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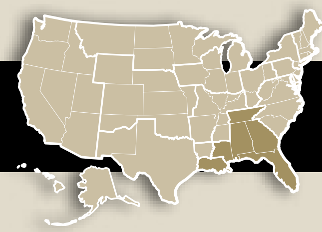

View from the District
A Sixth District Perspective — Atlanta

Lessons Learned from the Bank Failure Epidemic in the Sixth District: 2008–2013

by Michael Johnson, Senior Vice President, Federal Reserve Bank of Atlanta

The period during and following the December 2007 to June 2009 Great Recession was an exceptionally challenging operating environment for U.S. banks. Between 2008 and 2013, more than 480 insured financial institutions failed nationally. Conditions in the Southeast, however, were particularly acute: More than one-third of the nation's failures occurred in the Sixth District. This equates to a regional failure rate of 15.1 percent, the highest of any Federal Reserve District.[1]


Michael Johnson

The number of bank failures in the Sixth District varied widely by state. Eighty-seven banks failed in Georgia, and 70 banks failed in Florida (Table 1). In contrast, the remaining states that make up the Sixth District (Alabama and portions of Louisiana, Mississippi, and Tennessee) reported only 14 total failures between them. This article discusses the factors that contributed to the high concentration of bank failures in Georgia and Florida and some of the lessons learned from this rash of failures.[2]

[1] This rate is calculated as a percentage of total banks at year-end 2007.

"The Usual Suspects": Contributing Factors to Bank Failures

The federal banking agencies have conducted several post-mortem studies on the banking crisis, including material loss

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[2] This analysis is based primarily on commercial bank (as opposed to thrift) data drawn from bank Call Reports and the Uniform Bank Performance Report.

INSIDE

Cybersecurity: Part 2 – Cyber-Related Risk Assessment and Controls*

by Qing Liu, Technology Architect, Federal Reserve Bank of Chicago, and Sebastiaan Gybels, Risk Management Team Leader, Federal Reserve Bank of Chicago

Each year, as new product vulnerabilities surface, millions of new malicious software (malware) programs, cyberthreats, and cyberattacks are developed to exploit these vulnerabilities for nefarious purposes.[1] The first article in this two-part series on cybersecurity highlighted the seven most common cyberthreats and cyber-related risks that community banks have identified and experienced.[2] This article illustrates a four-pillared general cybersecurity framework that can help community banks assess and mitigate cyberthreats and risks.

Cybersecurity Framework

Some community banks may suffer from "security paralysis," a condition in which banks fail to prioritize areas for remediation because of limited resources. Others simply attempt to apply a set of best practices, hoping that what worked for another bank will work for them. Neither of these approaches is a feasible strategy to protect banks and maximize their return on investment in cybersecurity. Considering that cyber-related incidents will continue to increase in both frequency and sophistication, all community banks should consider developing a cybersecurity framework — a coherent methodology and mechanism — to address cybersecurity threats and risks.[3]

A cybersecurity framework enables banks — regardless of size, degree of cybersecurity risk, or sophistication — to support four concurrent and continuous functions (described as

*This article is the second of a two-part series that discusses cyberthreats and cyber-related risks and how to implement an effective risk management framework. The first article, titled "Cybersecurity: Part 1 — Demystifying Cyberthreats," appeared in the First Quarter 2014 issue of *Community Banking Connections* and is available at www.cbcfrs.org/articles/2014/Q1/cybersecurity.

[1] Kaspersky Lab, *Kaspersky Lab Report: Financial Cyber Threats in 2013*, April 2014, available at http://ow.ly/yYrl6.

[2] Specifically, these seven cyberthreats are (1) malware, (2) distributed denial of service attacks, (3) automated clearinghouse/payment account takeover, (4) data leakage, (5) third-party/cloud vendor risks, (6) mobile and web application vulnerabilities, and (7) weaknesses in project management or change management.

[3] The cybersecurity framework described in this article is consistent with the National Institute of Standards and Technology's *Framework for Improving Critical Infrastructure Cybersecurity*, published on February 12, 2014, available at www.nist.gov/cyberframework/index.cfm.

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Core Functions in the National Institute of Standards and Technology Cybersecurity Framework):

- **Identification** — identify the internal and external cybersecurity risks to systems, assets, data, and capabilities
- **Protection** — protect business operations from damages or losses
- **Detection** — detect and identify the occurrence of a cybersecurity event
- **Response and Recovery** — respond to a detected cybersecurity event and recover and restore any capabilities or services that were impaired during the event

Furthermore, a cybersecurity framework should integrate with a bank's risk management processes, enabling the bank to make informed and prioritized decisions. It should support recurring risk assessments, which allow a bank to dynamically select and direct improvements in cybersecurity risk management. Lastly, a cybersecurity framework should be flexible, allowing for a broad array of cybersecurity risk management processes.

A model cybersecurity framework is a risk-based structure that achieves stated objectives through four pillars:

- Risk Identification (Identification)
- Policies, Procedures, and Controls (Protection)
- Governance and Monitoring (Detection)
- Resilience and Incident Response (Response and Recovery)

While processes, threats, vulnerabilities, risk tolerances, and needs may differ by institution, the cybersecurity framework can be leveraged to strengthen an existing cybersecurity program. The framework allows an institution to prioritize and manage cybersecurity threats and risks based on its risk assessment.

Pillar 1 — Risk Identification

While the board of directors is ultimately responsible for the oversight of risk management, bank management is accountable for the daily operation of risk management processes. Risk identification is the starting point. Through risk identification activities, management identifies cybersecurity threats and risks as well as their potential impacts on the bank. Management then develops the organizational view of cybersecurity risks by characterizing and quantifying the risks to systems, assets, data, and capabilities.

The risk identification process consists of the following steps:

- Create a complete inventory of systems and data.
- Determine the criticality of the systems and data.
- Identify all vulnerabilities and threats to the systems and data.
- Collect and classify controls.
- Determine the residual risk based on the identified risks and mitigating controls in place.
- Generate reports and submit the results to senior leadership.

"While processes, threats, vulnerabilities, risk tolerances, and needs may differ by institution, the cybersecurity framework can be leveraged to strengthen an existing cybersecurity program."

A bank can evaluate the effectiveness of its risk identification processes by answering the following questions.

Does the bank have an effective risk assessment process to identify and react to new and emerging cybersecurity threats/risks? Bank management should assess the bank's existing risk assessment processes. These processes should provide for an ongoing evaluation of the impact that cybersecurity risk could have on business operations and bank objectives. In addition, it is important for management to incorporate lessons learned from previous cybersecurity events and incident responses into the process.

Does the bank have an effective process to assess the impact of cyberevents on vendor relationships? Bank management should understand how vendors access the bank's assets or data on-site and how vendors use and store the bank's data off-site. Management can use this information to assess the risk exposure at both the bank's and vendors' sites.

Bank management should require its vendors to adequately protect its data. Additionally, the vendors should test their security controls and report the test/audit results back to the bank via vendor management channels, such as the enter-

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Development and Maintenance of an Effective Loan Policy: Part 1*

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

Loan portfolios typically have the largest impact on the overall risk profile and earnings performance (interest income, fees, provisions, and other factors) of community banks. The average loan portfolio represents approximately 62.5 percent of total consolidated assets for banking organizations with less than $1 billion in total assets and 64.9 percent of total consolidated assets for banking organizations with less than $10 billion in total assets.[1]

In order to control credit risk, it is imperative that appropriate and effective policies, procedures, and practices are developed and implemented. Loan policies should align with the mission and objectives of the bank, as well as support safe and sound lending activity. Policies and procedures should serve as a framework for all major credit decisions and actions, cover all material aspects of credit risk, and reflect the complexity of the activities in which a bank engages.

Policy Development

While risk is inevitable, banks can mitigate credit risk through the development of and adherence to effective loan policies and procedures. A well-written and descriptive loan policy is the cornerstone of a sound lending function, and a bank's board of directors is ultimately responsible for framing the loan policies to address the inherent and residual risks (i.e., those risks that remain even after sound internal controls have been implemented) in the lending business lines. Once the policy is formulated, senior management is responsible for its implementation and ongoing monitoring, as well as the maintenance of procedures to ensure they are up to date and relevant to the current risk profile.

Policy Objectives

The loan policy should clearly communicate the strategic goals and objectives of the bank, as well as define the types of loan exposures acceptable to the institution, loan approval authority, loan limits, loan underwriting criteria, and several other guidelines.

It is important to note that a policy differs from procedures in that it sets forth the plan, guiding principles, and framework for decisions. Procedures, on the other hand, establish methods and steps to perform tasks. Banks that offer a wider variety of loan products and/or more complex products should consider developing separate policy and procedure manuals for loan products.

Policy Elements

One place to start when determining which key elements should be incorporated into the loan policy is with the regulatory agencies' examination manuals and policy statements. This article relies primarily on the Federal Reserve's *Commercial Bank Examination Manual*,[2] which organizes and formalizes the examination objectives and procedures that communicate supervisory guidance to bank examiners on a wide range of topics.

Although this article does not provide an all-inclusive listing of elements one should find in a loan policy, it does outline and discuss the basic elements that should be included in a general loan policy. Loan policies will differ significantly between banks based on the complexity of the activities in which they are involved; however, a general loan policy should incorporate certain basic lending tenets.

*A loan policy should attempt to specify *what* is permissible, *who* is responsible, and *how* activities will be controlled, reported on, and verified. This article, which is the first of a three-part series that covers key elements of a sound community bank loan policy, discusses the *what* and the *who*. The next two articles will review the *how*, touching on topics such as underwriting, appraisals, risk ratings, pricing, and documentation, along with other related topics, such as loan review and postorigination activities.

[1] Federal Reserve data as of December 31, 2013.

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

Common Loan Types in Community Banks

Retail Loans	Commercial Loans
• Residential Mortgages	• Commercial Real Estate
• Home Equity Loans and Lines	• Commercial and Industrial
• Personal Loans	• Small Business
• Automobile — Direct and Indirect	• Agricultural
• Credit Cards	

Loan Types

Consistent with the lending strategy, the board should identify not only which types of loans are permissible and impermissible but also the types of loans the bank will and will not underwrite regardless of permissibility. The box to the right outlines some of the more common loan types found in community banks.

Each loan type listed in the box has numerous loan product subcategories. Community banks offer a diverse range of loan products, and this list is by no means all-inclusive. A few of the loan types listed, including home equity[3] and commercial and industrial (C&I) lending,[4] have been discussed in recently published *Community Banking Connections* articles. A recent article in the Federal Reserve Bank of St. Louis's *Central Banker* also discusses lending by community banks during the financial crisis.[5]

In determining permissible lending activity, the board should ask a number of questions such as the following:

- How can we better serve the credit needs of our community?
- Will our primary focus be retail lending, commercial lending, or a mix of the two?
- What types of retail and/or commercial loans will we offer?
- What is our desired mix of loans in comparison with total loans and total assets?
- Do our lending and credit administration staff members have the appropriate skill sets?

Undesirable or impermissible lending activity should also be identified within the loan policy. This will ensure that management and lending staff members do not spend undue time or resources cultivating relationships or pursuing loan types that are not aligned with the bank's goals or strategy. Undesirable lending activity could include activity that may harm the reputation of the bank or for which the expected return is not commensurate with the level of risk. If the lending staff members do not have the expertise to underwrite, service, or monitor certain loan types, the bank should not undertake such activities. The policy should also state that engaging in the financing of illegal or illicit activities is unacceptable.

Policies and procedures need to be continually evaluated and updated. For example, desirable and undesirable loan types may change as a result of shifting economic conditions, technology, and market demographics, so policies should be reevaluated whenever they are presented to the board for approval.

Loan Participations — Purchases and Sales

The loan policy should adequately address participations, both purchases and sales.[6] The most common type of loan participation generally shares profits and losses on an equal basis; therefore, relying solely on the lead banks' analysis and not conducting independent, thorough analysis is imprudent. Adequate financial analysis and due diligence must be performed prior to entering into any participations.

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[3] See Michael Webb, "Home Equity Lending: A HELOC Hangover Helper," *Community Banking Connections*, Second Quarter 2013, available at www.cbcfrs.org/articles/2013/Q2/Home-Equity-Lending-A-HELOC-Hangover-Helper.cfm, and "Home Equity Lending: A HELOC Hangover Helper — Part 2," *Community Banking Connections*, Fourth Quarter 2013, available at www.cbcfrs.org/articles/2013/Q4/Home-Equity-Lending.

[4] See Cynthia Course, "Sound Risk Management Practices in Community Bank C&I Lending," *Community Banking Connections*, Fourth Quarter 2012, available at www.cbcfrs.org/articles/2012/Q4/Sound-Risk-Management-Practices-in-Community-Bank-CI-Lending.

[5] See Gary S. Corner and Andrew P. Meyer, "Community Bank Lending During the Financial Crisis," Federal Reserve Bank of St. Louis *Central Banker*, Spring 2013, available at www.stlouisfed.org/publications/cb/articles/?id=2342.

[6] A loan participation is a sharing or selling of ownership interests in a loan between two or more financial institutions. Normally, but not always, a lead bank originates the loan and sells ownership interests to one or more participating banks. The lead bank retains a partial interest in the loan, holds all loan documentation in its name, holds all original documentation, services the loan, and deals directly with the borrower for the benefit of all participants. See *CBEM* section 2045.1, "Loan Participations, the Agreements and Participants."

Recruiting and Retaining Community Bank Directors

by Cynthia L. Course, CPA, Director, Federal Reserve Bank of San Francisco

As community banks move beyond the Great Recession and explore new opportunities for growth and profitability, their outside directors will play an increasingly important role in guiding the banks through both familiar and uncharted territories. Though it may not be as easy to recruit and retain new external community bank directors today as it has been in the past, the challenges are not insurmountable.

This article is not intended to establish or describe supervisory expectations for boards of directors. Rather, it suggests some ways that community banks can think about recruiting and retaining qualified, effective directors and potentially evaluating the effectiveness of the board through self-assessments. Many of the suggestions for ways to recruit and retain qualified directors come from a panel survey of community bankers in the western United States.

Is There an "Ideal" Director Profile?

Given the pace and scope of change in the banking environment, the board of directors collectively and each member individually play a critical role in the overall success of a community bank. This does not mean that each board candidate has to be an expert in banking to be considered for board membership.[1] To the contrary, the diversity of experiences, education, views, and opinions can make the strength of a community bank board greater than the sum of its parts.

Given the importance of bank directors in overseeing the successful operation of the bank, is there an "ideal" director profile? In a word — *no*. As noted previously, a community bank's board of directors can be strengthened by diversity.

The Federal Reserve recently issued supervisory guidance that discusses certain personal or business experience characteristics that have proven problematic when reviewing applications for directors at de novo and troubled institutions.[2] In short, individuals whose backgrounds raise questions regarding their integrity, financial responsibility, or competence, or otherwise raise doubt about their ability to fulfill the responsibilities of a bank director, have been viewed unfavorably.

However, for the purposes of this article, it may be more informative to consider the combination of characteristics that could indicate the likelihood that a director will be a good fit for the bank. Most likely, this combination will be a mix of personal attributes, experience and education, and a willingness and ability to dedicate the necessary time to this important role.

The box on the next page illustrates some of the personal attributes, experience, education, and other qualities that are generally found in capable community bank directors.

While there will likely be quite a bit of similarity in the attributes of a capable director across different community banks, the fit of each individual director should be considered within the context of the institution's strategic direction and culture as well as the attributes, experience, and education of the directors already on or being considered for the board.

Recruiting Community Bank Directors

Given an understanding of the desired characteristics of a director, how can a community bank recruit capable directors?

To ensure the best fit between a director candidate and the bank, the board's nominating committee or similar subset of the board should assess the skills and demographic profile of its current directors, compare the skills and profiles with the bank's strategic direction and risk profile, and identify any collective gaps. This exercise will increase the likelihood that the board will find an individual with the skills, abilities, talent, and commitment to make a difference. Importantly, it will

[1] Although board candidates are not required to have expertise in banking when they are appointed to the board, they are expected to quickly become familiar with the basics of banking in order to provide effective oversight of management and to make informed decisions. In addition, a bank that is a public company subject to Securities and Exchange Commission oversight is required to have an audit committee financial expert on its board of directors and audit committee.

[2] See Supervision and Regulation (SR) letter 14-2/Consumer Affairs (CA) letter 14-1, "Enhancing Transparency in the Federal Reserve's Applications Process," available at www.federalreserve.gov/bankinforeg/srletters/sr1402.htm.

become the "bottom line" in the discussion with the candidate about how he or she will be able to make a direct impact on the bank's success.

Admittedly, recruiting new bank directors may have been easier to do in the past than it is today. Historically, many business and community leaders considered it an honor to be asked to serve on their community bank's board of directors. These candidates viewed membership on the board as evidence of their business expertise and prominence in the community, and they appreciated the shareholders' vote of confidence in their skills. While serving on a board of directors is indeed an honor, many may now also weigh the benefits against the potential burden or legal liability.

Today, recruiting new directors often requires the members of the nominating committee to "sell" potential director candidates on board membership. This includes having frank discussions with the candidate about the institution[3] and how he or she can contribute to the bank's future. This also

Qualities of an Ideal Director

Personal Attributes

Honesty and Integrity

- Puts bank interests ahead of personal interests
- Avoids actual and perceived conflicts of interest in life, at work, and while serving on the board
- Thinks independently, rather than simply following the pack

Engagement

- Is inquisitive
- Provides constructive guidance and opinions
- Asks tough questions and expects satisfactory answers
- Voices constructive dissent when appropriate

Analytical Skills

- Draws analogies between past experiences and current challenges
- Is willing to learn and develop new skills
- Is strategically engaged but operationally distant

Experience and Education

Business

- Possesses financial, business, and managerial acumen
- Actively engages in the field of employment
- Has connections with other businesses and industries

Community

- Has knowledge of the communities served
- Actively engages in and with community groups

Banking

- Has a basic understanding of banking, regulatory systems, laws, and regulations
- Is willing to fill knowledge gaps

Other Qualities

Has Time to...

- Learn the business
- Commit to board activities
  - Prepare for and attend meetings
  - Review examination and audit reports and ensure responsiveness
  - Keep up with the affairs of the bank
- Pursue professional development opportunities

Complementary Attributes

- Is independent of bank management
- Possesses a skill set that complements those of the other directors
- Has skills that support the bank's long-range vision
- Enhances board member diversity (e.g., gender, ethnicity, industry, socioeconomic profile)

includes discussing the benefits of serving as a bank director and giving reasonable assurances to the candidate about the board's expectations of and commitment to each member.

Community banker nominating committees can consider the points that are detailed in the box to the right when preparing discussion topics to use when approaching director candidates.

When done effectively, the process of recruiting qualified directors will be very similar to recruiting qualified executives, but with the shareholders having the final say on the nominee.

Retaining Strong Bank Directors

Once the bank's shareholders have elected a director to the board, the board's focus should shift from recruiting to engagement and retention. To be most effective, efforts to engage and retain capable directors should begin the moment they are appointed and should continue throughout their tenure.

Orientation. Effective community banks will develop an orientation program that is tailored to the size and complexity of the bank and the experience and knowledge of each new director. Elements of a comprehensive orientation program could include:

- Meetings with the heads of each business line to gain an understanding of the challenges and opportunities in each area
- Meetings with other board members
- Introductions to key external parties, such as bank counsel, bank auditors, and bank examiners
- Access to materials not made available during the recruitment process, such as bank examinations and audit reports
- Demonstrations of access to virtual private networks or other information-sharing tools used by the board of directors
- Access to director training materials commensurate with the director's experience, such as the Federal Reserve System's Bank Director's Desktop[4]

Discussion Points for Director Candidates

Institution Profile

- Publicly available information
- Nonpublic information, subject to constraints of federal and state law
- How the institution is providing value to its shareholders, employees, and the community

Director Profile

- How personal knowledge and talents align with the bank's needs, today and in the future
- How candidates' knowledge and talents will add value to the board

Benefits of Service

- Give back to the community
- Meet new people in the industry and the community
- Continually build upon existing skills and knowledge
- Stay abreast of local and national issues
- Receive a competitive compensation package

Assurances

- Transparency in all aspects of the bank's operations
- Timely and sufficient information
- Opportunities to use their knowledge and skills for the benefit of the bank and the board
- Respect for their opinions, encouraging constructive discussion and dissent
- Appropriate training and educational opportunities
- Respect for their time
- Appropriate compensation and benefits, including liability insurance

Culture and Atmosphere. A professional and inclusive culture and atmosphere within the board and between the board members and management should enhance director retention. Directors are more likely to remain on the board when:

- Management is transparent about all aspects of the bank's operations.
- The board receives timely and sufficient information to make sound decisions.
- The board is empowered to make decisions.
- The board members are treated with respect.

[3] Federal and/or state laws may limit the nature of information that can be shared with director candidates. For example, banks are prohibited by law from disclosing their bank and holding company supervisory ratings and other nonpublic supervisory information to nonrelated third parties without written permission from the appropriate federal banking agency. See "Confidential Supervisory Information Disclosure Rules" in the First Quarter 2013 issue of *Community Banking Connections*, available at www.cbcfrs.org/articles/2013/Q1/Confidential-Supervisory-Information-Disclosure-Rules.

[4] See www.bankdirectorsdesktop.org/.

- Management is respectful of the board's time.
- Management sincerely seeks the directors' input and shows appreciation for the board's contributions.
- There is a clear linkage between the board's activities and the organization's success.

Education and Training. Ongoing education and training are as important for community bank directors as they are for the bank's staff and management. However, there is a delicate balance between maintaining respect for the directors' time commitment and ensuring that they have the knowledge necessary to make informed decisions. While directors are expected to bring to the boardroom the views and perspectives gained from their personal and professional experiences, they must also be able to put those views in the context of the bank and the environment in which it operates.

Each director should possess knowledge of the bank and the banking industry that is appropriate for his or her tenure. In addition, each board member should be expected to complete continuing education and training to build upon and maintain the skills necessary to be an effective community bank director. Board members may find that choosing from a variety of educational opportunities, such as the following, helps them balance time constraints against information needs:

- Targeted training or education sessions as a part of board meetings
- Annual director retreats that focus on training as well as strategic planning and bank operations
- Subscriptions to print or electronic periodicals and newsletters that discuss current and emerging community bank issues
- Attendance at banker association, trade group, or regulatory conferences and seminars, with formal debriefings to the other directors at board meetings

Recognition. Recognizing director contributions, whether through words and actions or through monetary compensation, is also a significant element in director retention. Recognition and compensation can be tailored to each director's contributions; however, they generally will not be sufficient to retain capable directors without an atmosphere and culture that is conducive to effective board operations and sufficient education and training to ensure that each director is well informed.

Evaluating Board Performance

To remain strong and independent, community bank boards of directors may find value in periodically evaluating their effectiveness and identifying opportunities for improvement and growth.

Community bank boards may find that self-assessments are effective at highlighting emerging governance issues.[5] For example, a board self-assessment at the highest level could ask focused questions about the board's primary responsibilities. Subsequent questions could drill down into the board members' perceptions around the bank's mission and purpose, the effectiveness of strategic planning, the sufficiency of succession planning, the appropriateness of the board's monitoring and control activities, and the involvement of the bank in its community. Self-assessments can also provide valuable insight into the functioning of the board through questions that address ethics, the interpersonal relationships among board members, the selection and training of directors, the effectiveness of dialogue at board meetings, the engagement and contribution of individual directors, and the organization of the board and its committees.

Completing the circle, the periodic use of self-assessments may also help a community bank's nominating committee recruit new directors. Candidates likely will be more interested in joining a company that seeks out and acts upon holistic director feedback than a company in which director feedback is sought only on very narrow and specific decisions.

Concluding Thoughts

Banks play an important role in the economic lives of their communities, and community bank directors have a great opportunity to influence and help shape their local economies. For a community bank, recruiting and retaining qualified and effective directors is as important as recruiting and training an effective management team. In the words of a former board chairman and member, "At the end of the day there's nothing like a strong board that operates independently, asks good questions, and does its homework."[6] ■

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[5] Recommending a specific self-assessment process is beyond the scope of this article, and the Federal Reserve does not endorse any specific self-assessment tools or templates. However, a variety of resources for community bank boards of directors interested in developing self-assessments is available through trade groups such as the Bank Director website and magazine at www.bankdirector.com/.

[6] Comment by Lew Platt, former chairman, board member, and chief executive of Hewlett-Packard, while serving as a Boeing board member, as referenced in *Knowledge@Wharton*, "Re-Examining the Role of the Chairman of the Board," December 18, 2002, available at http://ow.ly/Cghop.

Managing Service Provider Relationships and Risks: Questions Concerning Federal Reserve Guidance on Managing Outsourcing Risk

by Roger Pittman, Director of Examinations, Supervision and Regulation, Federal Reserve Bank of Atlanta

The Board of Governors of the Federal Reserve System issued supervisory guidance on managing outsourcing risk on December 5, 2013.[1] This article covers some of community bankers' most frequently asked questions regarding the guidance as well as the supervisory process for reviewing a bank's outsourcing arrangements.

Q Was there existing guidance on this topic? Why did the Federal Reserve see a need to issue this guidance?

A In 2004, the Federal Financial Institutions Examination Council (FFIEC) issued the booklet "Outsourcing Technology Services" as part of its *Information Technology Examination Handbook*,[2] and the Federal Reserve's 2013 guidance expands upon this existing guidance. The Federal Reserve's guidance places particular emphasis on the importance of sound risk management practices for all outsourcing relationships (i.e., not just technology services).

Q What is the difference between vendors, third-party suppliers, contractors, and service providers?

A Terms such as *vendor*, *third-party supplier*, *contractor*, and *service provider* can be used to signify a specific type of product, service, or activity that is provided by a third-party affiliate or nonaffiliated entity to a financial institution. Although these terms are sometimes used interchangeably, the guidance uses *service provider* because it is relatively all-encompassing and focuses on relationships in which business functions or activities are provided to financial institutions. The guidance also defines a *service provider* as an entity that may be a bank or a nonbank, affiliated or nonaffiliated, regulated or nonregulated, and domestic or foreign.

Q Which financial institutions are subject to the Federal Reserve's guidance?

A The Federal Reserve's guidance applies to all state member banks, bank and savings and loan holding companies (including their nonbank subsidiaries), and U.S. operations of foreign banking organizations. The Office of the Comptroller of the Currency (OCC)[3] and the Federal Deposit Insurance Corporation (FDIC)[4] have issued similar guidance for institutions that they supervise.

Q If a community bank has already implemented risk management practices for outsourcing arrangements to its non–information technology relationships, can the institution assume that it is in compliance with the guidance?

A A financial institution's program may be very close to meeting the 2013 guidance if the current program covers all outsourcing arrangements,[5] but it should be reviewed for any existing gaps. Just like the FFIEC's guidance on outsourcing of information technology, the Federal Reserve's guidance addresses the core elements of a service provider risk management program as generally including risk assessments, due diligence and selection of service providers, contract provisions, oversight and monitoring, business continuity and contingency plans, and foreign-based service providers. However, the guidance has been updated to include new

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[1] See Supervision and Regulation (SR) letter 13-19/Consumer Affairs (CA) letter 13-21, "Guidance on Managing Outsourcing Risk," available at www.federalreserve.gov/bankinforeg/srletters/sr1319.htm.

[2] The booklet is available on the FFIEC website at ithandbook.ffiec.gov/it-booklets/outsourcing-technology-services.aspx.

[3] See OCC Bulletin 2013-29, "Third-Party Relationships," available at www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html.

[4] See FDIC Financial Institution Letter FIL-44-2008, "Guidance for Managing Third-Party Risk," available at www.fdic.gov/news/news/financial/2008/fil08044.pdf.

[5] While the guidance applies to all outsourcing arrangements, as a practical matter, a financial institution's service provider risk management program should focus attention on outsourced activities that have a substantial impact on the institution's financial condition, are critical to the institution's ongoing operations, involve sensitive customer information or new bank products or services, or pose material compliance risk.

considerations such as incentive compensation, suspicious activity report filing, internal audit, and model risk management activities.

Q How frequently should risk assessments be conducted?

A A financial institution should consider the criticality of the service and the level of risk when determining the frequency of conducting risk assessments of outsourced business functions or activities. Services with higher levels of risk or greater criticality should be subject to more frequent risk assessment and may also warrant certain types of ongoing monitoring. Risks may also need to be reassessed if the relationship between the service provider and the institution changes.

Q Are service providers examined, and can banks receive a copy of the reports?

A Not all service providers are examined, but internal controls can be assessed by reviewing audits or reports such as the American Institute of Certified Public Accountants' Service Organization Control 2 Report.[6] Technology service providers (TSPs) are examined jointly by the Federal Reserve, the FDIC, and the OCC (collectively referred to as the agencies). Information technology–related examinations of TSPs are conducted according to the guidelines contained in the "Supervision of Technology Service Providers" booklet, which is part of the *FFIEC Information Technology Examination Handbook*.[7]

While conducting supervisory activities, examiners obtain lists of regulated financial institutions that are serviced by TSPs. The lists of customers are used to identify and validate regulated financial institutions that are entitled to copies of the reports. The agencies then distribute the reports to serviced financial institutions, either automatically or upon request. A financial institution may request a copy of the examination report from the institution's primary federal regulator. However, only institutions that have a valid and current contract with the TSP as of the date of the examination will receive the report. The TSP examination reports remain the joint property of the agencies and are provided to financial institutions for their internal and confidential use.

Q How should a community bank implement the guidance? What should be completed before the examination?

A A community bank should begin by completing a gap analysis to identify whether its current program needs to be adjusted to meet supervisory expectations. An implementation plan should then be developed to address any identified gaps. The plan should include activities, timelines for completion, a list of responsible parties, and status reporting requirements.

Examiners will review the gap analysis and the implementation plan during the initial examination and assess whether they are appropriate for the community bank. During subsequent reviews, examiners will assess progress in executing the implementation plan and identify any issues.

Q What if bankers have additional questions?

A The Federal Reserve held two Ask the Fed sessions, on March 5 and 21, 2014, where bankers were able to ask questions concerning the guidance. Bankers can listen to archives of these presentations since all Ask the Fed sessions are recorded and can be accessed online by financial institutions. Visit www.askthefed.org to sign up to view the presentation and hear the sessions. Bankers may also direct questions to bank supervision staff at their local Reserve Banks. ■

[6] See the AICPA's "Illustrative Type 2 SOC 2℠ Report with the Criteria in the Cloud Security Alliance (CSA) Cloud Controls Matrix (CCM)," available at http://ow.ly/COTOJ.

[7] The handbook is available on the FFIEC website at http://ow.ly/COTeU.

Promoting an Inclusive Financial System: Spotlight on Minority Depository Institutions

by Erica Jill Tholmer, Supervisory Financial Analyst, Board of Governors of the Federal Reserve System, and H. Robert Tillman, Assistant Vice President, Supervision, Regulation and Credit, Federal Reserve Bank of Philadelphia

The Federal Reserve has a long history of fostering and supporting minority depository institutions (MDIs) because these banks play an important role in the U.S. financial system by providing banking services and extending credit to communities in underserved areas. The goals of this article are to bring attention to the legal foundation for supporting MDIs, discuss the key characteristics of MDIs, and explore some federal resources that are available to MDIs.

Background on MDIs

An MDI is defined by law as any depository institution whereby one or more socially and economically disadvantaged individuals owns 51 percent or more of the bank's voting stock or a depository institution in which the board of directors, account holder base, or community served is composed mostly of minorities.[1] As of June 30, 2014, there were 174 MDIs in the United States, 17 of which were state member banks supervised by the Federal Reserve.

Section 308 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank),[2] requires the secretary of the Treasury to consult with the Chair of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency (OCC), the chair of the National Credit Union Administration, and the chair of the board of directors of the Federal Deposit Insurance Corporation (FDIC) on the best methods of achieving the following goals:

- Preserving the present number of MDIs
- Preserving the character of MDIs in cases involving mergers or acquisitions
- Providing technical assistance to prevent insolvency
- Promoting and encouraging the creation of MDIs
- Providing for training, technical assistance, and educational programs

Each of these federal banking agencies has established a program to promote the sustainability of MDIs. Information on each agency's program, including the Federal Reserve's Partnership for Progress (PFP) program, is available on the agencies' respective websites. Under Dodd-Frank, these agencies are also required to submit to Congress an annual report describing their efforts to meet the goals set forth in section 308 of FIRREA.

Characteristics of MDIs

Like most community banks, MDIs are a diverse group of institutions that vary by size, complexity, and location. Most are small community banks with total assets of less than $500 million (Figure 1).[3] The asset size distribution of MDIs is consistent with the asset size distribution for all community banks.

Most MDIs are headquartered in major metropolitan areas, with a concentration in the most populous states: California, Texas, New York, and Florida.[4] MDIs also vary by minority ownership, with the largest percentage under Asian American ownership (Figure 2).

Like many traditional community banks, MDIs face difficulty accessing capital markets and competition from larger banks. In the aftermath of the most recent financial crisis, despite moderate improvements in earnings and capital levels, MDIs continue to struggle with compressed net interest margins. In many cases, compounding MDI challenges are the effects

[1] In regard to MDIs, *minority* is defined in the statute as any black American, Native American, Hispanic American, or Asian American.

[2] See Title III, section 367(4), 12 U.S.C. section 1463 (2001 & Supp. 2013), available at http://ow.ly/EsGu5.

[3] The Federal Reserve generally defines *community banking organizations* as those organizations with less than $10 billion in total assets.

[4] See FDIC, "Minority Depository Institutions: Structure, Performance, and Social Impact," *FDIC Quarterly*, Second Quarter 2014, available at http://ow.ly/EsKKn.

of economic hardships on MDI customers, many of whom reside in low- or moderate-income (LMI) communities.[5]

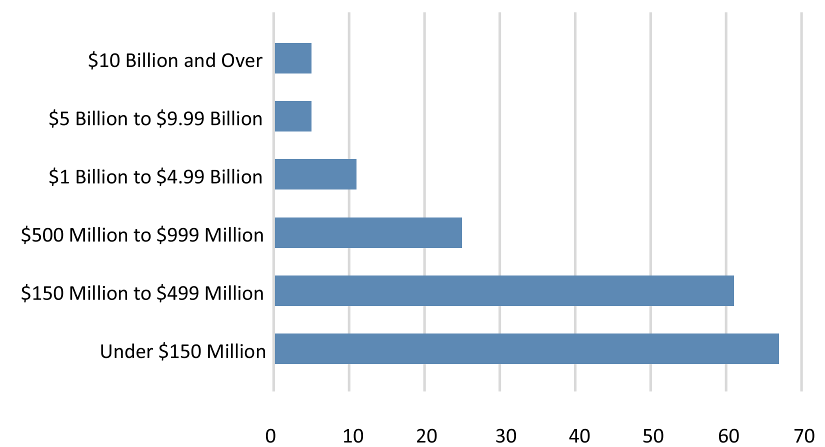
The Mission of MDIs

Many MDIs follow a mission to help communities that are challenged with demographic and economic weaknesses and in which options for accessing traditional banking services tend to be limited. In other cases, MDIs were formed to address discriminatory banking practices and to provide credit to groups of people who historically were denied credit. In carrying out their mission, these banks help to reduce the number of underbanked customers and provide banking services that may otherwise go unmet.

In addition to loan products for LMI residents, some recent examples of services provided by MDIs include the following:

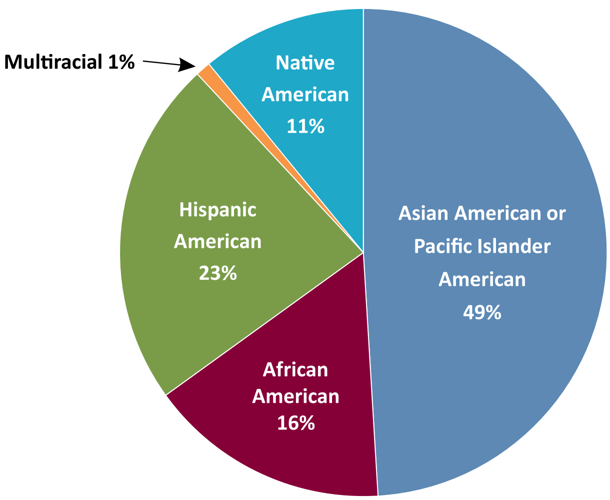
- An MDI in one Federal Reserve District provides auto loans to migrant farm workers.
- Several MDIs under Native American ownership support businesses on local reservations. Because these banks have deep local knowledge and ties to the Native American communities in which they operate, they may be more willing to look beyond traditional credit factors and underwrite more loans than other banks may be willing to do. For example, banks under Native American ownership may better understand the issues that surround loans in which the property held for collateral is in state trusts, which can make property seizure difficult in the event of default.[6]

Figure 1: MDIs by Asset Size



Source: Call Reports, as of June 30, 2014

Figure 2: MDIs by Ownership Type



Note: This chart combines MDIs that meet the ownership test with MDIs that meet the board member/community test for each racial category.

Source: www.fdic.gov/regulations/resources/minority/MDI.html

Federal Reserve Resources

Partnership for Progress Program

In 2013, the Federal Reserve reaffirmed its commitment to MDIs in Supervision and Regulation (SR) letter 13-15/Consumer Affairs (CA) letter 13-11, "Federal Reserve Resources for Minority Depository Institutions."[7] This

[5] See "Minority Depository Institutions: Structure, Performance, and Social Impact," available at http://ow.ly/EsKKn.

[6] See "Native American Bank: Banking the Unbanked," *Communities & Banking*, vol. 17 (Summer 2008), Federal Reserve Bank of Boston, available at http://ow.ly/EsXAK.

[7] SR letter 13-15/CA letter 13-11, "Federal Reserve Resources for Minority Depository Institutions," is available at www.federalreserve.gov/bankinforeg/srletters/sr1315.htm.

letter also discusses technical assistance that is available to MDIs through the Federal Reserve's PFP program, a national outreach effort to help MDIs confront unique business model challenges, cultivate safe banking practices, and compete more effectively in the marketplace.

PFP Website. The PFP website[8] provides relevant and timely information of interest to MDIs, including:

- Educational materials (for example, the online Bank Life Cycle curriculum provides content on the three phases of bank development: (1) starting a bank, (2) managing transitions, and (3) growing shareholder value)
- Information on new regulations and their impact on MDIs
- Announcements of regulatory and agency events relevant to MDIs
- Articles focused on market conditions and economic data related to LMI areas

PFP Leadership. The PFP program benefits from strong Federal Reserve coordination at the local and national levels. Maryann Hunter, deputy director of the Federal Reserve Board's Division of Banking Supervision and Regulation (BS&R), serves as the national coordinator of the program.[9] Staff members from both the Federal Reserve Board's Division of BS&R and the Division of Consumer and Community Affairs (DCCA) are responsible for program implementation. Further, an Executive Oversight Committee, comprising senior officials from both the Board and the Federal Reserve Bank of Philadelphia, meets regularly to discuss progress toward program objectives set for each calendar year.

" I have seen firsthand how access to financial services supports economic growth opportunities. In this way, MDIs play an important role through their focus on the communities they serve."

—Maryann Hunter, Deputy Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, and National Coordinator, Partnership for Progress Program

PFP District Coordinators. Each Reserve Bank has a PFP coordinator to oversee the program for the MDIs located in its District. State member banks with questions about the PFP program should direct their inquiries to the coordinator in their Federal Reserve District, as listed on the PFP website under "Contact Us."[10]

Division of Banking Supervision and Regulation

Staff members in the Federal Reserve Board's Division of BS&R provide technical assistance to MDIs to help these banks maintain safe and sound banking practices, primarily as they relate to the CAMELS rating components.[11] They also prepare presentations to explain the effect of new capital and regulatory accounting policies on banks. In addition, BS&R staff members attend industry conferences to discuss trends in the state member MDI portfolio and to provide guidance on emerging safety and soundness risks.

Division of Consumer and Community Affairs

Federal Reserve Board DCCA staff members support community development opportunities for MDIs. The DCCA's community development function sponsors initiatives aimed at increasing access to capital and financial services, promoting investment opportunities, and conducting applied research. These initiatives are especially important because, just as many households and communities suffered financially

[8] Visit the PFP website at http://fedpartnership.gov/ for more information.

[9] See Maryann Hunter, "Board Staff Perspective on Community Bank Supervision: One Size Doesn't Fit All," *Community Banking Connections*, Second Quarter 2014, available at www.cbcfrs.org/articles/2014/Q2/view-from-washington.

[10] A list of Reserve Bank PFP coordinators is available at www.fedpartnership.gov/contacts/.

[11] CAMELS ratings address the adequacy and quality of a depository institution's capital, asset quality, management, earnings, liquidity, and sensitivity to market risk. See SR letter 96-38, "Uniform Financial Institutions Rating System," available at www.federalreserve.gov/boarddocs/srletters/1996/sr9638.htm.

from the recent recession, so too did many community banks and MDIs that serve these communities.[12]

The DCCA is also instrumental in identifying opportunities for non-minority-owned banks to collaborate with MDIs. For example, non-minority-owned banks can receive consideration in their Community Reinvestment Act evaluations for collaborating with MDIs if the bank's activities help meet the credit needs of the MDI's local community, even if the activities are not within the non-minority-owned bank's assessment area.[13] Additional opportunities to collaborate with an MDI include making a deposit at, or capital investment in, an MDI; purchasing a loan participation from an MDI; or providing technical expertise to an MDI.

> "I make it a point to keep MDIs well informed of the policy changes that will likely impact their businesses. Although we may not always agree on policy direction, I have come to understand and appreciate their position."
>
> *—Arthur Lindo, Senior Associate Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System*

Community Depository Institutions Advisory Council
Each of the 12 Federal Reserve Banks has a local Community Depository Institutions Advisory Council (CDIAC) that meets regularly to discuss and share perspectives on matters relating to banking conditions. Several MDI bankers currently serve, or have served, on their local CDIAC. This council continues to be an important way for MDIs to communicate with the Federal Reserve on matters related to banking conditions and supervisory issues.

Other Resources Available to MDIs

Many opportunities exist for MDIs to build partnerships with the bank's primary federal regulator as well as with a number of other government agencies.

Biennial Interagency Meeting
In addition to each agency's efforts to support MDIs, the Federal Reserve, the OCC, and the FDIC jointly host a biennial interagency MDI conference. During these conferences, MDIs, as well as community development financial institutions (CDFIs) and representative trade groups, meet with staff members from each of the federal banking agencies along with leaders from other governmental and private agencies, to discuss regulatory hot topics, to consider collaboration opportunities, and to share perspectives on matters relevant to bank operations. The next interagency meeting will occur in July 2015.

Minority Bank Deposit Program
Through the U.S. Treasury Department's Minority Bank Deposit Program, the Bureau of the Fiscal Service distributes a list of certified MDIs to federal agencies, state and local government agencies, and private-sector enterprises to encourage these entities to establish banking services with certified MDIs.[14]

CDFI Fund
Nearly 40 percent of MDIs are also certified CDFIs, which are financial institutions that provide services to areas that lack access to traditional financial institutions. To support economic growth in underserved and financially disadvantaged communities, the U.S. Treasury Department's CDFI Fund invests in CDFIs and provides incentives for banks to invest in CDFIs and their communities.[15]

Summary

The Federal Reserve recognizes the importance of MDIs and their role in the national economy. The Federal Reserve's support for MDIs throughout the years demonstrates that even if it were not for the requirements of FIRREA, the work of MDIs is worthy of focus because of their contribution to the viability of local economies and their support of underbanked customers. ■

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[12] Those interested in learning more about the Federal Reserve's efforts to advance community development are encouraged to visit the DCCA's community development website at www.fedcommunities.org/.

[13] See 2 U.S.C. section 2903(b) and 12 CFR section 228.21(f).

[14] See the Bureau of the Fiscal Service's website for details at www.fms.treas.gov/mbdp/index.html.

[15] For more information, see the Department of the Treasury's CDFI Fund website at www.cdfifund.gov/who_we_are/about_us.asp.

Lessons Learned from the Bank Failure Epidemic in the Sixth District: 2008–2013 *continued from page 1*

reviews of failed banks[3] and aggregate analyses prepared by the Federal Reserve Board's Office of Inspector General (OIG)[4] and the U.S. Government Accountability Office.[5] All these studies identified a common set of factors that contributed to bank failures in recent years, including:

- rapid loan portfolio growth;
- high concentrations in commercial real estate (CRE), specifically construction and development (C&D) lending;
- heavy reliance on noncore funding, particularly brokered deposits;
- insufficient capital to cover losses;
- a large number of newer, untested de novo banks; and
- inadequate internal risk management policies.

These factors, in many respects, were more prevalent and more pronounced in Georgia and Florida; when timed with a rapid and acute economic contraction and deterioration in many local housing and construction markets, the resulting "perfect storm" created a deeper and longer-lasting impact than elsewhere in the nation.

Rapid Portfolio Growth and High Concentrations in CRE

Bank growth that greatly exceeds the local market economic growth rate, especially over a prolonged period, is often a red flag. Between 2005 and 2007, the Sixth District averaged comparatively robust double-digit total loan growth, nearing 15 percent in Georgia and 20 percent in Florida. This stands in contrast to the more modest loan growth of 7.7 percent for banks outside of the District. The growth in U.S. gross domestic product over this period was 5.7 percent.[6] In comparison, Florida's and Georgia's gross domestic product growth averaged 6.8 percent and 5.1 percent, respectively, during the same period. The loan growth in Georgia and Florida was heavily concentrated in real estate. CRE and C&D loan concentrations and growth in both states greatly exceeded national medians (Figures 1–3). As a result, the natural contraction in CRE lending was more severe when the market deteriorated, significantly affecting the local economy, more so than in many other areas. Exposures have since declined but still remain well above the rest of the nation.

Table 1: Count of Bank Failures: 2008–2013

District	Count
Boston	1
New York	12
Philadelphia	6
Cleveland	6
Richmond	28
Atlanta	171
Georgia	87
Florida	70
Remaining States in District	14
Chicago	79
St. Louis	16
Minneapolis	23
Kansas City	38
Dallas	11
San Francisco	97

Source: FDIC

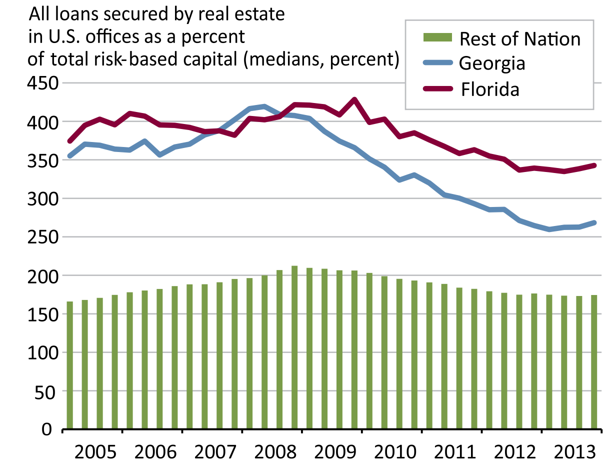
[3] Section 38(k) of the Federal Deposit Insurance Act requires that the inspector general of the appropriate federal banking agency complete a review of the agency's supervision of a failed institution and issue a report within six months of notification from the Office of Inspector General of the Federal Deposit Insurance Corporation (FDIC) that the projected loss to the Deposit Insurance Fund is material. Material loss reviews conducted by each of the agencies can be found at oig.federalreserve.gov (Federal Reserve), fdicoig.gov/MLR.shtml (FDIC), and http://ow.ly/FyyEF (Office of the Comptroller of the Currency).

[4] See Board of Governors of the Federal Reserve System Office of Inspector General, "Summary Analysis of Failed Bank Reviews," September 2011, available at http://ow.ly/EChJN.

[5] See Government Accountability Office, "Causes and Consequences of Recent Bank Failures," January 2013, available at www.gao.gov/assets/660/651154.pdf.

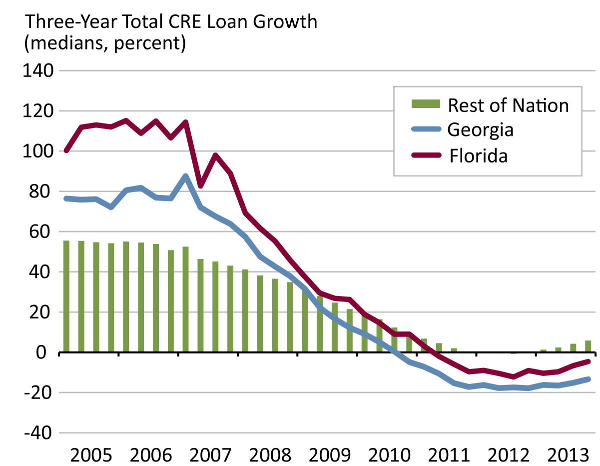
[6] Data are based on the average of quarterly year-ago percent change in nominal gross domestic product and were obtained from the Bureau of Economic Analysis.

Figure 1: CRE Exposures



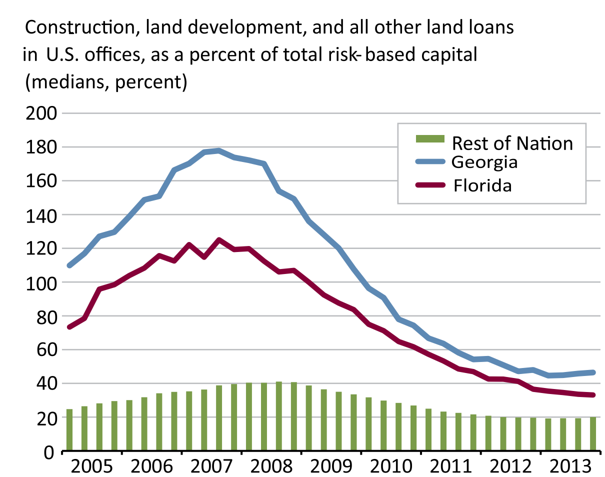
Source: Uniform Bank Performance Report: Concentration of Credit (page 7B)

Figure 2: CRE Loan Growth



Source: Bank Call Reports

Figure 3: C&D Exposures



Source: Uniform Bank Performance Report: Concentration of Credit (page 7B)

High CRE and C&D exposures were closely correlated with the incidence of bank failure. Indeed, between 2008 and 2013, more than half of the banks that failed reported that their highest ratio of delinquencies to total loans outstanding was in the C&D loan portfolio (Table 2 and Figure 4). Residential mortgages ranked second, followed by commercial mortgages (nonfarm nonresidential plus multifamily).

The prevalence of C&D loan delinquencies was even higher in the Sixth District when compared with the rest of the nation. More than three-quarters of the banks that failed in Georgia reported that their C&D loan portfolio had the highest delinquency rate of all loans at the time of failure.

Commercial and residential land values in some Sixth District markets (such as Atlanta, Orlando, South Florida, and Tampa) fell by at least 60 percent peak to trough.[7] Single-family permit issuance in Sixth District states fell by more than 80 percent, while the value of nonresidential construction put in place declined by nearly 60 percent.[8] In essence, it appears that rapid, outsized loan growth heavily concentrated in C&D lending led to high delinquencies in these risky categories when the market collapsed, which then contributed to a vicious negative reinforcing cycle.

Heavy Reliance on Noncore Funding

Beginning in 2005, total loan growth eclipsed deposit growth at the national level as well as in the Sixth District, causing banks to turn to other funding sources to sustain this robust pace.[9] However, as noted in the Federal Reserve OIG report on failed banks, "[r]eliance on non-core funding sources is a risky strategy because these funds may not be available in times of financial stress and can lead to liquidity shortfalls."[10] By 2008, the median net noncore funding dependence ratio in Georgia and Florida far exceeded the rest of the nation (Figure 5). In a majority of Georgia and Florida bank failures, reliance on certain specific funding sources (for example,

[7] Joseph B. Nichols, Stephen D. Oliner, and Michael R. Mulhall, "Swings in Commercial and Residential Land Prices in the United States," American Enterprise Institute Economic Policy Working Paper 2012–03, June 2012, available at http://ow.ly/ECioo.

[8] This information is based on U.S. Census Bureau data and Moody's Analytics estimates.

[9] This information is based on the Board of Governors of the Federal Reserve System Statistical Release H.8, "Assets and Liabilities of Commercial Banks in the United States," available at www.federalreserve.gov/releases/h8/default.htm, as well as on Call Report data for Sixth District banks.

[10] See "Summary Analysis of Failed Bank Reviews."

brokered deposits) was cited as a contributing factor in subsequent material loss reviews. Once again, growth beyond the economic capacity of the local market, in this instance with core deposits serving as a market proxy, can exacerbate an already problematic banking environment.

Insufficient Capital

Capital is a key indicator of a bank's health; ultimately, a bank fails when its capital is exhausted. Rapidly deteriorating asset quality, increases in the provision for loan losses, rising charge-offs, and declining earnings can quickly deplete bank capital unless additional capital injections can be secured. Rising losses at Florida banks pushed the median leverage ratio below that of the rest of the nation for several quarters beginning in 2009, and Georgia's ratio has, until just recently, trailed that of the nation (Figure 6). It is critically important for banks to engage in ongoing capital planning, which includes the ability to project the effects of market changes on the value of the portfolio.[11] Our anecdotal experience suggests that those banks that raised material amounts of capital at the beginning of the recession had a much greater chance of surviving relative to peers that took a wait-and-see approach to raising capital. In addition, troubled banks that had little or no perceived franchise value by investors, such as banks with low levels of core deposits or very limited retail deposit-gathering networks, found it very challenging to attract additional capital.

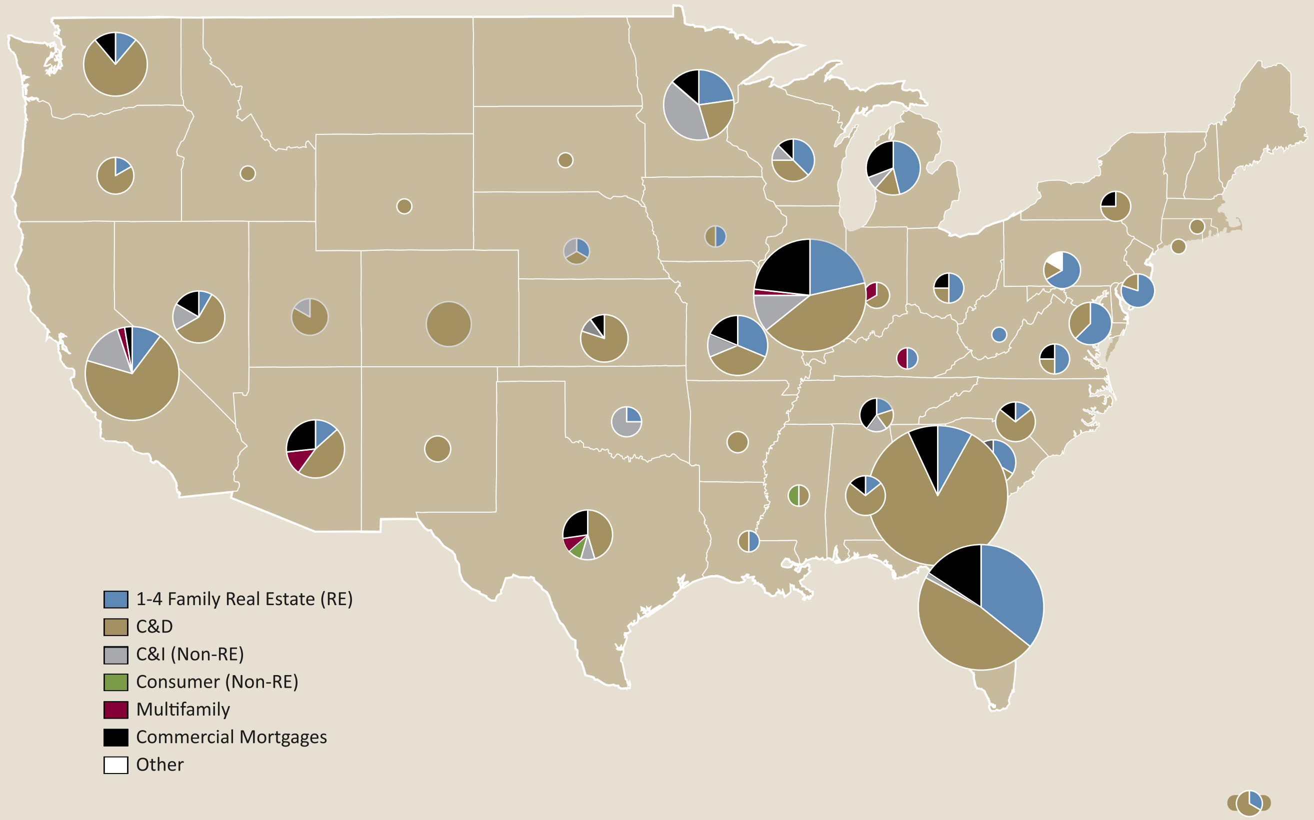
De Novo Banking

The Sixth District accounted for nearly 30 percent of new banking activity between 2000 and 2007.[12] California ranked

[11] For a discussion of the role of capital planning at community banks, see Jennifer Burns, "View from the District: Capital Planning: Not Just for Troubled Times," *Community Banking Connections*, Third Quarter 2013, available at www.cbcfrs.org/articles/2013/Q3/Capital-Planning-Not-Just-for-Troubled-Times.

[12] New banking activity is defined as institutions that are truly de novo, which excludes new specialty lenders and those that were sponsored by either a holding company that existed at least six months prior to the filing date of the new charter or a holding company that had at least one preexisting subsidiary. (This information was obtained from SNL Financial).

Figure 4: Bank Failures by State and by Highest Delinquency at Time of Failure: 2008–2013



Note: The size of each circle represents the relative count of bank failures.
Source: Bank Call Reports

first, Florida ranked second, and Georgia third in terms of new institution charters. Nationwide, the failure rate for these newer institutions was 14 percent, which contrasts with Georgia's much higher failure rate of 42 percent and Florida's 19 percent. These higher percentages are partially attributable to excessive C&D and CRE lending at Georgia and Florida banks. Some of these de novo bank failures can clearly be attributed to poor timing, but it is important to note that not all de novo banks failed. Those that did fail generally had more aggressive growth strategies, consistent with the characteristics previously discussed.

Inadequate Risk Management Policies

During the Great Recession, Georgia and Florida banks found themselves particularly vulnerable to a confluence of events that placed them at high risk for failure: rapid loan growth, excessive CRE and/or C&D exposures, deteriorating local economic or real estate conditions, overreliance on noncore funding, and lower levels of capital. However, these factors did not necessarily indicate that a bank was destined to fail. Indeed, most banks in the Sixth District did not fail during the recession despite facing many of the same headwinds as those that did. The majority of material loss reviews and the "Summary Analysis of Failed Bank Reviews" indicated that failure was, in part, attributable to a lack of sound risk management policies, including delayed action by management. For example, the Federal Reserve Board's quarterly Senior Loan Officer Opinion Survey on Bank Lending Practices[13] showed that banks, on net, were slow to tighten underwriting standards nationally on total

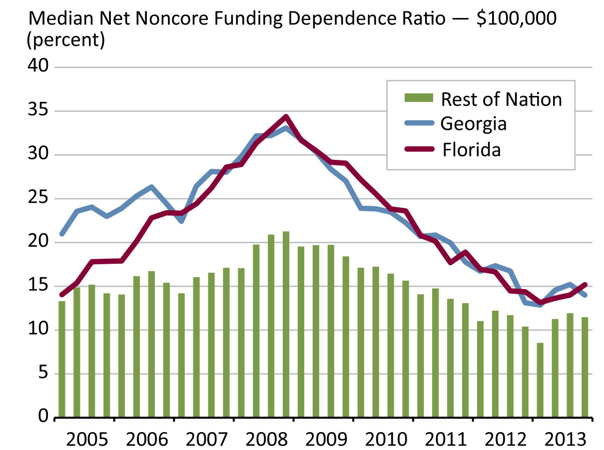
[13] See the Federal Reserve Board's website at www.federalreserve.gov/BoardDocs/snloansurvey/.

Table 2: Distribution of Highest Delinquency Rates by Loan Type as Share of Total Loans at Time of Failure

Loan Type	6th District	Rest of Nation
1-4 Family Real Estate (RE)	18.2%	22.6%
C&D	67.6%	51.6%
Nonfarm Nonresidential	12.8%	12.5%
Multifamily	0.0%	2.0%
C&I (Non-RE)	1.4%	9.9%
Consumer (Non-RE)	0.0%	0.6%

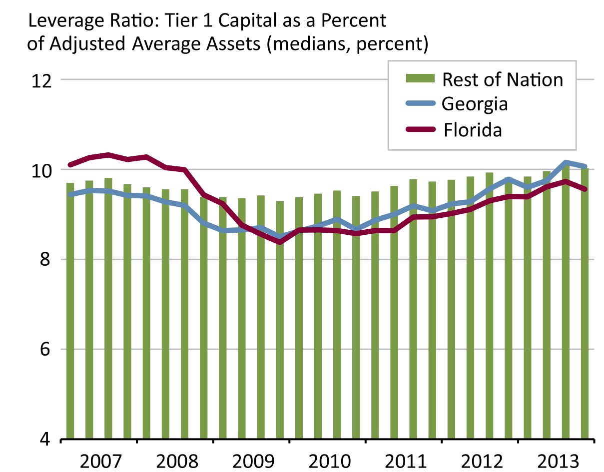
Source: Bank Call Reports

Figure 5: Net Noncore Funding Dependence



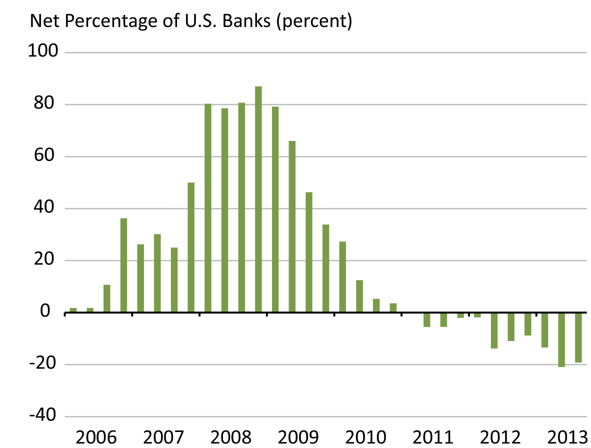
Source: Uniform Bank Performance Report (page 10)

Figure 6: Leverage Ratio



Source: Bank Call Reports

Figure 7: Tightening Standards for All CRE Loans



Source: Senior Loan Officer Survey/U.S. Board of Governors of the Federal Reserve System

CRE loans (C&D and nonfarm nonresidential, and multifamily mortgages) (Figure 7). In other words, it may have been a case of banks attempting to maintain "good" financial performance by continuing to add volume and taking on added risk in the hopes of riding out the recession.

Lessons Learned

It is clear that several factors contributed to bank failures in the Sixth District, and the discussion above dissected the particular issues that made experiences in Georgia and Florida so painful. What can community bankers take away from this review? The key to avoiding a similar fate in the next downturn will be for community bankers to take to heart the lessons identified in postmortem studies, particularly the importance of a sound, sustainable strategy and risk management practices. Sound strategy and effective risk management appear to have been key differentiating factors because not all banks with similar characteristics failed. Many of those that did fail continued to grow and lend in high-risk areas, funding that growth with non-core deposits, and were slow to raise much-needed capital or respond to the risks around them. While future crises will likely present a unique set of challenges, it is safe to say that those that will struggle are likely to repeat these themes, while those that survive will have learned these important lessons. ■

Cybersecurity: Part 2 – Cyber-Related Risk Assessment and Controls *continued from page 3*

prise vendor management program, contract review procedures, audit reports covering the vendors' operations, service-level agreements, and other reports.[4]

Does the bank have an effective risk assessment process to identify unauthorized access to critical data? Bank management should inventory bank assets and categorize critical data in motion and at rest. Management then needs to evaluate the access controls in place to prevent unauthorized access by employees, third parties, and vendors. These controls, along with access monitoring, will help to safeguard business confidentiality and customer privacy. If a data breach occurs, bank management must report the incident to regulators as defined in the incident response plan, discussed later.[5]

Pillar 2 — Policies, Procedures, and Controls

Bank management should implement appropriate policies, procedures, and controls that properly address identified cybersecurity threats and risks and protect business operations and critical services. Good communication is essential if bank personnel are to properly integrate policies and procedures with technology to produce effective controls. Many security policies fail because they do not consider the importance of training bank personnel on the established policies, procedures, and controls. Focusing only on information technology and technology controls without considering stakeholder needs is not enough; procedures should consider all stakeholders — including bank customers, bank employees, third parties, and external vendors — who interact with the bank's systems.

With careful consideration of the following questions, bank management can assess whether the implemented processes, policies, and an appropriate mix of controls can effectively detect and prevent cybersecurity threats from both internal and external sources.

Has management developed, implemented, and provided an ongoing review and revision of policies and procedures to effectively address the continuously evolving cybersecurity threats and risks? Bank management needs to establish an effective process to develop, implement, and maintain policies and procedures. Management should consider the following steps:

- Develop procedures to be consistent with legislation, regulation, corporate policies, and business operations.
- Take into account the results of risk assessments.
- Structure and optimize policies and procedures.
- Gain approval from senior management or, for policies, from the board of directors.

[4] For further guidance, refer to Supervision and Regulation (SR) letter 13-19/Consumer Affairs (CA) letter 13-21, "Guidance on Managing Outsourcing Risk," available at www.federalreserve.gov/bankinforeg/srletters/sr1319.htm.

[5] For further guidance, refer to SR letter 05-23/CA letter 05-10, "Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice," available at www.federalreserve.gov/boarddocs/srletters/2005/SR0523.htm.

- Train employees and convey an awareness of the seriousness of cybersecurity to all stakeholders.
- Improve and update policies and/or procedures.

Has management developed, implemented, and provided ongoing maintenance of controls to effectively address cybersecurity threats and risks? Controls can encompass identity and access management, including user access management and segregation of duties; authentication and authorization; third-party or vendor access monitoring; version controls on configuration management and patch management; and event monitoring and incident response. It is critical to update controls in a timely manner. Furthermore, bank management should continually review its risk assessment, map controls, and fill in the control gaps. The governance process will assist with the continual monitoring of controls and will provide input for updating the controls accordingly based on the risk profile.

Are the controls for cybersecurity threats and risks sufficient for the complexity of the environment? Cybersecurity controls need to be commensurate with a bank's risk tolerance, the complexity of the bank's business models, and the supporting information technology (IT) organizational structures. For example, some banks may not implement all preventive controls because of the high cost and, as a result, may instead rely heavily on detective controls. Other banks increasingly rely on cyberinsurance policies as a risk transfer strategy. It is important to note that cyberinsurance should not be seen as a control to mitigate the entire potential impact of cyberthreats and risks. Its purpose is to limit financial losses from a variety of cyberincidents, including data breaches, business interruption, and network damage. However, cyberinsurance will not cover indirect losses, such as reputational damage, the leakage of intellectual property or confidential information, and the decrease of shareholder value.

Do management and internal audit effectively identify control weaknesses, find gaps between control structure and policy, and verify the execution of appropriate and effective remediation actions to close the identified gaps and weaknesses? To achieve these goals, bank management may choose to acquire skillful and experienced internal audit staff or outsource these functions to a third party.[6] In either case, bank management should verify the qualification and professional certification of audit staff, and additional training may be necessary to enhance the skills of internal audit staff. With cyberthreats and risks changing over time, training should be seen as an ongoing effort.

Pillar 3 — Governance and Monitoring

A key to cyber-related risk prevention is developing and maintaining strong governance over cybersecurity. Effective governance establishes policies and practices in a manner that allows for communication of cybersecurity activities and outcomes across the organization from the executive level to the implementation and operational level. Bank management should also develop metrics and implement monitoring and reporting mechanisms to swiftly and effectively detect cyberevents and to allow for continual control improvements.

A bank can evaluate the effectiveness of governance and monitoring controls to ensure compliance with security policies and practices by answering the following questions.

Does the bank have adequate governance committees and structures in place to ensure appropriate oversight and monitoring of key information security risks? The governance structure needs to ensure that:

- The committee reporting structure escalates cyberevents to an appropriate level.
- The members of the committee structure have the appropriate authority.

An established process should monitor the effectiveness of controls and ensure that control breakdowns are reported in a timely manner. It is critical to have skilled staff involved during the control monitoring. The process should not just be IT-centric, as critical business lines should be involved in cybersecurity oversight as well. Successful cybersecurity procedures and control implementation should be transparent to business operations.

Governance also needs to address resource and training requirements. It is essential to integrate training and awareness education into a framework in order to influence the behavior of all stakeholders, including bank customers, bank employees, third parties, and vendors. To achieve this goal, appropriate resources should be made available.

Does the bank adequately monitor the control environment and sufficiency of key controls relative to informa-

[6] A recently published edition of this newsletter discusses outsourcing internal audit. See "Considerations When Outsourcing Internal Audit at Community Banks," *Community Banking Connections*, First Quarter 2014, available at www.cbcfrs.org/articles/2014/Q1/considerations-when-outsourcing-internal-audit-at-community-banks.

tion security? Control effectiveness has two components: design effectiveness and operational effectiveness. Design effectiveness refers to whether controls are properly designed to achieve control objectives if they operate as defined. Operational effectiveness refers to whether controls consistently operate as designed. Controls should be tested and documented on a regular basis by personnel with appropriate expertise and independence. For example, the penetration tests should be part of a routine control assessment, which is referenced by the Federal Financial Institutions Examination Council (FFIEC) *IT Examination Handbook*[7] and Payment Card Industry (PCI) Data Security Standard Security Scanning Procedures.[8] The penetration test results could be submitted to the board of directors as part of the periodic compliance and risk management reports.

Does the bank have adequate management information systems (MIS), and does it review security events on an ongoing basis? Bank management needs to develop a set of scenarios or key risk indicators that notify managers of security events in a timely manner. Appropriately skilled staff should be involved in identifying security events and in escalating and reporting critical issues to all key stakeholders. Timely and actionable MIS reporting will continue to improve the control environment for both current and emerging cybersecurity risks.

Pillar 4 — Resilience and Incident Response

Bank management needs to develop resiliency plans in order to respond to and recover from attacks — physical and cyber — against critical business operations. A well-tested process and plan should enable bank management to prioritize and respond appropriately to the most likely and potentially impactful incidents, including those that may escalate and threaten the actual survival of the bank itself.

By asking the following questions, a bank can assess the effectiveness of its business continuity/resiliency and incident response plans.

Does the bank's business impact analysis consider cybersecurity threat scenarios in its business continuity/resilience planning? In risk identification, bank management will use business impact analyses to identify cybersecurity threats and potential impacts on business operations and critical services. These potential impacts include loss of revenue; additional expenses from services, equipment, and overtime; regulatory, legal, and other expenses arising from fines, contractual obligations, and financial liabilities; reduction of service level; and impact on public image and market share.

Does the business continuity/resilience program take into account potential cybersecurity threats? When bank management develops a business continuity/resilience program, it should consider all key stakeholders who may be impacted by cybersecurity threats, including bank customers, bank business operators, information security staff, business partners, third parties, and vendors. The program should clearly document action steps from each of the key stakeholders and describe the expected results from each action.

Does the bank include identified cybersecurity events in its business resumption testing program? Cybersecurity events should be defined as valid test scenarios in a bank's business resumption program. Bank management should conduct tests around these scenarios at least once a year, with additional iterations whenever major changes to the environment or business processes occur.

Summary

Banks constantly face the challenges and changes that arise from new cybersecurity threats, data breach events, evolving technologies, business dynamics, and regulatory requirements. As a result, bank management should continually revisit its cybersecurity frameworks to update and enhance cybersecurity risk management practices.

An effective cybersecurity framework will help bank management to coordinate the response and recovery activities among all involved parties before, during, and after a cybersecurity event. Well-organized and tested business plans for continuity, incident response, and business resumption are vital to safeguard a bank's assets.

When a bank builds a strong and adaptive cybersecurity framework, the bank can have a better alignment between its business requirements, risk tolerance, and resources. An effective cybersecurity framework also enables bank management to continually refine its risk management priorities and to establish a road map that not only reduces cybersecurity risks but also aligns with organizational goals, legal and regulatory requirements, and industry sound practices. ■

[7] See the discussion of independent tests in the "Information Security Booklet" of the *FFIEC IT Examination Handbook*, available at http://ow.ly/yYv4Z.

[8] PCI Security Standards Council, *Information Supplement: Requirement 11.3 Penetration Testing*, April 2008, available at http://ow.ly/yYvjL.

Development and Maintenance of an Effective Loan Policy: Part 1 *continued from page 5*

Participations Purchased. A bank may choose to enter into participations if it is unable to generate sufficient loan demand independently. In this case, partnering with another strong bank operating in a healthier market could help generate additional assets and income. Also, participations may help to diversify risk among locales or lending types. Policies should stress the importance of prudent and independent underwriting, appropriate legal documentation, and ongoing monitoring of loan participations.

Participations Sold. When a bank is unable to advance a loan to a customer for the full amount requested because of lending limits or for other reasons, loan participations may be an appropriate alternative. In such situations, a bank may extend credit to a customer up to the internal or legal lending limit and sell participations to correspondent banks in the amount exceeding the lending limit or in the amount exceeding what the bank wishes to retain. Participation arrangements should be established before the credit is ultimately approved. Participations should be done on a nonrecourse basis, and the originating and purchasing banks should share in the risks and contractual payments on a pro-rata basis. Selling or participating out portions of loans to accommodate the credit needs of customers can promote goodwill and may enable a bank to retain customers who might otherwise seek credit elsewhere.[7]

If management participates in the underwriting of products similar to loan participation(s), such as syndications[8] and/or club deals,[9] the loan policy should appropriately cover the basic elements of these activities (limits, underwriting requirements, documentation, and so forth).

For additional information regarding loan participations, bankers should consult the Second Quarter 2013 issue of *Community Banking Connections*, which featured an article that discussed several ways to strengthen board and senior management oversight of loan participations.[10]

Loan Portfolio Mix and Limits

The policy should also establish the desired mix of the loan portfolio and limits on individual loan types. Exposure mix and limits should be monitored on an ongoing basis to ensure that they are appropriate and reasonable.

> “Policies should stress the importance of prudent and independent underwriting, appropriate legal documentation, and ongoing monitoring of loan participations.”

Limits should be determined based on risk tolerances and should be measured in comparison with loans, assets, and tier 1 capital plus the allowance for loan and lease losses (ALLL). Management should continually monitor the dollar and percentage exposures of each portfolio to ensure the bank maintains an appropriate risk profile with sufficient returns. When determining risk tolerances and limits, portfolio stratification is extremely important. Stratification or segmentation of the loan portfolios can be accomplished through numerous variables, depending on the desired granularity. Limits

[7] See *CBEM*, section 2040.1, “Loan Portfolio Management.”

[8] A syndication is a loan made by two or more lenders contracting directly with a borrower under the same credit agreement. Each lender has a direct legal relationship with the borrower and receives its own promissory note(s) from the borrower. Typically, one or more lenders will also take on the separate role of agent for the credit facility and assume responsibility for administering the loans on behalf of all lenders. A syndicated loan differs from a loan participation in that the lenders in a syndication participate jointly in the origination and the lending process.

[9] A club deal is the smallest type of syndicated loan, usually used for loans between $25 million and $150 million. Unlike the other loan types, the club deal is an equal denomination loan in which all parties lend the same amount; the arranger puts in the same amount as all other lenders, and all parties equally share the loan fee.

[10] See Michael Poprik, “Loan Participations: Lessons Learned During a Period of Economic Malaise,” *Community Banking Connections*, Second Quarter 2013, available at www.cbcfrs.org/articles/2013/Q2/Loan-Participations.

established by general loan type (e.g., commercial real estate (CRE), C&I, and small business) will provide a very broad portfolio overview. Using North American Industry Classification System (NAICS) codes will provide general industry and subindustry categories that should provide greater granularity and insight into the portfolio composition and risk characteristics. Management may also consider stratifying by borrower risk rating, collateral type, loan officer, or other variables.

Concentrations of credit and the legal lending limit are closely linked to portfolio mix and established limits; therefore, these topics are covered within this section.

Concentrations of Credit. Concentrations of credit are defined as exposure to an industry or loan type in excess of 25 percent of tier 1 capital plus the ALLL. Concentrations are not necessarily indicative of performance issues and quite often exist within portfolios. However, risk management practices should be commensurate with the risk profile of the concentrated exposure.

"Appropriate risk diversification through the establishment of prudent concentration limits may help to minimize the potential negative impact on earnings performance and/or capital should such an event occur."

Banks with concentrations in specific types of loans with common characteristics — for example, common industries and/or geographic areas — can be negatively impacted by a catastrophic event within the business line, industry, or geography. Therefore, banks need to have well-established policies and procedures that stress the identification of and the prudent controls over concentrations. Appropriate risk diversification through the establishment of prudent concentration limits may help to minimize the potential negative impact on earnings performance and/or capital should such an event occur.

In 2006, the federal banking regulatory agencies issued guidance on CRE concentrations.[11] The guidance addressed the agencies' observation that CRE concentrations had been rising at many institutions, especially at small-to-medium-sized institutions. While most institutions had sound underwriting practices, the agencies observed that some institutions' risk management practices and capital levels had not evolved with the level and nature of their CRE concentrations. Therefore, the agencies issued the guidance to remind institutions that strong risk management practices and appropriate levels of capital are important elements of a sound CRE lending program, especially when an institution has a CRE concentration or a CRE lending strategy that could lead to a concentration.

Legal Lending Limit. The loan policy should appropriately address the legal lending limit, which is the aggregate maximum dollar amount that a single bank can lend to a given borrower. Because the legal lending limit is tied to the bank's capital, management must calculate and monitor the legal lending limit on an ongoing basis.

State-chartered banks must comply with the legal lending limits established by the law of the state in which they are chartered. Some states have adopted parity provisions in their state banking laws that provide state-chartered banks with the option of complying with either the state legal lending limit or the limit established by the Office of the Comptroller of the Currency for national banks.[12]

Geographic Area

Community banks are typically established to serve the local communities in which they operate. The loan policy should identify the geographic area in which an organization will lend and the circumstances under which credit may be extended outside of that area. Familiarity with the geographic area provides insight and supports management's ability to closely and continually monitor borrower performance.

Lending outside of the local market can help to diversify geographic exposure, as explained in the loan participation section above, but it can also raise concerns about management's ability to closely monitor projects and remain informed about the local economy. Appropriate policies and procedures covering loan participations and potential concerns with out-of-area lending will help reduce, but not eliminate, some of these risks.

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[11] See Supervision and Regulation letter 07-1, "Interagency Guidance on Concentrations in Commercial Real Estate," and its attachment, available at www.federalreserve.gov/boarddocs/srletters/2007/SR0701.htm.

[12] See 12 CFR Part 32, available at http://ow.ly/COXUD.

Structure of Lending Function

The structure of the lending department or function varies widely among institutions. Ideally, the lending function should have an appropriate segregation of duties and independence in the roles throughout the department.

Management must strive to maintain sufficient controls and segregation of duties in all lending functions to avoid inappropriate credit decisions and/or weak underwriting processes. The ability to separate the activities of the loan generation function from the credit underwriting and analysis function has numerous benefits. Unfortunately, this is very difficult and often unrealistic at smaller banks, where these activities are usually combined. Smaller banks may struggle with implementing such controls and structure because of their limited staff and financial constraints.

Lending Authority

The loan policy should also clearly define the individuals and loan committees that have the authority to approve loans. Dollar limits should be established for individuals by name or by job title, individuals acting together (dual or multiple individual lending authority), loan committees, and the legal lending limit authority (board or committee thereof). Individual lending authority should be structured by job title and loan product, ensuring that lending decisions are being made by individuals with the appropriate credentials and expertise. However, no bank should delegate unlimited lending authority to one or a limited number of individuals.

Before a bank can establish lending authorities or limits, the board must establish the approval hierarchy or structure. The board is ultimately responsible for the affairs of the organization and must determine to what degree the board is willing to delegate lending authority. The board could determine that it will participate directly, establish a committee of the board, or delegate the authority to a senior management committee. In accordance with the Federal Reserve Board's Regulation O, the board must be involved in the ultimate credit decision when approving loans to insiders.

Conclusion

Regulators expect community banks to establish and maintain policies that provide an effective framework to measure, monitor, and control credit risk. However, community bankers do not need to start with a blank slate. Information on policy development and maintenance is readily available and easily accessible from a number of sources. The regulatory agencies' examination manuals and handbooks, along with Federal Reserve Supervision and Regulation letters, provide guidance and timely information on emerging issues and regulatory concerns that should be incorporated into the loan policy. In addition, industry associations and private organizations provide ongoing training and current information on effective policy development. While these resources may be helpful and serve as a solid foundation for a community bank loan policy, the importance of tailoring the policy to the banking organizations' activities cannot be overstressed.

Although this article addresses both *what* is permissible and *who* is responsible in a comprehensive community bank loan policy, it is by no means all-inclusive. The next two articles in this series will discuss additional elements that may be incorporated into the policy, such as underwriting, appraisals, risk ratings, pricing, and documentation; ongoing policy review and maintenance; and overall compliance with the loan policy. ■

Governor Lael Brainard has joined the Federal Reserve Board Subcommittee on Smaller Regional and Community Banking. The Board's subcommittee makes recommendations about matters related to community and regional bank supervision and regulation. Governor Jerome Powell is the chair of the subcommittee. Further information about Board committees can be found at federalreserve.gov/aboutthefed/bios/board/default.htm.

Maryann Hunter, deputy director of the Federal Reserve Board's Division of Banking Supervision and Regulation, testified before the U.S. Senate Committee on Banking, Housing & Urban Affairs at a hearing on "Examining the State of Small Depository Institutions" on September 16, 2014. Her testimony is available at www.federalreserve.gov/newsevents/testimony/hunter20140916a.htm.

Governor Jerome Powell gave introductory remarks at the Federal Reserve System/Conference of State Bank Supervisors Community Banking Research and Policy Conference, "Community Banking in the 21st Century." The conference was held at the Federal Reserve Bank of St. Louis on September 23–24, 2014. Powell's remarks are available at www.federalreserve.gov/newsevents/speech/powell20140923a.htm.

The Federal Reserve Board, on October 8, 2014, announced the members of its Community Depository Institutions Advisory Council (CDIAC) and the president and vice president of the council for 2015. John B. Dicus, chairman, president, and chief executive officer of Capitol Federal Savings Bank, Topeka, KS, will serve as president in 2015. Michael J. Castellana, president and chief executive officer of SEFCU, Albany, NY, will serve as vice president. The complete announcement, including the names of additional CDIAC members, is available at www.federalreserve.gov/newsevents/press/other/20141008b.htm.

On October 9, 2014, the Federal Reserve Board released answers to frequently asked questions (FAQs) regarding the competitive review process for bank acquisitions, mergers, and other transactions. The FAQs were developed jointly with the U.S. Department of Justice and provide answers to questions often raised by banking organizations that are considering filing applications. The FAQs are available at www.federalreserve.gov/bankinforeg/competitive-effects-mergers-acquisitions-faqs.htm.

The federal banking agencies, on November 5, 2014, announced the first of a series of outreach meetings to review their regulations under the Economic Growth and Regulatory Paperwork Reduction Act of 1996. The first meeting was held at the Los Angeles branch of the Federal Reserve Bank of San Francisco on December 2, 2014, with future meetings to be held in 2015 in Dallas, Boston, Chicago, and Washington, D.C. The announcement is available at www.federalreserve.gov/newsevents/press/bcreg/20141105b.htm.

Governor Daniel Tarullo delivered a speech on a tiered approach to regulation and supervision of community banks to the Community Bankers Symposium held at the Federal Reserve Bank of Chicago on November 7, 2014. His speech is available at www.federalreserve.gov/newsevents/speech/tarullo20141107a.htm.

The Federal Reserve Board, on November 24, 2014, released its first Semiannual Report on Banking Applications Activity, which provides aggregate information on proposals filed by banking organizations and reviewed by the Federal Reserve. The report is available at www.federalreserve.gov/bankinforeg/semiannual-report-on-banking-applications-20141124.pdf.

FedLinks
Connecting Policy with Practice

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

The most recently released *FedLinks* bulletins include:

"Introducing a New Product or Service" (September 2014) discusses five factors that examiners have found are associated with successful new product development: the repeatable process, strategic fit for the institution and its customers, risks and mitigants, regulatory compliance, and financial costs and benefits.

"Supervisory Expectations for Contingency Funding Plans" (September 2014) describes the underlying principles of a sound contingency funding plan (CFP), examiner expectations for evaluating its elements, and opportunities for improvement frequently recommended by examiners when assessing a bank's CFP.

These bulletins, and others like them, can be found online at www.cbcfrs.org/fedlinks.

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

On September 23–24, 2014, the Federal Reserve System and the Conference of Bank Supervisors hosted the second annual Community Banking in the 21st Century conference at the Federal Reserve Bank of St. Louis. The conference attracted more than 150 in-person guests and more than 1,500 webcast visitors. The two-day event brought together economists, lawyers, regulators, and bankers to discuss the latest in academic research on community banking issues as well as the practical challenges facing community banks.

The research from this year's conference focused on three primary areas: community bank formation and emerging technologies, the effect of government policy on bank lending and risk-taking, and the effect of government policy on community bank viability. The conference featured research from multiple academic disciplines, including economics, finance, and law. Each research session was moderated by an academic and also included comments and reactions from a community bank panelist.

This year's conference included the release of the findings from a national survey of more than 1,000 community banks in 38 states that was administered by state bank commissioners between April and July 2014. The findings are available at www.stlouisfed.org/banking/community-banking-conference-2014/content/pdfs/CBRCReport2014.pdf.

Visit the conference web page at www.stlouisfed.org/CBRC2014 to view remarks, videos, a summary of the town hall comments, abstracts of the research papers, and much more.

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

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

SR Letter 14-9, "Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program"

SR Letter 14-7, "Loan Coverage Requirements for Safety and Soundness Examinations of Community State Member Banks"

SR Letter 14-6, "Addendum to the Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure"

SR Letter 14-5/CA Letter 14-4, "Interagency Guidance on Home Equity Lines of Credit Nearing Their End-of-Draw Periods"

CA Letter 14-5, "Interagency Guidance Regarding Unfair or Deceptive Credit Practices"

CA Letter 14-3, "Interagency Statement on Increased Maximum Flood Insurance Coverage for Other Residential Buildings"

Connecting with You

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

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

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

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