# 2014

# A YEAR IN REVIEW

*a special issue*

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# A YEAR IN REVIEW

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# INTRODUCTION

*A Bank Insights Special Report*

# What Regulators Will Focus on in 2015

Welcome to *Bank Insights*' end-of-the-year regulatory roundup and look ahead for 2015. We've compiled a year's worth of "Read Between the Lines," our monthly feature that delves into regulatory news to give a unique perspective on supervisory priorities.

Throughout the year, regulators have discussed capital planning and stress testing, the nature of regulation for small banks, cybersecurity, the role of the Consumer Financial Protection Bureau, earnings and liquidity, enforcement, interest rate risk, management and board priorities and mergers and acquisitions. This book will review some of those highlights.

A handful of top regulators spent a lot of time in 2014 talking about the burdens of community bank regulation. The year ended with a community bank relief bill that would redefine the asset size of a small bank holding company, increasing it from $500 million to $1 billion. Qualified small bank holding companies would then be allowed to incur higher amounts of debt for acquisitions, which could help them raise more capital. (The relief affects just the holding companies).

Pay attention to the 10-year **overhaul** of outdated and unnecessary regulations, which is now underway. Regulators are having outreach **meetings** throughout the U.S. in 2015.

At the first one, held on Dec. 2 in Los Angeles, Comptroller Thomas J. Curry **said** that while most regulations "provide public benefits that outweigh the burden," it was also true that regulations have created layers of requirements that could be "quite onerous for small banks."

Curry said the OCC favored allowing more healthy banks to qualify for an 18-month exam cycle, by raising the asset threshold from $500 million to $750 million. He also said that community banks should be exempt from the Volcker Rule. It's worth watching to see what comes of these initiatives in 2015.

Officials from the Fed and the OCC have acknowledged that a "one-sized approach" to community bank regulation isn't working, and the FDIC has launched a major effort to communicate better with community banks. But FDIC Vice-Chairman Thomas Hoenig said in a **speech** in June that community banks had gone too far in asking for special exceptions from regulations simply because of their size.

Still, community banks that can learn to tell their own story to examiners will certainly get a friendly reception in the coming year. One way to do that is by using the results of capital stress testing to show examiners how your bank will fare in a downturn. You can then craft your own capital requirements, much like the larger banks do after they have undergone stress tests.

Smart banks would be wise to understand the stress testing and liquidity rules that apply to the largest banks and figure out how to best use those regulatory fundamentals to improve their risk management practices. Best practices often trickle down to community banks, even if the regulations are not a mandate.

Prudential regulators began the year concerned about interest rate risk, a focus that will continue in 2015. Strategic and capital planning remains a priority, as does a renewed and sharper effort on cybersecurity risk management. Expect cybersecurity mitigation issues to be brought up by examiners.

If your bank doesn't know about the Financial Services Information Sharing and Analysis Center, also called **FS-ISAC**, now is the time to participate in it. In November, the FFIEC alerted community banks that "information-sharing forums" are an essential element in any cybersecurity risk management program.

Regulators will continue to focus on the risk of outsourcing critical functions and whether your bank has the proper processes in place to spot risk in your third party vendors, especially when it comes to cybersecurity. Review your service agreements and plans.

Regulators will continue to demand a laser-like intensity from board members, so if your bank's board has uninvolved directors, it may be time to make a change.

Regulators expect consolidation in the community bank market to continue, but they aren't going to approve mergers and acquisitions unless your bank can demonstrate that the new entity has capital to survive a downturn. Stress test the combined banks to show regulators that the merger makes sense.

As more M&A deals are brought to regulators, there will be an increased focus on applications. Regulators are emphasizing that it is smart to go through a pre-filing approval process.

There's no doubt that the loans your bank made in the post-recession years are going to change down the road, when interest rates rise and the economy swings yet again. Regulators no longer look at historical performance to assess how your bank will fare in the future. Instead, they want to see how your capital will perform under a forward-looking stress test that looks at how your bank would perform in a two-year severe economic downturn. The loans your bank has made will each react differently to such a downturn, depending on when the loan originated and what the economy was like at the time.

Asset liability management will loom large in 2015. Systemically important banks will continue to be under pressure with the continued implementation of Dodd-Frank. As of mid-2014, almost a third of the Dodd-Frank rules were still incomplete.

Community banks need to take a realistic assessment of their individual situations with respect to their current regulatory and competitive position going forward. It is critical to focus on efficiency and activities where the bank has a competitive advantage.

# ASSET QUALITY

## Reviewing Appraisals and Evaluations

The Fed provided an **overview** of how examiners look at a community bank's appraisal and evaluation program. Examiners want the collateral valuation process to be independent from loan production and collection, though they concede asset quality may not be possible at small banks. Common mistakes that banks are making: using outdated appraisals or none at all, not using an appraiser certified or licensed by the state, and not meeting the appraisal regulation's minimum standards.

## HELOCs Again in Spotlight

Many community banks have failed to account for a borrower's ability to service their HELOC lines on an amortizing basis at origination, writes Michael Webb, Managing Examiner, Federal Reserve Bank of Richmond, in the Fed's ***Community Banking Connections***. Webb warns that there could be risk in HELOC portfolios as they approach their peak reset years for 2004-2008 vintage originations. Like other bank risks, board members must be kept informed of the bank's policies and procedures on HELOC exposures.

## Underwriting Standards Easing

The OCC's **Annual Survey of Credit Underwriting** shows that standards in commercial and retail loan products are easing, primarily though reduced collateral requirements and loosened covenants. Loan portfolios that eased the most included indirect consumer, credit cards, large corporate, asset-based lending, international, and leveraged loans. Portfolios that tightened since last year included HLTV home equity and conventional home equity.

## Understanding Asset-based Lending

Credit risk is the biggest risk associated with asset-based lending, according to a **new OCC handbook** designed for examiners. The handbook notes that ABL "requires intensive controls and supervision." Even though the risk of loss might be less than with other type of lending, bankers must have a "thorough understanding of the borrower's business, good reporting systems, and in-depth knowledge and evaluation of the collateral."

## Standards for Appraisal Management Companies

All the bank regulators have issued a **proposed rule** that sets out standards for states that will oversee appraisal management companies.

## Mortgage Lending Decreases, 2013 Data Shows

The Federal Financial Institutions Examination Council released HMDA data for 2013, showing that loan originations declined by 11 percent from 2012, refinancings dropped by 23 percent, and home purchase lending increased by about 13 percent. The **data** came from 7,190 institutions, down from 8,900 lenders in 2006.

## Regulators Outline HELOC Challenges

Regulators have **issued guidance** to banks to deal with the impending wave of home equity lines of credit that are reaching their end-of-draw periods. The guidance recommends that banks begin conversations with borrowers about what will happen when their loans reset or reach maturity.

It encourages banks to work together with borrowers to avoid defaults and gives tips on how to manage potential exposures and risks.

## Fed Says Some Municipal Lending is Risky

Community banks need to have "effective risk management programs in place" to cover municipal lending, the Federal Reserve warns in ***Community Banking Connections***. The article, written by examiners at the Federal Reserve Bank of Philadelphia, says the view that municipal lending is a low-risk lending activity "may be debatable." Community banks have reported an increase in municipal loans of nearly 25 percent over the past two years, and community banks with assets between $1 billion and $10 billion reported an increase of 157 percent since 2007, the article notes.

## Could Auto Loans Surpass HELOC Risks?

Deputy Comptroller Darrin Benhart, who is in charge of supervision risk management, **told** the Financial Services and Credit Risk Conference on Oct. 28 that banks have increased auto lending, but they are often focusing more on monthly payments than the overall debt of the borrower. "The results have yet to show large-scale deterioration at the portfolio level, but we are definitely seeing the signs of increasing risk," he said. One indication of trouble to come: Bank charge offs for bad auto loans increased 12 percent in 12 months. While regulators have warned of a HELOC crisis, Behart said banks and thrifts have taken the risks to heart, reducing their exposures by $43 billion. Still, he said, much remains to be done, which is why the banking agencies issued **guidance** in June on how banks should handle end-of-draw challenges.

# CAPITAL PLANNING & STRESS TESTING

## OCC to Target Strategic and Capital Planning/Stress Testing

As we've said before, the OCC and other regulators are zeroing in on the adequacy of strategic and capital planning processes at community banks. Look no further than the **OCC's semi-annual risk perspective,** which lists this issue as the main one for community banks it supervises. Other areas of concern for OCC examiners: IRR, loan underwriting, operational risk and compliance. The good news: OCC enforcement actions were down in 2013 from previous years.

## Fed Takes Over Bank Projections

The Federal Reserve sent a letter to the 30 largest U.S. banks notifying them that they will independently project each bank's balance sheet and risk-weighted assets under the supervisory stress scenario within the CCAR program, signaling its skepticism of the projected loan balances that the top 18 banks assumed in the prior CCAR stress tests.

Note: For most of the regional and community banks that have any levels of excess capital, loan growth is the centerpiece of their strategic plan, not dividends and buybacks. With our bank clients, Invictus treats loan growth as the Fed treats dividends and buybacks in CCAR: by assuming that it is achieved irrespective of the economic conditions. This allows us to quantify the impact on the bank's capital requirements. This is not a practical exercise, but a hypothetical one.

However, when regulators are reviewing the bank's strategic plan, they can see that the bank can handle that growth without affecting its capital adequacy, even under severe stress. This is especially important for aggressive growth banks that have loan growth rates of 15 to 20% plus per annum as part of their plan, says Invictus senior partner Adam Mustafa.

## Banks Not Prepared for Stress Testing Requirements

A recent survey from the accounting firm of Crowe Horwath found that just 20 percent of banks with assets ranging from $1 billion to $10 billion were prepared to meet stress testing requirements. The firm wrote that "it's likely that even community banks will face mandatory stress-testing requirements in the future" and that failure to comply could "limit all capital actions," including executive bonuses and dividends. The survey found that 87 percent of banks were still relying on a "mostly manual process for risk management and governance."

While stress testing is not mandated for community banks, many regulators have begun to view it as a best practice when it is integrated into strategic planning.

## OCC: Stress Testing is 'Fundamental Tool'

Risk management is essential in distinguishing the winners and losers in the banking market, according to Comptroller of the Currency Thomas J. Curry. He encouraged community banks to use stress testing tools to analyze commercial real estate, agriculture and other loan portfolios. In **virtual remarks** to the ICBA, Curry said stress testing tools help community banks understand how their portfolios will perform under different economic conditions. "I can't think of a more fundamental risk management practice than subjecting your credit book to rigorous testing," he said.

## Board Input Essential to Strategic Planning

Low interest rates and diminished loan demand are prompting many community banks to revise their strategies and business models. It's essential to make sure the board of directors is actively involved, cautions Cathy Lemieux, Executive Vice President, Supervision and Regulation, Federal Reserve Bank of Chicago, in **the Q1 issue** of the Fed's *Community Banking Connections*.

She writes that there are three elements critical to good strategic planning:

1. Have the "right people" and "careful execution."
2. Make sure there is expertise at the board level.
3. Stick to a plan, but revise it as often as needed.

Some banks are entering niche, unfamiliar markets, such as energy, health care and equipment financing, she writes. Commercial real estate is also becoming competitive again, especially in multi-family properties, though there is competition from larger banks and investors. That may prompt some community banks to loosen underwriting standards.

## More Time for Stress Testing

All the prudential regulators want to shift back the timing of the annual stress testing cycle by 90 days. The largest banks that are mandated to conduct stress tests would also not have to calculate their capital ratios using the **Basel III advanced approaches** until Jan. 1, 2016.

## TruPS and Volcker: Not a Problem

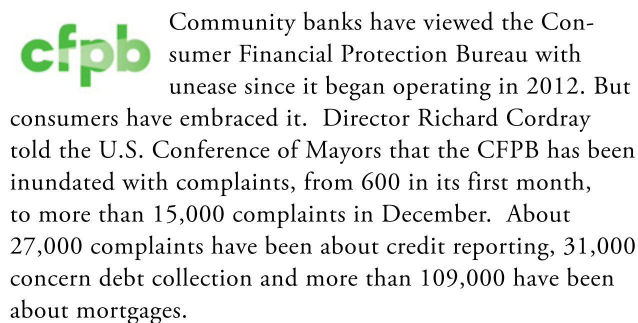
Federal regulators cleared the way for community banks to keep TruPS-backed CDOs as Tier 1 capital. **Regulators announced on Jan. 14** an exemption to the part of the Volcker Rule that considered those CDOs as covered funds. The exemption came about after the American Bankers Association went to court.

# CFPB AND CONSUMER ISSUES

## Make Sure Your Bank Follows Servicemembers Act, Fed Warns

The Federal Reserve is reminding community banks that examiners will review policies to make sure that the bank is complying with the Servicemembers Civil Relief Act. The Fed's latest issue of **FedLinks** reviews the Act, which gives certain rights to the military. Banks, for instance, cannot foreclose on real property during military service or 12 months afterward without a court order.

## Complaints to CFPB Rising




Community banks have viewed the Consumer Financial Protection Bureau with unease since it began operating in 2012. But consumers have embraced it. Director Richard Cordray told the U.S. Conference of Mayors that the CFPB has been inundated with complaints, from 600 in its first month, to more than 15,000 complaints in December. About 27,000 complaints have been about credit reporting, 31,000 concern debt collection and more than 109,000 have been about mortgages.

## CFPB Wants to Work with State Banking Regulators, AGs

The Consumer Financial Protection Bureau is already working with banking regulators in 14 states to share consumer complaints it receives on a real-time basis. CFPB Director Richard Cordray **told** the National Association of Attorneys General that every state AG's office should also partner with the bureau. He pointed out that the CFPB has "the ability to write new rules that create substantive law governing the operations of consumer financial markets. It is striking to me just how extensively the experience and perspective of attorneys general have been and will be informing these initiatives."

## HMDA Rule Changes Top 570 Pages

The CFPB's 573-page **proposed rule** changing the Home Mortgage Disclosure Act expands data reporting requirements, adding new categories on property value, loan terms, points, fees and creditor information. The rule would also require banks to provide more information about underwriting and pricing, such as an applicant's debt-to-income ratio, the interest rate of the loan, and the total discount points charged for the loan. Small banks with a low loan volume—fewer than 25 mortgages a year—would not have to report HMDA data.

## CFPB Needs Data Controls

Community banks have been grumbling about how much data the Consumer Financial Protection Bureau has been collecting, and what it intends to do with it all. The Government Accountability Office **now says** that the CFPB needs to beef up its written procedures and standards regarding the collection and use of consumer financial data. The GAO made 11 recommendations to enhance the CFPB's privacy and information security processes.

## Just in: Must-Read Guide to CFPB

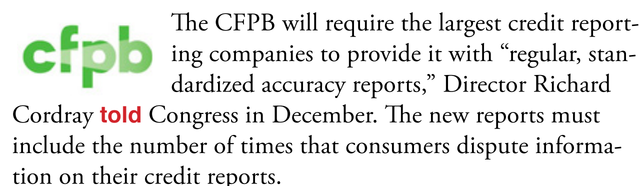
Banking attorneys at Paul Hastings have published a **must-read guide** to the Consumer Financial Protection Bureau, which has built "a strong record of both supervisory and enforcement activities" since it was created under the Dodd-Frank Act. For instance, it slapped M&T Bank with a **consent order** for deceptively advertising free checking accounts. The bank must refund $2.9 million and pay $200,000 in fines.

The lawyers stress that the CFPB's enforcement attorneys provide input to the supervisory examination process, routinely meeting with examiners and giving advice. So when should a bank cooperate with the CFPB, which has levied millions in civil money penalties and other fines against banks and other financial service providers? For one thing, the lawyers say, respond to requests for information as fast as possible. That can reduce a civil money penalty, if one is issued. The lawyers caution not to go over CFPB staff to senior officials, except "in truly exceptional circumstances."

## FDIC Videos Help with CFPB Mortgage Rules

The FDIC has produced the first in a **series of three videos** that will help banks comply with CFPB mortgage rules. The videos are part of the FDIC's efforts to help bank officers understand complex regulations. The hour-long video covers ability-to-repay and the qualified mortgage rule.

## New Requirements for Major Credit Reporting Companies




The CFPB will require the largest credit reporting companies to provide it with "regular, standardized accuracy reports," Director Richard Cordray **told** Congress in December. The new reports must include the number of times that consumers dispute information on their credit reports.

## New Rules on Prepaid Products

Prepaid products are among the fastest growing products in the U.S., with almost $100 billion in value loaded onto cards through 2014, the CFPB says. The agency has released an 870-page proposed **rule** to add protections for consumers who use prepaid cards. The rule could cover emerging payment systems, so banks should take note.

## Rulemaking Status

Want to see what the CFPB has in the works? Check out its updated regulatory **agenda**.

# COMMUNITY BANK REGULATION

## Hoenig: Community Banks Smothering Under Regs

Federal Deposit Insurance Corp. Vice Chair Thomas M. Hoenig told the Boston Economic Club in a **speech** that the Dodd-Frank law would not stop government bailouts. That's because "firms remain too large, too leveraged, too complicated, and too interconnected to be placed into bankruptcy when they fail," he said.

"In the meantime, regional and community banks are smothering under layers of new regulations even though they are not too big to fail, and even though they hold significantly higher levels of capital than the largest banking and financial firms."

## Fed's Tarullo Questions Small Bank Regs

Policymakers should take a look at exempting community banks from the Volcker Rule and the incentive compensation requirements in Dodd-Frank, Fed Governor Daniel K. Tarullo **said** at the Federal Reserve Bank of Chicago Bank Structure Conference in May. (A month later, FDIC vice-chair **Hoenig** say it was time to end community bank carve-outs.)

Tarullo noted that banking regulators have tried to "avoid unnecessary regulatory costs for community banks, such as fashioning simpler compliance requirements and identifying which provisions of new regulations are of relevance to smaller banks." But he conceded that there is a risk of "supervisory trickle down," where "supervisors informally, and perhaps not wholly intentionally, create compliance expectations for smaller banks that resemble expectations created for larger institutions."

## Fed Reviewing Community Bank Supervision

The Federal Reserve is conducting a "zero-based review" of its community bank supervision program, and will likely eliminate some guidance and revise others, according to the main article in the **Q2 issue** of the Fed's *Community Banking Connections*.

The article, "Board Staff Perspective on Community Bank Supervision: One Size Doesn't Fit All," emphasizes that the Fed treats community banks differently than larger banks. It says that Washington is "mindful" of community bank concerns that large bank requirements are often viewed as best practices that trickle down to community banks "in a way that is inappropriate."

## Regulators to Congress: One-Size Approach to Supervision Doesn't Work

Regulators told the Senate Banking Committee in September that community banks deserve a break from too much regulation. Comptroller Thomas Curry reiterated that a "one-size-fits-all approach to bank supervision is not appropriate" for community banks. Curry **testified** that the OCC tailored its supervisory programs to the risks and complexity of a bank's activities. He also pointed out that the OCC has been working to avoid "unnecessary regulatory and compliance burden on small banks."

Maryann Hunter, Deputy Director of the Federal Reserve's Division of Banking Supervision and Regulation, delivered the **identical message** to the committee. Hunter said the Fed uses a "risk-focused approach" to community bank supervision. Banks engaging in non-traditional or higher risk activities will get greater scrutiny, while examiners will have a "lower level of review" for banks with low risk activities. She said that the Fed began a process last year that actually reduced exam testing at community banks that performed well during the crisis and is increasing its use of off-site monitoring.

Fed Governor Daniel Tarullo **told the committee** that "regulatory compliance can impose a disproportionate burden on smaller financial institutions." He said the Federal Reserve supports excluding community banks from certain "statutory provisions" that are "less relevant to community bank practice," such as the Volcker rule and incentive compensation requirements.

"Even where a practice at a smaller bank might raise concerns, the supervisory process remains available to address what would likely be unusual circumstances," he noted.

Doreen Eberley, the FDIC's Director of the Division of Risk Management Supervision, was **less vocal** about exempting community banks from existing regulation. " We believe the evidence strongly supports the idea that the best way to preserve the long term health and vibrancy of community banks, and their ability to serve their local communities, is to ensure their core strength is preserved: strong capital, strong risk management and fair and appropriate dealings with their customers. We also believe our own supervision plays an important role in obtaining corrective action to address problems where this is needed, and that this also promotes the long term health of community banks," she said.

## Fed President Blasts Community Bank Regulation

Kansas City Fed President Esther George criticized the state of community bank regulation in her keynote **speech** at the recent Fed/CSBS conference. She said rules "are increasingly prescriptive and complex' and even capital rules were too complicated for community banks. "For community bank supervision, the substitution of rigid rules for examiner judgment has altered the supervisory process without adding value and has instead created higher costs of compliance," she said.

# CYBERSECURITY

## FDIC Letter Reminds Banks about Technology Outsourcing

In other signs of a sharpened emphasis on third-party risks, the FDIC sent out a **financial institution letter** on April 7, reissuing three documents that community banks can use to help guide them in selecting technology service providers. The documents remind banks to make sure that confidential bank information is protected and that any outsourcing meets the bank's objectives and strategic plans. **One document** details how banks can develop service level agreements to measure performance and monitor risk.

The law firm of Bryan Cave **notes** that "it is increasingly plain that we are seeing a significant sea change in how regulators approach the relationships between banks and their third party vendors. Examiners are digging deeper — especially into the content of bank contracts - and the scope of review is extending to more and more vendors."

## Community Banks Could Be Next Cyber Targets

Don't assume that hackers won't attack a community bank. That's the **message** from Comptroller of the Currency Thomas J. Curry in a May 16 speech. "And while the largest institutions might be the most tempting targets for the bad guys, what we've learned from other sectors and are now seeing in the financial sector is that as the larger financial institutions improve their defenses, hackers are likely to direct more of their attention to community banks," he said.

The Federal Financial Institutions Examination Council, which includes all the banking regulators, last year formed a Cybersecurity and Critical Working Group. They have plans to "more aggressively supervise smaller, community banks with cybersecurity vulnerability and risk-mitigation assessments," according to Phoenix attorney Richard H. Herold of Snell & Willmer.

## How to Set the Tone for Effective Cyber Risk Management

Build a security culture from the top to make sure your bank is timely monitoring cyber risks, according to a recent community bank **presentation** from the FFIEC. Management must identify, measure, mitigate and monitor risks; develop plans according to the bank's risk and complexity; make sure that the bank's IT strategy is aligned with its business strategy, and get regular metrics on its vulnerabilities. Questions to ask: How does the bank test its plans to respond to a cyber-attack and do those tests include key internal and external stakeholders?

About 500 community banks will undergo cybersecurity assessments as part of their regular exams under a **new FFIEC pilot**. Regulators will use the information from the assessments to assess how banks are managing cybersecurity and whether they are prepared to mitigate increasing risks. The FFIEC has also published a **webpage** about cybersecurity issues.

## Cybersecurity Risks Inherent at Community Banks

Expect new guidance as a result of the FFIEC cybersecurity assessment of community banks, regulators said in November. The review of 500 community banks **concluded** that CEOs and boards must evaluate the type, volume and complexity of connection types (such as VPNs, wireless networks, telnets), products, services and technologies at their banks. Any connection can be a potential entry point for an attack, the FFIEC warns. Banks should come up with disaster recovery plans in case of a cyberattack.

Bank officers should know what types of connections the bank has, how they are managed in light of their vulnerabilities and whether they are needed. Every type of technology the bank uses – including ATMs, the internet, cloud computing, mobile, can be the target of an attack. Banks must also assess their third party vulnerabilities.

Boards and senior management should routinely discuss cybersecurity issues, rather than just when attacks are in the news. "Strong governance includes clearly defined roles and responsibilities that assign accountability to identify, assess, and manage cybersecurity risks across the financial institution," the FFIEC says.

Every bank should assess how accountability is determined for managing cyber risks, including business decisions that may introduce new cyber risks. Banks should share cyber threat information and maintain event logs to record cyber events. They should also consider classifying and encrypting sensitive data.

To improve cybersecurity risk management, regulators say that banks should:

- Ensure ongoing and routine board and senior management discussions about cyberthreats and vulnerabilities and provide reports to the board on events and trends.
- Make sure that the bank has a process in place that provides for accountability for managing cyber risks, including those that may occur because of business decisions
- Gather and analyze threat and vulnerability information, then use it to mitigate risk
- Appoint someone to maintain relationships with law enforcement
- Update and review the bank's controls when the IT environment changes
- Make sure that third party connections have ways to manage cyber risks.

# EARNINGS AND LIQUIDITY

## The Future of Community Banking

The FDIC has updated its **community bank study** and two words are key: consolidation and earnings. The update notes that while community banks as a whole experienced their best year in 2012 since the crisis, those gains may be short-lived since future earnings growth is dependent on increases in net interest income. There have been virtually no new charters since the crisis began, and the market continues to tighten, with voluntary closures and mergers. Most of the community bank failures since the crisis have been tied to commercial real estate concentrations.

## FDIC Adds Community Bank Data

The FDIC has added a **new section** to its quarterly banking profile to report "insight into the condition and performance" of the community banking sector. Although net income at community banks of $4.4 billion was down 1.5 percent from the previous year, the percentage decline was less than the 7.6 percent decline in earnings reported by the entire banking industry.

## Fed Reminds Banks of Contingency Funding Plans

Worth reading: The Fed has issued an **overview** of what examiners expect when it comes to contingency funding plans in a liquidity crisis for community banks. Boards must monitor and approve annually the bank's liquidity risk management practices. The contingency funding plan should consider stress events with various time horizons.

## Examiners See Signs of Strategic Vulnerability

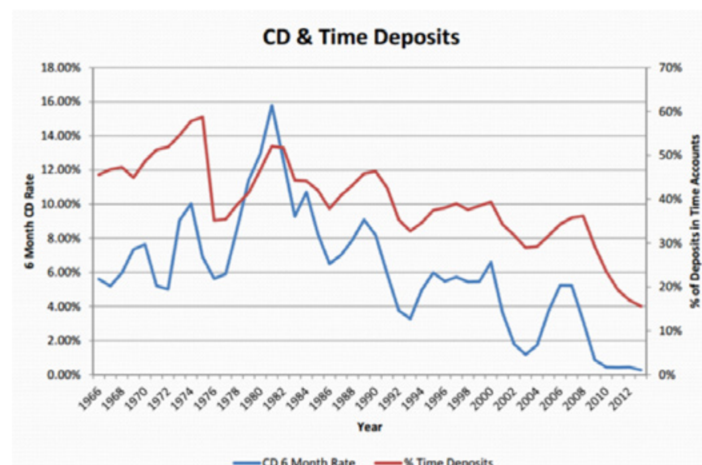
Regulators from the Fed, the FDIC and the OCC recently told New Jersey banks that they are increasingly seeing signs of strategic vulnerability among community banks. Banks are seeking alternative ways of increasing shareholder value, and even institutions with more than $1 billion are looking at mergers and acquisitions, hoping for economies of scale. Competition on lower pools of loans is putting pressure on deals and products, which is hurting margins. Banks are giving up yield to protect against rising interest rates. Staying liquid and having a tighter margin is a prudent approach, one regulator said.

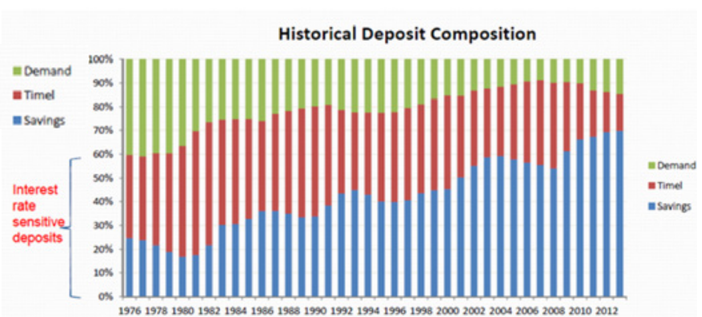
## Fed's 2015 Scenarios Include Liquidity Stress Test

Although the Fed doesn't say it, the Adverse Case scenario in the 2015 **CCAR scenarios** is a disguised liquidity stress test. Check out this quote from the Fed's instructions for 2015: "…firms should interpret the rise in short-term interest rates embodied in this year's adverse scenario as crystallizing certain risks to banks' funding costs. In particular, commercial deposits should be viewed as being unusually drawn to institutional money funds, which re-price promptly in response to changes in short-term Treasury rates."

In other words, regulators want to see how you will handle some form of disintermediation in your deposits in the face of a moderate recession. Although many community banks have taken steps forward in terms of collecting better data on their loans, most are sorely behind on the deposit side. Banks should be able to segment their deposits in much greater detail than they are currently doing. Only then will they be able to understand their risks on this front, as CCAR 2015 virtually requires this from the big banks.

### Why Strategic Planning Must Change




*As rates rise, money leaves the banking system looking for more attractive yields. There is inherent growth in deposits, which must be excluded to attempt to isolate the disintermediation that takes place. As CD rates change, there appears to be a correlation between the change in the percent of CDs to total deposits and the change in interest rates. Regulators will be tying interest rate risk, liquidity risk, and securities portfolio composition together. The adoption of the Fed's version of the Basel III-style liquidity coverage ratio for the largest banks will continue to cause an evolution in liquidity planning and investment portfolio structure. The interest rate sensitivity of the stress test, particularly the adverse case, should cause banks to perform major strategic introspection during the planning cycle.*

# ENFORCEMENT

## OCC Reveals Enforcement Statistics

The Office of the Comptroller of the Currency's 2013 **Annual Report** always offers a few telling nuggets. In fiscal year 2013, the OCC issued 43 cease and desist orders, 31 formal agreements, 1 PCA directive, 7 memorandums of understanding and 35 individual minimum capital ratio letters. IMCR letters require banks to maintain capital levels higher than regulatory minimums. If the bank's capital slips below this requirement, then regulators can mandate a capital plan.

Comptroller Thomas J. Curry highlights capital throughout the annual report, noting that "at the end of the day, the hundreds of community bank failures that followed the financial crisis came about because they lacked capital of sufficient quantity and quality to weather the storm." He writes that the new capital rule should help banks avoid such meltdowns in the future. The report also notes that the OCC expects banks to maintain capital "well above regulatory minimum capital ratios, especially during expansionary periods" when risks increase.

## Expect Examiner Focus to Remain Strong

Comptroller of the Currency Thomas J. Curry **told an OCC-Boston University conference** that the "cornerstone of a healthy financial system" is supervision and examiner judgment, especially "examiner boots on the ground." He also cited rules, stress tests, capital levels and data analytics as key ways regulators should evaluate a bank's health.

## Higher CAMELS Scores Returning

More than 85 percent of the 491 community banks in the OCC's Central District are rated a 1 or 2 on their CAMELS composite, a level not seen since 2009, the OCC **reports**. In Ohio, more than 92 percent of banks had a 1 or 2, up from 78 percent in 2009. The OCC says that banks in Chicago and Minneapolis saw the greatest decline in problem banks. "Community banks and thrifts supervised by our Chicago team had been in survival mode for several years," noted Nathan Perry, Assistant Deputy Comptroller in Schaumburg, Ill. He attributed the improvement to better risk management practices and a healthier economy.

## Strong Banks Hit with Matters Requiring Board Attention

Examiners handed out MRBAs to about 48 percent of banks with satisfactory CAMELS ratings from 2010 to 2013, and 85 percent of those banks were rated a 1 or 2, the FDIC reveals in its **summer issue** of *Supervisory Insights*. Loan issues (such as problem assets, ALLL and concentrations) accounted for 69 percent of the warnings, while lax board or management policies, (including audits, policies and inadequate strategic planning) made up 45 percent. Interest rate risk, which was cited in 17 percent of the MRBAs in 2010, skyrocketed to 30 percent in 2013. The good news: About 80 percent of the time the bank was able to address the deficiencies in its first response to the FDIC.

## Read Volcker Rule, Just in Case

The OCC has developed **"interim exam procedures"** to help examiners enforce the Volcker Rule by July 21, 2015. Community banks that don't engage in trading or investment covered by the rule don't need to worry about it --- but the only way to know that is to read the rule to find out if your bank is indeed exempt. The law firm of Nelson Mullins advises every national bank to "review its status under the rule, even if it believes it does not engage in Volcker-covered activities." The law firm expects Fed and FDIC examiners to use similar standards.

## Timing of Exam Reports Tied to CAMELS Scores

The OCC mailed exam reports to more than 90 percent of 1 or 2-rated community bank boards within 90 days of the exam start date, while those that were rated 3, 4 or 5 usually get their findings within 120 days, Senior Deputy Comptroller Toney Bland **testified** before the Senate Banking Committee in September.

While community banks are healthier than they were during the crisis, economic recovery and job creation is still a problem, Bland said. He noted that many community bankers can't find profitable lending and investment opportunities "without taking on undue credit or interest rate risks." Strategic risk is also a concern for bankers looking to generate earnings in a low interest rate environment.

## Curry Calls For Real Joint Exams from State Regulators

As a result of the financial crisis, state and federal regulators need to "step up our game," Comptroller Curry told the **Conference of State Bank Supervisors** in Chicago. Many of the failed community banks operated with flawed business plans, inadequate capital and excessive real estate concentrations, he noted. He urged state regulators not to simply put a department's name to a report. "A joint bank examination needs to be a joint product," he said.

## Fed Experiments with Off-Site Loan Review

The Federal Reserve is reviewing a pilot program that cut in half the on-site exam time for community banks by allowing examiners to look at loan documents off-site. The banks that participated in the experiment gave examiners secure access to loan portfolio information and the actual electronic loan documents needed for a credit review, the Fed reveals in ***Community Banking Connections***.

# INTEREST RATE RISK

### Interest Rate Risk Worries Examiners

The **FDIC quarterly report** shows the impact of rising longer-term rates on unrealized gains on available-for-sale securities. Banks reported $9 billion in unrealized losses on their available-for-sale securities. "Interest rate risk is an ongoing concern for bank regulators. And it will continue to be a focus of attention in our safety and soundness examinations," said FDIC Chairman Gruenberg. Community banks are seeking higher asset returns by going out further on the yield curve, leaving them vulnerable to interest rate risk.

### OCC to Focus on Strategic Planning, Interest Rate Risk

Expect your OCC examiner to pay attention to the adequacy of your bank's strategic, capital and succession planning procedures, according to the OCC's **Spring issue** of its Semiannual Risk Perspective. Examiners will want to make sure that strategic initiatives take into account these risks. (One way to do this is to make sure your bank incorporates capital stress testing into its strategic planning.)

Examiners also want to make sure your bank has effective interest-rate risk measurement processes. Examiners will monitor portfolios for changes in risk appetite, and they want assurance that management not only can assess the bank's vulnerability to interest rate changes, but also has tools to monitor and control the risk. "A key focal point" will be a bank's ability to identify and quantity IRR in both assets and liabilities under varying model scenarios.

The report notes that community banks have high strategic risk as they adapt their business models to the changing economic environment, and the sector's earnings outlook is uneven due to weak loan demand and declining investment yields.

### Expect Interest-Rate Risk Management Scrutiny from Examiners in 2014

Bank examiners will assess how community banks manage interest rate risk (IRR) exposures in 2014. They want to know if a bank's interest rate risk measurement process is adequate based on its risk profile and size.

All the federal regulators repeatedly issued warnings in 2013 about the need to monitor IRR and the responsibility of the board in setting a bank's risk tolerance and then overseeing proper risk controls. The Federal Deposit Insurance Corp. and the Federal Reserve have featured articles on interest rate risk in their most recent community bank publications. The Office of the Comptroller of the Currency cites interest-rate risk as a major concern in its latest semi-annual risk perspective, saying that examiners are "focusing on banks with significant concentrations in longer-term assets or liability structures that make them vulnerable to quickly increasing rates."

The winter issue of the Federal Deposit Insurance Corp.'s Supervisory Insights explores the challenges banks face in proactively managing and assessing their interest rate risk. "The recent environment of sustained low interest rates has led some banks to alter balance sheets in a reach for higher yields," which has increased interest rate risk, writes Doreen R. Eberley, FDIC Director of the Division of Risk Management Supervision.

The FDIC is concerned that many banks could see a significant securities portfolio depreciation in relation to capital when interest rates increase. Banks need to look now at the characteristics and duration of assets, funding sources and off-balance sheet exposures and how they contribute to the bank's overall interest-rate risk profile, the FDIC warns.

Examiners want to make sure a bank's policies, procedures, risk limits and strategies governing interest-rate risk have been reviewed and approved by senior management and the board of directors. Common mistakes banks are making:

- Risk limits are not defined or appropriate for the bank's risk tolerance.
- The board is not regularly reviewing the bank's policies, procedures and strategies. Directors need to know the impact of strategic decision on interest rate exposures.
- Policies do not outline specific oversight responsibility for measuring, monitoring and controlling interest rate risk. If interest-rate exposures exceed the bank's risk limits, the bank's senior management must report that to the board and provide an action plan to get the limits under control, the Fed notes. Examiners will want to see such documentation and progress.
- Banks are using inadequate tools to determine their risk exposures. FDIC examiners have found banks using inadequate stress tests that don't incorporate significant rate shocks (for example, 300- and 400-basis point shocks) and other scenarios specific to the bank's unique risks.
- The models banks are using can't accurately assess the complexity of their bank's balance sheet. Fed examiners say that some banks are using off-the-shelf models that are not customized for their bank. A rural bank, for instance, that has 50 percent of its assets in callable bonds should not rely on a simple maturity gap, the Fed points out.
- Some banks are not comparing the results of stress tests to their internal risk limits.
- Examiners will scrutinize the capabilities and accuracy of internal measurement systems as well as stress testing scenarios and assumptions, the FDIC warns.

# MANAGEMENT & BOARD ISSUES

## FDIC Releases Training Videos on TDRs, ALLL, Municipal Securities

As promised, the FDIC continued rolling out **videos** to help bank directors and officers understand regulatory issues and complicated changes. The agency released four videos in December, saying they address the most common questions the agency gets from bankers.

One on municipal securities addresses examiner expectations, investment policies, monitoring and purchase analysis. An ALLL video provides an overview of regulatory policy statements and accounting standards. It also illustrates an effective loss migration analysis. The troubled debt restructuring video shows how to identify a TDR, its accounting and regulatory treatment and the multiple note concept. The fourth video is about fair lending.

## Third-Party Oversight Reasons Revealed

Why are regulators so concerned about third-party due diligence? Deputy Comptroller for Operational Risk Carolyn DuChene offered some clues in a **speech** before OpRisk America. She said regulators began seeing "misaligned compensation and incentive schemes" in third-party relationships involving direct marketing activities to bank customers. Banks were also becoming lax in risk management of outsiders because they didn't have the expertise to know how to spot risky activity or to negotiate dispute resolutions.

Community banks need strong audit functions and "robust governance and oversight" when leveraging third parties, she said. "Frankly, as a supervisor, I've seen numerous examples where the quality of risk management simply hasn't always kept pace with the velocity and breadth of change and the rapidly evolving threats in the environment," she warned. Do not silo risk controls to one area of the bank, she said. Include risk awareness, identification, assessment and controls throughout the organization.

## Bank Director Liability Leading to Resignations

More than 15 percent of banks responding to an American Association of Bank Directors survey said they either had a director resign over fear of personal liability or had a candidate refuse to serve on the board for that reason, the AABD revealed in a comment letter to the OCC.

The **letter**, written in response to the OCC's proposed rule to increase director responsibilities at large banks, points out that many community banks have parent companies with identical boards. The OCC has said the proposal could be applied to banks of any size if they were deemed risky. "Forcing those institutions to have bank directors who cannot serve on the parent company does not make much sense," the AABD writes.

## Risks in Internal Audit Outsourcing

Although community banks have often turned to third parties for internal audit functions, there are risks that boards need to mitigate, according to an **article** in the Fed's *Community Banking Connections*. The article advises boards and management teams to make sure that the outsourcing arrangement meets regulatory expectations.

## A Strong Risk Culture Starts – and Ends – At the Top

Both Comptroller Thomas J. Curry and New York Fed President William C. Dudley are calling for large banks to improve their risk culture by starting at the top. Curry wrote a **paper** in the Clearing House's Banking Perspective that says the board and senior management of large banks must set the tone for healthy organizations. He emphasized that while community banks also have "improper business practices and deficient risk management systems," they rarely get the publicity that hurts the industry as a whole. Dudley said in a **speech** that compensation incentives are often to blame for risky behavior and change must begin at the top. "Risk culture is not easy for regulators to measure," Curry wrote. "It's not like credit quality or earnings strength. But it's important because it has an incredibly powerful influence on the risk decisions and behaviors at all levels of an organization."

## Executive Compensation Still in the Works, OCC Reveals

Comptroller Thomas J. Curry told the Clearing House Association annual **conference** in November that he hoped the incentive-based compensation regulations, which were mandated under Dodd-Frank for banks with at least $1 billion in assets, would soon be a reality. The rule, first proposed in 2011 and not yet finalized, would require reporting of incentive-based compensation deals that could lead to a material financial loss. "Banks should never wait for regulators when it comes to protecting their own safety and soundness or reputations," he said.

## OCC Updates Guidelines on Matters Requiring Attention

Deficient bank practices that merge in exams are sent in writing to bank boards and management teams as "Matters Requiring Attention." The OCC updated its **MRA guidelines**, noting that all such documents are in a "Five Cs" format: concern, cause, consequence, corrective action, commitment. The OCC must verify that the bank has taken corrective action before it will close a concern. Banks that identify concerns on their own are "an important consideration" when the OCC assesses the bank's risk management system. The guidance reinforces the need for timely and effective communication with bank management and boards.

# MERGERS AND ACQUISITIONS

## Fed to Disclose Bank Application Details

The Federal Reserve will start publishing a semi-annual report with statistics on how long it takes to process acquisition and expansion applications, the number of approvals, denials, and withdrawals – and the primary reasons for withdrawals. The first report will be released in the second half of this year, and include filings from January through June.

A careful reading of **SR Letter 14-2** offers clues about what it takes to win approval. Here are some highlights:

- Banks in in "less-than-satisfactory condition" – usually a CAMELS rating of 3 or worse -- usually don't win approval. A 3 in risk management or capital can doom a bank's chance to expand. An overall rating of 3 usually means it will be hard to get approval for an acquisition unless the bank can prove to the Fed that the move would "strengthen the organization."
- Experience matters, especially on bank boards. The Fed will review the background, finances and professional expertise of officers, directors and shareholders when looking at applications. Proposed directors or managers with insufficient banking experience can kill a deal. Someone who has worked at an investment bank may not be right for a community bank, the Fed says. The Fed also is also wary of those officers who were "associated" with troubled banks or ones that failed.
- Banks' business plans must make sense. The Fed has problems with overly aggressive plans, ones that would lead to concentrations of assets, or those that don't address known deficiencies or risks.

## FDIC's Gruenberg on Consolidation

While the community bank market is consolidating, the good news is that community banks are often those doing the acquiring. That's the takeaway from FDIC Chair Martin J. Gruenberg's **videotaped remarks** to the ICBA's national convention. An upcoming FDIC analysis will show that about two-thirds of the community banks that merged between 2002 and 2012 were acquired by another community bank. Most of the consolidation has been concentrated in banks with less than $100 million in assets, and 85 percent of those banks were acquired by other community banks.

## Fed Releases Banking Application Details

As promised, the Federal Reserve has for the first time released **statistics on banking applications**. A review of processing times for 2013 and the first half of 2014 by bank asset size reveals that M&A proposals submitted by community banks with between $1 billion and $10 billion in assets took on average 77 days, while those submitted by banks with assets below $1 billion took on average 51 days. The Fed received adverse public comments in about 12 percent of the M&A proposals from larger community bank. The Fed reported approving 61 M&A proposals from smaller community banks in the first half of the year, and 35 from larger community banks.

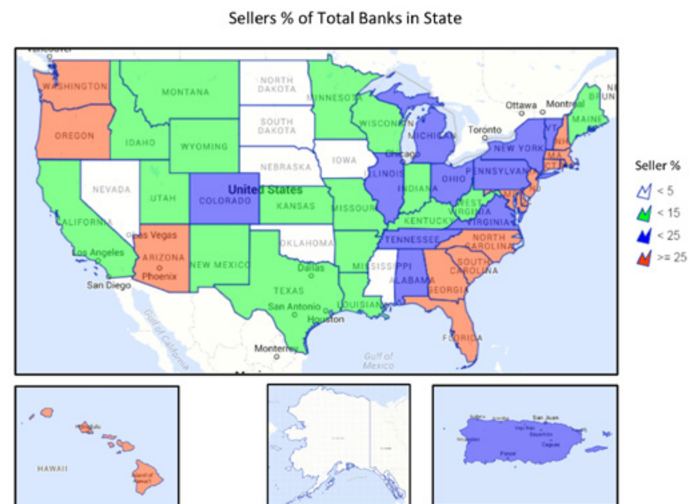
## Survey Hints at Coming Wave of M&A

Consolidation is on the agenda next year for more than 20 percent of banks that participated in a survey from the Federal Reserve and the Conference of State Bank Supervisors. The survey and state-by-state town hall **report**, was released as part of the second community bank **conference**, which was held in September. More than 60 percent of the respondents expected greater competition in the future, and while a majority have not received or made M&A offers, many community banks expect such offers next year.

## Examiners See Signs of Strategic Vulnerability

Regulators from the Fed, the FDIC and the OCC recently told New Jersey banks that they are increasingly seeing signs of strategic vulnerability among commu- nity banks. Banks are seeking alternative ways of increasing shareholder value, and even institutions with more than $1 billion are looking at mergers and acquisitions, hoping for economies of scale.

### Exclusive Data: Sellers Across the U.S.




*This map shows the community banks in the U.S. that must or should sell to maximize shareholder value, according to an exclusive Invictus analysis. There are 1,018 community banks that either must or should sell, or about 16 percent of the market, based on an Invictus analysis of third-quarter data. For more information, see* ***Leaders and Bleeders.***

that have changed how bank management (CEOs, CFOs and directors) approaches strategic planning, stress testing, asset liability management and M&A. We consider the impact of regulatory capital in every analysis we perform. Our patent-pending analytics and strategic advisory services show how capital will fare in the future – whether it's organic growth, a merger or an acquisition. Our leadership team includes former bank CEOs, regulators and global M&A experts,  many with more than 30 years of executive-level experience in commercial banking.