

COMMUNITY BANKING CONNECTIONS®

A SUPERVISION AND REGULATION PUBLICATION

A Message from Governor Bowman

by Governor Michelle Bowman

Second Issue 2020

I hope this message finds you, your families, and your colleagues in good health. On behalf of the Federal Reserve, thank you for the vital and ongoing role you and your institutions play in responding to the economic conditions resulting from COVID-19. In response to the crisis, we have taken several steps to assist you in better serving your customers and communities.

At a time of extraordinary challenges for our nation, community bankers are making important contributions to address the financial needs of families and businesses. Bankers across the country responded swiftly to implement effective measures to protect employees and maintain access to financial services. You have worked creatively to find solutions for your institutions and for those affected by this crisis.

The current environment poses unprecedented levels of uncertainty for the financial services industry given the size, scope, and nature of the pandemic. Economic disruptions caused by the coronavirus have created tremendous strains in financial markets and threatened to impair the flow of credit in the economy. Community banks have a long history of facing and overcoming financial crises. Today, community banks are at the forefront in providing credit quickly to businesses that need it. With the support of the Federal Reserve and other agencies, you are playing a crucial role in facilitating Paycheck Protection Program (PPP) loans to small businesses. In a recent Independent Community Bankers of America survey, despite many challenges, community banks reported they had each made an average of 166 PPP loans during the first round of funding. This success speaks to the flexibility, responsiveness, and commitment of community banks to their customers and communities. Your efforts in response to this event will contribute to the recovery of the economy.

At the Fed, we are doing everything we can to help American families and businesses weather this difficult period. Once the public health issues have been mitigated, state and local authorities will allow businesses to reopen, and people will begin to come back to work. Throughout this time, we will continue to use our tools as appropriate to support a robust economic recovery. As you know, the Federal Reserve has, in partnership with other agencies, and at the direction of Congress, taken steps, unprecedented in size and scope, to assist the economy. The regulatory actions that follow on the next two pages describe the steps that are intended to support community banks and their efforts to meet the financial needs of customers.



Governor Michelle Bowman

The Federal Reserve appreciates community banks and the indispensable role they play in our response to the economic effects of the COVID-19 pandemic. I encourage you to share any concerns, challenges, and commendations at outlook@phil.frb.org. Thank you for your continued efforts to support the economy. ■

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Regulatory Actions in Response to COVID-19

In response to the COVID-19 crisis, the Federal Reserve, as well as its federal and state regulatory counterparts, has taken a number of steps to ease the burden on consumers and support the flow of credit and liquidity. Below are highlights of the unprecedented actions taken by regulators in light of the pandemic. For a comprehensive list of Federal Reserve or interagency rulemakings/statements related to COVID-19, visit the Federal Reserve's COVID-19 resources page, available at www.federalreserve.gov/covid-19.htm.

Press Releases — Relief for Banks

Appraisals: Federal banking agencies are temporarily deferring real estate-related appraisals and evaluations under the appraisal regulations. The press release, issued on April 14, 2020, is available at www.federalreserve.gov/newsevents/pressreleases/bcreg20200414a.htm.

Capital: Federal bank regulatory agencies temporarily lowered the community bank leverage ratio to 8 percent, in accordance with Section 4012 of the Coronavirus Aid, Relief, and Economic Security Act. The press release, issued on April 6, 2020, is available at www.federalreserve.gov/newsevents/pressreleases/bcreg20200406a.htm.

CECL: Federal bank regulatory agencies are allowing banking organizations to mitigate the effects of the current expected credit loss (CECL) accounting standard in their regulatory capital. The press release, issued on March 27, 2020, is available at www.federalreserve.gov/newsevents/pressreleases/bcreg20200327a.htm. The related supervisory letter, SR 20-9, is available at www.federalreserve.gov/supervisionreg/srletters/sr2009.htm.

Regulatory Reporting: The Federal Reserve offered regulatory reporting relief to small financial institutions affected by the coronavirus. The press release, issued on March 26, 2020, is available at www.federalreserve.gov/newsevents/pressreleases/bcreg20200326b.htm.

Supervisory Approach: The Federal Reserve adjusted its supervisory approach to focus on monitoring and

outreach to help financial institutions of all sizes understand the challenges and risks of the current environment. The press release, issued on March 24, 2020, is available at www.federalreserve.gov/newsevents/pressreleases/bcreg20200324a.htm.

Supervisory Practices: The Federal Reserve issued guidance on supervisory practices regarding financial institutions affected by the coronavirus. The supervisory letter, SR 20-4/CA 20-3, is available at www.federalreserve.gov/supervisionreg/srletters/sr2004.htm.

Press Releases — Relief for Consumers

Savings Deposit Transfers: The Federal Reserve is allowing depository institutions to suspend enforcement of the six-transfer limit on savings deposits and to allow their customers to make an unlimited number of convenient transfers and withdrawals from their savings. The press release, issued on April 24, 2020, is available at www.federalreserve.gov/newsevents/pressreleases/bcreg20200424a.htm.

Small Business Lending: Federal bank regulatory agencies encouraged lending to small businesses through the Small Business Administration's Paycheck Protection Program, or PPP. The press release, issued April 9, 2020, is available at www.federalreserve.gov/newsevents/pressreleases/bcreg20200409a.htm. The related supervisory letter, SR 20-10, is available at www.federalreserve.gov/supervisionreg/srletters/sr2010.htm.

Working with Borrowers: Federal banking agencies encouraged financial institutions to work constructively with customers affected by COVID-19 and provided additional information regarding loan modifications and troubled debt restructurings. The press releases, issued April 7, 2020, and March 22, 2020, are available at www.federalreserve.gov/newsevents/pressreleases/bcreg20200407a.htm and www.federalreserve.gov/newsevents/pressreleases/bcreg20200322a.htm, respectively.

Mortgage Servicers: Federal financial institution regulatory agencies and the state financial regulators are providing regulatory flexibility to enable mortgage servicers to work with struggling consumers affected by the COVID-19 emergency. The press release, issued April 3, 2020, is available at www.federalreserve.gov/newsevents/pressreleases/bcreg20200403a.htm.

Small-Dollar Loans: Federal banking agencies encouraged banks, savings associations, and credit unions to offer responsible small-dollar loans to consumers and small businesses in response to COVID-19. The press release, issued March 26, 2020, is available at www.federalreserve.gov/newsevents/pressreleases/bcreg20200326a.htm. The related supervisory letter, SR 20-7/CA 20-5, is available at www.federalreserve.gov/supervisionreg/srletters/sr2007.htm.

Other Regulatory Actions

Discount Window: Federal bank regulatory agencies encouraged banks to use the Federal Reserve's discount window. The press release, issued March 16, 2020, is available at www.federalreserve.gov/newsevents/pressreleases/bcreg20200316a.htm.

Federal Reserve Programs: The Federal Reserve established various emergency liquidity and lending facilities as part of its broad effort to support the economy. Information on the various facilities is available on the Board's COVID-19 resources page under "Funding, Credit, Liquidity, and Loan Facilities" at www.federalreserve.gov/funding-credit-liquidity-and-loan-facilities.htm.

Testimonies

Federal Reserve Board Chair Jerome H. Powell gave his semiannual Monetary Policy Report to the Congress before the U.S. House of Representatives Committee on Financial Services in Washington, D.C., on February 11, 2020. The report is available at www.federalreserve.gov/newsevents/testimony/powell20200211a.htm. Chair Powell submitted identical remarks to the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, on February 12, 2020. ■

Speeches

Governor Michelle W. Bowman

gave a speech at the Conference for Community Bankers sponsored by the American Bankers Association, in Orlando, FL, on February 10, 2020. Her speech, "Empowering Community Banks," is available at www.federalreserve.gov/newsevents/speech/bowman20200210a.htm.

Chair Jerome H. Powell gave a speech at the Hutchins Center on Fiscal and Monetary Policy, the Brookings Institution, in Washington, D.C. (via webcast) on April 9, 2020. His speech, "COVID-19 and the Economy," is available at www.federalreserve.gov/newsevents/speech/powell20200409a.htm.

Governor Michelle W. Bowman gave a speech at the "Age of Advancement: The Intricacies of a Digital World" 2020 Banking Outlook Conference, sponsored by the Federal Reserve Bank of Atlanta, in Atlanta on February 27, 2020. Her speech, "Direction of Supervision: Impact of Payment System Innovation on Community Banks," is available at www.federalreserve.gov/newsevents/speech/bowman20200227a.htm.

Vice Chair of Supervision Randal K. Quarles gave a speech at Yale Law School in New Haven, CT, on February 11, 2020. His speech, "Spontaneity and Order: Transparency, Accountability, and Fairness in Bank Supervision," is available at www.federalreserve.gov/newsevents/speech/quarles20200211a.htm.

Governor Lael Brainard gave a speech at the Symposium on the Future of Payments in Stanford, CA, on February 5, 2020. Her speech, "The Digitalization of Payments and Currency: Some Issues for Consideration," is available at www.federalreserve.gov/newsevents/speech/brainard20200205a.htm.

CECL and the CARES Act

What

The Coronavirus Aid, Relief, and Economic Security (CARES) Act was signed into law on March 27, 2020, and contained Section 4014 Optional Temporary Relief from Current Expected Credit Losses. This section outlined the option to delay the implementation of current expected credit loss (CECL) accounting standards until the earlier of the date the national emergency related to the COVID-19 outbreak is terminated, or December 31, 2020. On April 3, 2020, Securities and Exchange (SEC) Commission Chief Accountant Sagar Teotia issued a statement indicating that eligible, participating institutions would be considered in compliance with Generally Accepted Accounting Principles.

Who

Impacted institutions are those scheduled to adopt CECL in 2020. Eligible institutions may opt to continue with CECL implementation as planned in 2020 rather than utilize the deferral. Most community banking organizations are not required to adopt CECL until 2023 (see table).

CECL Adoption Requirement	Public Business Entities		Private and All Others
	SEC Filers	All Other Public Business Entities	
	January 2020 (excludes smaller reporting companies)	January 2023 (includes smaller reporting companies)	January 2023

How

Under Section 4014, organizations may delay the implementation because of the uncertain nature of the current lending environment and the understanding that forecasting foreseeable losses is particularly challenging at this time. The application of CECL standards is retrospective to the beginning of the organization’s fiscal year.

Agencies Issue Revised Capital Transition of the CECL Methodology for Allowances

On March 27, 2020, the federal banking regulatory agencies announced an interim final rule that delays the estimated impact on regulatory capital stemming from the implementation of CECL for a transition period of up to five years. The interim final rule provides banking organizations that implement CECL before the end of 2020 the option to delay for two years an estimate of CECL's effect on regulatory capital, relative to the incurred loss methodology's effect on regulatory capital, followed by a three-year transition period. Alternatively, banking organizations may use the three-year regulatory capital CECL transition rule issued by the banking agencies in February 2019.

The agencies are providing this relief to allow such banking organizations to better focus on supporting lending to creditworthy households and businesses in light of recent strains on the U.S. economy as a result of COVID-19, while also maintaining the quality of regulatory capital. The recently announced changes to the regulatory capital transition timelines are effective immediately.

For information regarding the interaction between the CARES Act and the interim final rule, see Supervision and Regulation (SR) letter 20-9, "Joint Statement on the Interaction of Regulatory Capital Rule: Revised Transition of the CECL Methodology for Allowances with Section 2014 of the Coronavirus Aid, Relief, and Economic Security Act."

Resources

- SR letter 20-9: www.federalreserve.gov/supervisionreg/srletters/SR2009.htm
- Press release: www.federalreserve.gov/newsevents/pressreleases/bcreg20200327a.htm
- Ask the Fed (general CECL sessions): askthefed.org
- Ask the Regulators: COVID-19 Update — New Transition Provisions to Delay the Impact of CECL on Regulatory Capital: <https://bsr.stlouisfed.org/askthefed/Home/ArchiveCall/242>

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View from the District

A First District Perspective — Boston



First District Community Bank Supervision and Communication During the Pandemic

by Jim Nolan, Executive Vice President, Supervision, Regulation, and Credit, Federal Reserve Bank of Boston



Jim Nolan

The Federal Reserve Bank of Boston (FRB Boston) serves as the primary federal regulator for state member banks and holding companies in New England.¹ Prior to the outbreak of COVID-19, significant aspects of our community bank safety-and-soundness supervisory work focused

on liquidity and funding, with a particular emphasis on changing trends in financial institutions' funding composition and cost. Another area of supervisory focus in the First District was monitoring growth in commercial real estate (CRE) lending, which included the analysis of market conditions relative to price appreciation, and attention to the underlying strength of borrowers.

The COVID-19 pandemic necessitated short-term modifications to our community bank supervisory approach. We continue to engage with the management teams at state member banks to assess their ability to operate in a manner that ensures the safety of employees and customers while providing liquidity and credit to their communities. Community banks serve an important economic role, and the current environment has created unique challenges in terms of day-to-day operations and meeting the critical credit needs of individuals and small businesses. The services provided by community banks will be instrumental in supporting our local economies through the pandemic.

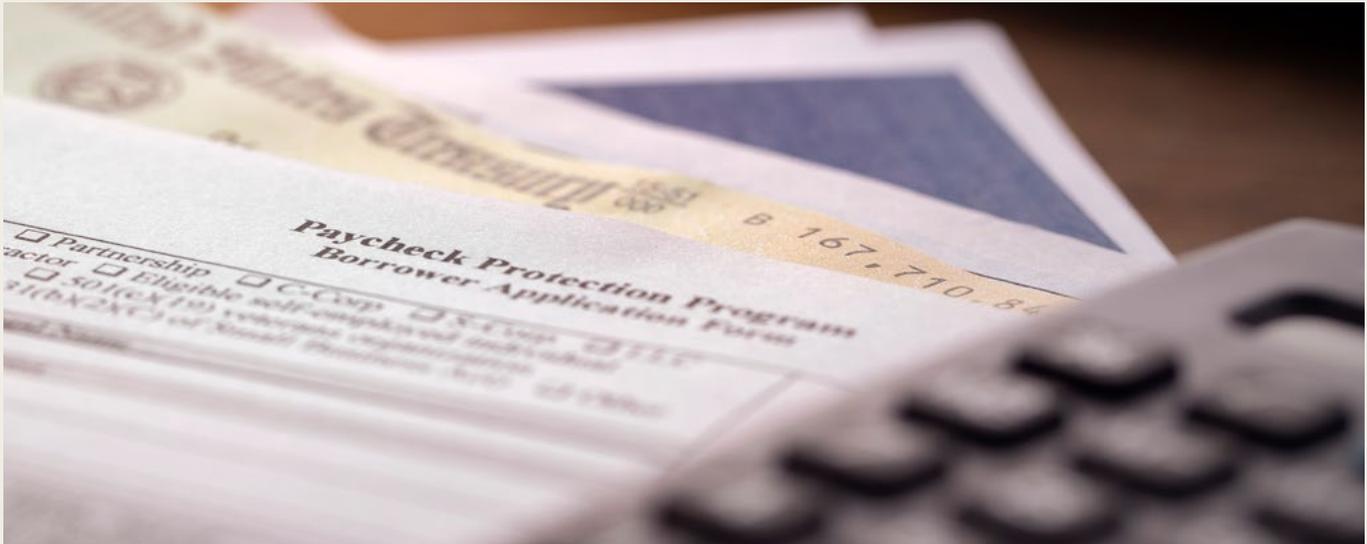
First District Community Banking in a COVID-19 Environment

Like most of the country, we have significantly changed the way we work this year with added emphasis on safety and health. In mid-March, with the exception of staff needed to provide essential services, FRB Boston transitioned most of the staff to full-time work-at-home status. FRB Boston examination staff worked closely with management teams at banks and with state banking agencies to inform relevant stakeholders of the changes to our examination approach and to coordinate completion of our examinations in process. Our examination teams transitioned from collaborative office or onsite working environments to remotely working from home. As a result, we have more intensively and more broadly incorporated a variety of technologies and tools into our day-to-day work to help us adapt to this new environment.

As conditions rapidly evolved through March and April 2020, the Federal Reserve System (System) adjusted its supervisory approach.² FRB Boston examination staff remained in contact with impacted bank management teams and coordinated with the state agencies in New England. Our supervisory program through the months of April and into May focused on monitoring rather than traditional examination work. In particular, we monitored modified bank operations; customer and state member bank liquidity needs, particularly in light of changes to

¹ The First District covers Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, and Connecticut (excluding Fairfield County).

² See the Board's March 24, 2020, press release, available at www.federalreserve.gov/newsevents/pressreleases/bcreg20200324a.htm.



the discount window borrowing programs;³ and how banks are working with borrowers and modifying loans.⁴ We also answered questions related to small business lending and banks' participation in the Small Business Administration's Paycheck Protection Program (PPP) and Economic Injury Disaster Loan Program. Most recently, we began to design and implement monitoring tools and processes to guide the First District's supervision program for the remainder of 2020.

The First District's community bank supervision unit established a weekly information exchange with senior management teams at state member banks. This communication platform provides a forum to discuss common challenges and shared successes and address questions from state member bank chief executive officers, such as new regulatory developments. The participation rate has remained high, which suggests the benefits of continuing this exercise. This outreach has provided us, as supervisors, with a better perspective on issues impacting community banks as well as needed information to discern which issues are pervasive and need to be addressed programmatically.

³ See the Board's March 19, 2020, press release, available at www.federalreserve.gov/newsevents/pressreleases/monetary20200319c.htm.

⁴ See the Board's press releases, issued April 7, 2020, and March 22, 2020, available at www.federalreserve.gov/newsevents/pressreleases/bcreg20200407a.htm and www.federalreserve.gov/newsevents/pressreleases/bcreg20200322a.htm, respectively.

Federal Reserve System Communication Tools for Community Banks

Since the beginning of this pandemic, the Federal Reserve has issued various statements and guidance that are relevant to community banks. This heightened flow of information has emphasized the benefits of staying in contact with management teams at community banks in the District and responding to their questions in a manner that is consistent for all state member banks. Three tools in particular have been especially helpful for supervisors and banks in the First District.

The Federal Reserve guidance portal organizes Supervision and Regulation (SR) letters and other issuances by year and by topic, and it can be found on the Federal Reserve Board's (Board) public website.⁵ The COVID-19 topic page⁶ is particularly helpful, as well as the Business Continuity and Disaster Recovery subtopic page.⁷

⁵ The Guidance Portal is available at www.federalreserve.gov/supervisionreg/srletters/srletters.htm.

⁶ See the COVID-19 Supervisory Policy and Guidance Topics, available at www.federalreserve.gov/supervisionreg/topics/covid-19.htm.

⁷ See the Business Continuity and Disaster Recovery subtopics, available at <https://www.federalreserve.gov/supervisionreg/topics/information-technology-guidance.htm>.

The second tool is the “Contact Us” portal on the Board’s website.⁸ A separate section was added specifically for coronavirus-related questions. Bankers from across the nation have submitted questions covering a variety of topics such as capital, credit, accounting, operations, and other areas of interest in the COVID-19 environment. These submissions are sent to appropriate subject matter experts to answer.

Ask the Fed sessions represent the third communication vehicle that is popular with District community banks.⁹ These sessions have covered a number of important topics related to banking during this pandemic, including working with borrowers, troubled debt restructuring guidelines, and the PPP program from the bankers’ perspective. In addition, the sessions give bank management the ability to hear directly about any new guidance and ask questions from subject matter experts at the Board.

Community Bank Risk Areas in COVID-19 Environment

Operational Risk

In mid-March, the first calls FRB Boston examination staff received from bankers centered on operations, specifically branch operations and reductions in service hours. Despite initial technical and logistical challenges, communications with supervised institutions remain effective. The bankers asked for guidance about providing services while simultaneously keeping employees and customers safe. Innovative operational strategies included expanded use of the drive-through window for a number of transactions that typically take place in a branch and commencing branch hours by appointment only. The use of electronic signatures was another topic of great interest in a socially distanced world. In general, community bankers found creative solutions to meet customer needs and protect the health of customers and employees.

⁸ Comments and questions can be submitted using the Contact Us form, available at www.federalreserve.gov/apps/ContactUs/feedback.aspx.

⁹ The Ask the Fed sessions are available at <https://bsr.stlouisfed.org/askthefed/Auth/Login>.

Cybersecurity

Cybersecurity risk is elevated in the current environment because routines are disrupted and attention distracted. Changes in operations and greater reliance on technology tools contribute to an increase in risk events. Awareness and preparation are important elements of any bank’s cybersecurity program, especially during unprecedented times. The *Federal Financial Institutions Examination Council’s Information Technology Examination Handbook* describes elements of a sound information security program for financial institutions.¹⁰

Liquidity Risk

As mentioned earlier, liquidity and funding were an important pre-pandemic area of supervisory focus within the First District and remain so in the current environment. During the initial stages of the pandemic in the United States, bankers were understandably concerned about having sufficient cash on hand to meet customer needs. The Federal Reserve’s FedCash Services ensured that bankers were able to access the level of cash needed for operations to meet customer demand. The announcements from the Board regarding changes in the terms of discount window loans spurred discussions with bank management about the importance of the discount window as a source of community bank funding. To date, with inflows from both the PPP and stimulus checks, community bankers within the First District are generally demonstrating solid liquidity positions. Going forward, it will be important to track and monitor deposit flows by customer type — commercial, consumer, and municipal — and size. Bank management should continue to monitor collateral and secondary liquidity availability through the Federal Home Loan Bank and the discount window as outlined in interagency liquidity guidance.¹¹ This will be particularly important if banks experience COVID-19-related credit deterioration.

¹⁰ See SR letter 19-13, “*FFIEC Information Technology Examination Handbook*,” available at www.federalreserve.gov/supervisionreg/srletters/SR1913.htm.

¹¹ See SR letter 10-6, “Interagency Policy Statement on Funding and Liquidity Risk Management,” available at www.federalreserve.gov/boarddocs/srletters/2010/sr1006.htm.

Credit Risk

Credit risk generally represents the most prominent risk for community banks. Over the past several years, both nationwide and in the First District in particular, we observed an increase in lending as a proportion of the balance sheet, particularly CRE. Guidance issued by federal banking agencies to date stresses the importance of working with borrowers for loan modifications.¹² These efforts are necessary to support the flow of credit for households and small businesses. For newer loan originations and for borrowers participating in businesses or industries that are particularly affected by COVID-19, the ability of the bank to understand a borrower's cash flows and ability to repay the loan takes on greater importance. For commercial lending, this could include practices such as monitoring changes in a borrower's monthly revenue to understand the resilience of the business. It is likely that the coming months will bring a variety of credit challenges as banks strive to prudently work with borrowers to continue to provide needed credit to local businesses.

Capital Planning

Capital planning is always an essential element of balance sheet management, but it becomes even more important during times of uncertainty or stress. It is reasonable to presume that there will be some degree of pressure on First District bank earnings and, by extension, capital related to the pandemic environment. Guidance issued in 2009 during the prior crisis remains highly relevant to capital planning for community banks with holding companies.¹³ The guidance focuses on capital actions at the holding company and discusses special considerations for the supervisory review of dividend payments, capital redemptions, and capital repurchases by bank holding companies (BHCs). The guidance also highlights sound practices for a BHC to consider when assessing capital adequacy. Factors outlined in the 2009 guidance include

¹² See the Guidance Portal, available at www.federalreserve.gov/supervisionreg/srletters/srletters.htm.

¹³ See SR letter 09-4, "Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies," available at www.federalreserve.gov/boarddocs/srletters/2009/SR0904.htm.

“As we continue to work through the current environment, our goals of promoting a banking system that is vibrant, safe, and sound and meeting the needs of customers are as important as ever.”

the quality and level of current and prospective earnings, inclusive of earnings capacity under a number of plausible economic scenarios; balance sheet risk, particularly relative to credit concentrations; potential losses that a BHC may incur from the need to increase reserves; and current and prospective cash flow and liquidity. A BHC's board of directors is also encouraged to consider other risks that affect the BHC's financial condition and the ability to serve as an ongoing source of financial and managerial strength to depository institution subsidiaries.

Conclusions

Community banks play an important role in serving the banking needs of their communities, and the pandemic highlights this point. Community banks in the First District and across the System have worked tirelessly and demonstrated great innovation, flexibility, and adaptability in meeting customer needs and facilitating the flow of credit to businesses and consumers in their communities.

As we continue to work through the current environment, our goals of promoting a banking system that is vibrant, safe, and sound and meeting the needs of customers are as important as ever. We appreciate community bank innovation, flexibility, and communication on this effort. The past few months have reinforced the importance of functional working relationships and effective communication between regulators and bankers. Stay safe. ■

Conducting Offsite Bank Examinations

by Kerri Allen, Examiner, Examinations and Inspections, Federal Reserve Bank of Kansas City and William Mark, Lead Examiner, Supervision and Regulation, Federal Reserve Bank of Chicago

Bank examinations may be conducted offsite for various reasons. During unique circumstances such as disasters and pandemics, offsite examinations may be necessary. The current coronavirus (COVID-19) pandemic, for example, emphasizes the urgency of evaluating and, in many cases, temporarily modifying the way business is routinely conducted, especially if mandated shelter-in-place orders and other operational challenges are presented that may interfere with standard operating practices. Although this pandemic and other disasters cause many economic and operational uncertainties, the Federal Reserve has established methodologies and practices to assess the safety and soundness of institutions offsite in an efficient and secure manner. This article discusses the Federal Reserve's use of offsite examinations as part of its safety and soundness supervision over community banks and the relevance of offsite examinations during unique circumstances, such as the current COVID-19 pandemic.

Benefits of Offsite Examination Work

Not long ago, bank examiners performed all bank examination procedures onsite, from reconciling the general ledger to counting cash in teller drawers. Over the past decade, significant technological advances have radically transformed the supervision process, which includes the proliferation of offsite examination work. Today, a considerable amount of monitoring and examination work is performed offsite. From both a convenience and continuity standpoint, conducting examinations offsite can be particularly useful for both bankers and examiners, especially when extenuating circumstances, such as weather or illness, impede individuals from working onsite at the bank.

Preparing for an offsite examination may require more coordination and preparation than for an entirely onsite review. However, despite some additional effort on the



front end, an offsite examination offers several benefits, including procedural efficiencies such as minimizing disruption of bank activities, providing greater flexibility for Reserve Banks to manage resources, and offering greater training or mentoring opportunities for newer examiners.

Consider the loan file review portion of an examination.¹ There are benefits and efficiencies to performing this process offsite. An offsite arrangement can reduce the number of examiners needed at the bank to perform loan reviews because a large portion of an examination team is devoted to assessing asset quality. This could minimize onsite disruption for bank staff. Although examiners and loan personnel may miss the traditional face-to-face interaction, discussions can still be conducted via phone and email. Flexibility to better accommodate the time demands of bankers, especially during unusual circumstances, is a positive byproduct of offsite loan reviews. Further, Reserve Bank staff can benefit from offsite work because this work may facilitate more

¹ See FRB guidance on offsite loan review at Supervision and Regulation (SR) letter 16-8, "Off-Site Review of Loan Files," available at www.federalreserve.gov/supervisionreg/srletters/sr1608.htm.

formalized training given the availability of a wider range of resources in the Reserve Bank or branch office.

Supervisory Work During Exigent Circumstances

Pandemics and natural disasters affect the way both bankers and regulators conduct their work.

For example, in light of COVID-19, the Federal Reserve adjusted its supervisory approach to focus on monitoring and outreach to help financial institutions of all sizes understand the challenges and risks posed by the current environment.² This shift allows banks to focus on day-to-day operations while examiners strive

to understand key issues and potential issues facing the banking sector. Examiners can assist community banks in leveraging the tools and programs available to them and regulators can implement modified examination and other monitoring operations as appropriate. In many ways, the role of the regulator during a pandemic or other crisis is to serve as a “voice” for the banks it oversees, relaying the collective challenges, patterns, and resource needs the banks are observing and experiencing.

The unique challenges of COVID-19 have highlighted the importance of offsite monitoring and examination support in the short term. In response to the added complexity of shelter-in-place orders in many parts of the country, the Federal Reserve has reinforced the use of various technological tools to facilitate efficient and secure communication in the context of teleworking.

² At the time this article was written, the Federal Reserve had placed a moratorium on most examination work for institutions in the community and regional banking organization supervisory portfolios in an effort to help banks to focus on their day-to-day operations. See the Board’s March 24, 2020, press release, available at www.federalreserve.gov/newsevents/pressreleases/bcreg20200324a.htm.

COVID-19 likely will continue to affect different geographic regions to varying degrees for quite some time. Because of this, predicting when supervisory practices will return to business as usual is difficult. Given these uncertainties, examiner judgment plays a greater role in the examination planning and scoping processes, as different approaches

to examination activities will likely need to be taken for different banks. Although there are logistical consequences in postponing and significantly modifying the scope of examination activities, the safety of examiners and financial institution staff is paramount. Undoubtedly, the COVID-19 experience will result in many supervisory “lessons learned” vis-à-vis the offsite examination processes.

“Regardless of where examination activities are conducted, it is essential that Reserve Bank staff effectively communicate with bank management.”

Communication Remains Key

Regardless of where examination activities are conducted, it is essential that Reserve Bank staff effectively communicate with bank management. Certain supervisory tasks and examination components do not require a great deal of face-to-face discussion with bank management and can be performed offsite. This generally includes the examination of certain financial components because examiners can review electronic documents and follow up with bank management if clarification is needed. While face-to-face interaction is reduced in these cases, examiners are expected to follow communication protocols during all phases of the examination, from scheduling and scoping to requesting additional information and conveying conclusions to bank management.³ When appropriate, it remains an effective practice for examination leadership, as well as central points of contact and Reserve Bank management, to visit with bank management onsite during examinations

³ See FRB guidance on examination communication expectations at SR letter 19-5, “Communication Expectations for Community Bank Examinations and Inspections,” available at www.federalreserve.gov/supervisionreg/srletters/sr1905.htm.

to foster open dialogue and build positive working relationships and rapport.

Communication between the offsite examination team and bank staff can be challenging because of real and perceived lag time between messages. These communication challenges can be mitigated if both parties promptly address the status of requested items, schedule meetings, or even acknowledge the receipt of messages.

From a monitoring perspective, communication between bank and examination staff is paramount. Together with information gathered in the examination and surveillance processes, periodic touchpoints between examinations help examiners understand changes in the organization's risk profile. Periodic touchpoints help examiners understand any changes in the bank's strategic plans, products and services, as well as its assets and liabilities. These conversations also provide insight into local economic conditions, which are invaluable to the risk assessment process.

In light of the current pandemic stress scenario, it is important that regulators remain apprised of newly implemented bank programs and efforts to assist or work with customers, including lending relief provisions or operational/branch modifications. Finally, these interactions provide opportunities for supervisory staff to share effective practices and clarify guidance and regulations.

Considerations for Conducting Offsite Examinations

When determining the ability to conduct examination activities offsite, examiners consider various factors such as risk profile, management preferences, and technology capabilities, particularly for loan file review. The quality

of submitted data and documentation, logistical hurdles, and the need for onsite observations of control processes are factors examiners consider to determine the extent of offsite work.

Technological and Logistical Considerations

The bank's technological capability plays a key role in determining whether it is feasible for certain examinations to be effectively completed offsite. To that end, examiners can leverage various tools to support the effective completion of an offsite examination. A Reserve

Bank's first day letter (FDL) that results from the offsite examination scoping process notifies bank management of an upcoming examination and requests documentation needed by examiners in support of the supervisory event. The FDL typically prescribes the items the bank should provide examiners prior to the examination versus items to be made available upon the arrival of the examination team at the bank. Bank management then uploads these requested documents

to a secure website, which saves examiners time by allowing them to review the documentation before and during the examination.

The example of the FDL illustrates the importance of a secure document uploading system in completing offsite examination work. Similarly, relevant information and supplemental documentation can be exchanged via secure email. In many cases, examiners and bankers use video conferencing tools to facilitate virtual "face-to-face" discussions when examiners are located offsite, and at the same time, they must ensure that these interactions are conducted in a secure manner.

Examiners have conducted the review of various financial and policy components of bank examinations offsite for

“ During contingency telework situations, such as pandemics, in which Reserve Bank facilities are unavailable, examination staff have stringent security guidelines in place regarding offsite loan review. ”

quite some time.⁴ Today, however, one of the primary and relatively recent offsite examination functions is loan file review, a process discussed earlier in this article. Performing a loan review offsite is a decision made in conjunction with bank management, as it is contingent on the bank's preferences as well as its technological capabilities and resources to provide electronically imaged loan files in a clear and secure way. Based on experiences with the offsite loan review process, the Federal Reserve recognizes that not all banks have the technical capability or desire to facilitate offsite loan file review. It is expected that the offsite loan review process will continue to evolve and be refined over time.

It should be noted that during contingency telework situations, such as pandemics, in which Reserve Bank facilities are unavailable, examination staff have stringent security guidelines in place regarding offsite loan review. In such cases, examiners must follow specific guidelines to ensure that sensitive information is not accessed by unauthorized individuals or listening devices. The Federal Reserve staff must consult with bank management during the examination scoping and planning process to determine whether the bank is amenable to such an arrangement.

Feedback on Offsite Examination Work

The Federal Reserve has conducted various quality assurance reviews to determine whether examination work conducted offsite is compromising the effectiveness of community bank examinations. Overall, these internal reviews have found that offsite examination work does not materially affect the overall outcomes of the supervision program.

As previously discussed, the offsite loan review process provides some efficiencies for banks and examiners and attempts to address bankers' requests to minimize the number of examiners who are present at the bank during



an onsite examination. The Federal Reserve recognizes the time and effort it takes bankers to prepare for an offsite examination. As part of the examination wrap-up process, Federal Reserve examiners often solicit feedback regarding the effectiveness of offsite examination processes from bank management, and feedback from bankers at any time is always encouraged.

Concluding Thoughts

As Governor Michelle Bowman indicated in her 2019 speech "A Conversation on Community Banking," "the Federal Reserve continues to tailor and reduce regulatory burden by conducting portions of community bank examinations offsite."⁵ This supervisory approach will bear in mind considerations for safety, risk, and technological capabilities. If some well-managed banks prefer examination activities to be completed onsite, the Federal Reserve plans to honor such requests. In her speech, Governor Bowman reinforces this point, noting that "personal contact and relationship building are important to community banking and, I believe, also to community bank oversight." Especially in times of operational and economic stress, it is even more crucial that the examination process, offsite or otherwise, be conducted with the backdrop of flexibility, open communication, and a risk-focused mindset. ■

⁴ See SR letter 95-13, "Recommendations to Increase the Portion of Examinations and Inspections Conducted in Reserve Bank Offices," available at www.federalreserve.gov/boarddocs/srletters/1995/SR9513.htm.

⁵ See Governor Bowman's February 11, 2019, remarks at the Conference for Community Bankers, sponsored by the American Bankers Association, San Diego, CA, at www.federalreserve.gov/newsevents/speech/bowman20190211a.htm.



Loan Modifications and COVID-19

by Jordan Jhamb, Financial Analysis Associate, Federal Reserve Bank of New York, Alex Kobulsky, Senior Financial Institution and Policy Analyst II, Board of Governors of the Federal Reserve System, and Jonathan Trunfio, Senior Financial Institution and Policy Analyst I, Board of Governors of the Federal Reserve System

In response to the COVID-19 crisis, the Federal Reserve, in collaboration with other agencies, has issued a number of statements to encourage banks to work with customers affected by the pandemic. This article summarizes the discussion from the April 24, 2020, Ask the Regulators session,¹ which highlighted the April 7, 2020, “Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus”² and clarified the interaction between existing accounting rules and Section 4013 of the Coronavirus Aid, Relief, and Economic Security (CARES) Act (section 4013).³

Interagency Statement

On April 7, 2020, the Federal Reserve, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Consumer Financial Protection Bureau, in consultation with state financial regulators, issued an interagency statement on loan modifications and reporting. The first section of the interagency statement encourages banks to work prudently and constructively

with borrowers affected by COVID-19. The agencies view loan modification programs as positive actions that can mitigate adverse effects on borrowers due to COVID-19, and prudent modifications done in a safe and sound manner will not be criticized. Proactive adjustments may serve to mitigate adverse effects on borrowers, reduce risk, improve loan performance, and ultimately serve the long-term interests of our communities. The interagency statement also clarifies the interaction between existing accounting rules and the temporary relief within section 4013; supervisory considerations on regulatory reporting; capital implications; and the agencies’ views on consumer protection considerations.

Accounting for Loan Modifications

As provided for under the CARES Act, a bank may account for an eligible loan modification either under section 4013 or in accordance with Accounting Standards Codification Subtopic 310–40.⁴ If a loan modification is not eligible under section 4013, or if the bank elects not to account for the loan modification under section 4013, the bank should evaluate whether the modified loan is a troubled debt restructuring (TDR).

¹ Visit <https://bsr.stlouisfed.org/askthefed/Home/ArchiveCall/250> to view the presentation and listen to the webinar.

² See www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200407a1.pdf.

³ Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116–136, 134 Stat. 281 (March 27, 2020).

⁴ ASC Subtopic 310–40, Receivables—Troubled Debt Restructurings by Creditors.

Accounting for Loan Modifications Under Section 4013

Section 4013 provides relief for banks from categorizing certain loan modifications as TDRs. A modification is eligible to be accounted for under section 4013 if the modification:

1. was in response to the COVID-19 pandemic;
2. occurred between March 1, 2020, and the earlier of December 31, 2020, or 60 days after the end of termination of the national emergency; and
3. was not more than 30 days past due as of December 31, 2019.

A modification that is accounted for in accordance with section 4013 is not treated as a TDR for accounting or regulatory reporting purposes for the remaining life of the modified section 4013 loan. Moreover, banks need not determine impairment associated with certain loan concessions that would otherwise have been required for TDRs, such as interest rate reductions, payment deferrals, and loan extensions.

Accounting for Loan Modifications Under ASC Subtopic 310–40

Banks should follow existing accounting guidance in ASC Subtopic 310–40 to determine whether the modification is a TDR, provided a loan modification is not eligible for or accounted for under section 4013. According to ASC Subtopic 310–40, a restructuring of a debt is a TDR if the creditor, for economic or legal reasons related to the debtor’s financial difficulties, grants a concession to the debtor that it would not otherwise consider. However, the interagency statement notes that a bank may conclude that the modification is not a TDR without further analysis if the modification is:

1. short term (e.g., six months or less), which includes payment deferrals, fee waivers, extensions of repayment terms, or other delays in payment that are insignificant;
2. made in response to the COVID-19 pandemic on a good-faith basis; and

3. current (that is, the borrower is less than 30 days past due on the contractual payments) at the time the modification program is implemented.

If a modification does not meet the criteria under section 4013 or the interagency statement, the bank should follow its existing accounting policies to determine whether the modification should be accounted for as a TDR.

Nonaccrual and the Allowance

Banks and regulators alike are concerned about nonaccrual status and allowance implications from loan modifications made in response to COVID-19. Short-term modifications that meet the criteria for eligibility under section 4013 or the interagency statement would generally not be required to be on nonaccrual status. However, each bank should refer to the applicable regulatory reporting instructions, as well as its internal accounting policies, to determine whether these loans should be placed on nonaccrual status and reported as such in regulatory reports. Banks should continue to maintain an appropriate allowance for loan and lease losses or allowance for credit losses, as applicable, for modified loans that are not accounted for as TDRs based on the criteria in section 4013 or the interagency statement.

Regulatory Risk Ratings and Risk Management

While related, a modified loan’s regulatory credit risk rating and its TDR analysis are separate and distinct decisions. Bankers and examiners alike should exercise judgment in reviewing modifications, including TDRs and section 4013 loans, to determine the appropriate risk grade for these credits. Examiners will not criticize banks for working with borrowers in a safe and sound manner.

Additionally, management should maintain records of the number of section 4013 loans outstanding and the outstanding balance of section 4013 loans, as these data will be collected on regulatory reports starting in the second quarter of 2020. ■

Federal Reserve Discount Window: What It Is and How It Works

*by Pam Hendry, former Director, Credit and Risk Management, Federal Reserve Bank of Atlanta; updated by Ben Clem, Senior Examiner, Supervision, Regulation, and Credit, Federal Reserve Bank of Richmond**

There have been several changes to the Federal Reserve's discount window¹ in response to the disruption caused by the COVID-19 pandemic. Most notably, the rate and term of borrowings have been modified as part of a broad set of tools to help depository institutions manage their liquidity risk. This article, originally published in 2016, provides basic information on the discount window and has been updated to highlight changes in response to the COVID-19 pandemic.

Discount Window Function

Lending at the discount window plays an important role in supporting the liquidity and stability of the banking system and the effective implementation of monetary policy. By providing ready access to funding, the discount window helps depository institutions manage their liquidity risks efficiently and avoid actions that have negative consequences for their customers, such as withdrawing credit during times of market stress. Thus, the discount window supports the smooth flow of credit to households and businesses.

Being prepared to borrow from the discount window can be an important component of a depository institution's planning for both strategic and contingency purposes. Depository institutions that do not envision using the discount window in the ordinary course of events are encouraged to execute the necessary documents for

contingency purposes because a need for discount window credit could arise unexpectedly. Additionally, depository institutions are encouraged to pledge collateral to the discount window to further enhance their ability to borrow should a need arise suddenly. In response to the current economic uncertainty, many depository institutions have increased their borrowing capacity at the discount window by pledging additional collateral.

Types of Borrowing Programs Available

Primary Credit

Primary credit was previously available to generally sound depository institutions on a very short-term basis, typically overnight. However, effective March 16, 2020, the discount window is offering terms as long as 90 days to depository institutions eligible for primary credit. These advances are prepayable and renewable by the borrower on a daily basis. Depository institutions are not required to seek alternative sources of funds before requesting advances of primary credit.

Reserve Banks ordinarily do not require depository institutions to provide reasons for requesting primary credit advances. Rather, borrowers are asked to provide only the minimum information necessary for the Reserve Bank to process a loan, which is usually the amount and term of the loan.

Secondary Credit

Secondary credit may be available to depository institutions that are not eligible for primary credit. The secondary credit program entails a higher level of Reserve Bank administration and oversight than the primary credit program. This type of credit is extended on a very short-term basis, typically overnight. However, in contrast to primary credit, there are restrictions on the uses of

* This article, which originally appeared in the Second Issue 2016 of *Community Banking Connections*, was written by Pam Hendry. Ben Clem updated the article to include changes that were made in response to the COVID-19 pandemic.

¹ Much of the statutory framework that governs discount window lending is contained in section 10B of the Federal Reserve Act, as amended, available at www.federalreserve.gov/aboutthefed/section10b.htm. The programs and policies that implement the statutory framework are set forth in the Federal Reserve's Regulation A, available at www.frbdiscowindow.org/.

secondary credit. Secondary credit is available to meet backup liquidity needs when its use is consistent with helping a depository institution return to market funding sources or the orderly resolution of a troubled institution. Secondary credit may not be used to fund an expansion of the institution's assets.

Seasonal Credit

The Federal Reserve's seasonal credit program is designed to assist small depository institutions in managing liquidity needs that arise because of seasonal types of businesses such as construction, college, farming, resort, tourism, and municipal financing. A depository institution may qualify for up to nine months of seasonal credit during the calendar year to assist in meeting the needs of the local communities where it operates.

Interest Rates on Primary, Secondary, and Seasonal Credit

Reserve Banks' boards of directors establish the primary credit rate at least every two weeks, subject to review and determination by the Board of Governors. The interest rates applied to primary and secondary credit change periodically to complement changes in the Federal Open Market Committee's (FOMC) target for the federal funds rate and to achieve broad monetary policy goals (see Table on page 18). Effective March 16, 2020, the spread of the primary credit rate over the FOMC's target range was reduced to help encourage more active use of the discount window by depository institutions to meet unexpected funding needs. The interest rate applied to seasonal credit is a floating rate based on market rates.

Eligibility to Borrow

By law, depository institutions that maintain reservable transaction accounts or nonpersonal time deposits (as defined in the Board's Regulation D) may establish borrowing privileges at the discount window. Eligibility to borrow is not dependent on or related to the use of Federal Reserve priced services.



The discount window, which was the Fed's primary tool in the early days, was an actual window located within the Reserve Banks. Shown here is the discount window at the New York Fed in the 1960s.

U.S. branches and agencies of foreign banks that hold reserves are eligible to borrow under the same general terms and conditions that apply to domestic depository institutions. Foreign banks with more than one branch or agency operating in the United States may have access to the discount window in more than one Reserve Bank District. Any discount window loan to those branches or agencies will be made by the Reserve Banks where the borrowing branches or agencies maintain accounts. Reserve Banks coordinate and monitor lending to such branches and agencies on a nationwide basis.

Bankers' banks, corporate credit unions, and other financial institutions are not required to maintain reserves under the Board's Regulation D and, therefore, do not have regular access to the discount window. However, the Board of Governors has determined that such institutions may obtain access to the discount window if they voluntarily maintain reserves. (Refer to Regulation D for more details.²)

² See www.federalreserve.gov/supervisionreg/regdcdg.htm for more information about Regulation D.

Table: Summary of Interest Rate Setting by Type of Borrowing

Lending Program	Eligible Borrowers	Setting of Interest Rate^a
Primary Credit	Depository institutions (DIs) in generally sound financial condition	The Reserve Banks' boards of directors establish the primary credit rate, and the Board of Governors approves the rate; the rate is currently set at the top of the range for the FOMC's target federal funds rate ^b
Secondary Credit	DIs that do not qualify for primary credit	Spread above the primary credit rate, currently 50 basis points
Seasonal Credit	Smaller DIs with a regular seasonal need for funds	Average of the effective federal funds rate and the three-month CD rate, typically resulting in a rate close to the federal funds rate target

^aCurrent and historical primary, secondary, and seasonal rates are available at www.frbdiscountwindow.org.

^bRates for all programs are proposed by the board of directors of the lending Reserve Bank and approved by the Board of Governors of the Federal Reserve System.

Eligibility for the Credit Programs

Primary Credit

A depository institution must be in generally sound financial condition, as determined by its Reserve Bank, to qualify for primary credit. A Reserve Bank reviews a depository institution's condition on an ongoing basis using supervisory ratings and capitalization data. Supplementary information, when available, may also be used. These criteria, among others, are used in determining whether an institution is in generally sound financial condition:

- An institution assigned a composite CAMELS rating of 1, 2, or 3 (or SOSA 1 or 2 and ROCA 1, 2, or 3) that is at least adequately capitalized is eligible for primary credit unless supplementary information indicates that the institution is not generally sound.³

- Institutions assigned a composite CAMELS rating of 4 (or SOSA 1 or 2 and ROCA 4 or 5) are not eligible for primary credit unless an ongoing examination or other supplementary information indicates that the institution is at least adequately capitalized and that its condition has improved sufficiently to be deemed generally sound by its Reserve Bank.
- Institutions assigned a composite CAMELS rating of 5 (or SOSA 3 regardless of ROCA) are not eligible for primary credit.

Secondary Credit

Depository institutions that do not qualify for primary credit may be eligible for secondary credit when the use of such credit is consistent with a timely return to a reliance on market sources of funding or the orderly resolution of a troubled institution. A Reserve Bank must have sufficient information about a depository institution's financial condition and reasons for borrowing

³ CAMELS stands for capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk; SOSA stands for strength of support assessment; and ROCA stands for risk management, operational controls, compliance, and asset quality.

to ensure that an extension of secondary credit would be consistent with the purpose of the facility.

Note that there are restrictions on lending to undercapitalized depository institutions: The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)⁴ amended the Federal Reserve Act to restrain extensions of Federal Reserve credit to an FDIC-insured depository institution that has fallen below minimum capital standards or has received a composite CAMELS rating of 5 (or its equivalent) from its federal regulator. Such depository institutions may request secondary credit, but Federal Reserve lending to a depository institution that is undercapitalized, significantly undercapitalized, or rated a composite CAMELS 5 (or its equivalent) is generally limited to 60 days in any 120-day period. Ordinarily, a depository institution that is critically undercapitalized may receive discount window credit only during the five-day period that begins on the day it becomes critically undercapitalized. Reserve Banks apply the same rules to depository institutions that are not insured by the FDIC but that are otherwise eligible to borrow at the discount window.

Any depository institution subject to one of the above-mentioned limits should maintain liquidity sufficient to keep its needs for discount window credit within appropriate bounds. If it appears that liquidity may prove inadequate, the depository institution should consult with its Reserve Bank as far in advance as possible. Such consultations may also include discussions of collateral arrangements needed to ensure the orderly continuation of Federal Reserve payment services.

Seasonal Credit

To become eligible for seasonal credit, a depository institution must establish a seasonal qualification with its Reserve Bank. Eligible institutions are generally limited to those with deposits less than \$500 million. A depository institution that anticipates a possible need for seasonal credit is encouraged to contact its Reserve Bank to ascertain its eligibility and make arrangements in advance. Making arrangements does not obligate the institution to borrow.

⁴ See www.fdic.gov/regulations/laws/rules/8000-2400.html for more information about the act.

Critically undercapitalized depository institutions are not eligible for seasonal credit. Undercapitalized or significantly undercapitalized depository institutions may be eligible but only after careful review of their condition and prospects; any lending to such institutions would be subject to statutory limitations established by the FDICIA as discussed in the Secondary Credit section.

Documentation Requirements for Borrowing

Any depository institution that expects to use the discount window should file the necessary lending agreements and corporate resolutions under the terms set forth in the Federal Reserve's lending agreement, Operating Circular No. 10.

Operating Circular No. 10 documents include:

- **Letter of Agreement** — indicates a depository institution's acceptance of the terms and conditions in Operating Circular No. 10
- **Authorizing Resolutions for Borrowers** — provides a depository institution's authorization to borrow from and pledge assets to a Reserve Bank
- **Official OC-10 Authorization List** — a list of individuals or corporate titles of individuals who are authorized to borrow or pledge or withdraw collateral as specified in the depository institution's Authorizing Resolutions for Borrowers
- **Letter of Agreement to Correspondent Credit and Payment Agreement** — required only if the depository institution does not have a Federal Reserve account and a correspondent is selected to receive discount window advances and make payments on the depository institution's behalf
- **Certificate** — provides the Reserve Bank with all the necessary information to make an effective Uniform Commercial Code-1 financing statement filing against the borrower. This document might not be required; contact the respective Reserve Bank for more information.
- **Legal Opinions from Both Foreign and U.S. Outside Counsel** — required for U.S. branches and agencies of foreign banks

“ Since the Federal Reserve System was established in 1913, discount window policies and programs have evolved in response to the changing needs of the economy and financial system. ”

Collateral

All extensions of credit must be secured to the satisfaction of the lending Reserve Bank by collateral that is acceptable for that purpose. Most performing or investment-grade assets held by depository institutions are acceptable as collateral, including loans that have been modified in a safe and sound manner in response to COVID-19 that incorporate temporary payment deferrals. Reserve Banks require a perfected security interest in all collateral pledged to secure discount window loans.

Reserve Bank staff can offer guidance on other types of collateral that may be acceptable. The following assets are most commonly pledged to secure discount window advances:

- Commercial, industrial, or agricultural loans
- Consumer loans
- Residential and commercial real estate loans
- Corporate bonds and money market instruments
- Obligations of U.S. government agencies and government-sponsored enterprises
- Asset-backed securities
- Collateralized mortgage obligations

- U.S. Treasury obligations
- State or political subdivision obligations

Assets accepted as collateral are assigned a lendable value (market value or an internally modeled fair market value estimate multiplied by standard, published margins), with additional adjustments as deemed appropriate by the Reserve Bank. The financial condition of an institution may be considered when assigning values. Collateral margins are applied to the Federal Reserve's fair market value estimate and are designed to account for risk characteristics of the pledged asset as well as the volatility of the value of the pledged asset over an estimated liquidation period. Collateral margins are discussed below.

Loans:

- The Federal Reserve uses reported cash flow characteristics and proxy credit spreads to calculate a fair market value estimate for each pledged loan.
- Margins for loan collateral are likewise based on reported cash flow characteristics. Margins are established based on the historical volatility of risk-free rates and proxy credit spreads, measured over typical liquidation periods.
- Note that loans originated through the Paycheck Protection Program fall into the U.S. Agency Guaranteed Loans category for margining purposes.

Securities:

- Securities are typically valued daily using prices supplied by external vendors. Securities for which a price is not available receive zero collateral value.
- Margins for securities are assigned based on asset type and duration. Margins are established based on the historical price volatility of each category, measured over typical liquidation periods.

Arrangements for pledging collateral should be reviewed with the Reserve Bank. Securities issued by the U.S. government and most securities issued by U.S. government agencies are held in an automated book-entry records

Continued on page 22

Did You Miss Any of These Sessions?

The COVID-19 pandemic has taken many of us out of our routines. With our changing commitments, trying to juggle work and our personal lives, many of us have not had the opportunity to participate in as many information-gathering opportunities as we would like. If you had planned to participate in any recent Ask the Fed or Ask the Regulators sessions but missed them because of other commitments, you can still go online and listen to the webinars and access the presentations. These are some of the most recent topics:

Ask the Fed:

- June 4, 2020 **Webinar for Potential Lenders in the Main Street Lending Program**
<https://bsr.stlouisfed.org/askthefed/Home/DisplayCall/264>
- May 29, 2020 **Main Street Lending Program for Borrowers**
<https://bsr.stlouisfed.org/askthefed/Home/DisplayCall/265>
- May 29, 2020 **The Supervision and Regulation Report**
<https://bsr.stlouisfed.org/askthefed/Home/DisplayCall/262>
- May 20, 2020 **The FRB PPPLF: Update on Pledging Purchased Loans and Operational Details on the Paydown Process for All Eligible PPPLF Participants**
<https://bsr.stlouisfed.org/askthefed/Home/ArchiveCall/259>

Ask the Regulators:

- April 24, 2020 **Interagency Statement on Loan Modifications & Reporting for Financial Institutions with Customers Affected by the Coronavirus**
<https://bsr.stlouisfed.org/askthefed/Home/ArchiveCall/250>
- April 14, 2020 **COVID-19 Update: New Transition Provisions to Delay the Impact of CECL on Regulatory Capital**
<https://bsr.stlouisfed.org/askthefed/Home/ArchiveCall/242>
- April 3, 2020 **COVID-19 Updates**
<https://bsr.stlouisfed.org/askthefed/Home/ArchiveCall/239>

system at the Federal Reserve. Other securities pledged as collateral generally are held by a depository or other agent through a custodian arrangement. Loans (customer notes) pledged as collateral typically are held by a custodian or under a borrower-in-custody arrangement. Physical securities, promissory notes, and other definitive assets may, however, be held on the Reserve Bank's premises.

Disclosure

In accordance with the provisions of the Dodd–Frank Wall Street Reform and Consumer Protection Act,⁵ the Federal Reserve changed its practices with respect to disclosure of discount window lending information. Effective for discount window loans (primary, secondary, and seasonal credit) extended on or after July 21, 2010, the Federal Reserve will publicly disclose the following information, generally about two years after a discount window loan is extended to a depository institution:

- The name and identifying details of the depository institution
- The amount borrowed by the depository institution
- The interest rate paid by the depository institution
- Information identifying the types and amounts of collateral pledged in connection with any discount window loan. This disclosure requirement does not apply to collateral pledged by depository institutions that do not borrow.

This information will be released quarterly and may be disclosed with less than a two-year lag if the Chair of the Federal Reserve determines that it is in the public's interest and that the disclosure would not harm the purpose or conduct of the discount window.

⁵ The text of the Dodd–Frank Wall Street Reform and Consumer Protection Act is available at www.gpo.gov/fdsys/pkg/BILLS-111hr4173enr/pdf/BILLS-111hr4173enr.pdf.

Conclusion

Since the Federal Reserve System was established in 1913, discount window policies and programs have evolved in response to the changing needs of the economy and the financial system. In response to current economic conditions, term financing is now available to primary credit depository institutions, borrowing rates for primary and secondary credit have been lowered, and policies affirm that loans modified in response to COVID-19 are acceptable as collateral.

The primary credit program, established in 2003, continues to serve as a safety valve for ensuring adequate liquidity in the banking system and as a backup source of short-term funds for generally sound depository institutions. Being prepared to borrow primary credit — similar to access to any backup liquidity facility — enhances a depository institution's liquidity and eliminates the need to pay high rates for contingency funding. Even if a depository institution does not envision using the discount window in the near term, it is encouraged to execute the required documentation for contingency purposes. Additionally, depository institutions are encouraged to contact their Reserve Bank to discuss collateral requirements and arrangements before a need to borrow arises. ■

While this article focused on the ordinary discount window lending programs, there have been numerous other changes to Federal Reserve lending programs in response to the COVID-19 pandemic. Perhaps the most significant change for depository institutions is the newly established Paycheck Protection Program Liquidity Facility (PPPLF). The PPPLF was created to support the flow of credit to households and businesses to help limit economic distress. For more information on the PPPLF and other changes, please visit www.federalreserve.gov/covid-19.htm.



2020 Writers' Cohort

Last year, the *Community Banking Connections* Advisory Board announced the creation of a Writers' Cohort. Supervision employees from across the Federal Reserve System were asked to submit a paper on one of two topics. From the submissions, 10 writers were selected to be part of the cohort. Their mission is to write feature articles to help readers better understand supervisory expectations, safety and soundness rules and regulations, and the role of supervisory guidance.

Several Cohort Writers Have Their Work Featured in This Issue

Several writers from the *Community Banking Connections* 2020 Writers' Cohort have contributed articles to this issue. **Kerri Allen**, an examiner at the Federal Reserve Bank of Kansas City, and **William Mark**, a lead examiner at the Federal Reserve Bank of Chicago, cowrote "Conducting Offsite Bank Examinations." **Ben Clem**, a senior examiner at the Federal Reserve Bank of Richmond, updated Pam Hendry's previously published article "Federal Reserve Discount Window: What It Is and How It Works." **Jordan Jhamb**, a financial analysis associate at the Federal Reserve Bank of New York, coauthored "Loan Modifications and COVID-19." Finally, **Kalyn Neal**, an examiner/supervisory specialist at the Federal Reserve Bank of Kansas City, compiled this issue's CECL Corner.

Cohort Chairs:

Ben Clem, Senior Examiner, Supervision, Regulation, and Credit, FRB Richmond

Jennifer Grier, Senior Examiner, Supervision, Regulation, and Credit, FRB Atlanta

Cohort Members:

Kerri Allen, Examiner, Examinations & Inspections, FRB Kansas City; **Robert Crepinsek**, Examiner, Supervision, Regulation, and Credit, FRB Boston; **Anthony Gonitzke**, Senior Examiner, Financial Institution Supervision and Credit, FRB San Francisco; **Jordan Jhamb**, Financial Analysis Associate, RCFI, FRB New York; **William Mark**, Lead Examiner, Supervision and Regulation, FRB Chicago; **Kalyn Neal**, Examiner/Supervisory Specialist, Examinations & Inspections, FRB Kansas City; **Alex Shelton**, Portfolio Central Point of Contact/Senior Examiner, Supervision, Regulation, and Credit, FRB Richmond; **Scott Zurborg**, Senior Large Bank Examiner, Supervision and Regulation, FRB Chicago



Connect with Us

What banking topics are most relevant to you? 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.

Direct any comments and suggestions to editor@communitybankingconnections.org.



Scan with your smartphone or tablet to access Community Banking Connections online.