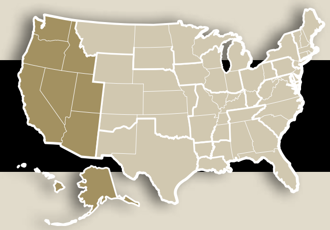
FEDERAL RESERVE SYSTEM

COMMUNITY BANKING
CONNECTIONS™
A SUPERVISION AND REGULATION PUBLICATION

First Quarter 2013



View from the District
A Twelfth District Perspective — San Francisco

Considerations When Introducing a New Product or Service at a Community Bank

by Teresa Curran, Senior Vice President and Banking Supervision and Regulation Division Director, Federal Reserve Bank of San Francisco

When I meet with community bankers in the 12th District — which encompasses Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah, and Washington — one recurring theme in our discussions is the challenge of maintaining core earnings. With today's low interest rates, community bankers must frequently look beyond the margin or spread. Cutting costs or raising fees on existing services, however, can only go so far. Consequently, many community bankers are rethinking business strategies and are developing new products and services.

Traditionally, new products and services have offered great opportunities for community bankers to innovate, connect with their customers, and provide value-added service. Choosing the right product or service for the institution and its customers, however, can be easier said than done. We have found that successful management teams and boards of directors typically identify and mitigate risks before considering and introducing new products and services. When risk is not identified and mitigated in advance, the unintended consequences can be costly to resolve. In this article, I will discuss some factors that management and the board should take into consideration before introducing a new product or service. In particular, I will highlight a few areas where an ounce of new product planning may be worth more than a pound of cure.

The Repeatable Process

Management teams that successfully identify and roll out new products and services typically have a documented, repeatable, and auditable process to guide their decision making. In practice, this often means that the board approves and the management team follows comprehensive new product policies and procedures, documents decisions sufficiently, and ensures that all relevant functions within the organization appropriately engage with one another.


Teresa Curran

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Effective Asset/Liability Management: A View from the Top*

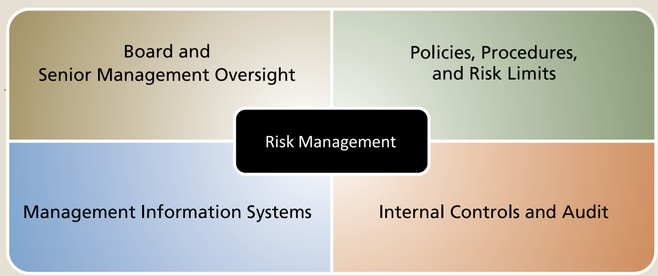
By Doug Gray, Managing Examiner, Federal Reserve Bank of Kansas City

"With growing cash balances and ever-declining interest rates over the past several years, the banking industry's net interest margins have trended downward, exhibiting some volatility."[1] While this quotation could certainly come from any banking publication today, the statement is actually from a paper published in 2005 that discusses balance-sheet management at community banks. Today, community banks are encountering some of the same challenges they faced nearly a decade ago: sizable cash balances, low interest rates, and reduced loan demand. The words of radio news broadcaster Paul Harvey seem appropriate: "In times like these, it helps to recall that there have always been times like these." However, simply acknowledging that these challenges have persisted does not help institutions respond to them. Rather, each community bank should have its board of directors' and its senior management's "view from the top" to effectively lead it through these challenging asset/liability management (ALM) times.

In general, ALM refers to efforts by a bank's board and senior management team to carefully balance the bank's current and long-term potential earnings with the need to maintain adequate liquidity and appropriate interest rate risk (IRR) exposures. Each bank has a distinct strategy, customer base, product selection, funding distribution, asset mix, and risk profile. These differences require that assessments of risk exposures and risk management practices be customized to each bank's specific risks and activities and not take a one-size-fits-all approach.

Regulatory Assessment of Asset/Liability Risk Management

Regulators assess risks and risk management activities in four broad categories, reflected in the figure below. This article will discuss two of these key aspects as they relate to ALM: 1) board and senior management oversight, and 2) policies, procedures, and risk limits.



* This is the second in a series of three articles on asset/liability management. Please see the first article "Interest Rate Risk Management at Community Banks" in the Third Quarter 2012 issue of *Community Banking Connections*.

[1] Todd Taylor and Sasha Antskaitis, "Balance Sheet Management for Community Banks," *Bank Accounting & Finance* (December-January 2005), p. 29.

Community Banking Connections is published quarterly and is distributed to institutions supervised by the Federal Reserve System. Current and past issues of *Community Banking Connections* are available at www.communitybankingconnections.org. Suggestions, comments, and requests for back issues are welcome in writing (donna.gulle@phil.frb.org) or by telephone (215) 574-3417.

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Board Oversight

In 1995, the Federal Reserve Board issued risk management guidance that emphasized that each bank's board is ultimately responsible for the bank's condition and performance.[2] Interagency guidance and policy statements issued since that time have reinforced the principle that although bank directors can delegate certain activities, they retain ultimate responsibility.

Effective oversight requires the board of directors to rely on sound ALM. Because ALM is complex, some bank directors might find overseeing interest rate and liquidity risks challenging. Senior management typically provides the board with information derived from IRR or liquidity models that contain general assumptions and produce output reports. Much of this information is driven by very detailed "behind-the-scenes" model inputs and assumptions. As a result, the directors' review is generally limited to monitoring exposures through key model output reports and measures but with little knowledge of the assumptions behind or limitations of those measures. While being able to quantify and monitor risk positions is important for sound oversight of balance-sheet exposures, effective board oversight requires more than simply evaluating model outputs; it also requires a broad perspective on all business lines and products, strategic goals, and risk management.

Board oversight should include:

- *Understanding Risks.* Through policies, reporting mechanisms, and discussions at board meetings, bank directors should demonstrate that they clearly understand the risks inherent in the institution's ongoing activities. Directors should also question senior management about risks and risk management costs presented by new activities and deliberate about the risk/reward trade-offs.
- *Providing Appropriate Guidance.* The board sets the tone and communicates the risk tolerance for the organization. Risk tolerance, including quantitative risk limits and definitions of permissible and impermissible activities, should be communicated so that the board, senior management, and other bank personnel clearly understand the bank's risk thresholds and approach to managing the effects of balance-sheet exposures on capital and earnings. This is most frequently accomplished by establishing appropriate policies and risk limits, which is discussed in greater detail later in this article.
- *Monitoring Exposures.* Once the risks inherent in the institution's activities are recognized and guidance is provided to staff, directors should require that senior management report risk exposures on a timely basis. In community banks with low IRR or liquidity risks, the board should review risk reports at least quarterly. However, in community banks with high IRR or liquidity risks, the board, or a designated committee, should review risk reports more frequently.

  Board reports should also be meaningful to the directors in their risk oversight role. For example, many IRR models have been developed to provide detailed quantitative data. However, some of this information is more meaningful to the senior managers evaluating daily activities than to the directors overseeing institutional risks and setting strategic direction. To be useful, board ALM reports should be timely, accurate, and appropriately detailed and should clearly note any noncompliance with bank policies. While directors should understand, at a high level, the assumptions made and any weaknesses in the models used to produce the reports, they do not need a detailed understanding of all the nuances or model mechanics. Too much or too little information, along with the wrong kind of information, can hamper the board's ability to effectively steer the institution through the sea of IRR and liquidity risks.
- *Making Personnel Decisions and Delegating.* Many community bank directors are specialists in fields outside of banking and likely lack a background in ALM issues and other risk areas. However, most community bank boards recruit key managers who possess the expertise necessary to effectively administer risk management activities. Bank directors also have the opportunity to allocate time and funding to train and develop individuals who need enhanced knowledge in balance-sheet risk management commensurate with the bank's risk exposure. Once key personnel are identified and developed, the board may confidently delegate daily risk oversight to these capable managers.

Senior Management Activities

In many cases, the board delegates routine oversight of balance-sheet risks to a committee of senior managers known as the Asset and Liability Management (ALM) Committee or the Asset and Liability Committee (ALCO). A commu-

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[2] See Supervision and Regulation (SR) Letter 95-51, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies," available at www.federalreserve.gov/boarddocs/srletters/1995/sr9551.htm.

Reversing the Trend: An Examiner's Thoughts About Negative Provisions and the ALLL

By Stephen Wheatley, Portfolio Manager, Federal Reserve Bank of Chicago

As the industry emerges from the financial crisis and estimates of the allowance for loan and lease losses (ALLL) have declined, some banks have begun reporting "negative provisions." This article discusses accounting for negative provisions and how Federal Reserve examiners evaluate the appropriateness of negative provisions.

What Is a Negative Provision?

In its basic form, a negative provision occurs when the allowance estimate at quarter-end is lower than the allowance per the general ledger. For example, assume that a bank has an ALLL balance of $150,000 at the end of November. In December, the ALLL methodology indicates that a lower balance of $125,000 is appropriate because of an improved economic environment, improved asset quality, and lower historical loss rates. In this case, the bad debts expense or provision would be ($25,000).

Negative provisions are not new. During the economic expansion from 2004 to 2007, many institutions recorded negative provisions. More recently, some community banks have also begun recording negative provisions.

Why Are Banks Reporting Negative Provisions?

Banks are reporting negative provisions because estimates of the allowance are declining. The decline in credit risk — as evidenced by declining charge-offs, declining delinquency rates, and declining adversely classified assets — coupled with improving economic indicators may have resulted in lower ALLL estimates. As shown in Figure 1, classified asset ratios at banks with total assets of less than $1 billion began to stabilize and decline beginning in mid-year 2011 (black line).[1] And as the volume of assets with the more severe classification ratings of "doubtful" and "loss" has declined, the weighted classifications ratio (gold line) has also improved.[2]

How Many Institutions Have Reported Negative Provisions?

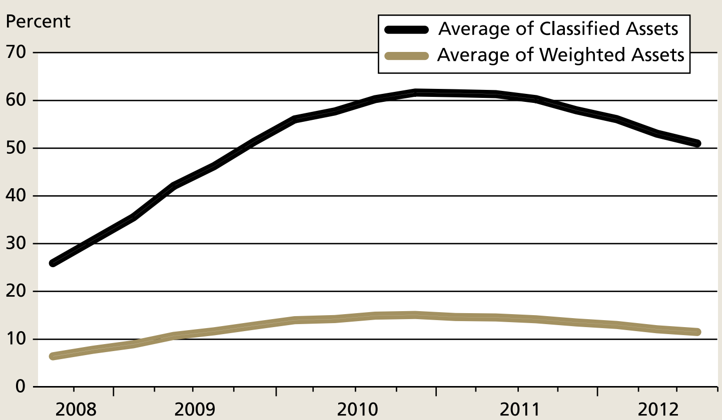
As shown in Figure 2, the number of banks under $1 billion in total assets recording negative provisions began to increase in 2010, with the trend continuing through the third quarter of 2012. At the end of 2010, only 56 banks, or 0.91 percent of banks, recorded a negative provision, but the proportion quickly increased to 178 banks, or 2.89 percent, as of the third quarter of 2012. At the same time, the number of banks incurring zero provisions increased dramatically beginning in late 2010 and into 2012. During 2010, 412 banks, or

[1] Classified assets are the sum of watch list loans or investments graded "substandard," "doubtful," and "loss" divided by the sum of the bank's tier 1 capital and ALLL. Bank examination data are based on the "as-of" date.

[2] Problem loans are weighted according to their severity. The weighted sum is divided by the sum of the bank's tier 1 capital and ALLL.

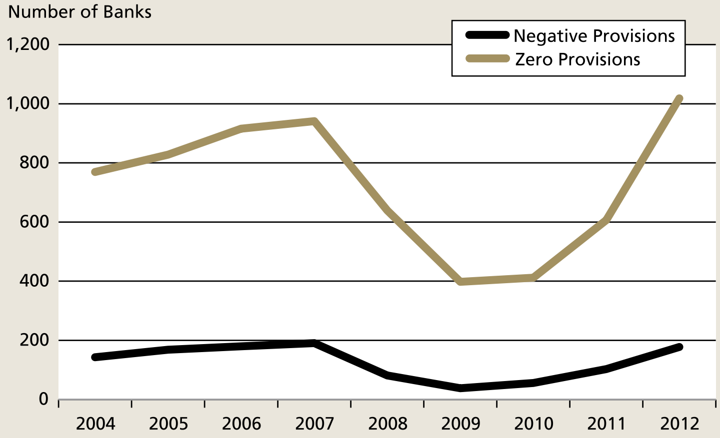
Figure 1: Classified Assets Ratio

Size: All Banks < $1 Billion (through 3rd quarter 2012)



Source: Supervisory Examination Reports

Figure 2: Banks with Negative and Zero Provisions
Size: All Banks < $1 Billion (through 3rd quarter 2012)



Source: Call Report Data

6.68 percent of the banks sampled, reported zero provisions (as illustrated in Figure 2), which almost tripled to 1,018 banks, or 16.51 percent of banks, as of the third quarter of 2012.

Is It Acceptable to Record a Negative Provision?

Lowering the ALLL through a negative provision is permitted under generally accepted accounting principles (GAAP). Accounting standards for loan losses allow banks to reduce reserves through negative provisions, and regulators are not opposed to the practice provided that the decision is well supported. When reviewing negative provisions, examiners focus on the appropriateness of the decision in light of the many factors that should be considered in estimating the allowance.

Under GAAP, changes in estimates are not considered errors. Rather, changes in estimates are accounted for in the period in which the estimate changes. Adjustments to the ALLL simply reflect changes in estimates, which in certain situations may need to be accomplished by booking a negative provision.

During each examination or as part of ongoing monitoring, examiners will evaluate whether a bank's ALLL methodology and the supporting loan review systems and other controls are effective in determining and maintaining an appropriate ALLL. Examiners will evaluate whether the bank has: a) reliable loan review systems and other controls providing effective identification of credit risk, b) an acceptable methodology and process that meet GAAP and interagency supervisory guidance, and c) documentation that demonstrates reasonable and properly supported assumptions, including analysis of significant environmental factors.

In the event a bank reports lower allowances through negative provisioning, examiners will review documentation justifying the bank's decision, including peer analysis conducted by the bank and board minutes. Documentation should describe changes to loan ratings, impairment measurements, loss rates, and environmental factors that have led to reductions in the allowance. Examiners will ensure that management's assumptions surrounding the environmental factors and asset quality (such as lower charge-offs and nonperforming loans) are reasonable and supportable and that the decision to take a negative provision was not made to provide an artificial boost to earnings. Examiners may also hold discussions with the bank's external auditors.

Expectations for improving credit quality should be based on sustained trends, and changes to the ALLL should be consistent with trends in credit risk (such as the level of nonperforming loans, loan grading migration, and new additions to the watch list). Examiners would have concerns if allowance levels are declining while the level of credit risk is still elevated and a large pipeline of watch list credits is still evident.

Other red flags that may concern examiners include:

- Abrupt and significant changes in environmental factors that are not directionally consistent with observable data or adjustments to impairments that are not based on current collateral valuations or otherwise supportable;
- Upgrades in loan ratings where the borrower's financial circumstances have not changed or the terms of the loan are not materially altered to improve collectability;
- Inappropriate removal of large losses from the bank's loss history when calculating historical loss rates on groups of loans;

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Confidential Supervisory Information Disclosure Rules

Community bankers routinely handle confidential and sensitive information. Typically, confidential information is related to the institution's own books and records or information about its customers, shareholders, or employees. However, there is another category of confidential information that requires special treatment: supervisory ratings and other nonpublic supervisory information.

The federal banking agencies have long-standing rules that address the disclosure of confidential supervisory information. To remind institutions of the importance of protecting this information, on February 28, 2005, the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (the agencies) issued the *Interagency Advisory on the Confidentiality of the Supervisory Rating and Other Nonpublic Supervisory Information*.[1] As noted in the advisory and the relevant rules and regulations, except in very limited circumstances, financial institutions are prohibited by law from disclosing their CAMELS or RFI rating and other nonpublic supervisory information to nonrelated third parties without written permission from the appropriate federal banking agency. This includes prohibitions on disclosure to insurers that are underwriting directors and officers liability insurance coverage, potential buyers, and consultants (other than certain certified public accountants or legal counsel, discussed below) engaged by the financial institution for any purpose not specifically permitted by regulation, as well as disclosure in response to a private litigant subpoena.

The Board of Governors of the Federal Reserve System (Board) has published rules regarding the disclosure of confidential supervisory information by financial institutions supervised by the Federal Reserve. These rules are published in the Code of Federal Regulations at Subpart C of 12 C.F.R. Part 261, *Rules Regarding Availability of Information*.[2] The rules provide that any supervised financial institution lawfully in possession of confidential supervisory information may disclose such information to its directors, officers, and employees and to its parent holding company and its directors, officers, and employees. In addition, the supervised financial institution may also disclose such information to any certified public accountant or legal counsel that it employs, subject to certain conditions.[3]

Any person who is not included in the class of permissible recipients in 12 C.F.R. §261.20(b) and who seeks access to confidential supervisory information about a state member bank, a bank or financial holding company, a savings and loan holding company, or another entity supervised by the Federal Reserve must file a request for disclosure with the general counsel of the Board, following the requirements set forth in 12 C.F.R §261.22. From a practical perspective, the institution may choose to coordinate the communication with the Board's general counsel through the local Reserve Bank. Further, if an examination is conducted jointly with state banking regulators, the report of examination is owned jointly by both regulators. Therefore, written permission to disclose confidential supervisory information about that examination must be obtained from the state banking department in addition to the Board.

As an initial response to a request for confidential supervisory information, financial institutions that receive such requests should consider referring requesters to publicly available information that may address the request. This could include, for example, any of the following:

- Quarterly regulatory reports filed with the agencies, such as the Call Report for banks or the FR Y-9C report for bank holding companies
- The Uniform Bank Performance Report (UBPR), which is available on the FFIEC's website at www.ffiec.gov/ubpr.htm
- Publicly available filings, if any, filed with the appropriate federal banking agency or with the Securities and Exchange Commission

[1] The complete interagency advisory is available in SR Letter 05-4, "Interagency Advisory on the Confidentiality of Nonpublic Supervisory Information," on the Federal Reserve's website at www.federalreserve.gov/boarddocs/srletters/2005/SR0504.htm.

[2] See 12 C.F.R. Part 261 at the U.S. Government Printing Office's website at www.gpo.gov/fdsys/pkg/CFR-2012-title12-vol4/pdf/CFR-2012-title12-vol4-part261.pdf.

[3] See 12 C.F.R. §261.20(b) at www.gpo.gov/fdsys/pkg/CFR-2012-title12-vol4/pdf/CFR-2012-title12-vol4-sec261-20.pdf.

- Reports and documents maintained in the financial institution's public Community Reinvestment Act (CRA) file
- Reports on or ratings of the institution compiled by private companies that track the performance of financial institutions or issue ratings on public debt issued by an institution
- Information on formal enforcement actions, as reported on the agencies' websites
- Any reports or other sources of information on an institution's performance or internal matters created by the institution that do not contain information prohibited from release by law or regulation

Institutions supervised by the Federal Reserve should contact their primary contact for banking supervision matters at their local Reserve Bank for additional information on applying the interagency advisory and 12 C.F.R. §261.20. ■

Disclosing Confidential Information

OK to Disclose

- Directors, officers, employees
- Parent company directors, officers, employees
- Certified public accountant (subject to limitations)
- Legal counsel (subject to limitations)

Check with Appropriate Agency

- Insurers
- Creditors
- Shareholders
- Customers
- Rating agencies
- General public
- Potential acquirers

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.

Bank Director's Desktop — This online course is a primer on the duties, responsibilities, and key roles of bank directors. It is an excellent tool for new directors who want to learn more about what is expected of them in their new role, and it is also useful for seasoned directors who want to refresh themselves on different elements of their role. This resource is designed to provide insight into current supervisory expectations, promote proper risk management practices and internal controls, and build core skills needed to fulfill the obligations of a bank director in a rapidly changing industry. It is available at: www.bankdirectorsdesktop.org/.

Consumer Compliance Outlook* and *Outlook Live — *Consumer Compliance Outlook* is a quarterly Federal Reserve System publication dedicated to consumer compliance issues. The online version of the publication is available at www.consumercomplianceoutlook.org. 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. *Outlook* and *Outlook Live* are available at: www.consumercomplianceoutlook.org.

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.communitybankingconnections.org/feedback.cfm.

Considerations When Introducing a New Product or Service at a Community Bank *continued from page 1*

Management and the board are wise to assess the sufficiency of their new product policies and procedures. They may want to consider whether these policies:

- require management and staff from various functions — including compliance, accounting, risk, internal audit, and line management — to vet, review, and recommend new products and services for senior management or board approval;
- cover the investigative stages of new products and services as well as the approval and deployment stages;
- require that operating policies and procedures are updated to provide clear guidance to staff on how to comply with all legal or regulatory requirements associated with the new product to avoid violations of law and undue exposure to legal liability prior to product introduction;
- address and mitigate risks throughout the product life cycle, including pricing, marketing, distribution, accounting, and ongoing service and maintenance; and
- require a post-decision review to determine whether the new product or service met the expectations and assumptions used to support the decision.

Management and the board should also ensure that the organization's culture encourages constructive dissent and robust dialogue around all issues. This could be evidenced by documenting dissenting viewpoints or considerations along with the new product recommendation.

Strategic Fit for the Institution and Its Customers

When institutions merely enhance existing products and services to meet customer demand, the resulting "new" products or services may not have a notable effect on the institution's risk profile or business processes. In other cases, however, community institutions enter new business lines, such as offering trust or wealth management services; expand into a new delivery channel, such as the Internet or mobile banking; or expand into new markets or new loan or deposit products, such as rewards credit cards or consumer remote deposit capture. When going beyond the boundaries of the institution's existing business model, successful management teams typically first think of new products and services in the context of the institution's strategic direction.

Strategic questions that management and the board would typically consider in this initial step of the process could include the following:

- How did we learn about this product? Did a current vendor suggest the product to complement our existing products? Did a new vendor cold-call on management? Are our competitors or peers in other markets offering the product? Have our customers asked for the product?
- Is this an established product or service, or is it "bleeding edge" (an extremely new or innovative product or service with higher uncertainty as to consumer acceptance) or "leading edge" (a proven product or service that is still new enough that it may be difficult to implement or support and where customer acceptance is still building)? If it is bleeding edge or leading edge:
  - How quickly is the product or service likely to evolve?
  - What will be the cost of keeping pace with the evolution?
  - What is the likelihood that our customers will value the product tomorrow?
- Do our personnel have the skills and capacity to deliver the product and service effectively? If we retrain our current employees and/or hire people with those skills, will we also have to change our compensation practices for consistency with other companies offering the product? Will we be changing the culture of the company?
- Will this product or service complement or cannibalize our existing products and services? Will it enable us to attract and retain new customers?
- Where do we see ourselves as an organization in three, five, or 10 years if we do or don't offer this product?

In addition to considering the product's strategic fit with the organization, successful management teams consider the institution's customer base. In particular, these banks review the new product from a fairness perspective, asking, "Does the new product or service benefit the consumers and communities we serve or does it diminish their capacity in any way?" Or, stated another way, "Are we benefitting at the consumer's expense?" When assessing fairness, management teams typically ask a number of questions, including:

- Do our existing customers have a need for this product or service, or are there less expensive products that would better serve our customers' needs?
- Are features, risks, and terms of the product explained clearly and conspicuously, or are they buried in a lengthy document full of "legalese" that makes it difficult for the consumer to make a truly informed choice?
- Are fees or penalties structured in such a way that unsuspecting, unsophisticated, or vulnerable consumers could experience financial difficulties from which it would be difficult to extricate themselves?
- Are there financial incentives for bank employees to offer this product over other products that may also be suitable for the consumer?
- Is this a product or service we would recommend to our families?

If a potential product or service appears to be a good strategic fit with the organization and its customers, only then do successful management teams delve into the more tactical aspects of the decision.

Risks and Mitigants

It is often tempting to focus disproportionately on the benefits of a new product or service and less on the potential risks. That is why it may be helpful to first consider the risks of a proposed new product before selling oneself on the benefits.

Successful management teams consider the costs and risks of a new product or service very broadly, looking at all risk dimensions across the organization. While a new product or service may appear to fit into a particular risk niche — a loan product may primarily affect credit risk, whereas a new delivery channel may primarily affect operational risk — the interconnectedness of all aspects of a community bank cannot be ignored.

For example, mobile or Internet banking can not only create a variety of operational risks but also lead to increased liquidity risk (e.g., funds can move at the click of a button), compliance risk (e.g., inconsistent or incomplete disclosures), and reputational risk (e.g., negative publicity from a data breach), among a host of other less obvious risks. New home equity products may allow consumers to lock in part of their variable-rate line of credit at a fixed rate but can also lead to increased sensitivity or credit risk (e.g., the consumer is locked into a higher payment even if rates fall), operational risk (e.g., if systems cannot account for the dual product), and compliance risk (e.g., if disclosures are incomplete or inconsistent with actual practice).

Risk-related questions that management and the board would typically consider include:

- Will this product or service increase, decrease, or leave unchanged aggregate or specific risks? If it will increase risk in one or more risk dimensions, is the new level within our already established risk tolerances?
- What steps can we take to mitigate risks to an acceptable level? Are there industry best practices we can consider?
- Will the new product or service cause changes to our financial position, including the calculation of regulatory capital ratios?
- Do we have or can we acquire the staff expertise to adequately manage and control the risk in the new product or service as well as the risk in our established portfolios of products and services?

Regulatory Compliance

Community banks operate in a highly regulated industry, and successful management teams assess whether new products or services fully comply with applicable federal and state laws and regulations. The scope of permissible products and services may be limited by the institution's chartering authority and can vary depending on whether the activity is conducted in the bank, the parent company, or a subsidiary of one or the other. Management teams are encouraged to discuss new product and service proposals with their regulators to determine whether an application or notice may be required.

In addition, certain regulatory issues carry increased risk. First, the new product or service may raise concerns about the fair treatment of or impact on consumers. Therefore, concerns about fair lending and unfair or deceptive acts or practices (UDAP) should be addressed early in the process and monitored after the product is introduced.

The new product or service may also affect the institution's Bank Secrecy Act/anti-money laundering (BSA/AML) profile. A successful rollout of a new product should include early consideration of BSA/AML issues.

Finally, when considering regulatory compliance, successful management teams also consider the regulatory compliance profile of third-party vendors used to develop, deploy, or service the product. While management can appropriately decide to outsource some or all of the operational aspects of the product or service, they cannot outsource the responsibility for complying with laws and regulations. A robust third-party vendor management and oversight process will evaluate all applicable risks, including those related to information security, privacy, and compliance with all applicable laws and regulations.[1]

In addition to compliance considerations, the nature of the proposed product or service may affect the bank's Community Reinvestment Act (CRA) profile. For example, a bank that targets niche markets, offers only unique or specialized products and services, or uses nontraditional delivery channels should consider how it is helping to meet the credit needs of its local community. At our Reserve Bank, we advise management teams to evaluate the potential effect of new products and services on the bank's ability to meet the credit needs of its local communities prior to implementation. A bank may want to consider submitting a CRA strategic plan to its regulator for approval. A best practice is to periodically review the bank's performance and assess its goals relative to the performance standards contained in the CRA and its implementing regulations.

Regulatory compliance-related questions that management and the board would typically consider in this step could include:

- Has the product or service been reviewed for compliance with applicable federal and state laws?
- Has the product been reviewed from a consumer fairness standpoint?
- Will an application or notice need to be filed with our federal or state regulator(s), and, if so, do we have the necessary information to submit with the application? How will that affect our lead time?
- Will the new product or service affect our BSA/AML risk profile?
- Will we use third-party vendors for any aspect of the new product or service? If so, do we have a sufficiently robust vendor management and oversight process to ensure that the vendor complies with all applicable laws and regulations?

Financial Costs and Benefits

Community bankers are adept at conducting financial analysis of borrowers, and the same rigor can be applied to the financial analysis of proposed products and services. It is useful to challenge the financial assumptions underpinning the new product analysis, considering scenarios where customer adoption and sales are less than expected or certain key costs are higher than expected. Sometimes even seemingly minor variances in key assumptions can significantly affect profitability. It is also important to document the analysis and provide a record for back-testing.

After completing the cost-benefit analysis, management and the board would typically consider the following questions:

- Do the assumptions underlying the financial analysis appear reasonable?
- Does the financial analysis adequately capture scenarios other than the best or most likely scenario? Can we live with those alternative outcomes?
- Have all assumptions and projections been documented and can they be back-tested?

Bringing It All Together

After the proposed product or service has passed the strategic fit test, the risks and regulatory compliance issues have been identified and evaluated, and the numbers have been crunched, management and the board are faced with two final questions:

- Do we thoroughly understand the purpose, risks, and benefits of this product or service?
- Do the potential benefits, both financial and nonfinancial, associated with the new product or service outweigh the costs of (i) developing, providing, and servicing the proposed product or service; (ii) mitigating the identified risks; and (iii) complying with applicable laws and regulations?

If the answer to either question is "no," then the disciplined new product review process may have saved the management team and board much financial and risk mitigation pain further down the road. As Steve Jobs once noted, "Deciding what not to do is as important as deciding what to do. That is true for the companies, and it's true for products."[2] But if the answer to both questions is "yes," then it's time to move forward!

[1] An article titled "Vendor Risk Management" was published in the First Quarter 2011 issue of *Consumer Compliance Outlook* at www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/2011/first-quarter/vendor-risk-management.cfm. In addition, a webinar presented on May 2, 2012, through *Outlook Live* titled "Vendor Risk Management - Compliance Considerations," can be viewed at www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/outlook-live/2012/vendor-risk-management.cfm.

[2] Walter Isaacson, "The Real Leadership Lessons of Steve Jobs," *Harvard Business Review* (April 2012), available at www.hbr.org/2012/04/the-real-leadership-lessons-of-steve-jobs/.

Final Thoughts

Over my many years in bank supervision, I have found that community banks are most successful when they connect with their customers and communities and provide value-added products and services that are both consistent with their mission and needed by their customers. While the prolonged economic recovery may be placing inordinate pressure on banks' earnings, taking a long-term strategic focus rather than just following the pack when considering new products and services should help ensure the continued viability of the community banking model. ■

The author would like to thank Tracy Basinger, Cynthia Course, and Ariane Smith of the Federal Reserve Bank of San Francisco for their contributions to this article.

D.C. UPDATES

Congress Extends the National Flood Insurance Program and Amends the National Flood Insurance Act and the Flood Disaster Protection Act

On July 6, 2012, President Obama signed into law H.R. 4348, the Moving Ahead for Progress in the 21st Century Act. Title II of this law contains the Biggert-Waters Flood Insurance Reform Act of 2012 (the Biggert-Waters Act),* which extends the National Flood Insurance Program (NFIP) until September 30, 2017, and amends the National Flood Insurance Act of 1968 (NFIA) and the Flood Disaster Protection Act of 1973 (FDPA).

Community banks should be aware that some of the Biggert-Waters Act's provisions provide for the following changes:

- Increasing civil money penalties (CMPs) against regulated lending institutions with a "pattern or practice" of violating certain flood insurance requirements from $385 to $2,000 for each violation and removing the $135,000 statutory cap on the amount of CMPs that may be assessed against an individual financial institution in a single calendar year. The changes will likely result in significantly higher CMPs on financial institutions that are determined to have engaged in a pattern or practice of violations of the federal banking agencies' flood insurance regulations implementing the NFIA and the FDPA.
- Requiring lenders or servicers, within 30 days of receipt of a confirmation of the borrower's existing flood insurance coverage, to terminate force-placed insurance and refund any premiums paid by the borrower for the force-placed insurance (and any related fees charged to the borrower with respect to the force-placed insurance) during any period when both the borrower's policy and the lender's policy were in effect.
- Allowing financial institutions that purchase force-placed flood insurance to cover the 45-day notice period for force-placed insurance to pass on the cost of the insurance and fees to the borrower.
- Requiring each federal entity for lending regulation, including the Federal Reserve Board, to direct regulated lending institutions, by regulation (after consultation and coordination with the FFIEC), effective July 6, 2014, to establish escrows for flood insurance premiums for residential improved real estate or a mobile home unless the institution:
    - (i) has total assets of less than $1 billion; and
    - (ii) on or before July 6, 2012, the regulated lending institution:
        - I. was not required under federal or state law to deposit taxes, insurance premiums, fees, or any other charges into an escrow account. The preceding exceptions may not be applicable if state law requires the escrow of flood insurance premiums; and
        - II. did not have a policy consistently and uniformly requiring the escrow of taxes, insurance premiums, fees, or any other charges.

In addition to these changes, President Obama signed into law S. 3677 on January 16, 2013, to clarify the escrow requirements in Section 100209 of the Biggert-Waters Act. As originally written, the escrow requirements appeared to apply to both residential and commercial real estate. The amendment clarifies that the escrow requirements apply only to residential improved real estate.

* Pub. L. 112-141, Div. F, Tit. II, Subtit. A

Effective Asset/Liability Management: A View from the Top

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nity bank's ALCO often assesses earnings, establishes loan and deposit strategies and pricing, monitors detailed IRR exposures, and evaluates liquidity risk exposures and contingency funding needs. Given the broad array of activities the ALCO conducts, representation should include senior managers from the bank's lending, investment, deposit-gathering, and accounting functions.[3] The ALCO should make regular reports to the full board, so appropriate oversight by the board can be carried out.

Senior management activities should include:

- *Implementing ALM Policies.* The primary responsibility of senior management when carrying out ALM activities is to ensure that policy and risk guidance established by the board is appropriately implemented. ALM policies should provide the blueprint for ALCO and other bank personnel to follow when identifying, measuring, and controlling IRR and liquidity risks. In addition to communicating appropriate risk tolerances, policies should direct management to develop or acquire risk measurement tools that provide ongoing quantitative reporting of the relevant risk exposures.
- *Developing Risk Monitoring and Reporting Tools.* Many community banks use a battery of tools to oversee ALM risks depending on the complexity of their balance sheet. IRR is often monitored using vendor models to identify and measure risk exposures under various rate scenarios. Liquidity risk is typically identified, measured, and monitored through spreadsheets that compute existing balance-sheet liquidity positions, forward-looking source and use projections, and adverse scenario effects. The key consideration for any management team in determining what measurement tool to use is ensuring that the tool can quantify the institution's specific risk exposures. For example, a small bank located in a rural community with nearly 50 percent of its total assets invested in callable bonds should not be relying on a simple maturity gap, since the complexity of the balance sheet would demand a more sophisticated tool regardless of asset size. It is imperative that management implement appropriate tools to adequately measure the risk in the balance sheet.
- *Reporting Risk Exposures to the Board.* Reports provided to senior management and the board should evaluate the institution's compliance with established risk limits. Regardless of asset complexity, funding characteristics, or the risk measurement mechanism used, the board relies on management's ability to properly identify the risk in the bank. For example, many community banks establish net interest income change limits for various interest rate change scenarios in their IRR management policies. In these banks, management would be expected to quantify and report to the board the level of and trend in net interest change percentages for those scenarios specified in the bank's policy. Directors should receive sufficient information to understand the bank's existing interest rate and liquidity risk profiles relative to established limits and the potential impact of strategic and tactical decisions on those exposures.
- *Attracting and Developing Personnel.* It is also critical that a bank's staff maintain adequate depth and expertise for carrying out risk measurement and mitigation activities. Risk oversight is dependent on having the proper personnel to understand the balance sheet's complexity and properly develop an ALM oversight program capable of ensuring that risks stay within the boundaries set by board policies. Hiring and developing appropriate staff can be particularly challenging for rapidly growing community banks or those with increasing product complexity. Typically, these banks are either acquiring other institutions or implementing new business lines. In these situations, the bank can avoid pitfalls by ensuring that the appropriate staffing infrastructure is in place to identify, measure, and report interest rate and liquidity risks from new activities prior to commencement. This requires that senior management exercise appropriate due diligence and risk analysis to determine how the new activities (for example, a new mortgage origination program) or products (for example, a new CD) could affect the bank's overall IRR profile. The results of these analyses should be presented to the board prior to imple-

[3] Often, outside directors are also included as ALCO members to ensure that an appropriate degree of independence is maintained in the oversight of balance-sheet risk decisions.

menting the new activity. This exercise, in turn, will allow senior management to propose and the board to adopt changes to policy and establish risk limits related to the new activities.

The responsibilities of the board of directors and senior management are summarized in the figure below.

Policies, Procedures, and Risk Limits

One of the most effective tools the board and senior management can provide to their staff is a sound policy directive for the bank's various activities and risk exposures. Through sound policies, the board communicates to frontline and senior personnel its expectations with respect to risk tolerance, desirable and undesirable activities, internal control and audit, and risk measurement. Typically, directors develop ALM policies that consolidate the board's expectations for interest rate and liquidity risk exposures and oversight. When examiners evaluate ALM policies, they are looking to see that the following issues are appropriately addressed:

- The policy should state the bank's objectives for ALM and provide a well-articulated strategy for managing the risks associated with balance-sheet accounts. This would typically include the board's view regarding tradeoffs between earnings and interest rate and liquidity risk exposures.
- Another critical element of any ALM policy is appropriate aggregate risk limits for interest rate and liquidity risk exposures. Traditionally, community bank ALM policies would establish maturity/repricing gap risk limits to address IRR exposures and one or two liquidity ratio metrics (e.g., loans-to-deposits or noncore funding dependence ratios) for liquidity risk exposures. With the proliferation of callable bonds, mortgage-backed securities, Internet and brokered CDs, correspondent bank and Federal Home Loan Bank borrowings, and financial derivatives, many community banks have implemented more robust, forward-looking risk measurement techniques.

  While many community banks have implemented better risk measurement tools, risk limits are not always established. For example, regulatory guidance suggests that sound risk limits for IRR exposures should address the risk in relation to earnings and capital exposures – usually framed in terms of limits to net interest income, net income, and/or the economic value of equity change percentages for specific interest rate shock scenarios.[4] Regulatory guidance has also pointed to the need for forward-looking analysis for sound liquidity risk management. Often, this takes the form of sources/uses projections. A sound policy would establish risk parameters in the form of minimum forward-looking cash flow coverage ratios. These risk limits should be clearly stated, should meaningfully address the bank's activities, and should effectively communicate the board's risk tolerance. Risk limits should also be periodically reevaluated in light of the institution's other risk exposures (e.g., credit, operational, reputational) and any new products or business activities.
- The policy should provide clear lines of authority, responsibility, and accountability regarding risk management activities. It should include addressing situations where the institution falls outside of its established risk parameters, defining who is responsible for implementing strategic and tactical activities, establishing and maintaining risk measurement systems, and identifying risks that may arise from new products or activities. In many community banks, these responsibilities fall to one or a few individuals. The board should be aware of any concentration in responsibility or authority and ensure that adequate controls are in place to mitigate any resulting risks. An effective control might include, for example, independent reviews of these activities by someone who understands the risk management activities and potential problems that could arise.
- The policy should also clearly delineate the types of activities that an institution may conduct. This might include the types of financial instruments or activities

[4] Interest rate shock scenarios often take the form of assumed instantaneous shifts – either up or down – in all interest rates affecting a bank's assets and liabilities. Regulatory guidance indicates that these shocks should be significant (i.e., 300/400 basis points or more), and limits should be established for significant and meaningful shocks. See SR Letter 10-1, "Interagency Advisory on Interest Rate Risk," available at www.federalreserve.gov/boarddocs/srletters/2010/sr1001.htm.

that are permissible for either the banking book or risk mitigation (that is, hedging) activities. When managing liquidity risks, the policy should indicate what types of funding are acceptable and to what degree these sources should be used. For example, some community banks have incorporated the use of Internet or brokered deposits to augment local deposit volumes. For such institutions, the ALM policy should discuss how Internet or brokered deposits might be appropriately used and the extent to which the board considers these deposits acceptable. While nontraditional funding may change the bank's inherent liquidity risk profile, sound controls over the volume and type of inherently riskier funding sources may help to mitigate risks.

While the use of financial derivatives by community banks to hedge certain interest rate risks remains relatively modest, especially at the smallest banks, the use of derivatives has nevertheless become somewhat more prevalent in community banks in the past several years. Any community bank using financial derivatives to hedge exposures should have personnel with sufficient knowledge and expertise to ensure that the bank's risk exposure is not elevated by these activities. Before the bank engages in the use of financial derivatives, bank policies should address the appropriate use of these instruments, including a discussion of permissible derivative activities, an independent review of derivatives and the effectiveness of hedging activities, and appropriate accounting policies. Management should ensure that, prior to using financial derivatives, they understand the economics of the instruments, the potential risks from improper use, and accounting requirements for hedging activities.

Leading ALM Risk Management Practices

Many community banks have developed structures and policies to enable the board and senior management to effectively oversee balance-sheet risk exposures. However, examiners continue to identify opportunities to improve oversight of these risks. Occasionally, those opportunities rest with the board's knowledge of IRR and liquidity concepts. While community bank directors are not expected to be subject matter experts, board members should have a certain level of foundational understanding to effectively carry out their fiduciary responsibilities. To ensure that the board has sufficient understanding of balance-sheet risk management concepts, some banks have benefitted from external resources for educating directors.[5] Other banks have included on their board at least one outside director who possesses a sound understanding of balance-sheet management concepts. Together, these approaches have been effective in improving boards' abilities to oversee balance-sheet risk exposures.

Another leading practice is to identify risks and update policies before implementing new products or activities.[6] In many cases, community bankers have responded to the challenge of meeting desired earnings targets by implementing new business lines or investing in new categories of assets. In some instances, while the board and senior management may have held cursory discussions regarding the characteristics of these assets or business lines, they nevertheless failed to conduct a thorough due diligence evaluation of risks, including interest rate and liquidity risks. In some cases, the bank commenced an activity or invested significant funds in a particular asset only to later learn that additional processes, resources, and personnel were needed to effectively manage the risks arising from these activities or assets. Thus, the potential boost to earnings initially expected from these strategies was consumed by unexpected risks and additional post-implementation expenses related to risk management.

Conclusion

The community banking landscape has changed significantly in the past decade, and these changes have required heightened attention to ALM risk management strategies and processes. These changes, which include more products with embedded options, have required directors and senior managers to acquire enhanced knowledge about interest rate and liquidity risks to both manage traditional ALM risks and keep up with new ways of doing business. Changes have also reinforced the need for directors and senior managers to reevaluate and communicate guidance and risk tolerances to bank personnel. By ensuring that a sound oversight structure based on strong communication of risk tolerance is in place, directors can effectively steer the bank through challenging banking conditions whenever they occur. ■

[5] External resources for educating directors can include consultant training and ALCO support, external training seminars, and online training modules. The Federal Reserve System has developed a resource for bank directors that can be accessed at www.bankdirectorsdesktop.org.

[6] For more information on new product or service considerations, please refer to the article "Considerations When Introducing a New Product or Service at a Community Bank" in this issue.

Reversing the Trend: An Examiner's Thoughts About Negative Provisions and the ALLL *continued from page 5*

- Overly optimistic assumptions when estimating expected future cash flow assumptions for the present value of cash flow calculation (for example, not incorporating probability of default or prepayment assumptions);
- Widespread use of stale appraisals when measuring impairment on collateral-dependent loans;
- Modifications offered by the bank lack prudent repayment terms in order to keep loans current (for example, long amortization periods, interest-only periods, or single pay notes when those features are not standard for the loan type);
- Nonrecognition of loan impairment or troubled debt restructurings; and
- A change in the historical look-back period or a resegmentation of the portfolio in order to arrive at a lower ALLL.

Factors that might support recording a lower ALLL through a negative provision include:

- A sustained reduction in watch list and classified loans;
- A sustained decline in delinquency and charge-off rates;
- Steadily improving economic conditions supported by credible sources;
- Reduction in high-risk segments from the loan portfolio (e.g., construction and land development); and
- An allowance estimate above the upper range of the allowance calculation when the estimate is based on a sound methodology.

Concluding Thoughts

It is a good practice for a bank to notify its primary supervisor to discuss the bank's particular situation before recording a negative provision. Examiners recognize that the allowance estimate requires a high degree of managerial judgment. Nonetheless, examiners also view the ALLL as one of the most significant estimates in a bank's financial statement. As such, provisioning practices remain central to examiners' overall assessment of banks. Management of a bank that is appropriately recognizing problems and managing credit risk should not feel reluctant to discuss a decision to reduce the bank's ALLL with its primary regulator when a well-documented, sound methodology, including appropriate support for any significant changes in loan ratings, impairment measurements, loss rates, and environmental factors, suggests that such a reduction is appropriate. ■

The author would like to thank Paul Jordan and John Mansfield of the Federal Reserve Bank of Chicago for their contributions to this article.

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First Quarter 2013

VIEW FROM THE DISTRICT
A Twelfth District Perspective — San Francisco

Considerations When Introducing a New Product or Service at a Community Bank

by Teresa Curran, Senior Vice President and Banking Supervision and Regulation Division Director, Federal Reserve Bank of San Francisco

When I meet with community bankers in the 12th District — which encompasses Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah, and Washington — one recurring theme in our discussions is the challenge of maintaining core earnings. With today's low interest rates, community bankers must frequently look beyond the margin or spread. Cutting costs or raising fees on existing services, however, can only go so far. Consequently, many community bankers are rethinking business strategies and are developing new products and services.

Traditionally, new products and services have offered great opportunities for community bankers to innovate, connect with their customers, and provide value-added service. Choosing the right product or service for the institution and its customers, however, can be easier said than done. We have found that successful management teams and boards of directors typically identify and mitigate risks before considering and introducing new products and services. When risk is not identified and mitigated in advance, the unintended consequences can be costly to resolve. In this article, I will discuss some factors that management and the board should take into consideration before introducing a new product or service. In particular, I will highlight a few areas where an ounce of new product planning may be worth more than a pound of cure.

The Repeatable Process

Management teams that successfully identify and roll out new products and services typically have a documented, repeatable, and auditable process to guide their decision making. In practice, this often means that the board approves and the management team follows comprehensive new product policies and procedures, documents decisions sufficiently, and ensures that all relevant functions within the organization appropriately engage with one another.

Teresa Curran

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