bcreg/20150220a.htm.

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