Community banks serve the areas in which they operate. In doing so, they accumulate information on local borrowers. Building up this information facilitates the provision of credit in ways out-of-area lenders cannot; therefore community bankers can facilitate effective, informed credit risk management. In this way, local communities and banks benefit from asset concentration.

But asset concentration also defines the accumulation of risk; it is the classic example of “putting one’s eggs in a single basket.” Not lending into a well-diversified pool of borrowers exposes community banks to potentially large losses. The losses can materialize if a downturn in an industry or economic sector significantly reduces the repayment ability of the bank’s concentrated borrower base and/or the collateral these borrowers pledge. In short, the assumption of asset concentrations allows banks to produce socially beneficial activity, while at the same time presenting a real risk to the bank.

This challenge exists for many banks in the Ninth Federal Reserve District, which is overseen by the Federal Reserve Bank of Minneapolis. The states of Montana, North Dakota, South Dakota, and Minnesota fall within the District, along with the western portion of Wisconsin and the Upper Peninsula of Michigan. Commodity-related production and industries, including those related to agriculture, timber, minerals and mining, and energy, have a long history in the Ninth District. Community banks in the Ninth District have always lent to firms that operate directly in these industries, as well as to firms that provide support to these industries and households with members working in these industries.
Business Resumption Planning for Banks

by Aaron Cohen, Technology Architect, Federal Reserve Bank of Chicago, and Anthony Toins, Examiner, Federal Reserve Bank of Chicago

Business resumption planning is a comprehensive bankwide process that defines how a bank is to respond to and recover from business disruptions, enabling a bank to continue to support constituents and stakeholders alike. The plans incorporate business processes, people, and technology.

Many community banks rely heavily on third-party service providers to deliver core banking solutions that, when key services fail, create a single point of failure for these banks. In 2012, when Superstorm Sandy disrupted payment processing and thereby affected liquidity levels, many community bankers realized the importance of having cost-effective solutions to manage single-point-of-failure situations.

Business resumption planning is not only about third-party risk but should also address everything from pandemics, like the 1918 flu pandemic,1 to terrorist attacks, such as the September 11th attacks, to natural disasters, to nation- or state-sponsored cyberattacks2 against financial sector institutions.

The planning process should address the range of disruptions or failures that could occur and include mitigants for each type of disruption or failure.

This article discusses business resumption in the context of business continuity and disaster recovery planning.3 The goals are to provide banks with concepts and ideas to consider when developing or strengthening their business continuity planning processes as well as to encourage a dialogue between institutions and examiners about business resumption planning based on a shared language.4

Business Continuity Planning Process

The business continuity planning process includes developing strategies for the resumption of critical business processes and the technical recovery of critical information systems


3 Bank senior management should not view business continuity and disaster recovery as one and the same. The goal of business continuity planning is to restore essential business processes. Disaster recovery is a subset of business continuity planning that focuses on bringing information systems back online.

4 While a business resumption examination is traditionally performed by information technology (IT) examiners, business resumption planning should extend beyond the bank’s IT area and include all bank functions and departments.
supporting those functions. A bank should approach business continuity planning as a bankwide responsibility that should prioritize business objectives. Business continuity planning should consider how essential processes, business units, departments, and information systems will contribute to a coordinated response to a bankwide disruption. The approach should include plans for both short-term and long-term disruptions and recovery operations. A tight integration of the institution’s overall planning process with that of the individual business units’ plans for resumption of essential processes is critical for business resumption and recovery. Bank senior management should set the tone at the top that business continuity is everyone’s responsibility and not just an information technology (IT) issue handled by the IT function.

Banks should consider adopting an iterative approach to business continuity planning. The four steps for an effective program are (1) business impact analysis, (2) risk assessment, (3) risk management, and (4) monitoring and testing. Additionally, when key bank functions are outsourced, third-party risk should be considered during the planning process. The business continuity planning process should evolve continuously in response to changes in potential threats and business operations and to address audit recommendations and test results.

**Business Impact Analysis**

The first step in the business continuity planning process is the business impact analysis, which identifies mission-critical business functions and quantifies the impact a loss of those functions (for example, operational and financial) may have on the organization. It also should determine how quickly essential business units and/or processes can return to full operation following a disruption, as well as identify the resources required to resume operations. It is important that the analysis include a bankwide view, with contributions from senior management representatives from all lines of business, not just the IT function. And, finally, the business impact analysis should be approved by both the bank’s senior management and board of directors and should be updated at least annually or when there are significant changes at the bank to either business processes or the IT infrastructure.

A business impact analysis should include:

- an assessment and prioritization of all business processes;
- identification of the potential impact of business disruptions resulting from uncontrolled, unknown events on the bank’s business functions and processes;
- identification of the legal and regulatory requirements;
- an estimate of maximum allowable downtime; and
- an estimate of recovery time objectives, recovery point objectives, and critical path recovery (banks should document how recovery times/objectives are determined and whether they are validated by testing).

**Risk Assessment**

Risk assessment is the second step in the business continuity planning process. While a risk assessment determines what could cause an outage, a business impact analysis attempts to measure the effects should an outage occur. The risk assessment identifies threats, vulnerabilities, and the potential impact on a bank’s critical activities and supporting resources. Senior management should use this information to identify where risks exceed risk appetite and develop a program to reduce the likelihood and impact of disruptions.

The risk assessment should include:

- an evaluation of business impact analysis assumptions using various disruption scenarios;
- analyses of potential disruptions based on the impact to the bank, its customers, and the local economies served;
- prioritization of potential business disruptions based on severity; and
- an analysis of the gap between existing business continuity planning and the policies and procedures that should be implemented.

A bank’s senior management should be responsible for maintaining a current risk assessment based on changes to the

---


7 Recovery time objective is the amount of time it takes to recover from a disruptive event.

8 Recovery point objective is the acceptable amount of data loss measured in time that can be lost from a disruptive event.

9 Prioritization should reflect a continuum of disruptions. For example, if a rural bank is located near a railroad track, the bank should perform a risk assessment that would include a train derailment and chemical spill representing a low-probability/high-impact disruption in contrast to a temporary weather-related power outage representing a high-probability/low-impact disruption.
This article touches on postorigination risk management activities and tools that examiners will normally find in an effective bank loan policy: a risk rating system; a monitoring framework; management information systems (MIS) and reporting; internal controls, including audit, loan review, and credit administration; and a problem loan workout function. Although maintaining an appropriate allowance for loan and lease losses (ALLL) is also a key component of postorigination risk management, much guidance and numerous articles have been written on the topic; therefore, it will not be covered in this article.1

As mentioned in the prior articles in this series, processes and procedures that govern lending activities do not necessarily need to be incorporated within one single loan policy; however, a bank should maintain a central repository that houses all relevant policies to promote consistent application by its employees.

Risk Rating System
A key element of a sound monitoring framework is a well-defined and adequately documented risk rating system. The importance of risk ratings was discussed in part two of this series, noting that the bank should have a process to assign accurate and timely risk ratings and to update ratings when appropriate. While the granularity of risk rating systems can vary significantly based on portfolio size, composition, and product complexity, management should ensure that risk ratings are accurate and reliable. Ineffective risk ratings systems will result in weak portfolio oversight, an inaccurate ALLL, and ultimately, increased credit losses.

An effective risk rating system should:

- Provide the foundation for credit risk measurement, monitoring, and reporting
- Support management and board decision-making
- Be sufficiently flexible to allow for use with various types of credit exposure
- Provide appropriate granularity of risk ratings (including regulatory classification grades) that accurately reflect the risk of default and credit losses
- Offer multiple pass grade options as appropriate for the complexity and risk of the portfolio that adequately differentiate pass risk ratings
- Precisely define ratings criteria using both objective (quantitative) and subjective (qualitative) factors
- Consider both the borrower’s expected performance and the transaction structure
- Be independently validated2

The loan policy, at a minimum, should outline these same factors.


Monitoring Framework
To promote appropriate risk identification, measurement, and monitoring, the loan policy should clearly identify and establish procedures related to the ongoing management of the loan portfolio and identify the appropriate staffing level and skill sets required for such tasks.

Monitoring and reporting on the performance and collateral of loans should start immediately following the dispersal of loan proceeds. Therefore, the individual, group(s), or committee(s) responsible for ongoing monitoring, controls, and incentives should be well established to ensure appropriate oversight. While a bank may choose different management approaches for credit monitoring, many banks have the business line serve as the first line of defense for ongoing monitoring in order to leverage their lending expertise to identify potential issues and to maintain a strong, ongoing relationship with the borrower. This approach, however, is not a requirement.

The monitoring framework should also include an assessment of compliance with the bank’s underwriting criteria. This includes testing loan covenants, both positive and negative, to evaluate whether the borrower is complying with loan covenants or is in technical default, or whether the repayment of principal is expected or jeopardized.

Management Information Systems and Reporting
Sound MIS and reporting will enhance the efficiency and effectiveness of lending decisions, ongoing portfolio monitoring, and overall credit management. The loan policy should clearly identify the primary monitoring reports necessary to support credit management and to establish the frequency for producing the reports. Reports should be targeted to the user and based on the level of oversight and granularity required for management, committees, and the board. For example, management reports may be more granular, while board reports may provide a high-level yet comprehensive overview of lending activity and risks.

All reporting should be relevant and adequately convey the level of detail required by the end user. Reports should be expressed in both dollar and percentage changes along with volume and/or transaction details. This level of detail will provide a balanced report so that a single large-dollar transaction does not unnecessarily skew reports that have a significant volume of low-dollar transactions.

The following information should be readily available and routinely reviewed by management:

- Total loans and commitments
- Pipeline reports (to identify emerging concentrations or risks)
- Loans in excess of existing credit limits
- New extensions of credit, credit renewals, and restructured credits
- Delinquent and/or nonaccrual loans
- Credits adversely graded or requiring special attention
- Credits to insiders and their related interests
- Credits not in compliance with internal lending policies, laws, or regulations

For the board of directors to be fully effective, bank management should provide the board with sufficient information that will enable directors to understand the key risks in the loan portfolio and assess the adequacy of risk management practices and internal controls. The board of directors should receive board meeting materials far enough in advance of a meeting to promote active meeting participation.

Internal Controls
Internal controls, such as internal audit, loan review, and credit administration, are critical functions that play an important role in maintaining effective monitoring of the lending process. The loan policy should establish a system for loan review to confirm that credit policies, underwriting procedures, and internal rating assignments are being thoroughly reviewed by experienced and independent personnel. A system for ongoing loan reviews should provide management with sufficient information to assess adherence to internal policies and the ability of approvers to accurately risk rate credit exposures.

continued on page 15

---


On July 21, 2015, the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (Federal Reserve Board), the Office of the Comptroller of the Currency (OCC), the Farm Credit Administration (FCA), and the National Credit Union Administration (NCUA) jointly published a final rule to implement new flood insurance requirements enacted by the Biggert-Waters Flood Insurance Reform Act (BWA) of 2012 and the Homeowner Flood Insurance Affordability Act (HFIAA) of 2014. The final rule makes four changes to the federal flood insurance requirements:

- Lenders are required to escrow all premiums and fees for flood insurance for loans secured by residential real estate or mobile homes in a special flood hazard area that are made, increased, extended, or renewed on or after January 1, 2016, subject to certain exceptions, including an exception for small lenders. For loans made, increased, renewed, or extended before that date that are still outstanding and not subject to one of the exceptions, lenders must notify borrowers by June 30, 2016, of the option to escrow flood insurance premiums and costs.
- To help reduce the cost of premiums, the rule exempts structures that are part of a residential property but detached from it and do not serve as a residence (such as a tool shed or pool house) from the mandatory flood insurance purchase requirement, although lenders still have the option to require it to protect the collateral underlying the loan.
- Lenders may charge the borrower for the costs of force-placed coverage beginning on the date the borrower’s previous coverage lapsed or did not provide sufficient coverage.
- If a lender charges a borrower for force-placed flood insurance but later learns that the borrower actually had sufficient coverage, the lender or its servicer must terminate the force-placed insurance and refund any premiums or fees paid during the period of duplicate coverage.

This article summarizes the final rule.

Escrow of Flood Insurance Payments for Loans with Triggering Events

A regulated lending institution, or a servicer acting on its behalf, must escrow all flood insurance premiums and fees for loans secured by residential improved real estate or a mobile home in a special hazard area unless the loan or the lending institution qualifies for one of several exceptions. The escrow requirement applies to any nonexcepted loan secured by residential improved real estate or a mobile home that is made, increased, extended, or renewed on or after January 1, 2016.

The rule also states that the escrow provisions of the Real Estate Settlement Procedures Act (RESPA) apply to flood insurance escrows if the loan is subject to RESPA, which applies to “federally related mortgage loans.” The escrow provisions of RESPA generally limit the amount that may be maintained in escrow accounts and require escrow account statements. The rule also requires lenders to provide the escrow notice for any excepted loan that could lose its exemption during the term of the loan.

Escrow Notice to Affected Borrowers

For loans subject to the escrow requirement or loans that could be subject to it if one of the escrow exceptions discussed in the following section no longer applies, lenders must notify borrowers of the escrow requirement in the Notice of Special Flood Hazards. To facilitate compliance, the agencies updated the model notice form in Appendix A of their regulations to include this information.

---


2 For the Federal Reserve Board’s regulation, refer to 12 CFR section 208.25.

3 Regulation X, 12 CFR section 1024.2(b).

4 RESPA’s escrow requirements are codified at 12 CFR section 1024.17.
Small Lender Exception
The final rule excepts from the flood insurance escrow requirement any financial institution with total assets of less than $1 billion (as of December 31 of either of the two prior calendar years) that, as of July 6, 2012:

- was not required under federal or state law to deposit taxes, insurance premiums, fees, or any other charges in an escrow account for the entire term of any loan secured by residential improved real estate or a mobile home, and
- did not have a policy of consistently and uniformly requiring the deposit of taxes, insurance premiums, fees, or any other charges in an escrow account for loans secured by residential improved real estate or a mobile home.

Financial institutions are not required to count the assets of other institutions under common ownership with the regulated lending institution when calculating asset size. The final rule also reaffirms that a regulated lending institution that may initially qualify for the exception, but later exceeds the $1 billion asset-size threshold, must begin escrowing for any loans made, increased, extended, or renewed on or after July 1 of the first calendar year of changed status.

Loan-Related Exceptions
The rule also excepts several categories of loans from the flood insurance escrow requirement:

- Loans with a subordinate position to a senior lien secured by the same property for which flood insurance is being provided
- Loans secured by residential improved real estate or a mobile home that is part of a condominium, cooperative, or other project development when covered by a flood insurance policy that (a) meets the mandatory flood insurance purchase requirement; (b) is provided by the condominium association, cooperative, homeowners association, or other applicable group; and (c) the premium for which is paid by the condominium association, cooperative, homeowners association, or other applicable group as a common expense
- Loans secured by residential improved real estate or a mobile home that is used as collateral for a business, commercial, or agricultural purpose
- Home equity lines of credit
- Nonperforming loans, which the regulation defines as a loan that is 90 or more days past due and remains nonperforming until it is permanently modified or until the entire amount past due, including principal, accrued interest, and penalty interest incurred as the result of past due status, is collected or otherwise discharged in full
- Loans with terms of 12 months or less

As a general rule, if a lender or its servicer determines during the term of a loan covered by this rule that an exception does not apply, the lender or its servicer shall require the escrow of all flood insurance premiums and fees as soon as reasonably practicable.

Option to Escrow on Outstanding Loans
The final rule requires regulated lending institutions to offer and make available to a borrower the option to escrow flood insurance premiums and fees for loans secured by residential improved real estate or a mobile home that are outstanding as of January 1, 2016, subject to the exceptions outlined previously. The final rule clarifies that the option to escrow does not apply to an outstanding loan that is already escrowing flood insurance premiums and fees or will be subject to the flood insurance escrow requirement. Furthermore, the rule requires regulated lending institutions that lose the small lender exception to offer the option to escrow to existing borrowers with outstanding loans secured by residential improved real estate or a mobile home. Regulated lending institutions have until June 30, 2016, to provide notice to affected borrowers about the option to escrow.

To facilitate compliance with the Option to Escrow notice requirement, the final rule includes a new model clause in Appendix B of the agencies’ flood regulations. Using the model clause provides a safe harbor for complying with the notice requirement.

Detached Structures
Under the final rule, flood insurance is no longer required on structures that are part of a residential property but are detached from the primary residential structure and do not serve as a residence, such as a tool shed or pool house. Previously, detached nonresidential structures had to be insured separately from dwellings (except for detached garages that were covered under dwelling policies up to 10 percent of the policy amount).

According to the final rule, “a structure that is part of a residential property” refers to a structure used primarily for

continued on page 17
Asset Concentrations Present Deep Tradeoffs for Community Banks and Bank Supervisors

continued from page 1

The numbers tell the story: Forty-nine percent of all community banks in the Ninth District have a concentrated exposure to agriculture, with more than 25 percent of total loans used for agricultural production or secured by agricultural real estate.1 Further, 26 percent of the banks are highly concentrated in agriculture, with over 50 percent of their total loans used for agricultural production or secured by agricultural real estate. This does not include the many banks heavily exposed to the other commodities already mentioned. The Bakken oil patch of North Dakota and Montana has created a whole set of banks with borrowers heavily exposed to the price of crude oil.

Commodity exposure heightens the risk that standard asset concentration raises, as commodity markets have a particularly high degree of volatility. Banks with many borrowers dependent on commodity prices and markets must manage a concentration with unpredictable and significant ups and downs.

Of course, concentrations certainly go beyond basic commodities. Concentrations in local real estate lending come easily to mind given the centrality they played in the last financial crisis and the banking crises before it. Within the Ninth District, 34 percent of the banks meet or exceed the supervisory screening criteria for commercial real estate (CRE) concentrations.2 And CRE concentrations are not unique to the Ninth District. There are 4,824 community banks outside of the District, with 24 percent having more than 25 percent of their loans in agriculture and 42 percent that meet or exceed the supervisory screening criteria for CRE concentration.

These data and prior discussion make it clear that an open question for supervisors concerns the ability of banks to manage asset concentrations. Banning concentrations would curtail beneficial lending. Ignoring concentrations would fail to consider important risks to safety and soundness.

Supervisors have responded to this challenge by issuing guidance that details specific risk management practices that banks are expected to have in place to appropriately manage concentrations. For example, the Federal Reserve issued guidance specific to the management of agricultural credit risk, which has particular salience for agricultural banks (see SR letter 11-14, “Supervisory Expectations for Risk Management of Agricultural Credit Risk”). The Federal Reserve, along with the other banking supervisors, also issued guidance for the management of CRE concentrations (see SR letter 07-1, “Interagency Guidance on Concentrations in Commercial Real Estate”). I encourage bankers to read the guidance and implement the practices noted.

I will try not to summarize the guidance in the rest of this article. Instead, I will describe some general approaches that banks should consider as they balance the costs and benefits of their concentrations.

Start with Capital and Reserves
Concentrations, as previously noted, mean higher inherent risk. Banks should hold capital and reserves commensurate with that risk to protect against the higher chance of loss. Minimum prompt corrective action capital levels, as a result, are not typically appropriate for banks with concentrations.3 Likewise, banks with a significant exposure to a particular loan type, market, or industry should incorporate the likelihood of strong correlations among the loans when determining the appropriate allowance for loan and lease losses. The exact capital level that a bank targets depends on the facts and circumstances of its operations. But, all else equal, I would generally expect to see higher capital for higher concentrations. While “all else is not equal,” I am surprised that banks with concentrations do not, on average, hold more capital as their concentration levels rise, as the figure shows.

1 For supervisory purposes, the Federal Reserve uses the term “community banking organization” to describe entities with $10 billion or less in total consolidated assets.
2 The guidance sets forth the supervisory screening criteria as (i) construction and land development loans exceeding 100 percent of a bank’s capital or (ii) all CRE loans exceeding 300 percent of a bank’s capital and growth in CRE over the last three years exceeding 50 percent. CRE loans exclude nonfarm, nonresidential loans for which the primary source of repayment is cash flow from the ongoing operation of the property owner or an affiliate thereof (in other words, “owner-occupied” CRE loans).
The figure below reports the average capital level for concentrated banks, broken out by the type of concentration (for example, agriculture and CRE). The level of concentration is reported by decile within each type of concentrated bank. So, for example, the figure reports the average level of capital for agricultural banks that are the least concentrated (up to the 10th percentile) and the most concentrated (at or over the 90th percentile). The capital levels are not materially different for more concentrated banks, with most banks having a leverage ratio of about 10 percent. This fact should give the banking industry and supervisors some pause.

**Diversify, but Carefully**

The natural cure to an asset concentration is diversifying. Many agricultural banks are able to achieve a level of diversification by lending to both row crop producers and livestock operations. Some of the forces that stress one loan segment may benefit another segment. For example, low crop prices will hurt the crop producers but can be a benefit to livestock operators by lowering feed costs. This type of diversification provides some protection from concentration risk; however, many of the stressors cross agricultural sectors.

But diversifying may not always prove to be so easy for a community bank. A geographically concentrated bank may look to out-of-area loans to reduce risk. This may seem particularly tempting in an environment in which bank profits are under pressure. A prudent bank needs to underwrite an out-of-area loan or participation using the same effective credit risk management practices it uses for in-territory loans. That standard can be very hard to meet for a bank that does not have rich information on the out-of-market borrowers or specialized expertise for out-of-market loans. Does a bank focused on energy loans have the expertise to buy out-of-area CRE loans? Note that the same is true for banks lending into an area of potential concentration. Out-of-territory participations that originated out of shale boom areas could provide needed returns to a bank in an agricultural area, for example. Yet, it is not a trivial task for an agricultural-expert bank to underwrite a loan for which repayment is tightly linked to oil/gas development.

An alternative way to seek diversification is through the size and composition of a bank’s securities portfolio. Diversification can occur in at least two ways. Banks can use the

---

**Figure: Mean Tier 1 Leverage Ratio for Banks with Loan Concentration by Decile**

*(as of June 30, 2015)*

* For the purposes of this article, I define banks as having an agricultural, commercial and industrial, and residential real estate concentration if more than 25 percent of their total loan portfolio is in one of those three categories (for example, a bank would have an agricultural loan concentration if more than 25 percent of its total loans are loans for agricultural production or secured by agricultural loan production). A CRE concentration is defined in footnote 2.
securities portfolio to reduce their overall loan-to-asset ratio. This ratio proved to be an effective forecaster of agricultural bank failure in the agricultural banking crisis of the 1980s, for example. Banks can also purchase securities that have less of a link to the local economy than do their typical loans.

Of course, these options have very important limitations. Banks can take on risks they do not fully understand when they purchase securities. Perhaps more detrimental, a purchase of a Treasury security does not serve the local community. There is no free lunch for banks seeking to serve a relatively undiversified local community.

The Importance of Effective Credit Risk Management for All Loans
Lending in an area of potential concentration creates a potential risk across the entire loan portfolio. A shale boom area turns virtually all loans into energy-related loans. For example, an auto loan could be dependent on income from oil exploration employment for repayment. This means that banks must adjust underwriting standards to meet the specific risk posed by a borrower and a point in time. Perhaps most critically, banks must consider the potential downturn in the area of concentration and its implications across the full portfolio when they initially underwrite a loan and when they periodically review the loan. What does this principle mean in practice? Effective banks in the Ninth District and elsewhere make use of many strategies, including:

- recognizing the collateral risk and using a conservative loan-to-value ratio when determining how much to lend against the collateral;
- ensuring that borrowers can repay loans even if their income falls below historical norms; and
- availing themselves of government guarantee programs or other risk-sharing approaches.

Critical to all credit risk management approaches is the amassing of private information about borrowers. There is a distribution of credit quality among borrowers in an area of concentration. Some borrowers have a stronger ability to generate income than do others. Some borrowers have higher quality resources to fall back on if their income falters. And still other borrowers have a greater willingness to repay debt. A bank that seeks to thrive, or even survive, with a concentrated portfolio must have the information to sort out these borrowers and ensure that its underwriting and pricing match the risks assumed by the bank.

Strong underwriting of credits is necessary but not sufficient to manage concentration risk effectively. The bank needs to have a strong system for early identification of deterioration in credits. The credit review system should not only identify deterioration in individual credits but also provide management and the board with an early warning of the potential for related credits to deteriorate. Early problem loan identification will facilitate efforts to address emerging problem credits quickly and effectively.

Market Analysis
The need for specialized information goes beyond deeply understanding a specific borrower. Bank management and the board of directors need to routinely monitor conditions that affect the area of concentration locally, nationally, and internationally. This will come as no surprise to bankers. I have been frequently impressed with the industry-specific knowledge that many bankers bring to bear as they manage concentrations. Effective bankers also bring this deep industry knowledge to bear when they underwrite specific credits.

Board and Senior Management Oversight
The board and senior management play a critical role in ensuring a bank has appropriate controls over concentra-

---


5 The appropriate response to problem credit may include working with the borrower to address weaknesses and need not include curtailing a credit line. See SR letter 11-14, “Supervisory Expectations for Risk Management of Agricultural Credit Risk,” and SR letter 09-7, “Prudent Commercial Real Estate Loan Workouts.”
Roles for the board include establishing the level of risk tolerance by setting limits on concentrations or ensuring it considers concentrations when assessing capital and reserve needs. The board needs to receive reports that provide it with sufficient information to allow it to understand and, if necessary, react to changes in the level of concentrations and the risk profile of the portfolio.

The Limits of Timing as Risk Management
Timing matters, but it is nearly impossible to time your way to effective risk management. It seems likely that financing the first new hotel in an energy boom’s heretofore small locale is less risky than financing the 20th hotel. But timing markets with a fair amount of volatility is challenging to say the least.

Banks trying to make the last loan at the peak seem more dependent on luck than skill.

Concluding Thoughts: The Middle Road for Supervisors
While it is a cliché, supervisors must find a balanced approach to the potential risks I just noted. Just because times are at their best does not mean the tide is about to turn. Moreover, banks exist to provide credit, and a boom in an industry may justify a prudent increase in credit to borrowers benefiting from the good times. At the same time, supervisors cannot count on a permanent elimination of volatility to ensure that banks are safe and sound. Finding the right lines is the challenge for banks and supervisors.

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 most current) 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/bankinfo/letters/srletters/srletters.htm and by topic at www.federalreserve.gov/bankinfo/topics/topics.htm. A complete list of CA letters can be found at www.federalreserve.gov/bankinfo/letters/caletters/caletters.htm.


SR Letter 15-11/CA Letter 15-9, “Examinations of Insured Depository Institutions Prior to Membership or Merger into a State Member Bank”


CA Letter 15-7, “Revised Interagency Examination Procedures for Regulation P”

CA Letter 15-6, “Revised Interagency Examination Procedures for Regulation Z and Regulation X”

CA Letter 15-5, “Transfer of SAFE Act Supervisory Responsibilities and Publication of SAFE Act Examination Procedures”
Bankwide Risk Management
Risk management is the third step in the development and maintenance of a sound business continuity planning process. Risk management in this context should be able to measure and reduce risks to an acceptable level through a well-developed business continuity planning process. This process should be based on the business impact analysis and risk assessment. While the development and maintenance of the business continuity plan may be outsourced, the ultimate responsibility for risk management resides with the bank’s board and senior management. The business impact analysis and risk assessment should be an integral part of the formally documented business continuity plan. The impact analysis and risk assessment should provide the bank with sufficient information to monitor its business continuity plan and to determine when material and significant changes in internal and external conditions have occurred that necessitate revisions to the plan. The business continuity plan should focus on threats that have a relatively high likelihood of disrupting operations and should describe the various types of realistic events that could prompt the formal declaration of a disaster and the process for invoking the business continuity plan. Also, the business continuity plan should be updated by each business unit, reviewed and approved by the board and senior management at least annually, and communicated to employees for timely implementation.

Monitoring and Testing the Plan
Monitoring and testing make up the final step and validate that the business continuity planning process remains viable and does not overlook significant changes that may require revisions to the plan. Therefore, senior bank management should commit sufficient budget, staff, and time to a robust bankwide testing program to validate that the business resumption plans would actually work in the event of a disruption. Bank testing programs should define roles and responsibilities; outline test strategies and test plans; analyze and report testing results, including lessons learned; and lead to the development of action plans to address weaknesses identified through the testing.

Business Continuity Planning for Outsourced Technology Services Management
Banks are increasingly outsourcing critical operations to third-party service providers. However, this practice does not relieve bank management of its oversight responsibility for ensuring that outsourced activities are conducted in a safe and sound manner. An effective vendor management program should provide the framework for bank management to identify, measure, monitor, and mitigate the risks associated with outsourcing. The bank’s oversight process should provide sufficient information to monitor the performance of its third-party service providers that could negatively affect the bank’s ability to recover IT systems and return critical functions to normal operations in a timely manner. There are four key areas of business continuity planning that banks should address with respect to the resilience of technology services:

- Third-Party Management addresses the bank’s responsibility to control the business continuity risks associated with outsourcing.

After building out an effective business continuity planning program and incorporating third-party risk, a bank should test its plans at least annually.
its technology service providers and their subcontractors.

- **Third-Party Capacity** addresses the potential impact of a significant disruption of a third-party serviced’s ability to restore services to multiple clients.
- **Testing with Third-Party Technology Service Providers** addresses the importance of validating business continuity plans with technology service providers and provides considerations for a robust third-party testing program.
- **Cyber Resilience** addresses aspects of business continuity planning unique to disruptions caused by cyber events.\(^{13}\)

**Test Strategies and Approaches**

After building out an effective business continuity planning program and incorporating third-party risk, a bank should test its plans at least annually.\(^{14}\) However, there may be situations that require a bank to test the plans more frequently. For instance, if a bank undergoes a merger or acquisition or if there have been material changes to business processes or the IT infrastructure, the bank should consider retesting the business resumption plans to reflect the new environment.

There are four testing approaches\(^ {15}\) (listed in order of least to most rigorous):

- Tabletop exercise
- Walk-through drill
- Functional drill
- Full-interruption test

**Preliminary Exercises.** Tabletop exercises and walk-through drills should be viewed as preliminary tests to the more rigorous testing methods discussed below. In these preliminary tests, representatives from each of the bank’s functional areas meet and review the business resumption plans. In a tabletop exercise, the bank’s business line representatives review and evaluate the plans in context of objectives, scope, assumptions, and organizational structure, as well as review testing, maintenance, and training requirements. In a walk-through drill, the representatives take testing one step further and identify a specific potential disruptive event scenario. The representatives talk through the steps that would be performed as part of the restoration and recovery of the bank’s business operations. The challenge with these two methods is that they give minimal insight into how the bank would actually respond in the event of a real disruption because none of the business resumption plan components are actually engaged and evaluated for real-world effectiveness.

**Real-World Testing.** Functional drills and full-interruption tests involve implementing and executing the bank’s business resumption plans in a setting that closely mimics real-world disruptive events. A functional drill is a full test of the bank’s plans and generally includes running the bank’s business operations from an alternate site and the primary site concurrently and comparing the results. The end goal is to determine if the alternate site can support the bank’s business operations. By contrast, a full-interruption test *shuts down the primary site’s operations* and has the alternate site support the bank. The full-interruption method should be thoroughly planned before executing to ensure that business operations will not be negatively affected.

Senior bank management should ensure that the appropriate staff is assigned to participate in testing. Senior bank management should also evaluate the inherent tradeoffs between testing rigor and the level of confidence provided by the testing approaches and select a method that is most appropriate for the bank. The selected testing method should reflect the bank’s experience with business resumption for its current environment in the context of size, complexity, and nature of its business. Some banks have addressed the inherent tradeoffs in testing methods by performing an annual functional drill test and benchmarking their results against formally defined recovery time and point objectives.

**Business Resumption Testing Documentation**

Banks should document the following when performing any test:

- Date/time of testing
- Locations tested
- Business processes tested
- A summary comparing testing objectives with actual testing results
- Identification of material deviations from test plans, including whether or not intended participation levels were achieved
- Issues identified during testing, including remediation plans

---

13 See the FFIEC Cybersecurity Assessment Tool, which helps in the evaluation of the cyber-related risk profile and the maturity of the control environment for an institution, available at http://ow.ly/SUmAc.


15 These test methods are also commonly referred to as “structured walk-through test,” “simulation test,” “parallel test,” and “full-scale test,” respectively.
• Evaluation by a qualified independent party not involved in the testing

For testing results to have meaning, senior bank management should review the results and provide a report on its assessment of the results to the board, audit function, functional business units, and the IT function. Consistent with conducting testing at least annually, reporting should also be performed at least annually. The reporting that is presented to the board should provide enough information to allow the board to determine if the business resumption plans meet the objectives embodied in the business impact analysis.

Change Control
When there are material changes to the environment either from a business process or technology perspective, bank examiners expect that the business resumption plans will be updated to reflect the new environment and tested to determine that the plans are still valid. Examples include regulatory changes (such as data retention requirements), mergers and acquisitions activity, changes in vendor relationships, and changes to the IT infrastructure.

Typical Business Continuity and Disaster Recovery Planning Deficiencies Noted by Examiners
Typical deficiencies noted during examinations have included the following:

• Business continuity/disaster recovery test plans and/or testing not completed or updated in a timely manner
• Business impact analyses that do not
  ▶ Identify critical business processes
  ▶ Identify supporting systems, maximum allowable downtime, recovery time objectives, or recovery point objectives
• Inadequate staff training
• Testing inadequacies
  ▶ Failure to demonstrate recovery capability
  ▶ Failure to test alternate site relocation, including connectivity tests
  ▶ Failure to test all critical systems at least annually
• Inadequate or infrequent annual reporting of test results to the bank’s board of directors, including the failure to provide timely information about
  ▶ Overall program status
  ▶ Testing and training results
  ▶ Lessons learned
  ▶ Test results against recovery time and point objectives

Conclusion
Business resumption concerns have the potential to go to the very heart of a community bank’s ability to serve its key stakeholders, including customers, vendors, and business partners, as well as its ability to maintain appropriate liquidity levels. Therefore, when a bank’s senior management reviews its business resumption program, bank management should make sure that there is a well-defined and comprehensive process incorporating appropriate real-world scenarios and corresponding response plans based on those scenarios. The process should transcend business resumption planning for just the IT function and embrace all lines of the bank’s business. In the final analysis, examiners need the bank to demonstrate that it has an appropriate recovery mechanism for the entire bank and has the wherewithal to maintain ongoing operations and support key stakeholders when a disruptive event occurs.
Audit Function
To be able to assess whether the lending function’s design and controls are effective and working appropriately, the board of directors or its audit committee should require regular comprehensive audits of the function. The audit plan should be risk-focused and incorporate coverage of key lending areas, including areas in which concentrations exist. Audits also should include adequate testing of compliance of the lending function with the bank’s policies and procedures. Additionally, the audit function should review compliance with loan documentation standards and federal and state banking laws and regulations, as well as the accuracy of past-due and charge-off reports. Audits should be conducted with appropriate frequency, and adequate resources should be assigned to perform the review. The scope of the audit should be suitable for the desired coverage. The audit function either can be housed internally or outsourced, based on the size and complexity of the bank’s lending activity and operations. The board of directors is ultimately responsible for determining whether the audit function is performed in house.

Loan Review Function
The responsibility for underwriting and structuring a loan according to policy and for confirming that a loan is performing to expectations rests primarily with the line of business or the party approving the credit. The line of business is also responsible for appropriately risk rating the credit and promptly identifying any emerging issues or deterioration in the credit. An independent loan review function may be used to provide additional oversight of the portfolio. Similar to the audit function, this function can be housed internally or outsourced to a qualified and independent candidate or firm; however, as with all delegated functions, ultimate responsibility for sound risk management remains with the bank.6

Loan review plays a critical function by providing an independent assessment to senior management and the board about the bank’s overall level of credit risk, effectiveness of credit risk management, and identification of potential risks that could negatively impact the portfolio. An overview of the loan review function and its responsibilities is outlined in Attachment 1 of SR letter 06-17, “Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL).”7 The attachment discusses the elements for establishing an effective loan review system.

The duties and responsibilities of the loan review function should be formally documented within the larger policy framework. The loan review policy should establish the required level of portfolio coverage and time frame(s) within which the reviews should be conducted. Loan reviews should be risk-focused, and the portfolios and individual loans that pose the greatest risk to the organization should be reviewed on a more frequent basis. The loan review scope should be clearly defined yet flexible enough to identify any new emerging risks.

Credit Administration — Loan Policy Compliance
Ongoing compliance reviews, along with a clearly articulated loan policy, impose discipline and sound loan administration. Pressures related to productivity and competition may result in lenders being inappropriately motivated to relax credit underwriting standards or to approve a loan that is not fully compliant with all aspects of the loan policy. While exceptions to a policy may be appropriate, a bank should have an MIS that properly identifies, justifies, and approves all exceptions.

A bank’s loan policy should establish clear processes for requesting, approving, and documenting policy exceptions. The policy should also require aggregate reporting of all exceptions to the board or a board committee and should include audit and/or loan review mechanisms to identify unreported exceptions.

---


Problem Loan Workout
The main objective in problem loan workout is to enhance or preserve the bank’s overall position with respect to cash flow and collateral; therefore, early detection of problems is the key to success. The loan policy should appropriately address the main aspects of problem loan workout, including practices and procedures surrounding nonaccrual status, troubled debt restructuring, and foreclosure. The policy should also cover the general administration and reporting processes within the loan workout function.

The workout of problem credits can be done within the line of business or, if appropriate, may need to be removed from the line of business to a separate unit that focuses solely on problem loan resolution. There are multiple benefits to retaining the workout function within the line of business, including familiarity with the borrower and the global borrowing relationship; however, moving a troubled borrower out of the business line’s oversight may allow lenders to focus on new business development and to work with performing borrowers. A dedicated workout staff can also focus on developing, implementing, and monitoring the workout strategy.

The decision to implement a standalone workout function may depend on criteria such as staffing availability and expertise, the number and dollar amount of problem credits, and the overall likelihood of reducing losses through the implementation of a separate workout function.

Conclusion
One of the most significant risks facing community banking organizations today is credit risk, and maintaining a current and comprehensive loan policy is one of the most effective ways to mitigate that risk.

For most community banks, the credit risk profile is directly correlated to the quality of the loan policy. The policy and procedures should be living documents that reflect current and emerging credit practices. Management and the board should continually monitor and evaluate the loan policy to determine that the bank’s lending activities are conducted in a safe and sound manner and are aligned with its strategic objectives, current market practices, and economic conditions.

While the board is ultimately responsible for the development and annual approval of sound policies, many other parties within the bank are responsible for executing the board-approved strategy. An effective policy provides the road map for all bank staff to align their efforts with the bank’s strategic direction.

FedLinks: Connecting Policy with Practice
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.cbcfrs.org/fedlinks.

By subscribing to FedLinks bulletins at www.cbcfrs.org/subscribe, you will receive an e-mail notification when new bulletins become available.
personal, family, or household purposes, and not used primarily for agricultural, commercial, industrial, or other business purposes. In instances in which certain structures are used for both residential and business purposes, the exemption applies only to structures with a primary residential purpose. A structure is “detached” if it stands alone, meaning it is not joined by any structural connection to the residential structure. Furthermore, the detached structure may not “serve as a residence.” Since the lender is in the best position to consider all the facts and circumstances surrounding the detached structure, the final rule requires lenders to consider the actual and intended use of a structure and to determine in good faith if the structure serves as a residence. While the rule notes that structures can vary greatly in terms of size, value, purpose, and facilities, the rule explains that a structure could be considered a residence if it includes sleeping, bathroom, or kitchen facilities. The status of a detached structure must be re-examined upon a qualifying “triggering” event, such as making, increasing, renewing, or extending a loan.

Although detached structures are exempt from the mandatory purchase of flood insurance, lenders may nevertheless require flood insurance on a detached structure to protect the collateral securing the mortgage.

**Force Placement of Flood Insurance**

Under the new rule, financial institutions may charge a borrower for the cost of force-placed flood insurance and related fees starting on the date on which flood insurance coverage lapsed or did not provide the proper amount of coverage for the property securing the loan.

It is important to emphasize that a lender is not required to force place flood insurance on the date it learns insurance is required for a property securing an existing loan. A regulated lender must send a force-placed notice to the borrower on that date but is permitted to wait until 45 days after sending the notice before force placing insurance. When determining whether to force place on the date a lender learns flood insurance is required, a lender may consider in the case of a lapsed policy that the National Flood Insurance Program provides a grace period during which an expired policy remains in effect for 30 days after its expiration date as long as the overdue premium is paid within 30 days. Therefore, a lender’s greatest risk for a lapsed policy is the period after the grace period expires and before the lender is required to force place on the 46th day if the borrower does not comply.5

The final rule also requires a lender to refund any premiums and fees for the period during which a lender force placed flood insurance and the borrower already had coverage. The rule requires the lender to contact the insurer to terminate the force-placed insurance and refund any overlapping premiums and fees charged within 30 days of receiving proof of a borrower’s existing flood insurance coverage. For purposes of confirming existing flood insurance coverage, a financial institution or servicer must accept from the borrower an insurance policy declarations page that includes the existing flood insurance policy number, the identity of the insured, and contact information.

**Effective Dates**

The mandatory escrow of flood insurance premiums provisions and the escrow option provisions becomes effective on January 1, 2016. The force placement provisions became effective on July 6, 2012, when the BWA was enacted, and the detached structure exemption became effective on March 21, 2014, when the HFIAA was enacted.

**Conclusion**

It is important for financial institutions to become familiar with these new flood insurance regulatory requirements. Financial institutions should update their policies and procedures and provide training to their staff to ensure compliance with these new flood insurance rules by the applicable effective dates. Specific issues and questions should be raised with the consumer compliance contact at your Reserve Bank or with your primary regulator.

---

5 The grace period does not apply when a building or mobile home securing an existing loan is remapped into a special flood hazard area or when the borrower has an insufficient amount of insurance (in the case of an insufficient amount of insurance, the grace period would apply only to the amount of the lapsed insurance policy, which is insufficient to protect the lender’s security interest in the property).
The federal bank regulatory agencies will hold the final Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) outreach meeting in the Washington, D.C., area on December 2, 2015. The Federal Reserve and the other bank regulatory agencies are engaging in a series of outreach meetings with bankers, consumer groups, and other interested parties as part of the regulatory review being conducted in accordance with the EGRPRA of 1996. The EGRPRA requires the agencies, along with the Federal Financial Institutions Examination Council, to conduct a review at least every 10 years to identify outdated or otherwise unnecessary regulations. For more information about this or prior outreach meetings or to submit a comment, visit the EGRPRA site at http://egrpra.ffiec.gov/outreach/outreach-index.html.

Chair Janet Yellen and Governor Lael Brainard spoke at “Community Banking in the 21st Century,” the third annual community banking research and policy conference cosponsored by the Federal Reserve System and the Conference of State Bank Supervisors. The conference was held at the Federal Reserve Bank of St. Louis on September 30 through October 1, 2015. Chair Yellen’s introductory remarks are available at www.federalreserve.gov/newsevents/speech/yellen20150930a.htm, and Governor Brainard’s speech on community banks, small business credit, and online lending is available at www.federalreserve.gov/newsevents/speech/brainard20150930a.htm.

The Federal Reserve Board announced the members of its Community Depository Institutions Advisory Council (CDIAC) and the president and vice president of the council for 2016. The CDIAC advises the Board on the economy, lending conditions, and other issues of interest to community depository institutions. Members are selected from representatives of commercial banks, thrift institutions, and credit unions who serve on local advisory councils at the 12 Federal Reserve Banks. A press release was issued on September 29, 2015, and is available at www.federalreserve.gov/newsevents/press/other/20150929a.htm.

The Federal Reserve Board announced the approval of enhancements to the Federal Reserve Banks’ same-day automated clearing house (ACH) service. The enhancements are intended to align the Reserve Banks’ same-day ACH service with recent amendments to the National Automated Clearing House Association’s ACH operating rules. The enhancements will facilitate the use of the ACH network for certain time-critical payments, accelerate final settlement, and improve funds availability to payment recipients. A press release was issued on September 23, 2015, and is available at www.federalreserve.gov/newsevents/press/other/20150923a.htm.

The Federal Financial Institutions Examination Council announced the availability of 2014 data on mortgage lending transactions at 7,062 U.S. financial institutions covered by the Home Mortgage Disclosure Act (HMDA). Covered institutions include banks, savings associations, credit unions, and mortgage companies. The available HMDA 2014 lending activity data include applications, originations, purchases and sales of loans, denials, and other actions related to applications. A press release was issued on September 22, 2015, and is available at www.ffiec.gov/press/pr092215.htm.

The Federal Reserve Board announced the members of its newly created Community Advisory Council (CAC). The CAC, which is composed of 15 individuals with consumer- and community development–related expertise, will provide information, advice, and recommendations to the Board on a wide range of relevant policy matters and emerging issues of interest. A press release was issued on September 22, 2015, and is available at www.federalreserve.gov/newsevents/press/other/20150922a.htm.

The Federal Financial Institutions Examination Council (FFIEC) announced an initiative to streamline and simplify reporting requirements for community banks and to reduce their reporting burden. As an initial step by regulators to streamline some reporting requirements, the federal banking agencies, under the auspices of the FFIEC,
are seeking comment on proposals to, in part, eliminate or revise several Call Report data items. A press release was issued on September 8, 2015, and is available at www.ffiec.gov/press/pr090815.htm.

The Federal Reserve Board clarified Regulation II (Debit Card Interchange Fees and Routing) regarding the inclusion of transaction-monitoring costs in the interchange fee standard. Regulation II implements, among other things, standards for assessing whether interchange transaction fees for electronic debit transactions are reasonable and proportional to the cost incurred by the issuer, as required by section 920 of the Electronic Fund Transfer Act. A press release was issued on August 10, 2015, and is available at www.federalreserve.gov/newsevents/press/bcreg/20150810a.htm.

The federal banking agencies released the 2015 list of distressed or underserved nonmetropolitan middle-income geographies. Revitalization or stabilization activities in these geographies will receive Community Reinvestment Act consideration as community development. A press release was issued on July 8, 2015, and is available at www.federalreserve.gov/newsevents/press/bcreg/20150708a.htm.

Interested in Reprinting a Community Banking Connections Article?

Please contact us at editor@communitybankingconnections.org. We generally grant reprint permission free of charge provided you agree to certain conditions, including using our disclaimer, crediting Community Banking Connections and the author, and not altering the original text.
Connect with Us

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.cbcfrs.org/feedback.cfm.