

# COMMUNITY BANKING CONNECTIONS™

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## VIEW FROM THE DISTRICT A Tenth District Perspective — Kansas City

### The Importance of Effective Corporate Governance

by Kevin Moore, Senior Vice President, Supervision and Risk Management Division, Federal Reserve Bank of Kansas City

Since 2009, I have served as the chair of a Federal Reserve System group known as the Community Banking Organization Management Group (CBOMG). This group was established a number of years ago to promote consistent and effective implementation of supervision programs and policies for community banking organizations. Members of the

CBOMG include senior leaders with responsibility for community bank supervision from each of the Reserve Banks and the Board of Governors. The group meets regularly to share information about banking conditions and emerging risks. It also provides a platform for promoting best practices and enhancing communication and coordination within the Federal Reserve System, as well as with our federal and state banking supervision partners.



Kevin Moore

As the senior vice president of the Supervision and Risk Management Division at the Federal Reserve Bank of Kansas City and the current chair of the CBOMG, I have had a unique opportunity to observe how the financial crisis affected community banks and gain an appreciation for some of the causes of the crisis.

Simply stated, the recent financial crisis was fueled largely by the housing boom. Consumers, small businesses, and finan-

cial institutions took on excessive leverage to finance this growth. When economic conditions changed dramatically, many consumers and small businesses defaulted on their loans, and the largest banks faced severe liquidity constraints and a loss of market confidence, in large part due to their involvement in securitization and derivatives markets. Meanwhile, a number of community banks with large exposures in land and construction lending suffered severe losses and failed. So what went wrong for these banking organizations? In short, I would argue that the boards of directors of many of these banks were not sufficiently engaged or informed to question the adequacy of capital and risk management programs needed to enable their banks to weather a prolonged downturn.

In most cases, if a bank failure results in a significant loss to the Deposit Insurance Fund (DIF), the Office of Inspector General of the respective federal banking agency is required

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# Sound Risk Management Practices in Community Bank C&I Lending\*

by Cynthia Course, Principal – Policy and Implementation, Federal Reserve Bank of San Francisco

Given weak loan demand, community banks have been challenged to maintain positive net loan growth quarter over quarter. Since the third quarter of 2008, community banks (those with less than \$10 billion in assets) have reported positive net loan growth in only two quarters — the second quarters of 2011 and 2012 — although the rate of decline in other quarters has slowed more recently.<sup>1</sup> Despite the year-over-year decline in net loans through June 30, 2012, commercial and industrial (C&I) loans outstanding at community banks increased \$6.3 billion, or 2.8 percent, during the same period. And, on March 31, 2012, and June 30, 2012, C&I loans represented 16.7 percent and 16.6 percent of community banks' net loans, the highest levels in three-and-a-half years.

Although the uptick in C&I loans at community banks has

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<sup>1</sup> Based on data extracted from the Federal Deposit Insurance Corporation (FDIC) Statistics on Depository Institutions database ([www2.fdic.gov/sdi/index.asp](http://www2.fdic.gov/sdi/index.asp)) for institutions up to \$10 billion in assets (accessed September 26, 2012)

been modest, we thought that this was an appropriate time to remind bankers that they should establish controls and sound risk management practices before starting or expanding a C&I lending program.

## What Are C&I Loans?

C&I loans generally are loans to sole proprietorships, partnerships, corporations, and other business enterprises to finance accounts receivable or inventory or finance the acquisition of capital assets.<sup>2</sup> For some customers, C&I loans may be seasonal working capital loans, bridging uneven cash flows. The broad range of loans included in this category is illustrated in the table on page 3.

## Loss Rates on C&I Loans

While a C&I lending program can be a viable business strategy for a community bank, it is not without risk, as shown by the generally higher loss rates on C&I loans than on CRE-

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<sup>2</sup> For the purposes of this article, the term C&I loans has the meaning set forth in the instructions to the interagency Consolidated Reports of Condition and Income (Call Report), available at [http://www.ffiec.gov/PDF/FFIEC\\_forms/FFIEC031\\_FFIEC041\\_201209\\_i.pdf](http://www.ffiec.gov/PDF/FFIEC_forms/FFIEC031_FFIEC041_201209_i.pdf), p. 158.

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Editor: **Sally Burke**  
Project Manager: **Donna Gulle**  
Designer: **Dianne Hallowell**  
Advisory Board: **Jackie Brunmeier**, Assistant Vice President and Chief Risk Officer, Supervision, Regulation, and Credit, FRB Minneapolis, **Cynthia Course**, Principal, Banking Supervision and Regulation, FRB San Francisco, **Minh Farnsworth**, Specialist, Supervision, Regulation, and Credit, FRB Philadelphia, **Joan Fischmann**, Assistant Vice President and Regional Director, Supervision and Regulation, FRB Chicago, **Jinai Holmes**, Senior Supervisory Financial Analyst, Division of Banking Supervision and Regulation, Board of Governors, **Tara Humston**, Assistant Vice President, Supervision and Risk Management, FRB Kansas City, **Gavin Miller**, Supervisory Financial Analyst, Supervisory Oversight, Division of Banking Supervision and Regulation, Board of Governors, **T. Kirk Odgaard**, Assistant Director, Policy Implementation and Effectiveness, Division of Banking Supervision and Regulation, Board of Governors, **Erik Soell**, Director, Rapid Communications, FRB St. Louis, **Constance Wallgren**, Vice President and Chief Examinations Officer, Supervision, Regulation, and Credit, FRB Philadelphia, **Lauren Ware**, Assistant Vice President, Supervision, Regulation, and Credit, FRB Richmond, **Richard Watkins**, Assistant Director, Supervisory Oversight, Division of Banking Supervision and Regulation, Board of Governors

The analyses and conclusions set forth in this publication are those of the authors and do not necessarily indicate concurrence by the Board of Governors, the Federal Reserve Banks, or the members of their staffs. Although we strive to make the information in this publication as accurate as possible, it is made available for educational and informational purposes only. Accordingly, for purposes of determining compliance with any legal requirement, the statements and views expressed in this publication do not constitute an interpretation of any law, rule, or regulation by the Board or by the officials or employees of the Federal Reserve System.

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## Table: Examples of C&I loans

Common examples of C&I loans at community banks by borrower, purpose, or type include the following. The instructions to the Call Report provide a more complete list.

- By borrower for commercial, industrial, or professional purposes
  - ▶ Mining, oil- and gas-producing, and quarrying companies
  - ▶ Manufacturing companies
  - ▶ Construction companies
  - ▶ Transportation and communications companies
  - ▶ Wholesale and retail trade enterprises
  - ▶ Cooperative associations
  - ▶ Service enterprises, such as hotels, motels, laundries, automotive service stations, and nursing homes and hospitals operated for profit
  - ▶ Law, medical, accounting, and insurance professionals
- By purpose
  - ▶ Capital expenditures
  - ▶ Current operations
  - ▶ Construction if not meeting the definition of “loan secured by real estate”
  - ▶ Dealer floor plan
- By type
  - ▶ Loans guaranteed by the Small Business Administration
  - ▶ Credit cards and related plans that are readily identifiable as being issued in the name of a commercial or industrial enterprise

secured loans. As illustrated in the figure, while the net charge-off rate on C&I loans at community banks (gold line) was well below that of construction and land development (C&LD) loans (green line) during the crisis, it exceeded the net charge-off rate of nonconstruction CRE loans (blue line). In the early part of the previous decade, the net charge-off rate on C&I loans was over 10 times that of nonconstruction CRE loans. The spread between the net charge-off rates for C&I and CRE loans has generally been wider for the smaller community banks than for those with over \$1 billion in total assets.<sup>3</sup>

<sup>3</sup> The Federal Reserve Bank of San Francisco maintains a historical data set of net charge-off rates for its District and national populations at [www.frbsf.org/banking/data/chargeoff/AggregateNCORates.xlsx](http://www.frbsf.org/banking/data/chargeoff/AggregateNCORates.xlsx).

There are steps banks can take to manage and mitigate risks associated with C&I lending, and the remainder of this article will touch on effective risk management practices for a C&I lending program.

## Sound Risk Management Practices

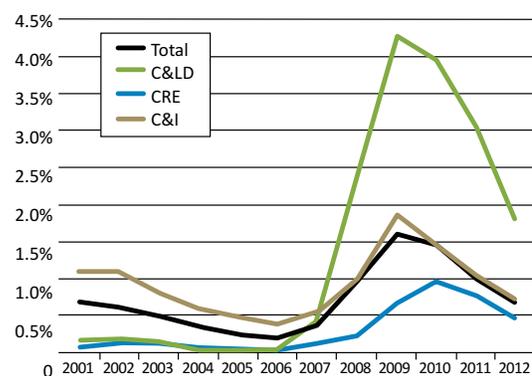
### Lending Staff

C&I lending often requires a different skill set than that required for real estate-based lending. This doesn't mean that real estate-based lenders cannot become effective C&I lenders with appropriate training and oversight, but it does mean that management should not merely ask real estate lending and credit administration staff to start making and monitoring C&I loans and expect them to be effective immediately. It may also be increasingly difficult to hire experienced C&I lenders and credit administration staff, as many community banks are seeking to expand into this market.

Community banks seeking to expand their C&I lending may be best served by a combination of targeted training and selective hiring. Experienced commercial lenders and credit administration staff can be trained on sound C&I lending practices and can learn on the job under the mentoring of experienced C&I lenders and staff. Regardless of the approach chosen, management should recognize that even selective hiring and targeted training can be expensive and that

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**Figure: Net charge-off rates by loan type  
Commercial banks < \$10 billion**



Source: Data extracted from the Federal Deposit Insurance Corporation (FDIC) Statistics on Depository Institutions database ([www2.fdic.gov/sdi/index.asp](http://www2.fdic.gov/sdi/index.asp)) for institutions up to \$10 billion in assets (as of September 26, 2012). The net charge-off rate is measured as annual net charge-offs divided by prior year-end balances; June 2012 charge-offs annualized.

# Weathering the Storm: A Case Study of Healthy Fifth District State Member Banks over the Recent Downturn

by Ray Brastow, Supervision and Regulation Financial Economist; Bob Carpenter, Supervision and Regulation Lead Financial Economist; Susan Maxey, Quantitative Research Analyst; and Mike Riddle, Risk and Policy Team Leader, Federal Reserve Bank of Richmond

*Note: This article was originally published in the Summer 2012 issue of the Federal Reserve Bank of Richmond's S&R Perspectives publication. It is being reprinted in Community Banking Connections with the authors' permission and with minor, nonsubstantive revisions. While the analysis focuses on banking organizations in the Fifth District, subsequent quantitative testing of these findings on a national sample suggests that these findings are also relevant to the broader community banking population.*

The financial crisis and subsequent economic downturn resulted in a significant number of bank failures. Analysis of failures by the banking industry, regulators, and academics has provided insight to help avert future banking crises.

In the midst of the crisis and the ensuing recession, some institutions did more than endure: They maintained strong financial conditions and above-average regulatory ratings throughout. How? In what ways did these institutions differ from weak or failed banks? During 2011, the Policy Analysis Group in the Federal Reserve Bank of Richmond's Supervision, Regulation and Credit's Risk and Policy unit explored these questions by conducting interviews of bankers at a sample of banks that successfully navigated the crisis.

## Methodology

The study focused on Fifth District state member banks, for which the Federal Reserve shares supervisory responsibility with state banking agencies.<sup>1</sup> Case interviews were con-

<sup>1</sup> A network of 12 Federal Reserve Banks perform a variety of Federal Reserve System functions, including operating a nationwide payments system, distributing the nation's currency and coin, supervising and regulating member banks and bank holding companies, and serving as banker for the U.S. Treasury. The 12 Reserve Banks are each responsible for a particular geographic area, or District, of the United States. The Fifth District includes Maryland, Virginia, North Carolina, South Carolina, the District of Columbia, and most of West Virginia.

ducted through direct discussions with community bankers. The project team chose an interview approach to allow for a complete exchange with bank management.

The primary selection criterion was based on CAMELS ratings. The group focused on institutions rated composite CAMELS "1" or "2" in the second quarter of 2007 (before the crisis) and that maintained a "1" or "2" rating through the recession to the first quarter of 2010.<sup>2</sup> Ratings were chosen over specific financial ratios because the composite rating captures a bank's overall financial condition plus an assessment of management. Additional criteria were considered to ensure diversity in terms of geographic footprint, size, and business model. Ultimately, nine banks were included in the sample. To provide contrast, a control group of banks that became distressed was also identified. This group was composed of institutions with composite ratings of "1" or "2" at the beginning of the sample period that subsequently were downgraded to less than satisfactory.

## Description of the Interview Sample

The sample included banks from Virginia, Maryland, and West Virginia. Selected banks operate in rural, suburban, or urban footprints, providing exposures to different economic environments, local business concentrations, and degrees of banking competition. All of the institutions are community banks, but total assets for the third quarter of 2010 ranged from about \$150 million to almost \$4 billion, with a mean of \$1.5 billion.

Financial characteristics at certain periods — before (1Q2000-3Q2007), during (4Q2007-2Q2009), and after

<sup>2</sup> The CAMELS rating system for banks consists of a composite rating that is based on an evaluation and rating of six essential components of an institution's financial condition and operations. These component factors address the adequacy of capital, the quality of assets, the capability of management, the quality and level of earnings, the adequacy of liquidity, and the sensitivity to market risk. See SR Letter 96-38, "Uniform Financial Institutions Rating System."

(3Q2009-2Q2011) the crisis — were used for this case study. Statistics for banks included in the study (healthy banks) were compared with those for a sample of eight Fifth District institutions that lost their “1” or “2” rating during the same period (the control group).

The study found that, relative to troubled institutions, the healthy banks entered the sample period with less dependence on noncore funding and lower asset concentrations, most notably lower commercial real estate (CRE). While capital ratios were high in 2007, these banks did not enter the crisis with higher capital ratios than control group banks. Unlike the control group banks, however, the healthy banks emerged from the crisis with capital ratios that were only slightly lower than pre-crisis levels.

### Interview Format and Findings

Participating banks were asked to respond to questions from the following categories:

- Business model and strategy
- Unique market and/or customer features
- Senior management and leadership
- Risk management policies and procedures
- Credit administration and asset quality policies and procedures
- Capital and liquidity
- Post-crisis challenges

An explanatory letter and list of questions were mailed to bank management prior to each interview. Banks were asked to focus on the conditions before, during, and after the recession. In each case, the bank’s president or chief executive officer (CEO) was present, occasionally accompanied by other members of the senior leadership team.

Several common themes emerged. The most common was the presence of veteran senior management, coupled with a supportive and engaged board of directors. Six of the nine institutions discussed this attribute as important for success. Senior management at these institutions are veteran community bankers with long tenures at their current or previous banks. The interviews highlighted two key features of an effective governance structure. First, the board approves and supports the bank’s strategic plan, including the risk appetite. Second, the board is not involved in daily decision-making but is committed to carefully monitoring management’s execution of the strategic plan.

In general, successful boards in this sample are composed of individuals knowledgeable about the community and their own businesses and committed to the bank. One of the board’s main functions is to initiate opportunities for business development. Leading up to and during the crisis, it was important for boards to remain committed to the bank’s business plan and to allow senior management latitude to engage in timely reactions to issues without board approval. In all cases, senior management had implemented the bank’s business model before the real estate cycle began. As local

“The study found that, relative to troubled institutions, the healthy banks entered the sample period with less dependence on noncore funding and lower asset concentrations, most notably lower commercial real estate (CRE).”

real estate markets began to heat up, each bank resisted the temptation to change focus and dramatically ramp up acquisition, construction, and development (ADC) lending. The sample banks are committed to conservative business models. They emphasize relationship banking, detailed knowledge of their markets and customers, conservative underwriting coupled with detailed loan administration, careful growth plans, diversified balance sheets, and business opportunities that fit the bank’s expertise. Several CEOs indicated that they welcomed growth, but only if it could be done responsibly. The study revealed that asset growth at healthy banks was slightly slower than that for the control group during the pre-crisis and crisis periods.

Prior to and throughout the crisis, each bank maintained strong capital levels. Banks held pre-crisis capital for acquisitions and organic growth or as part of a relatively conservative overall business model. According to one CEO, “For

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# Upgrades to Supervisory Ratings for Community Banking Organizations

By Bob Rell, Senior Specialist, Federal Reserve Bank of Philadelphia

Banking is a dynamic industry and supervisory ratings should reflect this characteristic. It is important that supervisory ratings accurately reflect a bank's underlying financial performance, risks, and management effectiveness. A variety of internal and external factors can influence an individual bank's examination rating. Examiners carefully consider the most pertinent factors, rigorously discuss preliminary examination findings, and take a fair and thoughtful approach when making their final determinations.

The financial crisis and protracted recession exerted considerable stress on the financial condition of many banking organizations. At some institutions, asset quality deteriorated rapidly, internal risk management weaknesses that may have been hidden during more stable economic times emerged, and capital and liquidity positions faced unprecedented market pressures. Consequently, the safety and soundness ratings for these institutions were often downgraded. Some measure of the extent of downgrades can be gleaned from the number of "problem" commercial banks tracked nationwide. In the third quarter of 2007, there were 44 composite rating downgrades to a composite CAMELS rating of "3" or worse. The downgrade count swelled to 393 in the fourth quarter of 2009 and then gradually receded to 30 in the third quarter of 2012.

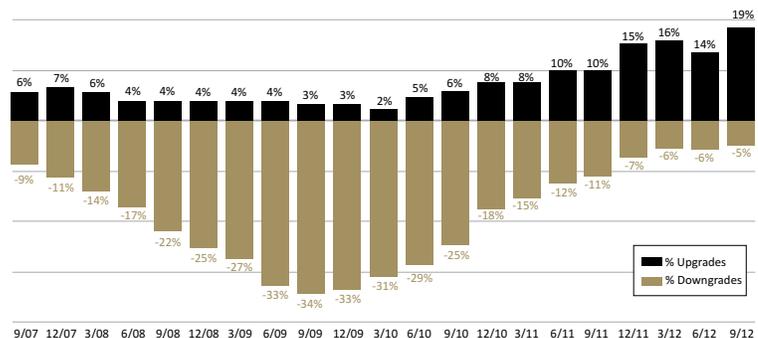
Significant improvement in bank performance tends to lag an economic recovery, in part because of troubled assets that remain on banks' balance sheets even after the recovery begins. As economic conditions have stabilized and started to improve, a cautious optimism about bank performance has emerged. Some notable improvement in bank ratings is already evident. For instance, as shown in the figure, a larger percentage of commercial banks received composite rating upgrades than received composite rating downgrades during examinations conducted in the past four quarters.

## Supervisory Guidance

In March 2012, the Federal Reserve Board issued Supervision and Regulation (SR) Letter 12-4, "Upgrades of Supervisory Ratings for Banking Organizations with \$10 Billion or Less in Total Consolidated Assets,"<sup>1</sup> to ensure that Federal Reserve examiners apply consistent standards for evaluating whether community banking organizations are eligible for supervisory rating upgrades. The guidance, which is primarily directed toward state member community banks,<sup>2</sup> was developed to ensure that timely upgrades occur when the banking organizations have made the requisite progress in addressing supervisory concerns.

While the guidance reiterates long-standing policies and practices, SR 12-4 goes on to delineate examiners' key considerations when assigning ratings in a period of stabilized or generally improving economic conditions, as well as to provide additional detail about the factors the Federal Reserve considers when evaluating whether an upgrade is warranted.

**Figure: Percent of Commercial Bank Examinations Each Quarter That Resulted in CAMELS Composite Rating Upgrade or Downgrade (downgrades are shown as negative percentages)**



Includes any change in composite CAMELS rating for all commercial banks nationwide; quarterly trends based on examination completion dates (mail dates); preliminary September 2012 figures.

Such factors include a demonstrated improvement in the organization's financial condition and risk management practices and indications of the likelihood that improvement will continue.

Notable factors that could substantiate an upgrade include evidence that:

- Key weaknesses that contributed to previous ratings have been addressed and risk management practices have been reinforced with appropriate policies. The board of directors should be actively engaged in the strategic review and oversight process and should ensure that deficiencies are corrected in a timely manner.
- Adversely classified and nonperforming assets are at manageable levels given the institution's capital levels and risk management practices, with evidence that the current level and improving trends are sustainable.
- Core earnings show improvement and sustainability, and management's projections and assumptions related to core financial factors are deemed reasonable.
- Capital levels, quality, and planning are commensurate with the organization's risk profile.
- Liquidity and interest-rate risk positions are generally

being managed prudently and in accordance with supervisory expectations.

The Federal Reserve will also consider whether the organization has demonstrated a sustained improvement in particular areas relevant to the organization's operation and financial condition as noted in reports of examination and condition.

Despite the recent turbulence the banking industry has endured, the financial system could emerge stronger and more resilient after the crisis, in part because of the steps that banks and supervisors are taking to address risk management and increase overall financial strength. As conditions continue to improve and bank performance trends and outlooks strengthen, the Federal Reserve strives to ensure that evaluations of community bank supervisory ratings are conducted thoroughly and consistently and that timely upgrades occur when warranted. ■

The author of this article, Bob Rell, passed away suddenly in August. Bob served as a senior specialist working for the executive vice president of the Supervision, Regulation and Credit Department of the Federal Reserve Bank of Philadelphia. Bob was a valued member of the department who made numerous contributions to the Reserve Bank's outreach program, including *Community Banking Connections*. Bob is greatly missed by his many friends and colleagues throughout the Third District and the System.

<sup>1</sup> See [www.federalreserve.gov/bankinforeg/srletters/sr1204.htm](http://www.federalreserve.gov/bankinforeg/srletters/sr1204.htm).

<sup>2</sup> While the factors discussed are particularly relevant for (but not exclusive to) state member community banks with consolidated assets of \$10 billion or less, they can be applied to other types of institutions supervised by the Federal Reserve.

## Community Banking Connections: More Than a Publication

*Community Banking Connections* is published each quarter to provide additional insight on recent supervisory and regulatory developments related to community banking and is delivered right to your front door or inbox. It provides news on regulations and supervisory guidance, policy updates, information about outreach programs at the various Federal Reserve Banks and the Board of Governors, and additional resources. Even more information is available on the *Community Banking Connections* website, located at [www.communitybankingconnections.org](http://www.communitybankingconnections.org). Users can also subscribe to the print or electronic version of the publication through the website.

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# The Importance of Effective Corporate Governance

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to conduct a material loss review. The purpose of these reviews is to determine, among other things, why problems at the bank resulted in losses to the DIF. In many of the recent reviews, the Office of Inspector General criticized failed banks' boards of directors and management for embarking on growth strategies without sufficient consideration of the risks involved and for not ensuring that these banks' risk management processes, internal controls, and capital were sufficient to mitigate the increased risk exposure.

The crisis therefore demonstrated that one consequence of a bank having weak corporate governance — the framework of rules and practices set by the board to ensure that the bank operates in a safe and sound manner — could be significant losses or even bank failure. The board of directors not only helps lay out the bank's risk limits and strategic goals but provides oversight as well. For that reason, I would like to spend the rest of this article talking about this important topic.

## Corporate Governance

Effective director oversight is crucial in any industry, but why is it the central element of a financially sound and well-managed bank? More specifically, what does effective corporate governance look like in a community banking organization?

Board and management oversight is the fundamental element of ensuring a safe and sound bank. Put another way, director oversight is the primary driver that keeps a bank moving in a positive direction, and it is a critical component of a bank's success. The Federal Reserve and other banking regulators have long recognized the importance of having strong director independence and collaborative board interaction. This is reflected in many supervisory policies and examination manuals used by examiners at the federal banking agencies.

Among the board's many responsibilities, four areas are especially crucial to the bank's successful performance:

1. Establishing the bank's **risk philosophy**, including both the aggregate level of risk and tolerance for risk;
2. Ensuring that the bank has an appropriate **risk management framework** to manage and mitigate risk;

3. Setting the bank on the right course by determining the bank's overall **business strategy**; and
4. **Monitoring** implementation of the strategy to ensure that the bank's strategic objectives are being accomplished within the parameters of its risk management framework

I will discuss the importance of these four primary responsibilities, followed by some additional thoughts regarding director qualifications, director independence, and how directors can enhance their overall understanding of supervisory expectations. Within the context of this discussion, I will share some examples that illustrate the types of questions directors should be asking to ensure that they are fulfilling the four key responsibilities noted above.

## 1&2: Risk Philosophy and Framework

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) provides a useful overview in a 2009 paper titled "Effective Enterprise Risk Oversight: The Role of the Board of Directors."<sup>1</sup> The paper notes that a key element of strategic goal-setting is first having a clear understanding of the organization's risk philosophy and making sure that the bank's risk appetite aligns with this philosophy. Because directors represent the views and expectations of the bank's shareholders and other key stakeholders, management should have an active and collaborative discussion with the board to establish a mutual understanding of the bank's overall risk appetite. Directors should inquire about existing risk management policies and practices and require management to demonstrate the effectiveness of those policies in identifying, assessing, and managing the bank's most significant risk exposures. In cases where the primary shareholders of the bank also hold senior management positions, the approach to discussions about risk philosophy and risk management may vary, but it remains the responsibility of all directors to ensure that strategic goals and risk management are properly aligned.

## 3: Setting Strategic Objectives

The COSO paper also notes that management is accountable to the board and that the board's focus on effective

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<sup>1</sup> Available at [www.coso.org/documents/COSOBoardsERM4pager-FINALRELEASEVERSION82409\\_001.pdf](http://www.coso.org/documents/COSOBoardsERM4pager-FINALRELEASEVERSION82409_001.pdf)

risk oversight should be applied within the framework of a strategy, formulating appropriate objectives and approving resource allocations consistent with effective implementation of the strategy. So an important question directors should ask is whether the bank's strategy is appropriate, clear, and convincing. Is it realistic and attainable? The board's responsibility is to make sure that the bank implements a strategy that is consistent with its risk philosophy and risk management framework and can be implemented by management and staff with sufficient expertise and resources. For example, prior to the crisis, we observed a number of community banks located in rural areas that elected to engage in a growth strategy by expanding into urban areas to increase commercial real estate lending. In many cases, this strategy was implemented without ensuring that the bank had adequate expertise to understand local and regional risks related to this new lending, which subsequently exposed the bank to a level of risk exceeding its internal risk tolerance.

#### **4: Monitoring Performance**

After establishing strategic goals and approving effective risk management policies, directors should receive ongoing information about how implementation of these goals and policies is working and make adjustments when needed. Periodic reviews of the bank's strategies and inherent exposure to risk by the board are necessary to understanding and assessing whether these strategies and exposures are consistent with the board's overall risk appetite. Risks are constantly evolving, so directors must receive timely and accurate information from management on key risk indicators in order for the board to effectively execute its fiduciary responsibilities and oversee the operation of the bank.

#### **Board of Directors**

Let me share some thoughts and provide some examples of why it is important to have qualified directors and an independent board. I will also briefly discuss some Federal Reserve resources that are available to help directors who want to improve their knowledge and qualifications.

#### **Director Qualifications**

Attracting and retaining qualified directors is a key component of maintaining an effective board. Although there is no one best set of minimum qualifications for directors, board members should be held to a high standard, and they should always keep the best interest of the bank in mind when establishing the strategic direction and risk management framework. Their ability to establish appropriate and effective policy guidance for the bank comes from having a

thorough understanding of the bank's risk appetite and risk management framework.

#### **Independence**

Directors should be objective, independent thinkers and should be able to bring their specific knowledge, expertise, and experiences to board and committee discussions. They should also be willing and able to challenge senior management if necessary on matters related to the bank's strategy and execution and should be willing to commit sufficient time and energy to their responsibilities as directors. By acquiring some knowledge about banking and the regulatory environment in which banks operate, board members are better able to successfully set strategic direction, establish appropriate risk management parameters and policies, understand concerns and issues that may be raised by bank supervisors, and determine criteria for assessing the performance of executive officers of the bank.

#### **Corporate Governance: Some Real-Life Examples**

One area that can be challenging is when the chairman of the board of directors or a member of senior management (e.g., the chief executive officer) has a domineering leadership style. This can be especially problematic if the bank is engaged in risky business activities without appropriate risk management and oversight. This leadership style may stymie effective board discussion, leading to slow identification of problems and development of solutions, which can exacerbate the severity of a situation. For example, some boards have allowed a dominant chief executive officer or board chairman to spearhead an aggressive or highly concentrated growth strategy without ensuring that the bank has appropriate risk monitoring, processes, or tools to adequately manage these risks.

Based on what we have seen over the past several years, some possible red flags that the board or management may be leading the bank in the wrong direction include: (1) an aggressive growth strategy, which may lead to a concentration of risk or an increase in existing concentrations; (2) slow reaction to dynamic market conditions and recent regulatory guidance; (3) rapid expansion into new markets without thorough due diligence and/or the commensurate level of expertise; and (4) lack of effective management information systems or robust risk assessment programs necessary to identify and control specific risk areas (e.g., risk concentrations).

A diverse board composition with a balance of expertise, skills, perspectives, and experiences can promote robust and

effective board interaction and can counter the influence of a dominant individual. Delineation between the responsibilities of the board and that of management is also important. It must be clear that the board sets direction and provides oversight and control, while management carries out board directives and manages the daily affairs of the bank. The board should ensure that it establishes a rigorous and robust compliance process that provides the board with the necessary information to ensure that the board and management fully understand the bank's objectives, risk appetite, and financial condition.

Even when a board is made up of a diverse group of individuals and when there is no dominant individual, we have observed through our bank examination and ongoing supervision activities that some directors are not sufficiently familiar with the business of banking. As a result, while their experience in other fields of business may provide them with a strong basis for skepticism and questioning, they may be hesitant to fully engage in discussions and decision-making. This can limit the effectiveness not only of the individual director but of the full board and the organization as a whole. In these cases, we strongly encourage directors to take advantage of training and tools that are available to help improve their knowledge and qualifications.

#### **Federal Reserve's Bank Director Training**

Recognizing the importance of having directors with appropriate skills and knowledge, the Federal Reserve System has

developed a number of resources to help directors understand their responsibilities and to develop their knowledge and skills. One of the Federal Reserve System's director training resources is the Bank Director's Desktop - A Federal Reserve Resource.<sup>2</sup> This online tutorial provides a primer on the duties, responsibilities, and key roles of bank directors.

In addition to the online desktop training, the Federal Reserve System also offers a book, *Basics for Bank Directors*, which is the basis for the online tutorial and provides more detail on banking, the Federal Reserve's approach to supervision and regulation, and the roles and responsibilities of bank directors.<sup>3</sup>

#### **A Few Final Thoughts**

I hope that directors will find my comments about their important responsibilities helpful, and I encourage all directors to take advantage of the Federal Reserve's director resources. Community banks have a vital role to serve in both our nation's economy and their local communities. In future issues of this publication, you will hear from many of my colleagues about their perspectives on the challenges and opportunities facing community banking organizations. ■

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<sup>2</sup> The online desktop training can be found at [www.bankdirectorsdesktop.org](http://www.bankdirectorsdesktop.org).

<sup>3</sup> Available online at [www.bankdirectorsdesktop.org/basics-for-bank-directors.cfm](http://www.bankdirectorsdesktop.org/basics-for-bank-directors.cfm)

## REGULATORY RECAP

### Supervision & Regulation (SR) Letters & Other Announcements

#### **SR Letters**

The following SR letters that have been published since the last issue of *Community Banking Connections* 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](http://www.federalreserve.gov/bankinforeg/srletters/srletters.htm) and by topic at [www.federalreserve.gov/bankinforeg/topics/topics.htm](http://www.federalreserve.gov/bankinforeg/topics/topics.htm).

**SR Letter 12-16/CA Letter 12-12**, "Interagency Statement on Restrictions on Conversions of Troubled Banks"

**SR Letter 12-15**, "Investing in Securities without Reliance on Nationally Recognized Statistical Rating Organization Ratings"

**SR Letter 12-14**, "Revised Guidance on Supervision of Technology Service Providers"

**SR Letter 12-13**, "FFIEC Statement on the Impact of Drought Conditions on Financial Institutions"

**CA Letter 12-13**, "Revised Interagency Examination Procedures for Regulation Z"

# Sound Risk Management Practices in Community Bank C&I Lending continued from page 3

personnel costs should be factored into the cost of any new or expanded C&I program.

A bank looking to expand its C&I lending portfolio should ensure that it is appropriately staffed at all levels to manage the risks inherent in this type of lending. This starts at the top of the organization, as chief credit officers should have proficiency in the risks of C&I lending in order to provide appropriate oversight to loan officers. Loan officers should understand the inherent risks and nuances of C&I lending in general. Moreover, institutions lending in niche areas — such as entertainment lending in Los Angeles or oil and gas lending along the Gulf Coast or in the emerging regional shale geographies — should also ensure that their lenders have expertise in the targeted niche. Moreover, small business lending should be considered a niche, with lenders needing deep knowledge about the risk patterns of small businesses and the requirements of guarantors, such as the Small Business Administration.

C&I lending requires a continually open, honest, and transparent business relationship between the lender and the borrower. Depending on the structure of the loan, the lender may have monthly, weekly, or even daily discussions with the borrower about draws, repayment plans, and business issues. While maintaining this close relationship, the lender should be careful not to become an advocate for the borrower's interests over those of the bank.

A full discussion of the appropriate skill set for a seasoned commercial lender is beyond the scope of this article.<sup>4</sup> However, at a high level, management should ensure that the commercial lenders have the skills to understand and critically analyze core elements of C&I loans, including:

- The operations and business cycles of the customer base
- Financial statements and financial metrics

- Cash flow analysis and projections, including sources and uses of cash and cash needs to replace depreciable assets
- Global cash flow for a closely held business or groups of related businesses/partnerships
- Liquidity sources for repayment
- Collateral valuation
- Loan structure and covenants that will protect the bank without unnecessarily constraining the borrower
- Appropriate advance rates on eligible receivables and inventory

## Policies and Procedures

As noted above, various sources, including the Federal Reserve's *Commercial Bank Examination Manual*,<sup>5</sup> provide general guidance on community bank lending policies. In addition to establishing growth and concentration parameters to mitigate risk, banks' boards of directors should set policies, such as those discussed below, that promote a successful C&I lending program. Exceptions to these policies should be reported to the board, and trends in exceptions should be analyzed to determine whether the volume and nature of exceptions are contributing to higher-than-desired C&I credit risk.

*Underwriting.* An important distinction between C&I lending and construction and land development lending (the focus of many community banks during the pre-crisis expansion) is that in C&I lending, cash flows from business operations are the primary means of debt service. Therefore, the focus of C&I underwriting should be on the ability of the business to generate cash flows through normal operations and maintain sufficient liquidity to service the debt. The loan should also be underwritten to ensure that there are two sources of repayment. The first source, as mentioned, should be from business cash flow that should be sufficient to make the contractual loan payments (which may be interest-only in the case of a line of credit, or principal and interest in the

<sup>4</sup> National and local bankers associations offer or provide information on programs to build or validate a C&I lender's skill set. Other organizations provide analytical information that could help lenders better understand the risks inherent in specific industries.

<sup>5</sup> For example, see section 2040, Loan Portfolio Management, and section 2080, Commercial and Industrial Loans, in the Federal Reserve's *Commercial Bank Examination Manual* at [www.federalreserve.gov/boarddocs/supmanual/cbem/cbem.pdf](http://www.federalreserve.gov/boarddocs/supmanual/cbem/cbem.pdf).

case of term financing). Underwriting the second source of repayment should ensure that the liquidation of the collateral will repay any remaining principal balance if the primary source of repayment is insufficient.

*Collateral.* The liquidation of collateral — typically accounts receivable, inventory, and property, plant, and equipment — is the primary source of principal repayment if the borrower defaults. Therefore, the institution should develop policies that encourage the proper monitoring and valuation of collateral and should also establish acceptable loan-to-value ratios based on the type of collateral. As many C&I lenders have learned, there can be a high risk of fraud with these types of collateral. For example, inventory and equipment can be easily moved and accounts receivable can become uncollectible. C&I lenders should understand the nuances of accepting this type of collateral and have the experience to appropriately evaluate its worth and secure the bank's priority lien position in the event of default.

*Covenants.* Loan covenants can provide an early warning system for emerging problems. A complete discussion of covenants is beyond the scope of this article, but some highlights are worthy of consideration.

A C&I lender should tailor the loan covenants and documentation to appropriately match the borrower's business and risk profile. While loan covenants should be aligned with the borrower's financial condition and projections, the loan policies should require certain covenants for all C&I loans and provide optional covenants to be applied at the lender's discretion, with a mechanism for prior review of exceptions when warranted. Further, because of the protective nature of covenants, community bank C&I lenders are strongly discouraged from making "covenant-lite" loans, as those loans increase the bank's longer-term risk despite the current creditworthiness of the borrower.

Covenants can take various forms, but most relate to either the operation of the business or the maintenance of financial measures. Some covenants may require a borrower to take certain steps (affirmative covenants), while other covenants may prohibit a borrower from taking particular actions (negative covenants). When the lender drafts the covenants, it is important to ensure each one meets a defined objective. Broadly, financial covenants are generally structured to (i) maintain cash flow, (ii) preserve asset quality, (iii) control growth and leverage, and (iv) maintain the borrower's net worth. Nonfinancial, or operational, covenants are generally

designed to (i) require full and timely disclosure about the borrower's operations and financial position; (ii) maintain management commitment and quality, which could include personal guarantees by key members of management; and (iii) ensure the continued viability of the borrower's operations.

However, despite the value of covenants, they are no substitute for a C&I lender's ongoing monitoring, analysis, and anticipation of emerging problems.

*Remediation.* Despite a bank's best efforts, borrowers may experience financial difficulties. Lending policies and individual loan documents should establish a remediation framework that permits certain actions in the event of a covenant violation or any other event of default. A well-structured

“Covenants can take various forms, but most relate to either the operation of the business or the maintenance of financial measures.”

remediation framework should provide the bank with the flexibility to ensure that its interests are protected. Consequently, one focus of credit administration should be on enforcing covenants through default letters and imposition of default interest rates. While covenant forbearance (which is temporary) or covenant waivers (which are permanent) may be appropriate in certain circumstances to both protect the bank's interests and ensure the viability of the business, granting forbearance should be considered carefully, and granting covenant waivers should be the exception rather than the norm. The bank's response to any covenant violation, whether enforcing the covenant or granting forbearance or waiver, should be communicated promptly to the borrower in writing to preserve the bank's rights under the loan agreements.

*Pricing.* Setting an appropriate interest rate and appropriate fees for C&I loans is both an art and a science. It is an art, since the pricing is expected to reflect the lender's judgment about a myriad of risk factors unique to the borrower's busi-

ness and the purpose and terms of the credit. Yet, it must also be a science to ensure that the institution receives an appropriate risk-adjusted return for its shareholders. Without consistently applied interest rate and fee pricing parameters and centralized monitoring of all C&I loan proposals, individual lenders could make inconsistent pricing decisions, often to the detriment of the borrower and the bank.

Pricing C&I loans based on competitors' pricing may generate volume, but at the potentially steep cost of insufficient compensation for higher risk. In fact, the comparative advantage of a community bank C&I lending program may not be price, but instead the personal service that a community bank credit team can provide.

*Exit Strategy.* Acknowledging that defaults will occur, management should identify a strategy to exit nonperforming C&I loans. In the recent financial crisis, community banks often found it difficult to quickly and profitably dispose of CRE acquired when a real estate borrower defaulted. However, it can be even more difficult to secure and then dispose of accounts receivable, inventory, or property and equipment acquired when a C&I borrower defaults. Often, a community bank may find that an effective exit strategy for C&I collateral involves third-party vendors, such as factoring companies that specialize in this area.

### Monitoring and Reporting

Bank management should develop reporting to track specific elements of C&I lending, such as accounts receivable and inventory valuation at the individual loan or line level, over-credit-line reporting, as well as C&I sub-category reporting. C&I sub-category reporting is particularly helpful in assessing concentrations in C&I lending. Given the variety of industries, business cycles, and collateral in a community bank's C&I portfolio, measuring concentrations at the sub-category level will provide management with better indicators of concentration risk.

Internal and external loan review, as well as internal audit, should provide assurance that C&I loans are underwritten in accordance with policy, that credit administration activities are timely and comprehensive, and that emerging portfolio issues are identified promptly. A bank may choose to focus its review efforts on C&I loans originated in the previous 12 months, those with larger-dollar credit exposures, borrowers with a history of frequent delinquencies, and borrowers with a history of covenant violations. Bank management may also need to consider outsourcing some

aspects of internal audit if current audit staff does not have sufficient experience to audit C&I lending activities.

Information gleaned from monitoring and reporting will also be helpful in establishing appropriate provisions for losses on C&I loans. Management should review the *Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)* for guidance on establishing appropriate ALLL levels when entering into new lending areas for which historical loss information may not be available.<sup>6</sup>

Finally, management should consider performance expectations for the C&I sub-categories and for the portfolio as a whole under more adverse conditions.<sup>7</sup> For example, if management determines that a large proportion of its borrowers provide products and services to one large business, a scenario analysis may assess the impact on the portfolio if the large business were to experience financial difficulties.

### Closing

While this article touched on some of the risk management factors that bank management should consider when entering or expanding a C&I lending program, it is not a comprehensive list. Each community bank will likely identify different gaps in its staffing, policies and procedures, or monitoring and reporting that need to be addressed. However, if a community bank's management and board of directors determine that C&I lending is an appropriate and viable business strategy, management should implement a plan to mitigate the identified gaps and establish appropriate controls before making the first loan.

The Federal Reserve has been very clear that bank lending to creditworthy borrowers plays an important role in the ongoing economic recovery. To avoid a repeat of the factors that contributed to the financial crisis, however, both bank supervisors and banking organizations should ensure that prudent underwriting practices are maintained throughout the credit cycle and that underwriting standards are not compromised by competitive pressures, investor demands, or the desire for rapid growth or increased market share. ■

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<sup>6</sup>See SR Letter 06-17, "Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)," at [www.federalreserve.gov/boarddocs/srletters/2006/SR0617.htm](http://www.federalreserve.gov/boarddocs/srletters/2006/SR0617.htm).

<sup>7</sup>See the interagency *Statement to Clarify Supervisory Expectations for Stress Testing by Community Banks*, press release, May 14, 2012, at [www.federalreserve.gov/newsevents/press/bcreg/20120514b.htm](http://www.federalreserve.gov/newsevents/press/bcreg/20120514b.htm).

# Weathering the Storm: A Case Study of Healthy Fifth District State Member Banks over the Recent Downturn

*continued from page 5*

community banks, capital is king.” He and his board do not focus on the return to equity when managing the bank. Others mentioned the reputational enhancement that derives from strong capital, noting that their institutions benefitted during the downturn because of the public’s perception of their strength. These banks enjoyed significant deposit inflows and growth opportunities due to the strength of their balance sheets relative to those of competing community banks.

The healthy banks entered the crisis with strong, but not unusually high, capital ratios. Compared with the control group, there was no statistically significant difference between capital levels. However, capital levels should be assessed relative to an institution’s risk exposures. The healthy banks adopted conservative business models with comparatively low levels of risk on their balance sheets.

Perhaps the most widely reported characteristic of the healthy bank sample was the significant time and resources devoted to monitoring credit quality. The chief executive officers (CEOs) generally attributed their low levels of delinquencies to detailed and careful underwriting and credit administration. One CEO described his bank’s credit policy as “just blocking and tackling, fundamental community banking.” Several described their institutions as relationship banks. Another CEO described in detail the customer service that makes his bank a “high-touch bank.” His customers expect frequent contact from the bank, and one advantage of that model is on the credit side.

The healthy banks appear to understand well the behavior of their customers, their customers’ businesses, and their local markets. In contrast, they are reluctant to participate in markets or offer products that they do not understand. They lend aggressively in markets where they have expertise and relationships but generally resist opportunities in other business lines or markets where they lack detailed knowledge.

These banks also maintain a culture where problems are acknowledged immediately and dealt with aggressively.

These institutions were not immune to credit issues in the downturn. The key was how they dealt with problems. One bank formed a special assets group to deal with its impaired loans, implemented new and enhanced risk management practices, and adopted an aggressive loan modification policy. This same bank successfully managed to quickly repair asset quality and cover losses through earnings without depleting capital.

Healthy banks reported a commitment to diversification across the balance sheet. In several cases, banks insisted on tying business relationship lending to receiving the clients’ transaction accounts. In addition to providing sources of low-cost and stable funding, one banker acknowledged that this arrangement allows better monitoring of client cash flows. In all but one case, healthy banks’ local markets exhibited relatively low degrees of economic cyclicity and provided a relatively strong base for business opportunities. While for some banks the surrounding communities did experience rapid real estate growth, the healthy banks adopted business models that allowed them to have limited exposure to the ensuing downturn.

A final common characteristic is an emphasis on a strong management team and staff. CEOs described training efforts to create both a culture and the specific expertise required to successfully implement the bank’s strategies. Many of these banks work hard to recognize when staff limitations make it necessary to hire experience from outside. During the downturn, two banks hired staff with real estate finance backgrounds to manage losses and improve credit administration. Several CEOs reported hiring loan officers from larger competitors to bring both expertise and business relationships.

While these institutions have been relatively successful, CEOs also described several concerns about the future of community banking. Among those most commonly expressed were severe earnings pressures, difficulty in achieving or maintaining asset diversification, regulatory overload relative to staff size and expertise, growth challenges, and

management or director fatigue. Most CEOs also anticipate future community bank consolidation, speculating that community banks will need to merge to become attractive acquisition targets or to achieve competitive scale.

## Implications

Several implications emerged from the interview responses. Most important, the healthy banks have strong management and effective boards that support and monitor management's strategies. Although these banks have conservative business models, they were not immune to losses during the crisis and downturn. However, effective governance structures enabled these institutions to quickly address supervisory findings and emerging credit issues.

Banks in the interview sample are committed to controlled growth strategies while maintaining diversification on both sides of the balance sheet as well as across markets and customers. The strategies that made these institutions successful are very different from those of the control group. Those institutions had rapid growth strategies and significant CRE

concentrations. Risk management at control group banks was inadequate, given the increased risk profile. Institutions shouldn't wait to implement risk management processes appropriate to their exposures. The time to act is in good economic times when a bank's financial results are sound. Additionally, credit culture is central to the organization. Not all of the healthy banks completely avoided CRE and ADC, but they mitigated risk through detailed underwriting and credit administration.

Finally, capital adequacy must be considered relative to a bank's risk profile. Healthy banks had strong regulatory capital ratios but not substantially higher than those of peers. However, relative to risk exposures, these banks were truly well capitalized. Concentrations are inherently risky, even in asset classes that appear to be safe or offer attractive earnings. Supervisors expect to see some combination of enhanced risk management practices, explicit risk mitigants, or higher capital levels at institutions with large asset concentrations or otherwise risky profiles. Again, the time for these to be in place is prior to a downturn. ■

# FEDLINKS

Connecting Policy with Practice

The Federal Reserve is pleased to introduce a new communication tool targeted at community banking organizations: *FedLinks: Connecting Policy with Practice*. *FedLinks* is a single-topic bulletin prepared specifically for community banks. 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 targeted for use by banks and bank holding companies with total assets of \$10 billion or less and 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 first *FedLinks* bulletin, "Risk Management Supervisory Expectations for Agricultural Credit Risk," is now available at [www.communitybankingconnections.org/fedlinks.cfm](http://www.communitybankingconnections.org/fedlinks.cfm). This bulletin discusses risk management practices that supervisory staff consider in assessing the adequacy of a banking organization's risk management of agriculture-related exposures. Guidance on this topic is provided in Supervisory and Regulation (SR) Letter 11-14, "Supervisory Expectations for Risk Management of Agricultural Credit Risk" ([www.federalreserve.gov/bankinfo/srletters/sr1114.htm](http://www.federalreserve.gov/bankinfo/srletters/sr1114.htm)).

*FedLinks* bulletins can be found on the *Community Banking Connections* website. Users can also subscribe online at [www.communitybankingconnections.org/subscribe.cfm](http://www.communitybankingconnections.org/subscribe.cfm) to receive an e-mail notification when new *FedLinks* bulletins become available.

# Outreach Connections

The Board of Governors and the Federal Reserve Banks reach out to community banks through various programs and resources. In addition to live hosted events, many of these programs and resources are available online. Following is an overview of just a few of these outreach programs, with links to access more information or to subscribe.

## Consumer Compliance Outlook and Outlook Live — Consumer



*Compliance Outlook* is a quarterly Federal Reserve System publication dedicated to consumer compliance issues. In addition to the publication, the System hosts *Outlook Live*, a

popular webinar series that digs deeper into consumer compliance topics of interest. Each webinar is archived for future reference. *Consumer Compliance Outlook* and *Outlook Live* are available at: [www.consumercomplianceoutlook.org](http://www.consumercomplianceoutlook.org).

## Emergency Communications System (ECS) — The Emergency



Communications System (ECS) is a free tool used by state regulators and the Federal Reserve to communicate with financial institutions during emergency situations (storms, fires,

disasters, and major events affecting the financial industry). The service allows these agencies to quickly contact you and provide pertinent regulatory information in a timely manner. To learn more, contact the ECS Support Center at 877-327-5333 or [ecs.support@stls.frb.org](mailto:ecs.support@stls.frb.org). To register, visit [www.stlouisfed.org/ecs](http://www.stlouisfed.org/ecs).

# Connecting with You

What banking topics concern you most? What aspects of the supervisory process or the rules and guidance that applies 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.communitybankingconnections.org/contact.cfm](http://www.communitybankingconnections.org/contact.cfm).



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