2016: A REGULATORY OUTLOOK

A Bank Insights Special Report

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Banking Challenges in 2016

Welcome to *Bank Insights*' end-of-the-year regulatory roundup and outlook for 2016. The year ahead will be challenging. Community banks across the U.S. are worried about growth and earnings, yet see little in the economy to warrant optimism. For many, consolidation may be an answer.

The Federal Reserve has finally increased interest rates, though it has **signaled** the upward movement will be slow and methodical. Regulators are seeing signs of lax underwriting standards and potentially risky new products and business models. Cybersecurity remains a real threat. Oil and gas prices are the lowest they've been in years. The need for a high capital cushion has not gone away.

Throughout the year, regulators have discussed the nature of the community bank regulatory burden, the importance of strong capital and strategic planning, industry consolidation, the squeezing of net interest margins, and the lack of succession planning at many small banks. This handbook will review some of those issues.

"In the area of credit risk, the warning lights are flashing yellow," Comptroller of the Currency Thomas J. Curry **warned** as the year came to a close. "Regulators and bank management need to act now to prevent those risks from becoming reality. We can't afford to wait until the warning lights turn red."

Federal Deposit Insurance Corp. Chairman Martin J. Gruenberg made similar **comments** in November, saying there were signs of "growing interest-rate risk and credit risk" that will "continue to be a focus of supervisory attention."

Of particular concern to regulators are commercial real estate portfolios, where underwriting standards have weakened. Community banks with high CRE levels were "far more susceptible to failure" during the **recession** and regulators don't want a repeat.

Examiners will "pay special attention to potential risks associated with CRE lending" in 2016, regulators **advised** in December. "The agencies may ask financial institutions found to have inadequate risk management practices and capital strategies to develop a plan to identify, measure, monitor, and manage CRE concentrations, to reduce risk tolerances in their underwriting standards, or to raise additional capital to mitigate the risk associated with their CRE strategies or exposures," regulators advised.

One way to ensure that CRE concentrations are manageable is by "robust stress testing" that assures a bank has sufficient capital to withstand an economic downtown, OCC National Bank Examiner for Midsize and Community Bank Supervision Scott Schainost told Bank Insights. Banks should review the 2006 interagency CRE **guidance**, as well as the OCC's 2012 **recommendations** for community bank stress testing.

The number of FDIC-supervised institutions has dropped by 24 percent since the end of 2007, and the FDIC said in December that it **expects** consolidation to continue in 2016 and beyond.

Banks under pressure to provide better returns have begun looking at M&A as an option. "We are seeing more and more banks evaluate their business model and risk appetite," Schainost said in an interview. "We are seeing banks looking at their strategic plans and deciding whether they are an acquirer, or are they going to put their bank up for sale."

Banks that decide to embark on an M&A route should make sure they have a "robust due diligence process," and "have appropriate plans before they make the change in strategic direction," he said.

One of the most important tools to emerge in 2015 was the Federal Financial Institutions Examination Council's cybersecurity assessment **tool**. Ignore it at your peril. Regulators have announced that examiners will begin using it during exams in 2016. Smart banks will want to be ready.

The focus on outdated and unnecessary regulations, which included five meetings with bankers throughout the U.S. in 2015, will continue in 2016. Regulators **announced** that they are expanding the review to include recently issued final rules, including those concerning safety and soundness. Regulators have already proposed revisions to the Call Reports to make it easier for community banks. They are contemplating changing thresholds for appraisals, as well as the length of the exam cycle for some community banks.

Community banks must also pay attention to compliance issues, particularly as they relate to the newly required mortgage disclosures.

Be sure to watch for what the Financial Accounting Standards Board decides to do about the proposed forward-looking, current expected credit loss model, or CECL.

FASB Chair Russell G. Golden **said** that the proposal, which the board expects to take up in the first quarter of 2016, will require "assumptions only as long as there exists reasonable and supportable data about the future, generally two to three years." He cited the high number of community bank failures during the crisis, saying they "have been a major part of the problem," for why smaller banks should not be exempt from the new guidance. "Continue to do what you're doing—just make sure your expectation of the future is included in your loan loss reserves," he said.

While 2016 may pose challenges, banks with the right tools to develop forward-looking strategies will discover opportunities and competitive advantages. ▪

CFPB AND COMPLIANCE ISSUES

Highlights: *Expect examiners to pay particular attention to compliance with BSA/Money Laundering issues, which are not covered in this handbook. Bank examiners have also mentioned "fair access" as an issue in 2016, and some banking experts think the CFPB will focus on fair lending and access to credit.*

What to Expect During TRID Rule and RESPA Exams

FDIC examiners will consider your bank's implementation plans, staff training, and whether you have updated policies, procedures and processes when it evaluates compliance with the TRID rule and RESPA, the agency said in a **Financial Institution Letter**. Be sure to read the CFPB's **industry letter** for more expectations.

The CFPB issued a **reminder** in November that kickbacks and referrals are prohibited under RESPA.

Bank Cited for $27 Million in Redlining Case

The CFPB announced that it had worked with the Justice Department to file a redlining **complaint** against Hudson City Savings Bank. "Unfortunately, we can see that illegal redlining is still a reality for certain neighborhoods in the consumer financial marketplace," CFPB Director Richard Cordray **said**. "Rooting out discrimination to ensure fair and equal access to credit for all qualified borrowers remains a priority for the Consumer Bureau."

CFPB Request for Student Loan Info May Signal New Rules

The CFPB is asking the public to share their student loan servicing **stories**—and that may be a sign that reform is on the way. The bureau says it will use the info "to assist market participants and policymakers on potential options to improve borrower service, reduce defaults, develop best practices, assess consumer protections, and spur innovation."

The CFPB estimates that there are more than 40 million borrowers with student loans who owe at least $1.2 trillion –and 8 million borrowers are in default, owing more than $110 billion. Problems with student loan servicers have been uncovered by the FDIC, other federal agencies and the CFPB itself. The request for information notes that the student loan serving industry is not much different than the mortgage loan servicing industry, which has already come under strict scrutiny and rulemaking.

CFPB: Exams are Private

The CFPB issued a **bulletin** reminding financial institutions that confidential supervisory information should not be shared. Among items that should not be disclosed are exam reports and documents prepared "by, or on behalf of, or for" the CFPB for use during supervision of a financial institution.

CFPB Wants to Survey Thousands about ATMs

The CFPB wants to conduct a web survey of 8,000 people as part of its study of ATM/debit card disclosure forms. The **survey** would explore consumer decision-making and experiences with overdraft fees.

CFPB Cites CEO for Lender Originator Compensation Plan

Take note: The CFPB **fined** RMP Mortgage Inc. and its CEO for illegally paying bonuses and higher commissions to loan originators who steered consumers into costlier mortgages. The fines would total $20 million, including a $1 million civil penalty to be paid by the CEO individually. Banking experts warn lenders to review their loan originator compensation plans now. Failing to comply can disqualify loans from being considered qualified mortgages, which can have serious implications.

Rural Banks Win CFPB Reprieve

The year ended with President Obama signing into a law a highway bill that also included some community bank relief measures, including a provision that gave rural lenders more flexibility with CFPB mortgage rules. The bill gives the CFPB the right to exempt rural creditors from escrow requirements and allows them to treat balloons loans as qualified mortgages if they were extended by a rural community bank, the Conference of State Banking Supervisors **reported**.

CFPB Reports $5.8 Billion in Consumer Relief

The CFPB's 191-page **semi-annual report** says the agency is responsible for financial institutions paying more than $95 million in fines, while enforcement orders led to $5.8 billion in relief to consumers violated by consumer protection law failures. The report highlights the Know Before You Owe mortgage disclosure rule, which went into effect on Oct. 3. The CFPB has reference materials on the **rule** on its website that may be useful to banks. Some bank experts expect that the bureau will focus on the rule in 2016, particularly because it does not have a transition period for lenders.

CFPB Says Banks have Insufficient Data on Student Loans

Student loan debt, which is now more than $1.2 trillion, "continues to show elevated levels of distress," the CFPB writes in a **report** calling for reform of student loan servicing and increased standards. The CFPB estimates more than one out of four borrowers are delinquent or in default on student loans. One problem is the lack of data. Banks lump student loans with other types of non-mortgage credit products, which hampers oversight and limits policymakers, the CFPB said.

CURRENT EXPECTED CREDIT LOSS (CECL) EXPECTATIONS

Highlights: *The Financial Accounting Standards Board is expected to take up the current expected credit loss (CECL) model in the first quarter of 2016. Smart banks will want to start getting ready, even though implementation may be several years away. Although community banks are lobbying to be exempt from any new standard, that seems highly doubtful. FASB Chair Russell Golden reiterated in December that community banks must be part of the CECL standard. "The credit crisis of 2008 underscored the need for a more forward-looking model—one that gives preparers the opportunity to recognize losses that exist in the loan portfolio, and recognize them up front," he said.*

Fed Discloses Pilot Program to Target High-Risk Banks

The Federal Reserve hinted earlier in 2015 that it was using forward-looking risk analytics to ferret out weaker banks. Maryann Hunter, deputy director of the Federal Reserve's Division of Banking Supervision and Regulation, Community Banks **told** a Senate subcommittee in February that the Fed had an initiative "to use forward-looking risk analytics to identify high-risk community and regional banks, which would allow us to focus our supervisory response on the areas of highest risk and reduce the regulatory burden on low-risk community and regional banks." In April, Hunter told a House **subcommittee** that the program also included Call Report data.

Fed Chair Janet Yellen also **testified** before Congress in November that the Fed was using the financial data it collected from banks to "calibrate our examination procedures based on risk. We believe this will help us to be more forward looking in addressing emerging risks and to ensure that community bank examiners with specialized expertise and experience are allocated to the institutions exhibiting the highest risks," she said.

ICBA Blasts FASB over CECL Remarks

The Independent Community Bankers of America's executive board says FASB Chairman Golden **slandered** all community banks when he said they were a "major part of the problem" that led to the financial crisis and should not be exempt from CECL. Golden also **said** there was "a cascade of misinformation" about the CECL proposal. The ICBA letter says FASB is the one that is misinformed and repeats its position that there should be a "community bank forward-looking loss estimate application that utilizes actual observed historical losses—a tangible and definitive metric." The letter contends that otherwise "community banks will be forced to not only purchase and maintain complex models, but they will be expected to calibrate their models to ensure that reserves have increased by at least the 30-50 percent levels that regulators have already estimated in their own analysis of CECL."

A CECL Q&A

Q. *What is likely to be the key impact on reporting?*

A. The move to CECL is likely to increase the allowance balances due to "life of loan" credit loss estimates. Some say this will mean a more accurate balance sheet as asset balances, net of allowances, would reflect cash flows expected to be collected. Upon implementation, expect a one-time increase in allowance levels for existing assets on the books. After implementation, an on-going impact on earnings from new assets will probably occur.

Q. *What is expected to happen when the proposal takes effect?*

A. Initial estimates indicate an increase in ALLL of 25% to 50%. The cumulative effect of the change in ALLL would be run through retained earnings. The increase in the provision for credit losses will reduce common equity Tier 1 regulatory capital, and regulators have no plans to provide "transition relief," according to Fed meeting **records**.

Q. *How hard will CECL be to implement?*

A. Community banks do not need complex models, however they may need to make changes to current systems for data collection and analysis. This may prove to be overwhelming to some smaller banks. The Fed notes indicted that the proposal "likely will be difficult to implement, particularly for small banks," and that smaller banks with "a higher concentration of longer tenor assets" may have a greater impact from the

Q. *Is this a done deal?*

A. FASB is set to draft a final standard in the first quarter of 2016. The Fed has recommended that if CECL is finalized as proposed, there should be a five-year transition for implementation. The Fed also noted that FASB has not yet justified the benefits of the proposal, which would cause banks to add between $25 billion to $50 billion in reserves.

Getting Ready for CECL

While banks await the final standard, they can still start thinking about implementation based on the draft proposal. Here are some questions that the accounting firm of Plante Moran suggests you consider:

- ✓ How will the loan portfolio be segmented to create pools with at least two similar credit risk characteristics?
- ✓ How will the vintage of loans be factored into the loan pools?
- ✓ What data is available to estimate the average life of the loans within the identified pools?
- ✓ How will historical loss data be determined and tracked for each loan pool?
- ✓ How will credit losses be estimated for each pool?
- ✓ While not a requirement, is the institution positioned to develop and implement a probability of default model or migration analysis model?
- ✓ What economic data can be gathered to help support the economic cycles within the institution's lending area, commensurate with lending activities?

CREDIT RISK AND ASSET QUALITY

Highlights: *"As the economic cycle turns, we see banks and thrifts reaching for yield and growth, sometimes extending their reach at the expense of sound underwriting, strong risk management, and adequate loan loss provisioning," Comptroller Thomas J. Curry said in announcing the OCC's supervisory priorities for 2016.*

Increased Concentrations Can Lead to Higher Capital Requirements

Regulators are warning banks that capital requirements may increase if they don't properly manage their CRE lending portfolios. The FDIC, the OCC and the Fed put out a special **joint advisory** in December that examiners will be paying "special attention" to risks associated with CRE lending. Banks should ramp up their risk management practices related to CRE concentrations, which include stress testing to quantify the impact of an economic downtown on asset quality, earnings and capital, and enhanced board and management oversight. Banks should also make sure they have proper underwriting standards and global cash flow analyses of borrowers based on reasonable rental rates, sales projections and operating expenses. Banks do not have to exceed the recommended CRE thresholds to be under examiner scrutiny; the regulators say they will focus on banks that have a growth in CRE lending or whose strategies call for increased CRE loans. An Invictus analysis found 754 banks with CRE concentrations already above 250 percent. Regulatory **guidance** suggests banks have unhealthy concentrations when CRE loans represent 300 percent of capital.

Regulators Put Banks on Notice: Credit Risk is High

Underwriting standards have slipped for the third consecutive year in response to competitive pressures and market liquidity, the OCC said in releasing its 21st Annual **Survey** of Credit Underwriting Practices. "We are seeing trends very similar to those that examiners reported just prior to the most recent financial crisis," **said** Jennifer C. Kelly, Senior Deputy Comptroller and Chief National Bank Examiner. "With credit risk on the rise, OCC examiners will remain focused on evaluating new loan originations to assess banks' and federal savings associations' efforts to maintain prudent underwriting standards and practices through this stage of the credit cycle."

The OCC advised boards and senior management to "carefully consider" the impact of eased underwriting standards on their portfolios, particularly in leveraged lending, CRE loans, indirect consumer lending and credit cards.

Worry at the Top: Bank Regulator Chiefs Repeatedly Cite Credit Risk

The banking industry is facing challenges, FDIC Chairman Gruenberg **warned** in November. "In order to mitigate the impact of low rates on net interest margins, banks have been going out further on the yield curve and increasing the mismatch between asset and liability maturities. Lending in higher-risk loan categories has been growing. The recent Shared National Credits review of large syndicated loans noted that 'credit risk in the portfolio remains high, despite a relatively favorable economic environment.' And loan portfolios in regions that depend on oil and gas revenue are increasingly at risk due to the significant decline in energy prices.

At the same time risk profiles have been rising, banks have not seen corresponding growth in overall revenue," he said.

Comptroller Curry **repeated** those concerns. "Generally, we are seeing banks continue to make concessions on pricing, weaker or non-existent loan covenants, and maturities lengthening. We have also seen increases in underwriting exceptions and risk layering. All of which combine to introduce risk at origination. Bankers with long memories will remember the worst loans are made in the best of times, and the growing credit risk in their banks should be managed very closely," he said.

Loan Growth Misleading, Auto Loans a Red Flag

While loan growth at community banks may be strong, that doesn't mean there isn't trouble on the horizon, Comptroller Curry said in a **speech**. That's because credit quality "reflects the outcome of decisions made when loans are originated, perhaps months or years earlier, possibly under tougher standards than those in effect today. So the indicators that many are looking at most closely actually say little or nothing about the risk now embedding itself in bank portfolios," he warned.

Curry also warned about dangerous trends in auto lending, which made up more than 10 percent of retail credit at OCC-regulated banks at the end of the second quarter. Many banks are packaging auto loans into asset-backed securities, much the way mortgage-backed securities were sold prior to the financial crisis. "Today, 30 percent of all new vehicle financing features maturities of more than six years, and it's entirely possible to obtain a car loan even with very low credit scores." Curry warned.

CYBERSECURITY

Highlights: *“When you talk to directors and bank management, one of the biggest things that keeps them up at night is cyber risks. They want to know, what are we missing? Should I be sleeping at night? Examiners haven’t been able to give them a great answer,” OCC National Bank Examiner for Midsize and Community Bank Supervision Scott Schainost told Bank Insights.*

Regulators Unveil Cybersecurity Assessment Tool

The prudential regulators want all CEOs and boards to understand and determine their institution's overall cyber risks. The FFIEC has released a cybersecurity **assessment tool** to help. The Federal Financial Institutions Examination Council stresses that CEOs and the **board** must develop plans to conduct a cyber risk assessment and institute risk management practices to mitigate potential problems. The tool allows banks to calculate their inherent **risk profile** and cybersecurity **maturity level**. The OCC says it will begin using the tool during exams in 2016.

FDIC Unveils Video to Help Community Banks Combat Cyber Risk

The FDIC released a new cybersecurity awareness **video**, plus three new vignettes for its **Cyber Challenge**, resources that are part of the Community Banking Initiative. The video offers steps banks can take to make sure they are ready for a cyberattack. The challenge exercises include questions, reference material, instructional guides and real-life scenarios.

New York Officials Want To Coordinate Cyber Regulation

New York financial regulatory officials want to coordinate their cybersecurity efforts with federal regulators, leading to a "comprehensive cybersecurity framework," officials said in a November **letter**. The state regulators want the framework to mandate extensive written policies on items such as data governance and classification, business continuity, systems operations, customer data privacy, vendor and third-party management and incident response.

Cybersecurity Expectations for Banks

The FFIEC says each bank should:

- Securely configure systems and services
- Review, update, and test incident response and business continuity plans
- Conduct ongoing information security risk assessments
- Perform security monitoring, prevention, and risk mitigation
- Protect against unauthorized access
- Implement and test controls around critical systems regularly
- Enhance information security awareness and training programs
- Participate in industry information-sharing forums, such as the Financial Services Information Sharing and Analysis Center.

Regulators Worry about Bank Readiness

Regulators expect your bank to be on top of threats, including those that may hit your third-party service providers. In today's interconnected world, banks need to protect their data, websites, apps and internal network. "Cyber attacks have increased in frequency and severity over the past two years. The attacks often involve the theft of credentials used by customers, employees, and third parties to authenticate themselves when accessing business applications and systems," the FFIEC **warned** in late March.

Community banks should make sure they test their incident response and business continuity plans and know what to do if their bank – or a third-party provider – is attacked, the regulators warned. Banks should have a plan to make sure that recovery strategies reflect the potential for a simultaneous attack on both the bank and its backup data center.

Boards and CEO Responsible for Cybersecurity

The CEO and the board are responsible for cybersecurity management, the Conference of State Bank Supervisors stresses in a "Cybersecurity 101," a **report** designed for community bank CEOs.

Here are some questions every CEO should ask to understand a bank's risks, according to the guide:

Does my bank know what information it manages, where it is stored, how sensitive it is and who has access to it?

What are my bank's key business information assets and are they adequately protected? Is confidential information – data that would severely impact the bank if lost, damaged or released-- treated like a crown jewel?

What types of internet connections does my bank have and how are they managed and protected? Does the bank allow employees to bring their own devices to work and if so, what controls are placed on that?

How is my bank connecting to third parties and ensuring they are managing their cybersecurity risks?

Once CEOs understand the answers to those questions, and classify their information assets to know their importance, they can then begin identifying the bank's threats and vulnerabilities. Regulators have encouraged community banks to join the **Financial Services Information and Analysis Center**.

EARNINGS AND LIQUIDITY

Highlights: *Although earnings are slightly up, they remain a concern for many banks. To counter the impact of low interest rates on net interest margins, banks are increasing asset maturities. This may lead to problems when interest rates rise and the cost of funding liabilities reprice.*

FDIC Expands Definition of Brokered Deposits

The FDIC twice updated its **guidance** on brokered deposits in 2015. An earlier **update** appeared to have broadened the definition of brokered deposits, while narrowing when banks can obtain relief from accepting them. Undercapitalized banks are prohibited from accepting brokered deposits, and significant brokered deposits can increase a bank's insurance assessment. Bank lawyers say that banks with higher levels of brokered deposits often receive extra regulatory attention, such as mandates that they draft a liquidity plan to show how the bank would replace the brokered funds.

Boards Need to Step Up as Underwriting Standards Decline

Examiners are seeing a decline in underwriting standards as banks reach for yield and loan growth, Comptroller Curry said in a **speech** on June 15 . "Our goal as prudential supervisors is not just to ensure compliance with laws and regulations—important as that is—but to identify weaknesses in lending, liquidity, and operational risk management, as well as other threats to safety and soundness, and then to compel change," Curry said. That starts at the top—with the board of directors and senior management, he said.

Is Your Lawyer a Deposit Broker?

The FDIC has revisited the **question** of whether lawyers or accountants who refer clients to your bank are deposit brokers. If professionals refer folks to your bank informally without receiving a fee, then the deposits are not brokered, the agency now says. George French, deputy director of the division of risk management, explained to the FDIC Community Bank Advisory Committee, that the agency was referring to "programmatic or fee-based referrals," not "informal one-offs." He said the **FAQs** issued in January did not establish new policy and were a "living document going forward."

Federal Reserve Proposes Adding Munis to Bank Assets Needed for Liquidity

The largest banks would be able to use certain general obligation state and municipal bonds to satisfy regulatory liquidity requirements under a new Federal Reserve **proposal**. The liquidity coverage ratio requirement mandates that large banks hold high-quality liquid assets that can be easily converted into cash within 30 days during a period of financial stress. The proposal would include investment-grade U.S. state and municipal bonds as high-quality liquid assets if they meet the criteria that apply to corporate debt securities.

Top Four Banks Hold 91 percent of Derivatives: OCC

The largest four banks hold 91 percent of the total notional amount of derivatives, and the largest 25 banks hold nearly 100 percent, according to the OCC's **quarterly report** on trading and derivatives. Derivative contracts are concentrated in interest rate products (78 percent), which gives larger banks an edge over community banks in hedging interest rate risk. Regulators finalized a swap margin **rule** for large banks in October. Community banks are exempt from the margin and capital **rules** for covered swap entities.

Reciprocal Deposits Lead to Ire in FDIC Small Bank Assessment Rule

Community bankers are objecting to the section of the FDIC's small bank assessment proposed **rule** that would treat reciprocal deposits like brokered deposits, saying that would in essence be a "significant new tax." The FDIC received 505 comments from community banks and trade groups on the rulemaking proposal, and most objected to the new treatment of reciprocal deposits. The letters noted that the FDIC did not give a reason or data to justify the change, which would lead to higher assessments for banks with reciprocal deposits.

FDIC Studying Why Certain Banks are Profitable

The FDIC has launched several **studies**, including one that looks at the challenges and opportunities for small, closely-held banks and one that looks at the structural profitability of community banks, with an emphasis on banks that consistently out-perform their peers and those that under-perform.

EXAMS AND ENFORCEMENT

Highlights: *Regulators are listening to community bank complaints that the regulatory burden is too high and are considering ways to shorten exams and make them more meaningful. But with credit risk rising, expect scrutiny to increase as well.*

OCC Details Areas of Supervisory Concern

Enforcement orders and matters requiring attention continue to decline, the OCC **reported** at year's end. The top MRA categories for small banks are credit (45 percent), enterprise governance (18 percent), bank information technology (12 percent), BSA/AML (9 percent), and consumer compliance (9 percent).

Fed Vows to Make Exams Shorter

Smaller community banks with low risk profiles should have less intensive exams, Federal Reserve Governor Jerome H. Powell **said** at the New York Fed's annual Community Bankers Conference. Powell said that the Fed has asked examiners to begin risk assessments before they arrive at the bank, which since 2014 has allowed them to spend more time on higher-risk concerns. He said the Fed has asked examiners to spend less time on uncommon areas of consumer compliance. As a result, in the last 16 months, the average length of time for exams has decreased. "Bankers have told us that the examiners seem to have a better grasp of the key issues and that exams are, as we intended, more closely tailored to the business characteristics and risk profile of individual institutions," he said." "Examiners also tell us they sometimes see increased consumer compliance risk at community banks that are expanding beyond their traditional product offerings, often using outside vendors to introduce new products such as prepaid cards or credit card add-ons. These products are often complex, and community banks may not always be familiar with the risks the products pose."

New York Fed Using Automated Tools at Exam Time

The New York Fed is trying to reduce the amount of time examiners spend onsite at community banks, F. Christopher Calabia, Senior Vice President, **said** at the New York Fed's Community Bankers Conference. He said the Fed is doing "more homework" to evaluate a bank's capital adequacy, earnings and liquidity before showing up at the bank, so it can then spend more exam time asking pointed questions about its concerns. It is also adopting "a variety of automation tools" to simplify the exam process. Banks will be asked to submit responses and data online before an exam, which should also help speed up the process. The New York Fed is eager to find community banks that want to experiment with using electronic loan review files, which would enable the Fed to conduct off-site loan reviews, as other districts are doing. Calabia revealed that the new automated tools recently cut by 40 percent the onsite time examiners spent sat one community bank, from 32 days to 18 days.

FDIC Looking at Pre-Exam Requests

The FDIC has formed two work groups to explore ways to improve the pre-exam letters sent to community banks, Doreen R. Eberley, director of the division of risk management supervision told the FDIC Community Bank Advisory Committee at its April 2nd **meeting**. Some bankers have complained that they can't tell how the agency is using the information that examiners are requesting.

Make Sure Your Business Continuity Plan Includes IT

In yet another sign of increasing regulatory focus on cybersecurity, the prudential regulators have added an **appendix** to the FFIEC Information Technology Examination Handbook to cover outsourced technology services. The new section discusses a bank's reliance on third-party service providers and reminds examiners to make sure that there are effective policies to identify, measure, monitor and mitigate risks associated with outsourcing, especially when it comes to recovering IT and critical functions in an emergency. OCC Deputy Comptroller Beth Dugan repeated those themes in a Feb. 11 **speech** in Chicago. "Financial institutions need to expand their disruption scenarios to consider the impacts of cyber threats not only to themselves and their critical systems and operations, but also from and to their third-party relationships, their customers, and the critical infrastructure components on which they depend."

FDIC Inspector General Says Better IT Exams Needed

The FDIC Inspector General says better IT **exams** are needed to combat cybersecurity threats. The inspector general said third-party reviews are especially important since most audits seem to focus on internal controls over financial reporting rather than "security, availability, processing integrity, confidentiality, and privacy." The inspector general also said that FDIC examiners should get better training on cyber risks.

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INTEREST RATE RISK

Highlights: *With the Fed's decision to finally raise interest rates, regulators are paying "very close attention" to interest rate risk. Comptroller Thomas J. Curry said bank earnings could decline if short-term rates rise relative to long-term rates. "We expect banks to assess their interest rate risk exposure under a variety of scenarios specific to the bank's own risk and complexity," he said in December. "Banks should consider the long-term implications to earnings and capital in strategic planning when assessing their exposure to changes in interest rates."*

Regulators Focus on Community Bank Interest Rate Risk Assumptions

Make sure the key assumptions that your bank is using to assess interest rate risk (IRR) are reasonable, forward-looking and specific to your bank's unique scenarios. Community banks are often getting marked down in their Sensitivity to Market Risk portion of their FDIC exams for having "unsupported or stale" IRR assumptions, the FDIC reported in ***Supervisory Insights***.

The FDIC said the common mistakes that banks are making include:

- Using peer averages without considering the bank's unique circumstances.
- Failing to differentiate between rising and falling interest rate scenarios.
- Oversimplifying balance sheet categories.
- Forgetting to evaluate how IRR results would change if the assumptions also change.
- Using off-the shelf vendor assumptions that do not reflect the bank's assets, liabilities and local markets.
- A lack of qualitative adjustment factors to historic data.

In addition, the FDIC noted that "customer behavior may not reflect past behavior when market rates change in the future." Banks with large investments in longer-duration securities must develop rising-rate scenario assumptions "where bond depreciation may pose outsized our unintended risk to earnings and capital," the FDIC said.

Fed Concerned about Community Bank Interest Rate Risk: Yellen

Community banks typically have risks from their lending activity, but the Federal Reserve is also concerned about interest rate risk, Fed Chair Janet Yellen says in ***Community Banking Connections***. "Our examiners have been reviewing whether banks are able to manage risk arising from future changes in rates," she says. She adds that "the vast majority" of community banks are paying "adequate attention" to interest rate risk management. Yellen also said the Fed is "mindful" of complaints from community bankers that large bank requirements often trickle down to smaller banks as industry best practices. She says that the Fed is "enhancing communications with and training for examination staff" to make sure they know that the expectations for smaller banks are not the same as for the largest ones.

Fed Reveals Three Common IRR Mistakes

A FedLinks **advisory** on interest rate risk for community banks reveals three common interest rate risk management deficiencies:

1. Board-prescribed risk limits do not match the risk measurement tools used to quantify risk exposures.
2. Banks are failing to customize or assess vendor default or industry standard assumptions in IRR models.
3. Banks are not using independent or third-party reviews to ensure the integrity of their IRR management programs.

FDIC: Examiners Taking Interest Rate Risk 'Very Seriously'

Community banks need to be prepared for a period of rising interest rates and show examiners that they are ready for different scenarios, according to George French, FDIC deputy director of the division of risk management. The FDIC offers these tips to managing assumptions:

- ✓ Be aware that historical data may not reflect future trends.
- ✓ Use your bank's own historical information for deposit assumptions.
- ✓ Assume a minimal level of prepayments.
- ✓ Measure the interest rate risk of your current balance sheet.
- ✓ If you use a growth assumption, also use a 'no growth" analysis.
- ✓ Perform an independent review of your bank's IRR measurements.

OCC Reviews Modeling Assumptions

The OCC **reviewed** IRR data from more than 1,500 community and mid-sized banks, finding a range of modeling practices and assumptions. The OCC concluded that "outliers in reported exposures and NMD assumptions may indicate diversity in balance sheet profiles or unrealistic or incorrect modeling assumptions."

The OCC review found that most banks used EVE to measure IRR, and the results ranged from a 44 percent loss in EVE to a 29 percent increase. The OCC noted that "banks reporting exposures below the median should carefully consider the risk to capital and ensure the board and senior management understand the potential exposure and are comfortable with the risk."

MANAGEMENT AND BOARD ISSUES

Highlights: *Bank boards and executive management have a fiduciary responsibility to make sure that a bank is well run. "The quality of management and the way it governs a bank's affairs are probably the most important factors in the successful operation of a bank," FDIC Chairman Martin J. Gruenberg said in a speech in May.*

Regulators say Lack of Management Succession Planning is 'Key Risk'

One of the main responsibilities for bank boards is hiring and retaining senior management. Yet management succession and keeping key staff is a "key risk" at community banks, the OCC has repeatedly noted in its semi-annual **risk perspectives**.

Boards must incorporate succession planning into strategic planning, the OCC advises. Indeed, many bank boards under enforcement orders have been told by regulators to not only increase participation in the bank's activities, but to also put together a written management succession plan or identity future senior executives, according to a review of FDIC and OCC enforcement orders. The FDIC also noted in ***Supervisory Insights*** that the lack of succession planning was a major element leading to Matters Requiring Board Attention during community bank exams.

Finding and Keeping Community Bank Directors

Community banks across the U.S. may be finding it hard to recruit and retain outside bank directors, the Federal Reserve noted in ***Community Banking Connections***. But strong directors are more important now than ever, and banks must make sure they are providing the necessary training and education to ensure proper oversight, the article advises.

Banks must conduct periodic board assessments to review directors' responsibilities, determine the effectiveness of strategic planning and monitor policies and procedures. Such assessment can reveal important questions about "the engagement and contribution" of individual directors, the article notes.

The article says that director candidates do not need to be expert in banking. The Fed, however, **suggests** that proposed directors of de novo banks have "appropriate" community bank expertise, and cautions that the inclusion of directors from failed banks can be a red flag in a de novo application.

OCC Encourages Community Bank Collaboration

The OCC issued a **new paper** that encourages community banks to pool or share resources to reduce costs and leverage expertise.

FDIC Planning New Tools for Boards

The FDIC is working on a vendor management video that will include case studies, according to Doreen Eberley, Director of the Division of Risk Management Supervision. She told the July community banking advisory meeting that the FDIC is also updating its videos on interest rate risk management and putting together a new practical handbook for directors. The guide will include information about corporate governance, risk management and ethics, with particulars on how a director's responsibilities differ from day-to-day management, how to develop a sound business plan and a robust strategic plan, and ways to effectively communicate with examiners. The handbook will also discuss the differences between rules, guidance and best practices.

Here are other director training resources:

- **The FDIC's Director Resource Center** is continually being updated, with technical videos on topics ranging from troubled debt restructurings to appraisals and evaluations, as well as a series on rulemakings, fiduciary responsibilities and risk management best practices.
- **The Federal Reserve's Bank Directors Desktop** offers lessons for new directors, with quizzes to make sure they understand the topics.
- **The Office of the Comptroller of the Currency** conducts workshops for community bank directors across the country on compliance, credit risk, governance and essentials of being a new director.

Survey Finds Potential Compliance Cost of $4.5 Billion

Community banks have been complaining for years about their increasing regulatory burden, but no one has been able to calculate the cost – until now. A survey of community banks, conducted by the Fed and CSBS as part of its Community Banking in the 21st Century **conference**, found that the "hypothetical compliance cost" could be $4.5 billion a year. That's because banks in the survey reported that regulatory compliance made up 11 percent of personnel expenses, 16 percent of data processing costs, 20 percent of legal, 38 percent of auditing and accounting, and 48 percent of consulting expenses – or 22 percent of their income. The report does not indicate whether the costs outweigh the benefits, or whether they are even high or low, but it does note that "they are sufficient to frustrate bankers."

Regulators Propose Call Report Changes

The Federal Reserve, the OCC and the FDIC have proposed **revisions** to portions of the Call Reports to reduce the reporting burden for banks. Other changes are expected in the future. The proposed changes delete some items and change the reporting thresholds for others.

STRATEGIC AND CAPITAL PLANNING

Highlights: *Capital is still king. Examiners want to make sure that banks have adequate strategic and capital plans. Don't be surprised if examiners ask your bank to hold even more regulatory capital as a cushion against interest rate risk and higher concentrations.*

OCC's Focus on Strategic, Capital Planning and M&A to Continue

The OCC's examiners will have a "specific focus" on "determining the adequacy of strategic, capital, and succession planning" in 2016, according to the Committee on Bank Supervision's Fiscal Year 2016 **Operating Plan**. This has been a priority for all bank examiners since the recession. OCC examiners will also scrutinize business models and strategy changes, as well as M&A processes and procedures. Other priorities include credit underwriting, particularly HELOC end-of-drawer periods, cybersecurity, interest rate risk, bank secrecy and AML compliance.

Banks Face High Strategic Risk

Community banks face "high strategic risk as banks adapt their business models to respond to sluggish economic growth, low interest rates, and intense competitive pressures from both banks and nonbanks, the OCC said in its fall semi-annual **risk perspective**.

Examiners will focus on "the adequacy of strategic, capital, and succession planning" at community banks in 2016. They will assess "whether banks' plans are appropriate in light of the risks in new products or services. Examiners will assess the bank's merger and acquisition processes and procedures, if applicable." The OCC also listed strategic planning and execution as its first supervisory priority in its mid-cycle status report in June.

Strategic Planning Means Managing Tradeoff between Risk and Return

The FDIC's ***Supervisory Insights*** explores how banks should handle strategic planning "in an evolving earnings environment." Written by the FDIC's policy staff at the division of risk management supervision, the article notes that "the return of loan growth and an uncertain future interest-rate environment pose important strategic questions" for bank directors and managers. The writers suggest that banks need "a disciplined approach" to identifying opportunities and quantifying risks. The article advises banks that they must manage "the tradeoff between risk and return," making sure that "capital, earnings and staff expertise" have a reasonable correlation to a bank's risk profile. It would be wrong for bankers to manage to earnings targets without taking into account risk, the article warns.

Gruenberg: Failing to Plan is Planning to Fail

Too many banks are reaching for yield, launching new products or business lines or looking for sources of non-interest income without adequate strategic planning, FDIC Chairman Gruenberg **told** the American Association of Bank Directors. "There's an old saying that 'failing to plan is planning to fail.' One of the important lessons we learned from the financial crisis is that poor planning can harm institutions, their communities, and the financial system as a whole," he said.

He said that regulators expect banks "to have a strategic planning process to guide the direction and decisions of management and the board," he said. "I want to stress the word 'process' because we don't just mean a piece of paper." He said that effective strategic planning "should be a dynamic process that is driven by the bank's core mission, vision, and values. It should be based on a solid understanding of your current business model and risks and should involve proper due diligence and the allocation of sufficient resources before expanding into a new business line. Further, there should be frequent, objective follow-up on actual versus planned results."

Fed Reiterates Importance of Capital Planning

The Federal Reserve Bank of Atlanta has taken another look at why so many banks failed in Georgia and Florida during the crisis. One takeaway: "It is critically important for banks to engage in ongoing capital planning," writes Michael Johnson, senior vice president, in ***Community Banking Connections***. Johnson says that the key to avoiding bank failures in the future is for banks to implement "a sound, sustainable strategy and risk management practices."

Regulators Release New Regulatory Capital Tool

The OCC, the FDIC and the Fed have developed an **automated tool** to help banks calculate risk-based capital for securitization exposures under the revised capital rules. Use of the tool is discretionary. The prudential regulators have compiled 13 pages of **frequently asked questions** about the new rules for regulatory capital, based on queries from many community bankers.

FORWARD-LOOKING RISK ANALYTICS

Highlights: *Banking regulations have changed since the financial crisis, and so have risk management best practices. Regulators have begun using forward-looking risk analytics to help identify banks in trouble. Examiners expect banks to use these types of analytics to manage concentrations. Smart community banks are also using forward-looking analytical tools in stress testing, M&A, capital planning, interest rate risk management and ALLL calculations. These tools not only give banks a competitive edge, but they also help them win high marks from examiners.*

Fed Announces Bank Surveillance System

The Fed ended the year by **announcing** it had made its supervision framework "more forward-looking and data-driven." The new program includes the use of forward-looking metrics to target high-risk banks "for enhanced supervision," while identifying "low-risk" banks that would merit more of a "streamlined supervisory approach."

The program will include an outlier list and a watch list that would identify banks "with expanded or new areas of risk-taking" and flags those in the early phases of financial trouble. The algorithms used in the data modeling were first tested on community banks, the Fed wrote, but they are now being expanded and customized for all banks. Some metrics are still being developed and full implementation is not expected until 2017.

Community banking organizations supervised by the Fed may receive a surveillance write-up if their rating drops from the previous quarter, or if a new contributing risk factor is identified, the Fed **wrote**.

OCC Updates Risk Assessment Guidance

The OCC also **announced** in December that it had updated its guidance for its Risk Assessment System to clarify the "forward-looking elements" of both the system and CAMELS. The guidance "broadens the concept of risk" to include its impact on a bank's projections. It also expands the definition of strategic and reputation risk assessments to include both the quantity and quality of risk management. The guidance notes that under the new definitions, "financial condition includes impacts from diminished capital and liquidity," and that capital includes potential impacts from losses, reduced earnings and market value of equity. The OCC stressed that strategic risk was a key risk and top concern for examiners. The updated guidance is now reflected in the OCC's **handbook** on Community Bank Supervision.

Regulators Want Banks to Manage Concentrations

Regulators are **concerned** about the increase in CRE concentrations at community banks. They are emphasizing that banks need the right strategies "to ensure capital adequacy and allowance for loan losses" that support a bank's lending strategy and are consistent with the level of CRE risk in their portfolios. The regulators advised banks to perform "market and scenario analyses" to quantify the potential impact of changing economic conditions on asset quality, earnings and capital – in other words, forward-looking capital stress tests.

Community Banks Should Use Stress Tests to Assess Capital Needs

Stress tests can be valuable to community banks to assess "adequate capital needs for their exposures and market conditions, **according to** the community bank performance panel at the third annual Community Banking Research and Policy Conference, hosted by the Federal Reserve System and the Conference of State Bank Supervisors. CSBS has been a proponent of community bank stress testing **since 2010**, when it issued a white paper advocating stress testing for community banks as "a fundamental part of this new era of risk management."

OCC Risk Perspectives Cites 'Forward-Looking' Management

The latest issue of the OCC's semi-annual risk perspective **discusses** "forward-looking management teams" who differentiate their banks "by focusing on long-term strategies that leverage technology, produce balanced growth in core businesses and markets while maintaining satisfactory liquidity, ALLL, earnings, and capital positions."

FASB to Address CECL in 2016

The Financial Accounting Standards Board is expected to draft the final current expected credit losses standard in the **first quarter of 2016**.

Under the proposed CECL model, a bank would recognize as an allowance its estimate of the contractual cash flows not expected to be collected. Unlike the incurred loss model, the CECL model does not specify a threshold for the recognition of an impairment allowance. Rather, a bank would recognize an impairment allowance equal to the current estimate of expected credit losses for financial assets as of the end of the reporting period. Under CECL, a bank's expected credit losses represent all contractual cash flows that the bank does not expect to collect over the contractual life of the financial asset.

To make their ALLL estimates under CECL, banks will need to look at the economic conditions at the time of the loan, as well as forward-looking forecasts of what could happen during the life of the loan.

One tool for banks that may become essential is vintage

analysis, according to an April 2015 American Bankers Association Discussion **paper**. It suggested that "vintage analysis, whereby loan portfolios are broken out into cohorts by each issuance year, could become a minimum requirement in order to support the ALLL estimate under CECL."

FASB Chair Explains Why CECL is Forward-Looking

Here's why CECL came about, according to Financial Accounting Standards Board Chair Russell G. Golden: Financial statement preparers told the board that GAAP prevented them from booking losses, even when they knew the loans were risky and certain to lose money. "In other words, current GAAP was prohibiting banks from looking forward. The credit crisis of 2008 underscored the need for a more forward-looking model—one that gives preparers the opportunity to recognize losses that exist in the loan portfolio, and recognize them up front," Golden said in a December **speech**.

OCC Again Calls for Community Bank Stress Testing

Stress testing can help bank boards know if they have "adequate capital relative to all of its risks," Deputy Comptroller Darrin Benhart said in **speech**. Although stress testing is not mandated for community banks, "all banking organizations, regardless of size, should be able to analyze the potential effects of adverse events on their financial condition as part of sound risk management practices," Benhart said. He called on community banks to use stress testing to understand risks associated with concentrations and as part of strategic planning. "The most valuable and often most difficult risk management decision is knowing when to say "no" because you have exceeded your risk limits," he said.

Forward-Looking Risk at Center of Assessment Proposal

The reason why the FDIC is changing the way it calculates deposit insurance assessments for banks with assets below $10 billion is to "make assessment rates more forward looking in how they capture risk," FDIC Chairman Gruenberg said in announcing the **proposal**. The new model will estimate the probability of failure using data from the financial crisis, but also assess banks for potential risks in their loan profiles. The **proposal** is revenue neutral, so it "would only change the allocation of premium costs based on the risk profiles of banks," he said. Banks can use a small bank assessment **calculator**.

Small Bank Assessment Change Could Lead to Higher Capital Requirements

The FDIC's **proposal** to change the way it assesses deposit insurance for small banks will have an adverse impact on banks with a high concentration of construction and development loans, bankers complained at an FDIC community bank advisory committee **meeting**. That's because the rule would count such loans as high-risk under a new loan mix index.

There is one way that banks with large concentrations of C&D loans can mitigate higher assessments, advised Diane Ellis, FDIC Director of Insurance and Research: Increase capital levels. "We're approaching this like most insurance companies do," Ellis responded. "They look at the portfolios of risk they are underwriting. Certain business models create higher risk and that is what we are trying to charge for."

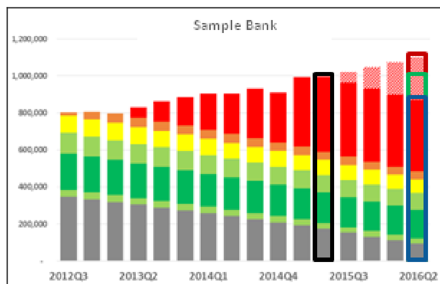
Editor's Note

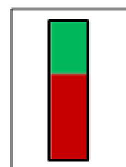
Invictus has been at the forefront of changing bank analytics since 2008. The Invictus Forward-Looking Risk Analytics™ system combines capital assessment via stress testing to quantify the amount of FreeCapital™ available for strategic actions, including organic growth and M&A. The Invictus M&A analytical system is built from proprietary forward-looking risk analytics linked to economic conditions. The system evaluates a potential target based on the capital structure, timing needs, product line, geography and yields of the acquirer. It allows banks to understand at what ceiling price a deal is worth, what strategic options exist for the bank if it decides not to buy, and what hidden risks a target might present. For more information, contact George Dean Callas at ***gcallas@invictusgrp.com****.*

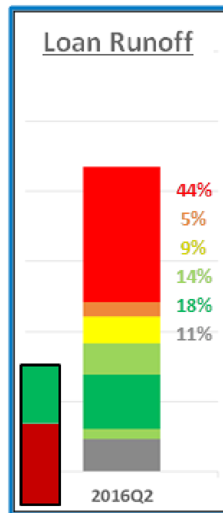
How Banks Can Use Forward-Looking Risk Analytics

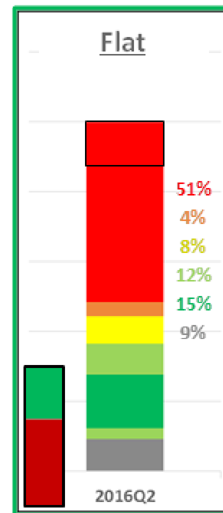
Forward-looking risk analytics help banks make smart strategic moves. These charts show how it works. Invictus analyzed the lending environment of every quarter since the financial crisis and assigned scores based on the risk vs. reward profile of loans originated in those quarters. Loans originated in the immediate aftermath of the recession have the lowest risk to highest reward profile and are represented in green. Loans originated in recent quarters have the highest risk to lowest reward profile and are represented in red. Loans forecast for the next four quarters are expected to be in the “red zone” as well. Every loan originated in the current environment will incrementally increase the risk and lower the yield of the bank’s overall portfolio. The higher the growth, the lower the ending yield But loans provide a higher return on capital than the alternative of cash or securities. Banks must understand the current risk/reward profile of their loan portfolios and assess the short- and long-term implications of strategic decisions. Among these is whether alleviate CRE concentration concerns with growth in another category. Stress testing can also be used to show examiners that a bank has enough capital to withstand a downturn, even with concentrations.

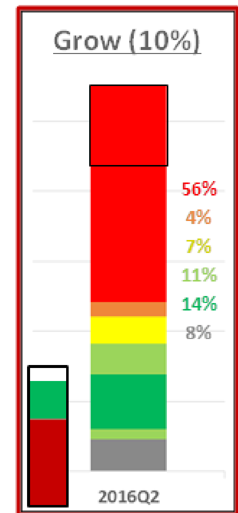
Forward-Looking Risk Analytics *1 Year Forecast*
Sample Bank











	Today	Loan Runoff	Flat	Grow (10%)
Wtd-Avg Loan Rate:	4.79%	4.72% ↓	4.65% ↓	4.61% ↓
Gross Return on Allocated Total Capital:	54%	41% ↓	44% ↑	46% ↑

MERGERS AND ACQUISITIONS

Highlights: *As community banks struggle with organic growth and earnings, many are looking to mergers and acquisitions as a solution. Expect examiners to assess your M&A "processes and procedures". Banks that use forward-looking analytics and stress testing will benefit. Some banks are looking at M&A to "supplement their own management team or give it a new direction," OCC Midsize and Community Bank National Bank Examiner Scott Schainost told Bank Insights.*

Only One New Bank Charter in 2015, M&A on Uptick

The latest FDIC ***Quarterly Banking Profile*** notes that there was just one new bank chartered in 2015, only the second new charter of an FDIC institution since December 2010. As of the third quarter, 224 banks had merged, including 72 in just the third quarter, and six had failed. The FDIC's chief economist, Richard Brown, told a Fed **conference** last year that there could be an increase in de novos when interest rates move up, leading to an improvement in earnings. He said there was a high correlation between new banking charters and economic variables, including the federal funds rate.

Small bank Holding Company Rule Allows More Debt

The asset threshold for small bank holding companies has been increased from $500 million to $1 billion in assets, according to the Federal Reserve's final **rule**, which also applies to savings and loan holding companies. The rule allows small bank holding companies to operate with higher levels of debt, and excludes them from consolidated capital requirements. Banks that are now considered small bank holding companies "should revisit their financial projections to consider whether introducing debt funding at the holding company can increase returns on equity without taking on unwarranted financial risk," advises the law firm of Bryan Cave. The new rule may spur more M&A because it allows banks to use debt to finance up to 75 percent of the purchase price of an acquisition, which in theory could lead a holding company to have a debt-to-equity ratio of up to 3-to-1.

FDIC Small Bank Assessment Proposal Gives Incentive to Acquire

Under the FDIC's proposed small bank assessment **rule**, banks that grow significantly in a year may face a higher assessment rate, unless that growth is 'through merger or by acquiring failed banks."

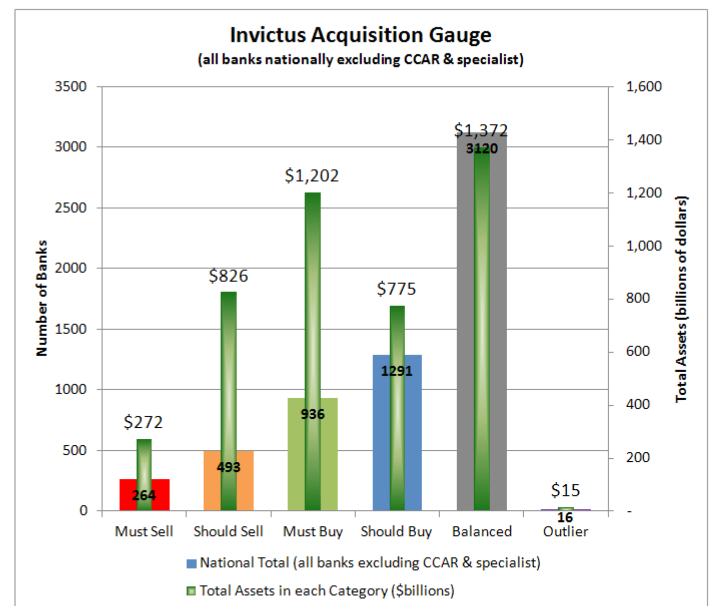
Fed: Pre-Filing 'Very Useful' to Community Banks

Want smoother sailing for your merger or acquisition? Then make sure your bank goes through a pre-filing review to get regulatory feedback on the application, the Federal Reserve suggests in its **report** on banking applications.

"Processing delays can be avoided by using the pre-filing process, which provides applicants the opportunity to work with Federal Reserve staff to receive critical feedback on potential issues related to acquisitions or other proposals before filing a formal application," the report notes. The Fed says its pre-filing process is especially useful to community banks. Each application is allowed just one pre-filing review. Although optional, the process allows banks to get critical feedback before a formal application is filed.

Study Cites Regulation as Reason for Consolidation

A new Harvard Kennedy School paper, ***"The State and Fate of Community Banking"***, explores whether the Dodd-Frank law is responsible for community banks' declining market share since 2010. The paper suggests that "inappropriately designed regulation and inadequate regulatory coordination" may be responsible for industry consolidation. It recommends that Congress conduct cost-benefit analyses of financial regulations and simplify capital rules.



A Look at Banks that Should Buy or Sell

Invictus runs a stress test on every bank in the country. The test calculates each bank's post-stress capital position, the capital required to support its assets, and the expected capital loss under stress. The results of the test allow Invictus to allocate each bank into an M&A category. These categories represent what should be the best course of action for each bank, and do not necessarily indicate what the bank will do.

The Invictus Consulting Group is the industry thought-leader in bank analytics. Our groundbreaking tools and new analytical processes have changed how bank executives approach strategic and capital planning, stress testing and mergers and acquisitions. Our analysis gives banks, investors and insurers the edge in executing their plans and developing their businesses. For more information, please contact George Dean Callas at gcallas@invictusgrp.com.