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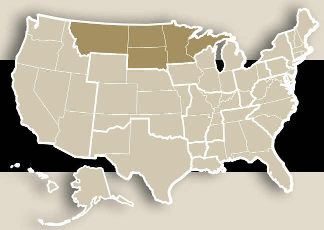

View from the District

A Ninth District Perspective — Minneapolis

Confronting "This Time It Will Be Different" in 2013

by Ron Feldman, Senior Vice President, Executive Services, Supervision, Regulation and Credit, Federal Reserve Bank of Minneapolis

In 2009, Carmen Reinhart and Kenneth Rogoff published their influential book, *This Time Is Different.* The subtitle — *Eight Centuries of Financial Folly* — foreshadows the bottom line, which the authors spell out in the first paragraph of the preface:

> This book provides a quantitative history of financial crises in their various guises. Our basic message is simple. We have been here before. No matter how different the latest financial frenzy or crisis always appears, there are usually remarkable similarities with past experience from other countries and from history.

They go on to identify the fallout from credit booms and debt accumulation as the hallmark of financial (and sovereign debt) crises.[1]

Ron Feldman

While Reinhart and Rogoff take a broad and international perspective, in this article I will consider the local implications of their message and encourage bankers in communities across the United States to do so as well. I will show how "this time it will be different" thinking could prove potentially costly to banks. I will focus my discussion on two issues that are directly relevant to the upper Midwest, where the Federal Reserve Bank of Minneapolis is located and I have the privilege of working.[2] That said, I think these issues apply to a broad range of banks across the United States. The issues I will discuss concern (1) lending in an environment of rapidly increasing natural resource values and (2) operating in a stressed earnings environment produced, in part, by persistently low interest rates.

[1] Carmen M. Reinhart and Kenneth S. Rogoff (2009), *This Time Is Different: Eight Centuries of Financial Folly* (Princeton: Princeton University Press).

[2] The Federal Reserve Bank of Minneapolis operates in the Ninth Federal Reserve District, which includes the states of Montana, North Dakota, South Dakota, and Minnesota; the western portion of Wisconsin; and the Upper Peninsula of Michigan. See www.minneapolisfed.org.

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INSIDE

Home Equity Lending: A HELOC Hangover Helper*

by Michael Webb, Managing Examiner, Federal Reserve Bank of Richmond

I recall many years ago when my Aunt Marie took my brother and me on an all-day shopping spree. I had noticed her buying various items that day with a plastic card, and being a curious six-year-old, I asked her about it. I distinctly recall her sitting back in her chair, eyeing us in a cagey manner, and replying, "Don't you worry about that, honey. Buying on credit is a whole lot of fun, but you get one doozy of a hangover later on."

For many in the banking industry, the wreckage of the 2007 financial crisis is still painfully recent. One can wonder whether Aunt Marie's analogy can apply not just to borrowers but to those who extend credit as well. Few community banks outside of the nation's heartland completely escaped the acute pain of unplanned provisions for credit losses and large credit charge-offs. The conventional view is that most of the loss is currently behind us, but the pain of the credit boom may still linger, at least for certain loan products. Some national data seem to suggest that home equity lines of credit (HELOCs) may still pose significant credit risk to the banking system; therefore, community banks that are involved in HELOC lending should be mindful of their potential risks.

* This article is the first of a two-part series that provides an overview of risks still inherent in HELOC lending activity, especially for institutions with large HELOC portfolios. The second article will discuss risk management techniques that HELOC lenders should consider when managing their HELOC portfolios.

Yet Another "Perfect Storm" Cliché

The banking industry continues to face strong headwinds, including a high unemployment rate, slow growth in consumer lending, and residential real estate values that are at off-peak levels in certain regions. In the past, most banks fared reasonably well when making interest-only HELOCs with a seven- to 10-year duration. These loans were commonly underwritten in the industry, as many investors assumed that property values would appreciate substantially over the course of a decade and that consumer wage levels would increase in response to steady economic growth and normal inflationary pressures. But those traditional assumptions have proved questionable with the numerous economic and demographic challenges in the recent past.

Although interest rates are at historical lows today and may remain so for some time, we can expect that this low-rate environment will not last forever. Community banks involved in HELOC lending activity should ask themselves

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a critical question: Will most borrowers be able to amortize their HELOC obligations in an environment of even moderately higher interest rates, let alone more normalized interest rates? Consider a hypothetical HELOC relationship with a standard 10-year, interest-only period followed by 10 years on amortizing terms. Assuming an interest rate of 4 percent and a funded balance of $100,000 without fluctuations in draws or pay downs, the monthly debt service requirement is roughly $333. Assuming the loan resets to amortizing status at 7 percent for the latter 10 years, the monthly debt service requirement more than triples to $1,161. Banks need to consider this factor at initial underwriting and implement procedures to measure, monitor, and control the risks associated with portfolio resets if conversion to amortizing status was not considered at origination.

Other trends may not be as apparent but may nevertheless have particular implications for HELOC lending. The potential loss given default (essentially, the percentage of an exposure that a bank is likely to lose if a borrower defaults) inherent in certain HELOC loans and any other residential products in a junior-lien position can be substantial in an environment of lower property values. Depending on the originating loan-to-value ratio, losses can approach 100 percent for second-lien HELOCs, especially for those loans that were underwritten during periods when market values were particularly "frothy," such as during the real estate boom leading up to the financial crisis. Exercising rights and remedies can also be logistically more problematic when the lender is in a second-lien position.

In the past year or two, regulators and others have renewed their focus on analyzing national HELOC data, and two observations from the data have raised concerns. First, a research study conducted by the Federal Reserve Bank of Richmond in 2012 indicated that a large volume of HELOC products were underwritten without factoring in the borrower's ability to amortize the obligation. Second, a large portion of outstanding HELOC loans are vintage 2004 to 2008 originations — that is, loans made at the height of the real estate boom. Federal Reserve staff estimates indicate that just under 60 percent of outstanding HELOC balances nationally will reach the end of their draw period between 2014 and 2017. While HELOCs in this group are made up of numerous payment structures, seven- and 10-year interest-only terms with balloon payments are fairly common in the industry.

Another potential area of concern is the rise in strategic defaults in recent years. A fair portion of future consumer default risk to banks is likely to be caused by potentially distressed borrowers forced to choose among multiple creditors. Traditionally, distressed consumers opted to make their monthly mortgage payment before servicing other types of consumer installment debt. With many mortgages still underwater and the backlog of national foreclosures, many distressed consumers are now upending traditional payment hierarchies by meeting automobile loan and credit card obligations while allowing first mortgages to go delinquent.[1] Much of this can be ascribed to consumers electing to service debts most closely tied to immediate household funding needs and day-to-day expenses. In the current environment, consumers also have a strong incentive to keep available credit lines on HELOCs open by maintaining current payment status. As a result of this dynamic, current payment status on a HELOC loan does not necessarily imply that the borrower is current on his primary mortgage; the bank may not recapture unpaid principal on the HELOC in a foreclosure if the outstanding principal on the primary mortgage exceeds the value of the collateral. Community banks need to be aware of this dynamic, and monitoring the payment status on a borrower's first-lien position is, therefore, a critical component to strong HELOC risk management.

So, to summarize the "perfect storm" perspective, a large volume of potentially unsecured loans with uncertainty regarding the borrowers' ability to amortize the loans are to reset at potentially higher interest rates in the near term. Several events may help to reduce the fallout. Possible mitigants could include, for example, a wave of debt consolidation or refinancing over the next few years or interest rates staying low for an extended period. With luck, much of this concern will be alleviated. The key takeaway from this article is that community banks need to understand the risks in their HELOC portfolios and, if necessary, take early action to manage those risks.

Now that we have identified some of the key risks in HELOC loans, the second article in this series will discuss internal controls, management information systems, policies and procedures, board reporting, and risk mitigation strategies. ■

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[1] See, for example, *Payment Hierarchy Analysis: A Study of Changes in Consumer Payment Prioritization from 2007 through 2011* (TransUnion white paper). Available at www.transunion.com/docs/rev/business/marketperspectives/financialservices/industryTrends/Payment_Hierarchy_White_Paper.pdf; Ezra Becker and Matt Komos, "Why Banks Should Pay Attention to How Consumers Prioritize Bills," *American Banker* (October 3, 2012). Available at www.americanbanker.com/bankthink/why-banks-should-pay-attention-to-how-consumers-prioritize-bills-1053230-1.html.

Contingency Funding Plan: Banking Busywork or Essential Management Tool?

by Rachel Bryant, CFA, Capital Markets Examiner, Federal Reserve Bank of Atlanta

A contingency funding plan (CFP) is, at its core, a liquidity crisis management instrument. The document is prepared as a directive for a future emergency and stands ready to be referenced, someday, as a response plan and potential forecast of how a distant liquidity event may unfold. But then, the scenarios presented in the CFP may not occur. The next liquidity crisis may be an event that not a single bank management team could have ever imagined. After all, clairvoyance is not typically listed as a required banking skill.

Luckily, the objective of the contingency planning process is not to predict the future. Rather, the CFP's great value lies in its utility both as a crisis management document and a regular deep dive into the bank's liquidity profile. As an assessment tool, the contingency planning process provides additional insight into the community bank's liquidity strengths and weaknesses beyond the bank's normal reporting activities. In this role, the CFP serves as a comprehensive evaluation, similar to a person's annual health examination, which complements ongoing asset/liability monitoring. This endeavor can provide new risk mitigation knowledge that management can use to protect the bank both in an emergency and in the day-to-day competitive arena.

Even without the additional benefit as a risk assessment tool, establishing a rainy-day plan is a worthy exercise on its own. Of course, bank management teams do not intend for their banks to experience severe distress or, more tragically, failure. However, liquidity events can materialize in a variety of unexpected ways. For instance, a correspondent bank may go out of business, a terrorist attack may disrupt the payment system, or the primary employer in the bank's hometown could decide to relocate. If the bank has an established CFP with descriptive roles, responsibilities, and action plans, management will be better prepared to execute a controlled response to unforeseen stress events. Further, scenario analysis may identify an undesirable liquidity position before a crisis begins.

Supervisory guidance provides direction for creating and maintaining a CFP. Federal Reserve SR Letter 10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management," is akin to a CFP handbook because nearly half of the letter is devoted to the topic of CFPs.[1] Real-life liquidity crises reveal the importance of this supervisory guidance.

Contingency Funding Plans in Action

In 2011, a community bank that appeared to have ample liquidity and stable funding nearly failed because of a run on deposits. The bank had been in business for over 15 years, was active in the community, and enjoyed a solid reputation. However, after an erroneous media report indicated that closure of the bank was imminent, a significant volume of deposits was withdrawn in four days. Operating cash was nearly depleted, and depositors were frenzied.

Fortunately, the bank had an effective CFP, which helped mitigate the crisis. Responsibilities were clearly outlined, and each team member executed his or her role as planned. Communication lines remained open within the bank and with the community. Senior management officials talked with large depositors to quell fears, and a designated individual responded to inquiries from local news reporters with a calming and informative message.

As reputational risks were addressed, management monitored the inherent liquidity position closely. Informational reporting systems permitted continuous analysis of the bank's liquidity with increased reporting frequency. Management had also preestablished access to the discount window and Federal Home Loan Bank (FHLB) advances, which was particularly beneficial because the registration process can take weeks. These sources provided critical liquidity backstops that aided in navigating the temporary funding crisis and allowed the bank to emerge successfully.

[1] SR Letter 10-6 is available at www.federalreserve.gov/boarddocs/srletters/2010/sr1006.htm.

Around this same time, the directors at another community bank met late into the night. The bank had battled credit deterioration for months; liquidity was not previously a concern. Rate-hungry brokered depositors had been abundant and lined up to put money into the bank, not take it out. But lately, brokered depositors were no longer the abundant liquidity source they once were. The mounting credit losses were becoming more publicly known, and core depositors were growing concerned with the eroding capital and margins. The growth in volatile funding sources escalated an otherwise credit-related problem into a liquidity crunch. Core depositors wanted their money back, and even assurances of Federal Deposit Insurance Corporation (FDIC) coverage were not persuading all of them to stay.

A liquidity squeeze was under way, and the directors wanted explanations as to why conditions were continually worsening. After all, the bank had a CFP.

Yes, the bank held a document that was titled "Contingency Funding Plan." But without key components, the CFP failed to serve as an operational guide. The plan lacked the necessary descriptions of roles and responsibilities, action plans, and alternative funding sources. Questions arose that could have been addressed beforehand in the CFP: Who is responsible for raising funds, and what approvals are needed? Which funding alternatives should be pursued first? Who will initiate intraday liquidity reporting? Who will speak to customers, and what will the message be? While the bank did

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Federal Reserve to Co-Host Inaugural Community Bank Research Conference This Fall

The Federal Reserve is joining the Conference of State Bank Supervisors (CSBS) in hosting "Community Banking in the 21st Century," an inaugural community banking research and policy conference, on October 2-3, 2013, at the Federal Reserve Bank of St. Louis.

The conference will bring together community bankers, academics, policymakers, and bank supervisors to discuss the latest academic research on community banking and to share extensive on-the-ground reports from state bank commissioners, who are conducting town hall sessions with community bankers in their states this spring and summer.

Federal Reserve Chairman Ben Bernanke will kick off the conference on the afternoon of October 2. Other guest speakers will include Federal Reserve Governor Sarah Bloom Raskin.

"Community banks play a vital role in the U.S. economy," Bernanke said. "It is crucial that we thoroughly explore the issues that may impact the future of the community banking model."

The conference will feature current academic research in the community banking sector, findings from town halls with community bankers, and keynote presentations and roundtable conversations from thought leaders across the industry.

Due to the high level of interest in the conference, all presentations and paper discussions will be webcast. Registration for the webcast and a formal agenda will be available on the conference website at www.stlouisfed.org/cbrc2013 in August 2013, after research papers for the conference have been officially accepted. ■

Investing in Securities Without Relying on External Credit Ratings

by Christopher McBride, Senior Supervisory Financial Analyst, Board of Governors

When Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) to strengthen the financial regulatory system in the wake of the financial crisis, one area of concern it addressed was the accuracy of credit ratings for structured financial products. Specifically, section 931 of the Dodd-Frank Act states: "In the recent financial crisis, the ratings on structured financial products have proven to be inaccurate. This inaccuracy contributed significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy in the United States and around the world. Such inaccuracy necessitates increased accountability on the part of credit rating agencies."

Therefore, Congress directs the federal regulatory agencies in section 939A of the Dodd-Frank Act to amend their regulations to remove any reference to, or reliance on, nationally recognized statistical rating organizations (NRSROs) and to create a standard for determining the creditworthiness of securities and money market instruments.[1] The agencies recently completed this work. As a result, supervisors' expectations for banks' investment securities oversight processes have shifted from allowing relatively passive oversight of credit risk to requiring a more active process of analysis and assessment. This article reviews the process of investing in securities without relying exclusively on NRSRO ratings (commonly known as external credit ratings).

On June 4, 2012, the Office of the Comptroller of the Currency (OCC) issued a final rule to implement section 939A.[2] This rule, which was effective January 1, 2013, applies to the national banks and federal savings associations supervised by the OCC. The rule applies more broadly, however, because the Federal Reserve Board's Regulation H[3] and the Federal Deposit Insurance Corporation's (FDIC's) regulations on activities of insured state banks and insured savings associations[4] prohibit member and nonmember state banks and state savings associations from engaging in activities and investments that are not permissible for national banks and their subsidiaries. Therefore, the OCC's final rule establishes the standard for *all* banks and savings associations.

The OCC rule changed the definition of "investment grade" — which previously had been based on external credit rating categories — to mean "the issuer of a security has an adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure. An issuer has an adequate capacity to meet financial commitments if the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected."[5] This standard is consistent with sound loan underwriting standards and requires a bank to analyze and verify repayment ability. To facilitate state member banks' understanding of these new requirements, the Federal Reserve Board published SR Letter 12-15, "Investing in Securities Without Reliance on Nationally Recognized Statistical Rating Organization Ratings," which provides guidance on the new requirements.[6]

Credit Risk Due Diligence

Using external credit ratings has long been an efficient tool to identify credit risk before making an investment decision. Management must now analyze the investment quality of the issuer or pool in a way that is similar to conducting loan due diligence, except for differences in customer interaction. It

[1] The Federal Reserve Board prepared a report to Congress on references to NRSRO ratings in Federal Reserve regulations. See Board of Governors of the Federal Reserve System, *Report to the Congress on Credit Ratings*, July 2011, at www.federalreserve.gov/publications/other-reports/files/credit-ratings-report-201107.pdf.

[2] See Office of the Comptroller of the Currency (2012), "Alternatives to the Use of External Credit Ratings in the Regulations of the OCC," final rule, *Federal Register*, vol. 77 (June 13), pp. 35253-35259.

[3] See 12 CFR 208.21.

[4] See 12 CFR 362.

[5] See 12 CFR 16.2.

[6] The FDIC and OCC have also published guidance for the institutions they supervise. See FDIC Financial Institution Letter FIL-48-2012, "Revised Standards of Creditworthiness for Investment Securities," at www.fdic.gov/news/news/financial/2012/fil12048.html, and OCC Bulletin 2012-18, "Alternatives to the Use of External Credit Ratings in the Regulations of the OCC," at www.occ.gov/news-issuances/bulletins/2012/bulletin-2012-18.html.

is important to note that the regulations still allow banks to use an external rating as a component of their credit risk due diligence, but banks can no longer rely solely on that rating.

Banks are now required to identify credit risk in investment securities by fully assessing the issuer's repayment ability. While the process may be more intensive than reliance on external credit ratings, management has several existing tools at its disposal to identify and monitor credit risk. A bank's existing loan underwriting processes provide a basic starting point for identifying credit risk. As with underwriting credits, the degree of due diligence needed for any specific investment is dependent on the security's credit quality, the complexity of the structure, and the size of the bank's investment. So, for example, while a small investment in a straightforward general obligation bond of a local municipality should still receive an appropriate assessment of credit risk, such an investment would likely require less intensive review than a large investment in a corporate bond or a private label mortgage-backed security.

Bank management also has the ability to use a variety of external sources, including credit rating agency reports. These reports offer bank management the ability to efficiently ascertain appropriate facts to understand whether or not an investment will fit with the bank's risk appetite. However, any time a bank uses a third party to assess the credit risk of an investment, the bank must make sure that the third party has the appropriate skills and experience to conduct a factual assessment of credit risk.

"Banks are now required to identify credit risk in investment securities by fully assessing the issuer's repayment ability."

The new guidance uses examples to lay out several factors that can be used in assessing credit risk. The nonexhaustive list of suggested factors provides insight into what methods may be appropriate for different types of securities. Management is not expected to use all of these factors for every transaction, but they can be helpful in providing a baseline for what might be expected depending on the type of security. These factors include, among others, both readily available market data and specific data related to various microeconomic factors.[7] The examples are not mandated by regulation but should aid management in identifying components of an effective investment security credit risk oversight program.

Investment Complexity

Of course, not all investment securities or portfolios are alike and, as such, not all oversight programs are expected to be alike. A U.S. government or agency bond, for example, generally is considered to have so little credit risk that it does not need to be subjected to individual credit analysis. At the opposite end of the spectrum, a highly structured asset-backed security would require a thorough assessment, focusing on factors such as the structure of the bond, the asset pool, and the underlying repayment capacity. Management should understand that there is a range of expectations for securities depending on the issuer, structure, security type, and investment size.

Regulators expect management to put riskier securities, such as asset-backed securities, through a stringent review of credit risk. These securities, which are composed of asset pools that provide repayment, are highly structured and can contain options or other features that may significantly change the payoff and interest rate expectations depending on various factors. Simply stated, these securities are complex. Regardless of an institution's size, these securities require proper oversight and risk identification. Before investing, management needs to have a thorough understanding of the security, including:

- Tranche behavioral expectations
- Asset pool makeup (e.g., types of underlying assets, concentrations, microeconomic impacts, underwriter quality)
- Cash flow waterfall stipulations

The above list is not exhaustive, but it identifies a few credit risk components that should be reviewed before making an investment in a structured security. Management should ensure that all aspects of a structured security fit within the risk profile and needs of the bank.

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[7] Readily available market data include factors that allow comparison of security performance with nonobligor-specific benchmarks, for instance, by comparing spreads with U.S. Treasuries and default rates to assess consistency with bonds of similar credit quality. Microeconomic factors are those that are specific to the obligor, for instance, an obligor's capacity to repay its obligations or the sources of revenue and fiscal strength of a municipal authority.

Loan Participations: Lessons Learned During a Period of Economic Malaise

by Michael Poprik, Managing Examiner, Community and Regional Supervision, Federal Reserve Bank of Richmond

In the past, some community banks viewed loan participations as an effective way to diversify risk, supplement organic loan growth, leverage another lender's expertise, or gain access to a market segment. However, these exposures also posed risks that may not have been apparent until it was too late. During the recent economic downturn, some banks experienced stress in their loan participation portfolios. As a result, many community banks reduced their exposure to loan participations and have since vowed to participate only in "good deals" going forward.

The most common type of loan participation is an agreement that transfers a stated ownership interest in a loan to one or more banks or other entities. The lead bank typically retains a partial interest in the loan, holds all loan documentation in its own name, services the loan, and deals directly with the customer for the benefit of all participants.[1] Based on this structure, a participant may believe that the lead bank, not the participant, is responsible for the bulk of underwriting and credit risk management of the participation. Regulators, however, expect each participant to maintain a robust risk management program regardless of whether loan participations are purchased or sold. During the last period of pre-crisis economic growth, participants' understanding and risk management of purchased loans often failed to meet these expectations, resulting in purchased loans that were not well understood or monitored.

As community banks reenter the lending arena, some institutions are considering purchasing loan participations because local loan demand remains weak. Therefore, the timing is right to discuss sound principles of risk management for portfolios of loan participations. This article offers several ways to strengthen board and senior management oversight of loan participations, including:

- Establishing and following sound policies and procedures
- Applying the bank's own underwriting standards, policy limits, and monitoring guidelines
- Diversifying the bank's loan portfolio
- Being wary of lending outside of the bank's areas of expertise
- Avoiding entering into a relationship that is too complicated to understand
- Knowing the agreement details, including the lead bank and all participants
- Understanding how the participation will be sold

Establish and Follow Sound Policies and Procedures

During the period of economic expansion that preceded the most recent downturn, sound lending policies and procedures were often bypassed as banks sought to grow their loan portfolios. For example, many community banks sought to capitalize on the benefits associated with rising real estate values even when those values were rising most rapidly outside of their local markets. Therefore, many banks purchased loan participations, some of which resulted in concentrations in real estate loans that were located in distant and unfamiliar markets, were not well underwritten or managed, and were of questionable value, which ultimately led to loan losses.

Effective risk management for loan participations includes establishing board-approved policies and procedures. These policies and procedures should ensure that management:

- Limits the aggregate amount of loans purchased from and sold to a single outside source;
- Limits the total amount of loans purchased and sold;
- Limits the aggregate amount of loans to particular industries;
- Ensures that participation agreements with originating banks are comprehensive;
- Completes a thorough analysis and documents the credit quality of obligations purchased;
- Completes a detailed analysis of the value and lien status

[1] Loan participations can also be structured with several lenders coming together to each fund a share of the loan. In these cases, each lender documents its own share of the exposure and maintains its own relationship with the borrower.

of the collateral;
- Complies with appraisal regulations and guidelines;
- Maintains full, independent credit information on the borrower throughout the term of the loan;
- Applies appropriate underwriting standards; and
- Documents collection procedures.

Apply the Bank's Own Underwriting Standards, Policy Limits, and Monitoring Guidelines

One aspect of loan participations that was often overlooked during the period leading up to the recent downturn was the need for purchasing banks to apply their own underwriting standards, policy limits, and monitoring guidelines to each participation purchased. While it may seem convenient to accept a credit package prepared by another bank, it is imprudent to assume that the other bank's underwriting and documentation standards are sufficient. The information provided to the participant typically presents the credit in the best light possible and is meant to sell the participation and provide funding for the loan. The purchasing bank may also find it helpful to understand the relationship the lead bank has with the borrower and how much credit exposure the lead bank is willing to retain.[2] This may provide some insights into the lead bank's overall view on the quality of the credit.

When considering a loan participation, bank management should conduct its own due diligence, including a thorough review of the loan purpose, repayment sources, borrower and guarantor financial information, and collateral coverage. If real estate is taken as collateral, appraisals should meet regulatory guidelines and be reviewed by the purchasing bank's appraisal review function for reasonableness. A bank considering a loan participation should not assume it has been provided with all the information necessary to make a prudent decision. Bank management should independently gather and assess all necessary information before making a decision.

For example, one bank in the Fifth District found out the hard way that if a participation is for a construction project, bankers should visit the site to verify that work is being completed as reported by the borrower and the firm hired to sign off on the draw request. In this case, the bank had a project that was fully funded when only a small amount of work had actually been completed. The banks turned to the guarantor for support, but the guarantor, a well-known property developer, was arrested and ultimately sentenced to 16 years in prison for fraud relating to a historic tax credit program. In retrospect, there were red flags that, if noticed sooner, would likely have made banks more cautious about participating in projects involving this guarantor.

It is also critical to understand all loan agreements. In some cases, limited guarantees turned out to be even more limited than anticipated. In one instance, individual guarantors called upon to provide support noted that their limited guarantee applied to the entity that owned the borrowing entity. As such, their limited guarantees were reduced even further by the ownership structure of the borrower. Unfortunately, the bank participants were left without the level of protection they thought they had negotiated.

Diversify the Bank's Loan Portfolio

Loan participations can be an acceptable method to diversify a bank's loan portfolio. However, management should consider various factors to ensure that purchased loans' risk exposures are different than the loans currently in the bank's portfolio. During the pre-crisis rise in real estate values, management of some banks believed that real estate loans purchased out of their loan market would diversify their exposure to real estate–related loans. It turned out, however, that real estate location alone did not necessarily provide that desired diversification. For example, making loans on oceanfront condominiums in the Outer Banks of North Carolina is similar to making loans on oceanfront condominiums in Hilton Head, South Carolina, because each location is primarily impacted by the same economic driver: tourism. An honest assessment of the economic drivers of each market is key to ensuring diversity in loan participations. Additionally, a bank could be better served by limiting aggregate risk to industries and diversifying the portfolio by participating in more than one loan type (for example, commercial real estate).

Be Wary of Lending Outside the Bank's Area of Expertise

It is easy to assume that a lead bank offering a loan participation is knowledgeable about the industries it is underwriting. Bank management should keep in mind that credit memorandums are designed to gain approval by the board loan committee and may oversell the positives. In addition to reviewing the credit information with a critical eye, bank management should complete its own underwriting. The

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[2] While it can be a positive sign when the lead bank chooses to retain a large credit exposure, some smaller banking organizations may be unable to retain as large an exposure as the lead bank, for example, because of legal or internal lending limits, even when the bank has a very favorable view of the borrower and the credit.

Confronting "This Time It Will Be Different" in 2013

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I must stress the need for balance from the outset. Humans have a tremendous asset: the ability to forget past errors. After all, the inventor who persisted through tens or even hundreds of failed experiments is a staple of news accounts and history books. Likewise, not every increase in lending, change in lending standard, or development of a new banking product is a harbinger of future problems. Indeed, supervisors work with banks to ensure that qualified firms and households have access to the credit needed to facilitate appropriate economic growth. Nevertheless, continued vigilance and a critical eye to guarding against past mistakes, at a minimum, will help guard against history repeating itself.

Lending and Increasing Natural Resource Values

A shale gas and oil boom is occurring in parts of the Ninth District, as well as other parts of the country, including Texas, Pennsylvania, and other states. As of this writing, the Bakken oil formation in North Dakota and Montana accounts for about 10 percent of U.S. oil production, up from virtually zero percent a decade ago; 40 percent of the increase in U.S. oil production over the latter half of 2012 occurred in a 12-county area in those two states.[3] The increase in oil production has led to a massive increase in investment and inputs, as well as price increases and shortages across many goods and services — particularly labor and housing. By the end of 2012, average wages were up 20 percent, and the unemployment rate was 1.8 percent in the Bakken region.

A second boom has been occurring to various degrees in agricultural land and commodities over the past several years, although the precise state of play depends on the type of commodity (e.g., grain versus livestock) and the location (e.g., in an area of drought or not). Prices for corn and soybeans, for example, at year-end 2012 were at levels roughly three times what had been "normal" during the 1980s, 1990s, and much of the 2000s. Farmland values, too, have risen to record levels. U.S. crop land values — including those in agriculture-intensive states such as Kansas and Iowa — are at nearly 50-year highs, as are land valuations relative to the cost of renting farmland.

How should banks and bank supervisors respond to what sounds like and often feels like the best of times? We should not assume we have reached a new normal or that booms and busts in natural resource production and prices have gone away. In short, we should not count on this time being different.

Land values in shale and agricultural locales may not continue to rise. The disconnect between rents and land values should give us pause. Perhaps rents will go up but maybe not. Expected demand for agricultural products may fall below current levels or supply may increase more than expected. Either outcome could help drive down land values. A rapid increase in interest rates at some point in the future that deviates from expectations could also drive down land values. The supply of energy may be much higher or much lower than current forecasts. Again, either outcome could have dramatic effects on energy prices and/or where that production takes place.

Supervisors and banks must consider the possibility that this time will not be different. This consideration should show up directly in underwriting, credit risk management, and capital and liquidity contingency planning, to pick three examples. In the current context, underwriters for agricultural credits could assume producer ability to repay based on commodity prices that are closer to historical norms.[4] Funding of land purchases could also assume lower-than-current valuations or require higher equity contributions from borrowers. Overall credit risk management policies could set exposure limits to projects that rely to a large extent on the fate of shale energy, both on an absolute basis and in terms of growth. Capital and liquidity planning should consider the chance that the boom in agricultural or energy prices may not last.

The board of directors is responsible for determining how a bank positions itself during the boom. The board sets the

[3] The Federal Reserve Bank of Minneapolis provides data on many aspects of the Bakken oil formation at www.minneapolisfed.org/publications_papers/fedgazette/oil/index.cfm.

[4] See SR Letter 11-14, "Supervisory Expectations for Risk Management of Agricultural Credit Risk," for more details on managing agricultural related credit risk, at www.federalreserve.gov/bankinforeg/srletters/sr1114.htm.

bank's risk tolerance, establishes the framework the bank follows to manage that risk, and approves contingency plans addressing worse-than-expected outcomes.[5] These steps should be straightforward in principle, simple to explain, and not quantitatively complex. However, they may not be painless to implement. In the short run, these steps could reduce profits. Even more challenging, they may require banks to reduce exposure to the local economy they serve. Experience over the years, however, has shown that making prudent choices during boom times puts a bank in a better position to withstand severe stress later. The majority of Ninth District bankers I talk with report taking the longer view, typically motivated by scars from prior downturns in natural resource markets.

Operating in a Prolonged Stressed Earnings Environment

Community bank earnings face pressure from many sources. Interest rates are low and will be until the labor market outlook substantially improves. Reductions or recoveries in loan-loss provisions should diminish as a source of earnings. In addition, community banks must always be aware of compliance costs.

Banks may take on more risk in response. Banks could take on more duration or interest rate risk. Banks may also offer new products or renew focus on existing products. Banks may decide to grow their commercial and industrial lending, particularly if prior lending concentrations — especially in commercial real estate lending — have diminished. Of course, banks can succeed by taking on more well-managed risk. But these same strategies have led banks of all sizes to fail. That challenging history should not become a forgotten relic.

I encourage bankers and supervisors to read the First Quarter 2013 issue of *Community Banking Connections*, which included an article by my colleague Teresa Curran from the Federal Reserve Bank of San Francisco, detailing the factors bank management and boards should consider when offering new products or services.[6] Banks and supervisors should have these risks at the front of their minds. Just a few years ago, for example, banks looking for earnings expanded into new markets and products by purchasing out-of-area participations without having proper risk management in place to address the associated risks. An article in this issue of *Community Banking Connections* talks in greater detail about effective risk management for loan participations. We cannot forget that weak risk management in good times, especially in commercial real estate lending, defined and underpinned the recent crisis.[7]

Past issues of *Community Banking Connections* have also included articles emphasizing the critical importance of proper management of interest rate risk.[8] These articles discuss the core tenets of effective interest rate and duration risk management, focusing on the principles outlined in federal interagency guidance issued over the past few years.[9]

Conclusion

Effective bank management recognizes that risks from the past can occur again in the future. Bank management, therefore, is effective precisely when it recognizes that this time may not be different. ■

[5] For a more detailed discussion of corporate governance of banks, see Kevin Moore, "View from the District: The Importance of Effective Corporate Governance," *Community Banking Connections*, Fourth Quarter 2012, at www.communitybankingconnections.org/articles/2012/Q4/Importance-of-Effective-Corporate-Governance.cfm.

[6] See Teresa Curran, "View from the District: Considerations When Introducing a New Product or Service at a Community Bank," *Community Banking Connections*, First Quarter 2013, at www.communitybankingconnections.org/articles/2013/Q1/Considerations-When-Introducing-A-New%20Product.cfm.

[7] See Governor Sarah Bloom Raskin (2011), "Community Bankers and Supervisors: Seeking Balance," speech delivered at the Federal Reserve Bank of New York Community Bankers Conference, New York, April 7, at www.federalreserve.gov/newsevents/speech/raskin20110407a.htm.

[8] Doug Gray, "Interest Rate Risk Management at Community Banks," *Community Banking Connections*, Third Quarter 2012, at www.communitybankingconnections.org/articles/2012/Q3/interest-rate-risk-management.cfm, and Doug Gray, "Effective Asset/Liability Management: A View from the Top," *Community Banking Connections*, First Quarter 2013, at www.communitybankingconnections.org/articles/2013/Q1/Effective-Asset-Liability-Management.cfm.

[9] See SR Letter 12-2, "Frequently Asked Questions on Interagency Advisory on Interest Rate Risk Management," at www.federalreserve.gov/bankinforeg/srletters/sr1202.htm, and SR Letter 10-1, "Interagency Advisory on Interest Rate Risk," at www.federalreserve.gov/boarddocs/srletters/2010/sr1001.htm.

Contingency Funding Plan: Banking Busywork or Essential Management Tool? *continued from page 5*

present quantitative projections in its CFP, the plan lacked essential qualitative guidance.

Further, the quantitative projections were not employed as risk assessment tools. Among other benefits, the CFP's quantitative component should serve as a risk appraisal that identifies how various assets and liabilities may react to stress. But in this case, the ensuing liquidity event was not identical to any of the projected scenarios. Management therefore concluded that the CFP could not be implemented and put it aside when specific events captured in the document did not occur.

Liquidity became a critical safety-and-soundness concern; the bank's viability was in danger. Management strived to restore funding capability, but by this point, sources were scarce. Their efforts failed, and FDIC receivership was the final result. A CFP that contained all the major elements as set forth in supervisory guidance may have helped the bank avoid this outcome.

Building a Quality Community Bank CFP

Fundamentally, a CFP is a bank's battle plan as well as a primary tool for assessing liquidity risk. A CFP uncovers cross-exposures, funding concentrations, and operational strengths and weaknesses, which are beneficial pieces of information in any environment. Supervisory guidance is clear about the need for a CFP at every institution. SR Letter 10-6 states, "All financial institutions, regardless of size and complexity, should have a formal CFP that clearly sets out the strategies for addressing liquidity shortfalls in emergency situations."

SR Letter 10-6 further emphasizes that a complete CFP consists of both quantitative and qualitative components. This means that numerical projections must be accompanied by a qualitative narrative so that everyone understands how to react in a stressed environment. Projections are decidedly important, but the actual step-by-step process for carrying out the projections needs to be detailed as well. These steps may not be so obvious when a crisis is on the bank's doorstep.

The Qualitative Components of a Complete CFP

When firefighters combat a raging fire, not every person in the truck blitzes the burning building. Someone needs to manage the hose. The ladder will not raise itself. Victims probably should not be left to sit alone. Roles and responsibilities are clarified before arrival to avoid chaotic action or, just as perilous, crippling indecision. In the same manner, bankers should consider the qualitative description of roles and responsibilities as one of the most critical components of the bank's CFP.

Some bankers assume that these roles are simply understood. The bank has a treasurer; therefore, that person will take care of the problem. But will the treasurer speak to the press as local news crews start calling? Will he or she stand in the lobby and talk to panicked depositors? Will this person also sit outside the vault and meticulously count cash? One person or even one department cannot control a liquidity crisis. The CFP should span the full institution and provide for a comprehensive crisis management team with clearly defined roles. Action plans and the assignment of responsibility for carrying out these plans should be realistic and formalized in writing.

The Major Components of a Comprehensive Contingency Funding Plan

A CFP should identify all material contingent liquidity sources and discuss the order in which these alternatives will be pursued. Certain sources require that legal agreements be set up in advance (e.g., FHLB advances and the discount window). Others may become prohibitive as the bank's level of pledged assets approaches maximum levels and no more liquid assets can be spared. Collateral calls can also strain access to some funding sources because market devaluations may reduce the value of a given pledged asset and trigger the need for additional collateral. In identifying funding sources, the narrative should address potential barriers, such as these, to accessing funding alternatives.

Similarly, the CFP should not assume that all contingent liquidity will come from one source. Funding diversification is not only a worthy goal but is also a forced outcome in a crisis. To assume otherwise would ignore the reality that liquidity pressures tend to spread from one funding source to others. The CFP document should discuss multiple funding options and avoid undue concentrations.

Quantitative Analysis and Support

Scenario analysis and the CFP are fundamentally linked. Contingent liquidity events should be simulated to inform management's views of liquidity exposures before an event occurs. The purpose of this exercise is not to create a numerical prophecy of exactly what a contingency event will look like and exactly how assets and liabilities will be affected to the dollar. There are many possible stress scenarios, but the CFP projects only a tiny subset of this universe. Bankers should not toss the CFP aside just because it envisages events that are different from the one currently occurring. Reality often differs from projections. Scenario analysis is worthwhile because it requires management to go through the steps of considering how each asset and liability might behave in a disruption. Possible side effects are also exposed because changes in one asset or liability class may affect other areas of the balance sheet. Scenario analysis can reveal an undesirable liquidity position and give management the opportunity to address it before a crisis develops.

In choosing scenarios and accompanying time horizons, the CFP should consider a range of events. A proper CFP includes considerations for short-, intermediate-, and long-term scenarios, as well as idiosyncratic and market-wide events. Liquidity risk is not limited to the possibility of a five-day run on the bank; rather, liquidity stress can span many months and take many forms. Bank management should consider events that best reflect the institution's business activities, operations, and liquidity risk exposures. While supervisory guidance encourages banks to create their own scenarios, SR Letter 10-6 specifically calls for all institutions to consider certain cases, such as losing well-capitalized status and subsequently having to meet prompt corrective action (PCA) limits. Management should incorporate this consideration into the CFP.

When projecting the chosen scenarios, assumptions can make or break the analysis. Outrageously optimistic assumptions are not the primary danger because farfetched assumptions can be easily spotted and corrected. Instead, contradictory assumptions are the less obvious sources of weakness in otherwise healthy CFPs. Assumptions should be mutually supportive. For example, if the scenario simulates a reputational crisis, projections should not assume an increase in core deposits. If the bank might lose its well-capitalized status, brokered deposit assumptions should not be made as if PCA rules do not exist. Scenarios assuming market disruptions should not ignore the likelihood of decreased collateral values and impending collateral calls. Scenarios depicting deposit erosion should also consider deposit mix changes. Furthermore, SR Letter 10-6 notes that assumptions should be documented, reviewed, and formally approved.

Triggers are another important element of the CFP. The best CFPs recognize that bank management is not psychic. A crisis day will likely begin like any other. No one will call and warn the bank's management team that a liquidity event will begin at noon, last for one week, and conclude on Friday. Normal market corrections happen, as do seasonal decreases in deposits. How will management know if today's event warrants implementing the CFP? There is no way of knowing with perfect foresight that the projected scenarios are actually happening. Thus, early warning indicators are crucial in monitoring potential liquidity problems and enacting the CFP with appropriate timeliness. Like a stoplight, changing conditions first trigger "yellow" warning levels and prompt appropriate mitigating actions. If conditions continue to deteriorate, indicators move into "red" status, prompting further mitigation. These predetermined and objective triggers avoid the possibility that the CFP will be implemented too late.

Finally, the CFP should not neglect reporting needs. The document should describe the type and frequency of reports that will be delivered to key personnel in a crisis. Liquidity reports in a normal environment are usually delivered according to a schedule, perhaps biweekly. However, regardless of the bank's complexity, management should have the ability to increase the frequency of liquidity reporting quickly if a stressful event occurs. The bank may have an otherwise excellent CFP in place, but without swift and responsive reporting, management may not fully know how a liquidity crisis is affecting the institution and therefore how to implement the CFP.

Updating and Maintaining a CFP

A CFP is not a one-time project to be retired to a desk drawer until a liquidity problem arises. Like a business continuity plan, the bank's CFP merits revisiting on a regular basis.

As a first step, community banks should expect their board of directors' involvement. While the board may not create the CFP, the directors should understand and periodically review the full document. At a minimum, the CFP should be reviewed annually, with the stipulation that certain conditions may warrant more frequent review.

Management should also periodically test the operational components of the CFP, including documentation, procedures, and access to contingent liquidity sources. Management may consider enacting the full plan in a practice drill. Some institutions schedule this type of testing before the annual presentation of the CFP to their board, which allows the bank to strengthen the CFP before the directors' review. However, if employees know the drill is coming, they will understandably take steps to prepare and perhaps shore up documentation or operational practices that otherwise would have been revealed as weaknesses in a true crisis. Therefore, bank management should choose the testing period wisely and discreetly. Additionally, some circumstances may merit unscheduled testing if, for example, management can feel the rumblings of an impending economic disturbance. Proactive testing is effective preventive medicine.

Realistically, it may be impossible to test every component of the CFP; for example, fully testing the liquidation of assets is not viable. However, the bank can test the operational process for liquidating the assets, just as it should test the other elements of the CFP. Testing should ensure that contingent liquidity lines have been established and are quickly accessible. Participating bank employees should understand their roles without needing excessive guidance during the liquidity event. Management should validate that legal and operational documentation is in place where needed and confirm the mobility of cash, collateral, and other assets as called for in the CFP.

Testing may conclude with results that are not pretty. Ultimately, the purpose of testing is to uncover weaknesses, holes, or inefficiencies so that any glitches may be addressed forthrightly. Conversely, the board of directors should be wary of annual testing that does not unearth a single opportunity for improvement. As any athlete would concur, practicing once a year is unlikely to result in perfect performance. Also, a lot can change in a year, and testing will help identify how the CFP should evolve to complement the bank's development.

The Value of a CFP

In banking, liquidity risk offers a fast path to trouble. Deterioration in asset quality may be the most common banking affliction, but the ensuing decline normally transpires over a long period of time. Poor liquidity management, however, can sink the bank quickly with only a small push in the wrong direction. A CFP is valuable because the acts of building and maintaining it provide a continually updated risk assessment tool in addition to a crisis control guide. Documentation for the sake of documentation is not the goal. Community banks should embrace the contingency planning exercise as an opportunity, and the board and senior management will hopefully sleep better at night knowing that the bank is protected with a quality CFP. ■

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.

Investing in Securities Without Relying on External Credit Ratings continued from page 7

It is important to recognize that not only are there many different types of securities, but each class of security can also have a range of variation within the class. Municipal securities, for example, are quite varied and can have significantly different dynamics that require an oversight program tailored to the underlying bond risks. Municipal general obligation bonds and well-capitalized bank municipal revenue bonds are Type I securities and do not need to meet the investment-grade criteria to be eligible for purchase. However, to ensure investment activities are consistent with safe and sound banking practices, municipal bonds should be subject to a credit risk assessment.

Each state and locality has risks that are different from those of another state or even another locality within a state. Furthermore, an issuer can be a municipal agency, such as a road, sewer, or airport authority. Additional complications for this asset class are that governmental agencies have their own accounting protocols and that financial information is often inconsistent or out-of-date. These complications can create a problem if a bank is unable to obtain appropriate information on a timely basis or understand the information once it has been provided. Moreover, a portfolio of municipal investments within a bank's lending area could be monitored differently than a portfolio of out-of-area issuers. Given the diversity and complexity of municipal security portfolios, management should increase its oversight of issuers through publicly available sources to stay apprised of issuers' credit risk.

Ongoing Monitoring

Ongoing monitoring is a crucial aspect of managing credit risk. This process provides management the opportunity to properly manage the investment portfolio and reduce or change risk levels as appropriate. Active monitoring of the portfolio supports management's ability to remain within board-approved risk tolerances. Unlike due diligence, which can require a significant amount of work leading up to the investment, ongoing monitoring is focused solely on the credit risk of the issuer and its performance *after* the investment. Various sources of external data are available to monitor credit risk, although some issuers may not make data available in a timely manner.

Ongoing monitoring of the investment portfolio is expected to be a more intensive process under the new rules. However, management should understand the range of expectations for oversight. It is entirely appropriate to deploy resources in an efficient manner, focusing on attributes that are deemed significant (e.g., riskier assets, time since last review, complexity, size, or concentrations). This method promotes personnel efficiency while providing coverage to the portfolio. Not every investment needs to be reviewed every quarter. While quarterly review may be appropriate for some investments, it may be more appropriate to risk-focus the reviews of other investments. Management should develop an ongoing monitoring program, similar to loan review, that is properly tuned to the risks in the portfolio while providing sufficient coverage to promote risk awareness.

Summary

Credit risk is credit risk, whether in a loan portfolio or an investment portfolio. Bankers are comfortable underwriting loans and should be able to use those skills in developing an oversight process for identifying and monitoring credit risk in investment securities and portfolios. While an external credit rating can be one element of issuer due diligence, it cannot be used as the primary way to assess credit risk for either purchasing securities or ongoing monitoring.

The board of directors is ultimately responsible for the risk acceptance of a bank by establishing appropriate policies and limits, but management is responsible for implementing the board's restrictions. Management may find it necessary to implement a tiered process for the ongoing review of the investment portfolio that focuses on inherent risk, size, complexity, concentration, or any other factor important to the bank. The new due diligence requirements can be supported by third-party information and analysis, but the decision to invest must be controlled by bank management and cannot be outsourced. One of the lessons of the financial crisis was that credit risk in an investment portfolio can be as debilitating as credit risk in a loan portfolio. Sound credit analysis and review of investment security purchases should serve community banks well in the long run. ■

Loan Participations: Lessons Learned During a Period of Economic Malaise *continued from page 9*

underwriting process may reveal that the participating bank is lending outside of its area of expertise. For example, during the recent downturn, some agriculture-focused community banks found that their efforts to diversify by buying participations in out-of-area commercial real estate projects led to significant problems. While the projects were not overly complex, the banks lacked the expertise and experience in the business line to accurately assess the risks of the individual projects. By not having the proper expertise, coupled with limited control and borrower access, these banks frequently ended up with little control over collection activities.

> "When purchasing participations, the bank is purchasing both a specific loan and a relationship with the lead bank and all other participants. It is imperative to understand with whom the bank is doing business."

Avoid Entering into a Relationship That Is Too Complicated to Understand

Examiners reviewing loan files occasionally identify a loan relationship as "too complicated to understand." This informal phrase is used when an examiner believes the bank has entered into a complicated loan participation without fully understanding the credit, borrower, collateral, or guarantor. This often occurs with purchases of larger loans with more complex or financially savvy guarantors than would be typically seen at a community bank. To assist the bank in calculating a global debt service coverage ratio, these guarantors often provide tax returns that are delivered by the truckload, leaving bank lending personnel to piece together their numerous inter-related limited liability companies with information that may or may not reflect their current status.

In lieu of deciphering complicated tax returns, bankers in these situations often limit the guarantor analysis to a review of the personal financial statement, especially if that statement shows substantial net worth. This practice has proved to be risky. For example, if the guarantor is a real estate developer, its net worth may be overstated if it relies on inflated real estate values and lacks information on contingent debt. During the real estate downturn, the net worth of many real estate developers promptly vanished, and no guarantor support could be provided because contingent liabilities on other real estate projects were greater than the value of real estate the bank had financed. Also, any liquidity the guarantor reported often disappeared to service other debt. If a bank is not able to understand and clearly present the purpose for the loan, how it will be repaid, the operations of the business, and what support the collateral or guarantor provides, it may want to reconsider whether the loan is worth pursuing.

Know the Agreement Details, Including the Lead Bank and All Participants

When purchasing participations, the bank is purchasing both a specific loan and a relationship with the lead bank and all other participants. It is imperative to understand with whom the bank is doing business. The purchasing bank should ensure that the lead bank has the expertise and staff to appropriately administer the credit, determine how the lead bank will handle a workout situation, and know what the rights are under the participation agreement, particularly in the event of default. In addition, the purchasing bank should ensure that participants have a say in restructuring the debt and should understand that the smallest bank in the group may have a very different perception of what an appropriate workout situation looks like versus the largest participating bank's perception.

For example, a bank purchased a participation in a condominium project that was out of its market area. The bank purchased a small piece of the large credit and had participated not just with smaller community and regional banks but with a large financial institution as well. The building was completed, but because of the downturn in the real estate market, all of the original buyers of presold units canceled their contracts with only nominal penalties, and the guarantors did not provide meaningful support. The large financial institution's workout strategy was to liquidate the property as quickly as possible in order to redeploy the funds tied up in this nonearning asset. The smaller banks, however, could not accept the losses related to this liquidation scenario. Because of the structure of the participation agreement, their voice was not heard, as the controlling interest could dictate the terms of any restructure or workout plan. To minimize their losses, the smaller banks ultimately opted to buy out the large financial institution's participation in order to take a more measured approach to liquidation. While the potential loss on this loan would have been a pittance for the large institution, it could have wiped out over a year's worth of earnings at the smaller banks. To minimize their losses, the smaller banks wound up taking on more risk than was originally approved when the original participations were purchased.

Understand How the Participation Will Be Sold

While the primary focus of this article is on expectations for managing purchased loan participations, there are similar expectations for how the participation will be sold. Specifically, the same underwriting and diversification guidance noted above are applicable, but the difference is in truly understanding the legal obligations of a lead bank. The participation and loan agreements identify what information the lead bank is responsible for delivering to participants. Most often, this includes periodic financial information and correspondence with the borrower, among other items. Loan agreements tend to vary and could include quarterly debt service coverage covenants or specific construction draw requirements that must be monitored or executed by the lead bank. Failure to execute duties set out in participation agreements can subject the lead bank to legal risk, as participants might surmise that a borrower's deteriorating repayment prospects are related to improper administration or covenants that are no longer effective because they were never enforced. A bank acting in a lead capacity should ensure it has the resources and expertise necessary to properly administer credits and adhere to participation agreements.

Summary

Many institutions used loan participations inappropriately during the period of economic expansion before the recent financial crisis. Sound underwriting standards and risk management were, at times, ignored in a quest for increased earnings. While loan participations can play a meaningful role in managing a bank's loan portfolio, they should be approached as any other credit, with a systematic use of sound underwriting and risk management practices that balance the risk and reward of these relationships.

This list of best practices is not inclusive, and community banks are encouraged to review relevant regulatory guidance[3] on this issue, including risk management guidelines found in the *Commercial Bank Examination Manual*.[4] ■

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[3] See guidance on the Federal Reserve Board's public website, for example, at www.federalreserve.gov/bankinforeg/topics/topics.htm.

[4] See www.federalreserve.gov/boarddocs/supmanual/cbem/cbem.pdf.

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. But even more information is available on the *Community Banking Connections* website, located at www.communitybankingconnections.org.

The website houses much more than the online version of *Community Banking Connections*. 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.

Users can also link to the *Community Banking Connections* Twitter page and subscribe to the print or electronic version of the publication through the website.

Supervision & Regulation (SR) Letters

The following SR and CA letters that have been published since the beginning of 2013 apply to community banking organizations. Letters that contain confidential supervisory information are not included. All SR letters are available by year at www.federalreserve.gov/bankinforeg/srletters/srletters.htm and by topic at www.federalreserve.gov/bankinforeg/topics/topics.htm. A complete list of CA Letters can be found at www.federalreserve.gov/bankinforeg/caletters/caletters.htm.

SR Letter 13-13/CA 13-10, "Supervisory Considerations for the Communication of Supervisory Findings"

SR Letter 13-12, "Commodity Futures Trading Commission (CFTC) Swap Clearing Rules"

CA Letter 13-9, "Revised Examination Procedures for Regulation Z"

SR Letter 13-11, "Filing Procedures for Annual Independent Audits and Reports Required Under Federal Deposit Insurance Corporation (FDIC) Rules"

CA Letter 13-8, "Guidance on the Use of 2010 Census Data in Fair Lending Examinations"

SR Letter 13-10, "Format for Safety-and-Soundness Reports of Examination and Inspection for Community State Member Banks and Holding Companies Rated Composite '4' or '5'"

CA Letter 13-7, "Statement on Deposit Advance Products"

SR Letter 13-9/CA Letter 13-6, "Minimum Standards for Prioritization and Handling Borrower Files with Imminent Scheduled Foreclosure Sale"

SR Letter 13-8/CA Letter 13-5, "Extension of the Use of Indicative Ratings for Savings and Loan Holding Companies"

SR Letter 13-7/CA Letter 13-4, "State Member Bank Branching Considerations"

SR Letter 13-6/CA Letter 13-3, "Supervisory Practices Regarding Banking Organizations and Their Borrowers and Other Customers Affected by a Major Disaster or Emergency"

CA Letter 13-2, "Interagency Statement on the Impact of Biggert-Waters Act"

SR Letter 13-5, "Revisions to the Required Data Fields for the Interagency Loan Data Request"

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.

FedLinks
Connecting Policy with Practice

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

Recent *FedLinks* bulletins include:

"Allowance for Loan and Lease Losses"
"Risk Management Supervisory Expectations for Agricultural Credit Risk"

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A SUPERVISION AND REGULATION PUBLICATION

Second Quarter 2013

VIEW FROM THE DISTRICT

A Ninth District Perspective — Minneapolis

Confronting "This Time It Will Be Different" in 2013

by Ron Feldman, Senior Vice President, Executive Services, Supervision, Regulation and Credit, Federal Reserve Bank of Minneapolis

In 2009, Carmen Reinhart and Kenneth Rogoff published their influential book, *This Time Is Different*. The subtitle — *Eight Centuries of Financial Folly* — foreshadows the bottom line, which the authors spell out in the first paragraph of the preface:

> This book provides a quantitative history of financial crises in their various guises. Our basic message is simple. We have been here before. No matter how different the latest financial frenzy or crisis always appears, there are usually remarkable similarities with past experience from other countries and from history.

They go on to identify the fallout from credit booms and debt accumulation as the hallmark of financial (and sovereign debt) crises.[1]

Ron Feldman

While Reinhart and Rogoff take a broad and international perspective, in this article I will consider the local implications of their message and encourage bankers in communities across the United States to do so as well. I will show how "this time it will be different" thinking could prove potentially costly to banks. I will focus my discussion on two issues that are directly relevant to the upper Midwest, where the Federal Reserve Bank of Minneapolis is located and I have the privilege of working.[2] That said, I think these issues apply to a broad range of banks across the United States. The issues I will discuss concern (1) lending in an environment of rapidly increasing natural resource values and (2) operating in a stressed earnings environment produced, in part, by persistently low interest rates.

[1] Carmen M. Reinhart and Kenneth S. Rogoff (2009), *This Time Is Different: Eight Centuries of Financial Folly* (Princeton: Princeton University Press).

[2] The Federal Reserve Bank of Minneapolis operates in the Ninth Federal Reserve District, which includes the states of Montana, North Dakota, South Dakota, and Minnesota; the western portion of Wisconsin; and the Upper Peninsula of Michigan. See www.minneapolisfed.org.

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INSIDE

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