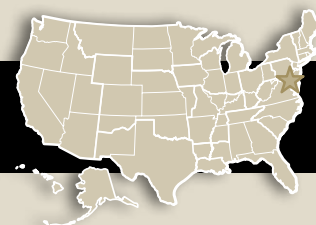


COMMUNITY BANKING CONNECTIONS[®]

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VIEW FROM WASHINGTON

Board Staff Perspective on Community Bank Supervision: One Size Doesn't Fit All

by Maryann Hunter, Deputy Director, Division of Banking Supervision and Regulation,
Board of Governors of the Federal Reserve System

One of the recurring features of *Community Banking Connections* is a series of “View from the District” articles, which offer valuable perspectives from the officers in charge of supervision at the various Federal Reserve Banks across the United States. These articles provide local insights from key Federal Reserve leaders on a wide range of topics that are pertinent to community bankers. In this issue, we decided



Maryann Hunter

to provide a “View from Washington” to share some perspectives from the Federal Reserve Board’s staff in Washington, D.C., on the Federal Reserve’s community bank supervision program. Although this article focuses on the view from Washington, I also have personal experience with the boots-on-the-ground operations of the Federal Reserve Banks. I began my career at the Federal Reserve Bank of Kansas City as a community bank examiner in 1981 and eventually became the officer in charge of bank supervision for that Reserve Bank. I also served as the branch manager in charge of bank operations at the Denver Branch of the Kansas City Reserve Bank. I

joined the Federal Reserve Board’s Division of Consumer and Community Affairs in 2006 and then the Board’s Division of Banking Supervision and Regulation in 2010. During my 30-plus years of Federal Reserve service, I have seen just how important community banks are to their local economies and how critical it is that we supervise community banks effectively and efficiently.

Just What Do We Do at the Federal Reserve Board?

When I meet with bankers, I am often asked to describe

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Municipal Lending at Community Banking Organizations — Emerging Risks?

by Ivy M. Washington, Supervisory Examiner, and William T. Wisser, Assistant Vice President, Federal Reserve Bank of Philadelphia

Many banks have viewed lending to municipalities as a relatively low-risk activity and an opportunity for the bank to earn other business from the municipalities, including deposits, cash management, and wealth management. Historically, loans to state or local municipalities were viewed as low-risk lending opportunities because municipalities frequently guaranteed repayment, which was often based on the state or local government's taxing authority. The so-called Great Recession of 2007–2009 and its aftermath have taken a toll on the financial state of many municipalities, making repayment less certain than it once may have been.

This article examines municipal lending by community banks, including common types of credit facilities, recent trends, and effective credit risk management practices.

Common Types of Municipal Lending at Community Banking Organizations

Various types of loans are made directly or indirectly to municipalities. These loans are repaid through general cash flows or through specific revenue streams, such as water and sewer fees or stadium and parking fees. In the past, com-

munity banks typically financed small municipal projects, such as purchasing new equipment or vehicles or providing a working capital line of credit to offset the seasonality of the municipality's cash flow. More recently, however, bank examiners have observed several community banks financing potentially riskier projects.

Project Finance

Over the past several years, examiners have observed a shift in smaller project financing away from capital markets to financial institutions. During the Great Recession, some municipalities either lost their investment ratings or saw their bond insurance premium costs increase; therefore, the cost of issuing debt securities in the capital markets increased. As a result, these smaller municipalities are turning to financial institutions to finance these projects.

Generally, these projects are longer term and supported by cash flows generated from the project. If cash flows are insufficient to meet the debt service requirements, the financial institution might be forced to restructure the transaction or obtain financial support from the municipality. Municipalities

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do not guarantee this type of debt but often offer financial support to ensure that services continue to be provided to their citizens. However, there are some cases in which the municipality may withdraw its financial support from a project. This occurred in Scranton, PA, in June, 2012.

The Scranton Parking Authority (SPA) was saddled with debt and dwindling liquidity in 2012. The SPA had insufficient cash to make its loan payment and therefore reached out to the City of Scranton for funding. The City of Scranton, also strapped for cash, decided not to fund the payment, which resulted in a default.

As with any lending, it is important that bank management understands the financial condition of the borrower (in this case, the municipality) and the ability and willingness

“As with any lending, it is important that bank management understands the financial condition of the borrower and the ability and willingness of the borrower to make the required payments.”

of the borrower to make the required payments. Management should also understand that not all municipal loans are created equal. Certain loans to municipalities could pose significant credit risks to the institution, which management must incorporate into its methodology for determining the adequacy of the allowance for loan and lease losses.

Tax and Revenue Anticipation Notes

Tax anticipation notes (TANs) and revenue anticipation notes (RANs) are generally short-term, self-liquidating loans or lines of credit to meet the cash flow needs of a municipality. These notes will be repaid with future tax collections, in the case of TANs, or revenues from the project that is being financed, in the case of RANs. Typically, these loans or lines of credit are tied to a specific revenue source and are collateralized by the revenue source. These obligations are generally repaid annually. New obligations are granted based on expected cash flow needs.

When a municipality is unable to repay a TAN or RAN or needs to fund fixed obligations, it will often turn to a financial institution or the capital markets to refinance the existing debt and amortize it over a defined period of time. In some cases, municipalities layer additional debt on the balance sheet in the hope that cash flow improves in future years. If cash flow continues to deteriorate or does not meet expectations, the municipality may be forced to borrow funds to meet the statutory requirement of a balanced budget. By borrowing additional funds, the layering of debt may place the municipality into a debt spiral that could lead to more serious financial problems. Bank management should carefully review these types of requests to ensure that it understands the challenges facing the municipality. Local leaders should also be prepared to make difficult decisions on taxes and expenditures if the municipality's cash flow does not improve.

Recent Bankruptcy Filings by Municipalities

Most U.S. municipalities appear to be in reasonably sound financial condition; however, over the past three years several larger municipalities have filed for bankruptcy protection under Chapter 9 of the Bankruptcy Code.¹ For example:

- Detroit filed for bankruptcy protection in 2013 with \$18.5 billion in liabilities, which to date ranks as the largest municipal bankruptcy;
- Jefferson County, Alabama, filed for bankruptcy protection in 2011 with about \$4 billion in liabilities;
- San Bernardino, CA, filed for bankruptcy protection in 2012 with \$1 billion in liabilities; and
- Stockton, CA, filed for bankruptcy protection in 2012 with \$700 million in liabilities.

In 2012 alone, 20 municipalities filed for Chapter 9 bankruptcy protection, the highest number of filings since 1991. Although only nine municipalities filed bankruptcy petitions in 2013, the largest municipal bankruptcy was filed in July 2013, as discussed below.²

Most of these cases resulted from changing demographics and falling real estate values, which adversely affected revenue sources for municipalities, while expenditure cuts

¹ Municipal debtors must file under Chapter 9 of the U.S. Bankruptcy Code (Adjustment of Debts of a Municipality), 11 U.S.C. section 901 et seq. Chapter 9 is available at www.gpo.gov/fdsys/pkg/USCODE-2012-title11/pdf/USCODE-2012-title11-chap9.pdf.

² The statistics are from the United States Courts at www.uscourts.gov/Statistics/BankruptcyStatistics.aspx.

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Bank-Owned Life Insurance: A Primer for Community Banks

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

Since the 1980s, banks have purchased bank-owned life insurance, or BOLI, for various business purposes — most commonly to recover losses associated with the death of a key person, to recover the cost of providing pre- and post-retirement employee benefits, and to provide a direct employee benefit. While the products and the reasons for purchasing BOLI are not new, the overall use of BOLI at community banks has been increasing, and regulators continue to receive questions about BOLI investments by community banks.

This article provides an overview of the different types of BOLI, trends in BOLI holdings at community banks, the unique risks of BOLI, and the impact of the revised capital framework on BOLI investments by community banks.

A BOLI Primer

BOLI is a life insurance policy purchased by a bank or bank holding company to insure the life of certain employees. Typically, the insured employee is an officer or other highly compensated employee, but a bank may purchase insurance for any employee. Since the bank owns the policy, the bank receives the proceeds from the death benefit, accrues revenue from investment earnings, and bears the risk of investment losses. However, banks may also purchase split-dollar life insurance policies as an employee benefit. With these policies, the bank and the employee share rights to the policy's cash surrender value (CSV) and death benefits (see box at right).¹ This article focuses solely on the BOLI policies owned by banks.

When purchasing BOLI, the bank often pays a single premium, which may range from thousands to millions of dollars depending on the nature of the policy. On the Call Report, the purchase of BOLI results in an increase in the

“Life Insurance Assets” category on Schedule RC-F, “Other Assets.” Over time, the reported CSV — the amount the bank would recoup after surrender charges but before taxes if it were to liquidate its BOLI holdings — is adjusted to reflect performance of the underlying investment(s). The primary benefit of BOLI is tax-related: Income earned on the policies is tax-free for the bank, and when an employee dies, the cash payments the company receives are tax-free.

There are two primary types of BOLI — general account and separate account — with a third “hybrid” category as well. The features of general account and separate account BOLI are summarized in Table 1. General account BOLI is a fairly straightforward product and is reasonably easy to understand. Separate account BOLI may be very complex, particularly when stable value protection (SVP) wraps² are included in

Key-Person Versus Split-Dollar Life Insurance

Key-Person Life Insurance: When the death of a bank officer or other key person would be of such consequence to the bank as to give it an insurable interest, key-person life insurance insures the bank on the life of the individual. The bank generally pays the entire premium and is the beneficiary. The primary purpose of this type of insurance is to indemnify the bank against the potential loss of net income that may result from the death of the insured.

Split-Dollar Life Insurance: This policy is a form of additional direct compensation, whereby the bank pays part or all of the insurance premiums and the executive's beneficiary receives some or all of the death benefit.

¹ See Supervision and Regulation (SR) letter 94-23, “Split-Dollar Life Insurance at State Member Banks,” available at www.federalreserve.gov/boarddocs/srletters/1994/SR9423.htm.

² In general, an SVP contract pays a separate account policy owner any shortfall between the fair value of the separate account assets when the policy owner surrenders the policy and the cost basis of the separate account to the policy owner. SVP contracts are most often used to mitigate price risk in connection with fixed-income investments.

Table 1: BOLI Characteristics

Characteristic	General Account	Separate Account
Investment Decisions	The insurance company makes all investment decisions, and the assets are part of its general fund.	The bank selects the investment style but does not control the investments. Investments must be bank qualified.
Protection from Insurance Carrier Creditors	CSV is an unsecured obligation of the insurance company and is available to general creditors in the event of the life insurer's insolvency.	The insurer invests in assets that are segregated by state law and protected from general creditors.
Interest Rate Risk	Interest rate risk is inherent in the policy's interest crediting rate, which is guaranteed by the insurer.	Interest rate risk is directly related to the performance of the specific investments in the separate accounts. The BOLI holder assumes investment and price risk. Separate account products may have SVP wraps to limit interest rate risk.
CSV	CSV fluctuates depending upon returns from the insurer's general investment account.	CSV fluctuates depending upon returns from the underlying investments supporting the policies. The cash value potentially could be zero.
Guarantees	None	May have an SVP wrap to protect against some declines in CSV and to smooth CSV fluctuations.

the contract. Hybrid BOLI generally combines elements of both types of policies, providing the creditor protection of separate account BOLI with the minimum guaranteed rates of general account BOLI.

BOLI Holdings at Financial Institutions

The number of banks reporting life insurance assets and the total reported balances of these assets have been increasing.³ As shown in Table 2, more than 3,500 commercial and savings banks reported over \$137 billion in life insurance assets at year-end 2013. And it is clear from the table that BOLI is not just a product for large banks; 3,467 community banks reported \$29 billion in BOLI assets at year-end 2013. This was an increase not only in the number of community banks reporting life insurance assets but also in the balances out-

standing and the level of the concentration of life insurance measured as a percentage of tier 1 capital plus the allowance for loan and lease losses (ALLL). There are likely many reasons for the increase in BOLI balances. One probable cause is the appreciation of the underlying investments. However, it is also possible that some institutions are purchasing new BOLI policies to obtain a higher tax-equivalent yield than is available on many securities or loans, which may raise supervisory concerns if banks do not understand the associated risks or do not have adequate risk management processes in place.

The type of BOLI held generally varies by the size of the bank. As shown in Figure 1, most community bank BOLI assets are considered “simpler” general account assets, which are unsecured obligations of the insurance company. However, at larger community banks as a whole, the balances of BOLI assets in separate accounts or hybrid accounts grow. The type of BOLI policy affects not only the risk of the assets but also their risk weighting for capital purposes.

³ Data in this section were extracted from commercial bank and savings institution Call Report filings as of year-end 2013.

Table 2: Commercial Banks and Savings Associations Reporting Life Insurance Assets in Call Report Filings

Banks by Asset Size	12/31/2013			12/31/2012			Year-over-Year Change		
	# Banks	Balances	Average % Tier 1 Capital + ALLL	# Banks	Balances	Average % Tier 1 Capital + ALLL	# Banks	Balances	Average % Tier 1 Capital + ALLL
Under \$100 million	698	\$819	17.28%	708	\$790	16.80%	-1.41%	3.67%	2.82%
\$100 million – \$500 million	1,913	\$7,837	15.63%	1,878	\$7,322	15.43%	1.86%	7.03%	1.28%
\$500 million – \$1 billion	455	\$5,321	15.25%	450	\$4,906	14.55%	1.11%	8.46%	4.82%
\$1 billion – \$10 billion	401	\$14,924	13.89%	382	\$13,787	13.75%	4.97%	8.25%	0.99%
Community Bank Total	3,467	\$28,901	15.71%	3,418	\$26,805	15.41%	1.43%	7.82%	1.95%
Over \$10 billion	66	\$108,506	13.27%	65	\$105,003	12.90%	1.54%	3.34%	2.91%
Total	3,533	\$137,407	15.66%	3,483	\$131,808	15.36%	1.44%	4.25%	1.95%

Source: Data were extracted from commercial bank and savings institution Call Report filings as of year-end 2013.

The likelihood that a community bank will hold BOLI assets also increases with its size. As shown in Figure 2, community banks of all sizes hold BOLI assets, with a positive correlation between bank size and percentage of banks reporting BOLI assets.

Concentrations of BOLI investments at some institutions are significant. As of year-end 2013, 363 institutions nationwide reported CSV greater than 25 percent of the sum of tier 1 capital and ALLL, which is a measure that the Federal Reserve uses to gauge concentrations. Twenty of those institutions, including 18 community banks with assets less than \$50 million, reported CSV greater than 50 percent of tier 1 capital and ALLL. While it may be understandable that smaller community banks have a greater BOLI concentration because of their relatively smaller balance sheets, they must be aware of and actively manage and mitigate the additional risks.

Supervisory Guidance

Given the number of institutions that own BOLI, the agencies have issued guidance on BOLI risk management and accounting. In December 2004, the Board of Governors of the Federal Reserve System, along with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, issued an “Interagency Statement on the Purchase and Risk Management of Life Insurance.”⁴ This statement expanded upon the interagency guidance issued in February 2004, “Interagency Advisory on Accounting for Deferred Compensation

Agreements and Bank-Owned Life Insurance (BOLI).”⁵ Although issued almost 10 years ago, the 2004 interagency statement and advisory remain relevant and helpful today.

The December 2004 interagency statement provides additional information — on topics such as the legal authority under which banks may purchase BOLI as well as BOLI accounting considerations — that is beyond the scope of this article. The interagency statement also provides a very detailed discussion of BOLI risk management considerations, which community banks owning or contemplating the purchase of BOLI are encouraged to consider. Finally, the interagency statement includes an appendix that discusses insurance types and purposes and provides a glossary of insurance-related terminology.

The remainder of this article focuses on two additional areas addressed in the interagency statement: BOLI risks and BOLI risk-based capital considerations.

BOLI Risks

An effective board of directors and management team will consider the risks of BOLI when deciding whether to purchase life insurance on its employees. This section highlights some of the risks associated with BOLI.⁶ Bank examiners

⁵ See SR letter 04-4, “Accounting for Deferred Compensation Agreements,” available at www.federalreserve.gov/boarddocs/srletters/2004/sr0404.htm.

⁶ See also a more general discussion of the Federal Reserve’s risk management expectations for banking organizations at 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.

⁴ See SR letter 04-19, “Interagency Statement on the Purchase and Risk Management of Life Insurance,” available at www.federalreserve.gov/boarddocs/srletters/2004/sr0419.htm.

take BOLI into consideration when assessing the institution's overall financial condition and risk profile and when assigning supervisory ratings.

Credit Risk

The performance of any life insurance contract depends on the financial condition of the insurance company that underwrites or guarantees the contract and the ability of that insurance company to honor the payment terms of the contract. Given that most insurance contracts are long-term assets, the insurance company's financial condition and ability to pay must be reviewed regularly over the life of the contract, just like a bank would review a borrower's financial condition and ability to pay on a regular basis. As part of the credit risk assessment, a bank should conduct a thorough analysis, including consideration of external information on creditworthiness as appropriate.

As discussed previously, a bank purchasing general account BOLI owns an unsecured obligation of the insurance company, whereas a bank holding separate account BOLI has some protection from the company's general creditors. With separate account BOLI, banks primarily face credit risk from the underlying holdings in the separate account. However, even separate account BOLI holders may be exposed to the credit risk of the issuer; the difference between the minimum guaranteed death benefit and the CSV of the separate account BOLI is an unsecured obligation of the insurance company.

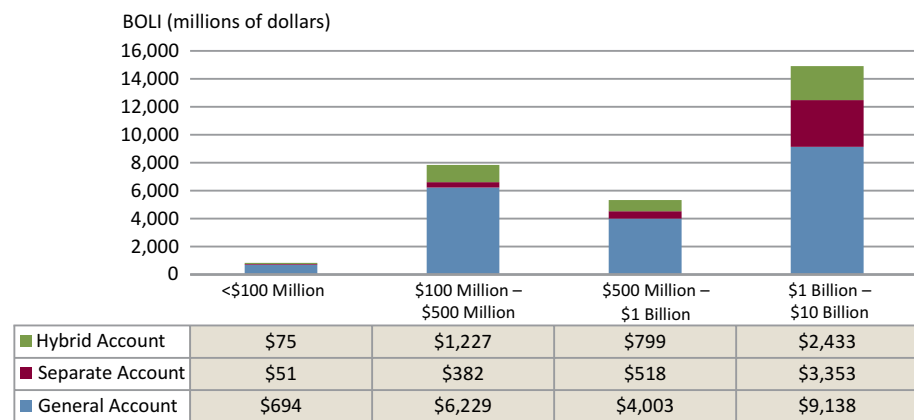
In addition, a bank should consider the credit risk arising from

a separate account BOLI policy's SVP wrap. The bank may have credit risk exposure to both the third party that provides the SVP wrap and to the insurance company responsible for the final payment under the policy.

The credit risk exposure associated with BOLI also raises concentration concerns. To mitigate credit concentration risk

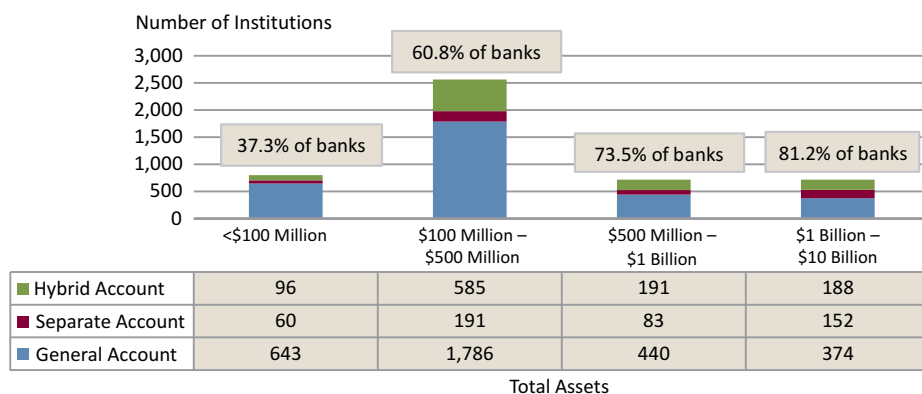
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Figure 1: BOLI Balances by Type at Community Banks



Source: Data were extracted from commercial bank and savings institution Call Report filings as of year-end 2013.

Figure 2: Community Banks Reporting BOLI by Size



Note: Some banks report more than one type of BOLI asset. The numbers in the table represent the number of banks reporting that type of BOLI asset; the actual number of banks reporting BOLI is less than the sum of the numbers in the table.

Source: Data were extracted from commercial bank and savings institution Call Report filings as of year-end 2013.

Loan and OREO Accounting Guidance ... for the Good Times

by Tim Melrose, Senior Examiner, and Kinney Misterek, Assistant Vice President, Federal Reserve Bank of Minneapolis

Banks are beginning to experience general improvement in the overall credit quality of their loan portfolios. When the credit crisis began, many bankers were confronted with accounting challenges that they may not have had to deal with for some time. For example, some bankers were unfamiliar with the accounting requirements governing other real estate owned (OREO) because they seldom held OREO prior to the crisis. Similarly, bankers are now confronted with accounting issues related to various improving credit events that they may not have experienced in the recent past. These events include:

1. returning a nonaccrual loan to accrual status;
2. selling OREO; and
3. evaluating troubled debt restructurings (TDRs).

To facilitate compliance, this article provides a basic overview of some of the more common accounting questions that arise as credit quality begins to improve. Although specific resources for more detailed guidance are included in this article, bankers may also want to seek their accountants' advice.

Returning a Nonaccrual Loan to Accrual Status

Regulatory guidance permits nonaccrual assets to be returned to accrual status under appropriate circumstances. A good resource for this process is the "Nonaccrual Status" entry in the Glossary of the "Instructions for Preparation of Consolidated Reports of Condition and Income (FFIEC 031 and 041)" (Call Report Glossary).¹ The Call Report Glossary describes two primary options to return a nonaccrual loan to accrual status (there are additional options detailed within this section of the Call Report Glossary for accrual accounting and the restoration to accrual status for formally restructured loans, but they are beyond the scope of this article).

The first option requires that none of the loan's principal and

interest (P&I) are due and unpaid and that the bank expects full repayment of the remaining contractual P&I. This option is met when a borrower brings all past due payments current. Additionally, a borrower can satisfy this option even when all past due payments have not yet been brought current as long as the borrower has resumed paying the full amount of the scheduled P&I payments and there is a sustained period of repayment performance (generally a minimum of six months) and reasonable assurance that all P&I contractually due, including any arrearages, will be collected in a reasonable period. For loans with interest-only payments or payments due less than monthly (that is, semiannually or annually), banks should perform a credit analysis and clearly document the timely collectibility of all contractually required payments prior to returning the loan to accrual status.

The second option requires that the loan be well secured and in the process of collection. This condition is typically met when the bank is reasonably certain that collection efforts, including legal action, will result in repayment of the debt or restoration to current status within a short period of time, generally within 30 to 90 days. Simply commencing collection efforts does not constitute "in the process of collection."

One item not discussed in detail in U.S. generally accepted accounting principles (GAAP) or the Call Report Glossary is the "cost recovery method." This entails accounting for restoring a nonaccrual loan to accrual status when interest payments have been applied to the principal while the loan is in nonaccrual status because of doubt about the collectibility of the recorded principal. The Call Report Glossary instructions state that interest payments that were applied to reduce the principal should not be reversed when returning the asset to accrual status. When the loan returns to accrual status, an acceptable method would be to recognize interest income based on the new effective yield to maturity on the loan.

For example, assume that a loan with a remaining balance of \$100,000, a 4 percent fixed rate, and five years remaining before it becomes fully amortized at \$1,841 P&I per month is moved to nonaccrual status. The loan is held in nonaccrual

¹ See Federal Financial Institutions Examination Council (FFIEC), "Instructions for Preparation of Consolidated Reports of Condition and Income (FFIEC 031 and 041)," available at www.ffiec.gov/pdf/ffiec_forms/ffiec031_041_200503_i.pdf.

status for 12 months. Assume further that the bank uses the cost recovery method (described in further detail on page 20) and the borrower makes all scheduled payments while the loan is in nonaccrual status. Because of doubt about the collectibility of the recorded principal, 12 payments of \$1,841 are applied to reduce the principal from \$100,000 to \$77,908. At the end of 12 months, the bank confirms that the loan satisfies the requirements discussed above to restore the loan to accrual status.

The \$100,000 loan would reflect the principal reduction of \$22,092, leaving a net loan balance of \$77,908, with a remaining four years of monthly payments at \$1,841. The bank would calculate a new yield based on the remaining loan balance, maturity, and scheduled payments to determine the allocation of future payments between the principal and the interest. In this case, the yield is adjusted from 4 percent to 6.32 percent. Amortization of the first monthly payment made is applied as follows: \$341 to the interest and \$1,500 to the principal.

“ Accounting for the sale of OREO can be challenging when the bank finances the sale. Proper accounting for the sale of OREO is detailed in the ‘Foreclosed Assets’ entry of the Call Report Glossary. ”

While this example is relatively simple, it illustrates an important concept. Because regulatory reporting instructions do not allow payments that were applied to reduce the principal to be reversed, the restoration accounting and the change in yield calculation can be complex.

Selling OREO

Accounting for the sale of OREO can be challenging when the bank finances the sale. Proper accounting for the sale of OREO is detailed in the “Foreclosed Assets” entry of the Call Report Glossary. In addition, Accounting Standards Codification (ASC) 360-20 is the primary accounting guidance for

the sale of any bank property, plant, or equipment. GAAP permit five different accounting methods when a bank finances the disposition of its own OREO: the full accrual, installment, reduced-profit, cost recovery, and deposit methods. Which method is appropriate in a specific case depends on all the facts and circumstances surrounding the sale.

While many banks commonly use either the full accrual or installment method to account for OREO dispositions that they finance, the primary considerations for determining the accounting method to be used are the buyer’s “initial investment” (that is, the down payment) and his or her “ongoing investment” (that is, the required amortization schedule). Specifically, the use of the *full accrual method* is allowed if:

1. the sale is consummated;
2. the buyer’s initial and ongoing investments are adequate to demonstrate a commitment to pay for the property (refer to ASC 360-20-55 for qualifications for using this method, including the minimum down payment based on the type of real estate financed);
3. the receivable is not subject to future subordination; and
4. the usual risks and rewards of ownership have been transferred, including the bank no longer having a substantial continuing involvement in the property.

Using the full accrual method allows the bank to recognize the sale, the corresponding new loan, and any gain at the time of sale. Any loss from the sale of OREO must be recognized immediately.

Other methods may be used when the transaction cannot meet certain conditions prescribed under the full accrual method. For instance, if the buyer’s initial investment is not adequate under the full accrual method but the bank’s ability to recover the cost of the property remains reasonably assured, the bank may use the *installment method*. This method recognizes the OREO sale and corresponding accrual loan. However, any gain from the sale will only be recognized as the bank receives payments (includes both initial and ongoing principal payments) from the buyer. A loss on a sale is always recognized immediately.

The following example illustrates the different accounting entries under these two approaches.

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Board Staff Perspective on Community Bank Supervision: One Size Doesn't Fit All *continued from page 1*

how the role of the Federal Reserve Board compares with that of the 12 Federal Reserve Banks with regard to bank supervision.¹ Broadly speaking, while the Board and the Reserve Banks work together closely, the Board is responsible for policy and program development and program management for bank supervision, whereas the Federal Reserve Banks conduct day-to-day supervision of financial institutions on a delegated basis. The Federal Reserve Banks and the examiners who work there are the face of the Federal Reserve's supervision program, especially when it comes to community bank supervision. Each of the Reserve Banks has detailed knowledge about banking and financial conditions in its respective District. Because the Board oversees and communicates regularly with the Reserve Banks, one of our key responsibilities is to synthesize this local knowledge and provide a national perspective on banking conditions and emerging risks.

The Banking Industry Is Looking Healthier

Our staff closely monitors the overall health of the banking system. What we have seen recently is that the overall condition of community banks has improved significantly in the wake of the financial crisis, although the business model remains under strain. The number of banks on the Federal Deposit Insurance Corporation's "Problem List" fell from a peak of 884 in December 2010 to 467 at year-end 2013.² Despite the decline, that number of problem banks compares unfavorably with historical averages of less than 100 in the years prior to the crisis.

Overall, capital levels and asset quality at small banks have improved in recent years, especially when comparing recent financial indicators with the lows that were reached during and after the financial crisis. The aggregate tier 1 risk-based capital ratio for community banks was 14.7 percent at year-end 2013, up from a low of 12.0 percent at year-end 2008,

and the aggregate leverage ratio was 10.4 percent, up from a low of 9.2 percent at year-end 2009.³ Noncurrent loans represented 1.9 percent of total loans at year-end 2013, down significantly from a peak of 4.1 percent at year-end 2010, while net charge-offs as a percent of average loans were down to 0.4 percent at year-end 2013, from a high of 1.6 percent at year-end 2009. Moreover, community banks saw an uptick in lending in 2012 and 2013, with annual year-over-year loan growth of 2.5 percent at year-end 2013. This is in stark contrast to the period from 2009 through 2011 when total loans declined each year. We are hopeful that this lending is a sign of increased economic activity.

Earnings have benefited in the past couple of years from reductions in provision expenses for loan and lease losses, but this benefit has waned recently. Community banks had an aggregate return on average assets of 1.07 percent at year-end

“Earnings have benefited in the past couple of years from reductions in provision expenses for loan and lease losses, but this benefit has waned recently.”

2013, which is below precrisis levels but represents a significant improvement over relatively anemic earnings reported from 2008 to 2011. Net interest margin pressures remain an issue for all banks, but particularly for smaller banks. Finally, liquidity levels at community banks are adequate, as banks are generally well stocked with core deposits and dependence on noncore sources is relatively low.

Enhancing Community Bank Supervision

As community banks return to health and crisis management thankfully takes up much less of our time and energy, it seems

¹ More information about the Federal Reserve Banks, including a map of the 12 Federal Reserve Districts, can be found on the Board's public website at www.federalreserve.gov/otherfrb.htm. Additional information about the Federal Reserve System is also available on the Board's website at www.federalreserve.gov/aboutthefed/default.htm.

² See Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, Fourth Quarter, 2013, available at www2.fdic.gov/qbp/2013dec/qbp.pdf.

³ Unless noted otherwise, data in this section are based on quarterly Call Report data filed by commercial banks.

appropriate to step back and take stock of our community bank supervision program. As Federal Reserve Board Chair Janet Yellen discussed recently in a speech to community bankers, it is critical that we avoid taking a one-size-fits-all approach to supervision.⁴ While the Federal Reserve has long tailored approaches relative to the size, complexity, and risk profile of the banks we supervise, we are very aware that what makes sense for large, systemically important banks does not typically make sense for community banks. With that in mind, let me share some thoughts on how we are trying to enhance our community bank supervision program.

For starters, the Federal Reserve's longstanding risk-focused consolidated supervision program provides that examination and inspection procedures should be tailored to each organization's size, complexity, risk profile, and condition. Reviews of banks and holding companies, regardless of size and complexity, entail:

- an evaluation of the adequacy of governance provided by board and senior management, including an assessment of internal policies, procedures, controls, and operations;⁵
- an assessment of the quality of the risk management and internal control processes in place to identify, measure, monitor, and control risks;
- an assessment of key financial factors such as capital, asset quality, earnings, liquidity, and sensitivity to market risk (including interest rate risk); and
- a review for compliance with applicable laws and regulations.

The way these reviews are conducted, however, differs significantly across portfolios of banking organizations.⁶

⁴ See Janet L. Yellen, "Tailored Supervision of Community Banks," speech delivered at the Independent Community Bankers of America 2014 Washington Policy Summit, Washington, D.C., May 1, 2014, available at www.federalreserve.gov/newsevents/speech/yellen20140501a.htm.

⁵ For further reading, see Kevin Moore, "View from the District: The Importance of Effective Corporate Governance," *Community Banking Connections*, Fourth Quarter 2012, available at www.cbcrfs.org/articles/2012/Q4/Importance-of-Effective-Corporate-Governance.cfm.

⁶ The Federal Reserve assigns domestic banking organizations to one of four supervisory portfolios of similar institutions, recognizing that there are also differences among banking organizations within these portfolios. Community banking organizations generally are defined as those with \$10 billion or less in total consolidated assets; regional banking organizations are those with total consolidated assets between \$10 billion and \$50 billion; large banking organizations are those with total consolidated assets of \$50 billion or more; and Large Institution Supervision Coordinating Committee firms are the subset of large banking organizations that are the largest and most complex.

Tailoring Supervisory Policies

There are distinct differences between the supervision programs for large and small banks. For one, large banks are under a continuous supervision model, whereas small banks receive point-in-time examinations. Large banks generally have a dedicated supervisory team that may reside at that bank. By contrast, small banks may meet with an examination team only every 18 months, depending on their condition. Large banks are also subject to more stringent regulatory requirements, as seen with the recent rulemakings implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Federal Reserve Board continually strives to make sure supervisory policies are appropriate and calibrated in a way that makes sense for community banks.

We recognize that regulatory burden tends to fall disproportionately on smaller banks; therefore, we are being careful to write rules and guidance so as not to subject community banks to requirements that would be unnecessary or too difficult to implement. To give just one example, the Federal Reserve and the other banking agencies have made clear that the stress testing requirements for large banks do not apply to community banks.⁷ Moreover, to make it easier for community bankers to navigate the lengthy regulatory capital rules and the Volcker rule, the Federal Reserve, along with the other federal banking agencies, has developed guides outlining the specific provisions of these rules that are most relevant to community banks.⁸

The Board is also providing additional clarity on the applicability of supervisory policies to community banks. When we are developing new policies, we always ask ourselves explicitly whether they should apply to community banks. For Supervision and Regulation (SR) letters, which are the primary way in which the Board issues supervisory guidance to bankers and examiners, we include an applicability statement at the begin-

⁷ The banking agencies issued a policy statement in May 2012 clarifying supervisory expectations for stress testing by community banks. See Board of Governors, "Agencies Clarify Supervisory Expectations for Stress Testing by Community Banks," press release, May 14, 2012, available at www.federalreserve.gov/newsevents/press/bcreg/20120514b.htm.

⁸ See Board of Governors, Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency (OCC), *New Capital Rule — Community Bank Guide*, July 2013, available at www.federalreserve.gov/bankinforeg/basel/files/capital_rule_community_bank_guide_20130709.pdf; and Board of Governors, FDIC, and OCC, "The Volcker Rule: Community Bank Applicability," December 10, 2013, available at www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a4.pdf.

ning of these letters to clarify which banks are subject to the guidance, with a special focus on community banks (see box below). This additional clarity not only allows community bankers to focus their efforts on the supervisory policies that are applicable to their banks but it also helps to reduce the chance that examiners will inadvertently subject community banks to large bank expectations.

The Future of Community Bank Supervision

In addition to these enhancements to the supervisory policy development process, the Federal Reserve is taking additional steps to review and enhance our community bank supervision program. For one, the Federal Reserve is conducting what we are calling a “zero-based review” of the community bank

“ In addition to these enhancements to the supervisory policy development process, the Federal Reserve is taking additional steps to review and enhance our community bank supervision program. ”

supervision program to make sure this program and related supervisory guidance are appropriately aligned with current banking practices and risks. This project consists primarily

of a review of all existing supervisory guidance, such as SR letters, that apply to community banks to determine whether the guidance is still relevant and effective. As a result of this review, we are likely to eliminate some guidance that is no longer relevant and to revise other guidance to bring it in line with current supervisory and banking industry practices.

Second, we are using bank regulatory reporting data more effectively to enhance off-site surveillance, identify emerging risks, and tailor on-site examination procedures. Third, we are developing and implementing common technology tools across the Federal Reserve System for use in our community bank supervision program that will improve efficiency and reduce the burden on supervised banks. Finally, we are investigating the possibility of conducting more off-site examination activities, including loan review work for banks that have invested in technology that would allow us to do so. This effort is discussed in more detail in the article titled “Federal Reserve Seeks to Conduct More Loan Reviews Off-Site,” which also appears in this issue.

As we develop supervisory policies and examination practices, we are mindful of community bank concerns that new requirements for large banks could be viewed as “best practices” and trickle down to community banks in a way that is inappropriate.⁹ To address this concern, the Board is

⁹ See Daniel K. Tarullo, “Rethinking the Aims of Prudential Regulation,” speech delivered at the Federal Reserve Bank of Chicago Bank Structure Conference, Chicago, May 8, 2014, available at www.federalreserve.gov/newsevents/speech/tarullo20140508a.htm.

Examples of Applicability Statements

SR Letter 14-4, “Examiner Loan Sampling Requirements for State Member Bank and Credit Extending Nonbank Subsidiaries of Banking Organizations with \$10–\$50 Billion in Total Consolidated Assets”

Applicability: This letter does not apply to institutions supervised by the Federal Reserve with \$10 billion or less in total consolidated assets.

SR Letter 13-25, “Interagency Statement Regarding the Treatment of Certain Collateralized Debt Obligations Backed by Trust Preferred Securities Under the Volcker Rule”

Applicability: This guidance applies to all institutions regulated by the Federal Reserve, including those with \$10 billion or less in total consolidated assets.

enhancing its communications with examination staff about expectations for community banks versus large banks to ensure that expectations are calibrated appropriately. Along this line, we also routinely conduct horizontal reviews of Reserve Bank practices to promote consistency and to clarify expectations with respect to the examination process.

Concluding Thoughts

In closing, we at the Board have a keen understanding of the important role that community banks play in the economy and the financial system. We are well aware that supervisory

expectations for the largest, most complex firms are often inappropriate for community banks, and we are committed to ensuring that large bank expectations are not applied to community banks when it does not make sense to do so. Rigorous supervision is still critically important, but I believe that we must also take a balanced approach that fosters stable, sound, and vigorous community banks.

The author would like to thank Jinai M. Holmes, senior supervisory financial analyst, and T. Kirk Odegard, assistant director, for their contributions to this article. ■

D.C. UPDATES

Chair Janet Yellen delivered a speech on community banking at the Independent Community Bankers of America 2014 Washington Policy Summit on May 1, 2014. Her speech on “Tailored Supervision of Community Banks” is available at www.federalreserve.gov/newsevents/speech/yellen20140501a.htm.

Governor Daniel Tarullo delivered a speech on the aims of prudential regulation at various types of financial institutions, including community banks, at the Federal Reserve Bank of Chicago Bank Structure Conference on May 8, 2014. His speech on “Rethinking the Aims of Prudential Regulation” is available at www.federalreserve.gov/newsevents/speech/tarullo20140508a.htm.

Stanley Fischer was sworn in as vice chairman of the Board of Governors of the Federal Reserve System on June 16, 2014. A biography of Vice Chairman Fischer is available on the Board’s website at www.federalreserve.gov/aboutthefed/bios/board/fischer.htm.

Lael Brainard was sworn in as a member and Jerome H. Powell was sworn in for a second term as a member of the Board of Governors of the Federal Reserve System on June 16, 2014. Biographies of the governors are available on the Board’s website at www.federalreserve.gov/aboutthefed/bios/board/default.htm.

Governor Jeremy C. Stein resigned as a member of the Board of Governors of the Federal Reserve System, effective May 28, 2014. Governor Stein, who has been a member of the Board since May 30, 2012, plans to return to his teaching position in Harvard University’s department of economics. Governor Stein was a member of the Board’s Committee on Bank Supervision, which oversees the Federal Reserve’s supervision and regulation activities. That committee remains actively engaged in matters affecting bank supervision and regulation. His resignation letter is available on the Board’s website at www.federalreserve.gov/newsevents/press/other/20140403a.htm.

The federal bank regulatory agencies published the first of a series of requests for comments to identify outdated, unnecessary, or unduly burdensome regulations imposed on insured depository institutions on June 4, 2014. The Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA) requires that the agencies review regulations applicable to insured depository institutions every 10 years. The agencies have organized the review by 12 categories of regulations, and this first request seeks comment on regulations from three categories: Applications and Reporting, Powers and Activities, and International Operations. The agencies will publish three additional Federal Register notices over the coming two years requesting comments on the remaining categories. The press release, which includes links to the Federal Register notice and the EGRPRA website, is available on the Board’s website at www.federalreserve.gov/newsevents/press/bcreg/20140604a.htm.

Municipal Lending at Community Banking Organizations — Emerging Risks? *continued from page 3*

did not keep pace. Municipalities are sometimes unable to cut certain expenditures given that they are fixed by other governing bodies, union contracts, or pension obligations. In these circumstances, municipal officials may be tasked with the difficult decision to cut services, restructure contracts and pension benefits, borrow funds, seek new revenue sources to balance budgets, or, in a worst-case scenario, file for Chapter 9 bankruptcy protection.

Detroit Bankruptcy Filing

Let's look at Detroit as an example of what can happen. Detroit filed for bankruptcy protection on July 18, 2013, because its budget and pension obligations were too large relative to its diminished taxpayer base. The population in Detroit has shrunk from nearly 2 million individuals in 1950 to about 700,000, according to the results of the 2012 census, and over the past decade alone the population has declined by 25 percent.³ As a result, city leaders were forced to raise taxes and borrow additional funds in an attempt to balance the city's budget. Despite these efforts, the City of Detroit in recent years spent more than it brought in as revenue. This spending, coupled with the mandate to balance the budget annually, resulted in additional borrowings that saddled the city with a heavy debt load and ultimately resulted in the city filing for bankruptcy.

Detroit's total debt now exceeds \$18 billion, which includes significant health-care and pension-related debt and obligations backed by enterprise revenue, as well as secured and unsecured debt, interest rate swap exposure owed to banks, and other liabilities.⁴ As Detroit emerges from bankruptcy, it will be interesting to see how these liabilities are right-sized for a shrinking city and the potential impact to other municipalities facing similar challenges.

³ See Kate Linebaugh, "Detroit's Population Crashes," *Wall Street Journal*, March 23, 2011, at <http://ow.ly/vRa9K>.

⁴ Information about the Detroit bankruptcy filing is available on the United States Bankruptcy Court for the Eastern District of Michigan website at www.mieb.uscourts.gov/apps/detroit/DetroitBK.cfm.

Other Municipalities and States with Potential Financial Troubles

Some municipalities and states have seen revenues drop due to falling real estate values, foreclosures, and a low interest rate environment. Although raising taxes and fees may increase revenues, municipal officials often try to minimize the burden of higher taxes and fees on their citizens, especially when unemployment is already high.

The cost of health-care and pension obligations seems to be the most significant expenditure for many municipalities and states. Because of the low interest rate environment, a number of pension funds have become significantly underfunded over the past five years; a 2011 study estimated that the total unfunded pension liabilities of all U.S. cities and counties was \$574 billion.⁵ A report by Moody's also concluded that unfunded pension liabilities may be understated because of unrealistic assumptions tied to expected rate of return and the life expectancies of retirees.⁶ If more realistic assumptions are applied, Moody's found that some states had large unfunded pension liabilities as a percentage of total state revenue, including the following:

- Illinois (241 percent)
- Connecticut (190 percent)
- Kentucky (141 percent)
- New Jersey (137 percent)
- Hawaii (133 percent)
- Louisiana (130 percent)

The impact of unfunded pension liabilities on states' and local municipalities' budgets is significant and will likely affect

⁵ See Robert Novy-Marx and Joshua Rauh, "The Crisis in Local Government Pensions in the United States," in Yasuyuki Fuchita, Richard J. Herring, and Robert E. Litan, eds., *Growing Old: Paying for Retirement and Institutional Money Management After the Financial Crisis*, Washington, D.C.: Brookings Institution Press and Nomura Institute of Capital Markets Research, 2011, available at www.stanford.edu/~rauh/research/NMRLocal20101011.pdf.

⁶ See Moody's Investors Service, "Adjusted Pension Liability Medians for U.S. States," June 27, 2013, available at <http://ow.ly/xQ9nr>.

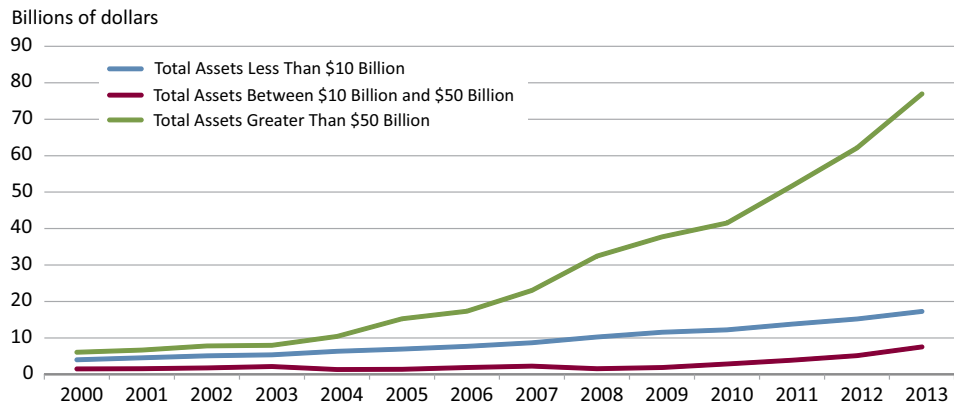
the financial performance of most of these entities over the next several years, if not decades. As a result, financial institutions should closely monitor the overall financial condition of municipalities when deciding whether to lend or invest.

Growth in Municipal Lending by Community Banking Organizations

Municipal lending has increased steadily since 2007 and totaled \$102 billion as of June 30, 2013 (Figure 1). Most of this growth was in financial institutions with total assets greater than \$50 billion; however, community banks, defined as those financial institutions with total assets of \$10 billion or less, also reported a steady increase in municipal loans. Much of this increase was reported by the largest community banks (those with total assets between \$1 billion and \$10 billion), which reported an increase in municipal loans of 157 percent since 2007 (Figure 2). Moreover, community banks have reported an increase in municipal loans of nearly 25 percent over the past two years.

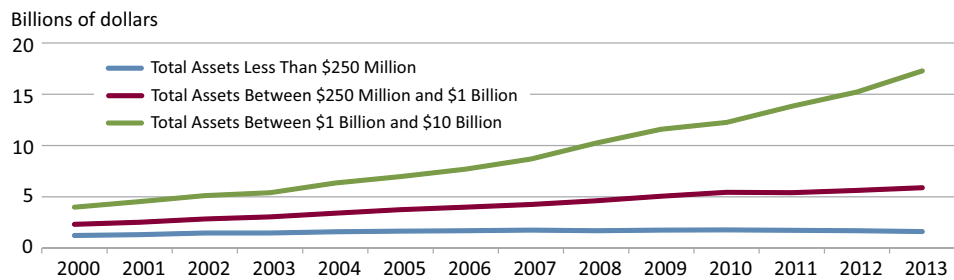
Several community banks also reported significant concentrations in municipal loans that must be closely monitored. For example, as of June 30, 2013, 33 community banks reported municipal lending that represented more than 50 percent of tier 1 capital plus the allowance for loan and lease losses, including four organizations that had levels greater than 100 percent of tier 1 capital plus the allowance. At these levels, bank examiners would expect institutions to have robust risk management practices in place to properly assess concentration risk within the loan portfolio.

Figure 1: Aggregate Municipal Loans Outstanding at Banks



Note: Call Report data as of June 30 of each year

Figure 2: Aggregate Municipal Lending by Community Banks



Note: Call Report data as of June 30 of each year

Municipal Lending Challenges

All municipalities have ongoing funding needs, which can include managing cash flow, balancing the fiscal budget, purchasing new equipment, and financing improvements in infrastructure. For those municipalities that are financially sound, the credit risk of lending for these purposes may be limited. However, some municipalities are financially distressed or are enduring significant financial struggles, raising questions as to whether they are creditworthy. As seen over the past two years, municipal bankruptcy filings are a real possibility. Therefore, to protect against financial loss and to mitigate risks, institutions should implement a robust due diligence process and conduct ongoing monitoring to ensure the municipal debt outstanding can be satisfied or, in a worst-case scenario, recovered.

An effective risk management framework is a critical factor in establishing a sound municipal lending program. Sound risk management principles include a formal written loan policy and limits, credit concentration monitoring procedures, sound loan administration and documentation practices, and an independent and reliable loan review program. Banks are expected to adhere to policies and procedures, with exceptions properly justified and documented.

While municipal lending is similar to commercial lending, how the loans are made and maintained can require different approaches and underwriting processes. Consideration should be given to secondary sources of collateral, as well as the municipality's willingness and ability to increase taxes or cut operational costs. Bank management should also obtain and maintain current financial statements and other relevant documentation to assess the municipality's financial condition and its ability to repay its debt.

Municipal loans are contracts that are designed in a similar manner to other commercial loans. Financial institutions are expected to adhere to prudent banking practices and relevant regulatory guidelines governing lending practices.

Conclusion

Community banking organizations will continue to remain a vital source of funding for municipalities for the foreseeable future, and the Federal Reserve encourages banks to make loans to creditworthy individual and institutional borrowers. As some municipalities continue to struggle financially, however, and with additional bankruptcy petitions possible, the view that municipal lending is a low-risk lending activity may be debatable. Municipal lending can be a profitable activity that meets the financing needs of the communities in which banks operate, but banks should ensure that they have an effective risk management program in place to address risks and regulatory concerns related to municipal lending. ■

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.

A *FedLinks* bulletin was recently released in May 2014:

“New Capital Rule for Community Banks” highlights some key changes and areas of supervisory focus related to the regulatory capital rules approved by the Board of Governors of the Federal Reserve System. Community banking organizations become subject to the revised capital framework on January 1, 2015.

This bulletin, and others like it, can be found online at www.cbefrs.org/fedlinks.cfm.

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

Federal Reserve Seeks to Conduct More Loan Reviews Off-Site

The Federal Reserve System continually seeks opportunities to be more effective and efficient in the execution of its supervisory responsibilities. Toward that end, the Reserve Banks have for some time conducted off-site work, primarily related to financial analysis and policy reviews, as part of bank examinations. This off-site work helps examiners to develop focused questions and prepare for meetings with bank management during the on-site part of the examination. While loan portfolio review is generally conducted on-site, tasks such as balancing the loan portfolio to the general ledger and developing the scope of file review may be performed off-site. Technological advances are now making possible the review of actual loan documents off-site.

During 2013, the Fed initiated a pilot program that included a series of targeted off-site loan reviews at institutions of various sizes and in different parts of the country. As a part of the pilot, the Fed surveyed state member banks to determine their willingness and technological ability to support off-site loan reviews. The survey identified a growing number of state member banks that had the technology and were willing to participate. Banks have typically provided examiners with electronic loan portfolio information through a secure transmission prior to an examination for preliminary analysis, but most of the review of specific loan files has then been done on-site at the bank. During the pilot, examiners received secure access not only to loan portfolio information but also to the actual electronic loan documents needed to conduct a credit review. The pilot examinations generally consisted of one week of off-site loan review activity, followed by one week of on-site activity, which involved much less time at the bank than the traditional two-week on-site examination.

The Federal Reserve generally received positive feedback from those banks that participated in the pilot, with many banks noting a general reduction in business disruptions. Moreover, Federal Reserve staff who participated in the pilot noted that the off-site work made the examination process more efficient and cost-effective by reducing travel without reducing the quality of the credit review. The pilot reviews were not without challenges, however, principally related to technical hurdles surrounding the imaging process and the preparation of data for examiner use. For example, for examiners to be

able to review electronic loan files, the image quality must be sufficient for easy reading, and the images must be sorted and labeled in ways that allow for timely, consistent, and accurate searches. Additionally, some bankers raised concerns about the potential impact of the reduced ability to share their insights through face-to-face interactions while discussing loans, assigning asset classifications, or resolving general issues.

The Federal Reserve is reviewing lessons learned from the pilot and plans to institute off-site credit review more widely for interested banks in the near future. Bankers interested in participating in the off-site loan review program should keep in mind the following factors:

- Technical preparation activities will require front-end resources to ensure that data are transmitted and/or made accessible to examiners in a secure method. Access to the loan images is usually provided through a secure virtual private network (VPN) client or by uploading exported images to a secure portal, but other sources may also be considered. Federal Reserve staff members understand that not all banks have the technical capacity to participate in the program; at this time, participation will not be mandatory.
- Maintaining effective and ongoing communication with examination staff throughout the loan review process, which includes on-site face-to-face conversations, is critical.
- A blended approach for loan reviews may work better for certain banks. For example, most credits could be analyzed with preliminary loan-specific questions answered off-site and emerging portfolio issues or themes and overall final results discussed on-site. Alternatively, a bank could provide off-site access to a particular loan portfolio or other subset of loans, with other portfolios reviewed on-site.

The effective use of technology can be a key tool to enhance the bank examination process and the Federal Reserve's communications with bankers. Leveraging the continuing maturation of imaging technology, such as through off-site examiner credit reviews, is one example of how the Fed seeks to enhance the effectiveness and efficiency of its examination processes. ■

Bank-Owned Life Insurance: A Primer for Community Banks *continued from page 7*

(as well as potential legal risk), management should establish appropriate policy limits on exposures to insurance companies, taking into consideration regulatory capital concentration thresholds, state legal lending limits, and any applicable state restrictions on BOLI holdings.

Market Risk

The market risk, or interest rate risk, of BOLI products differs based on the structure of the product. In general account BOLI, where the investments are held in the insurance company's general account, interest rate risk is inherent in the policy's credited interest rate; this is based, in turn, upon the insurance company's own investment results. Because the maturity of the assets in the insurance company's general accounts is often longer term, the value of the investments may fluctuate significantly when long-term interest rates change.

In separate account BOLI, interest rate risk is directly related to the specific investments held in the separate account. While this is similar to the market risk exposure in the bank's own investment portfolio, it is more difficult for management to control this risk because management cannot control the separate account assets. One way to mitigate some of this risk is through the purchase of an SVP wrap, which protects against declines in the value of the separate account assets due to changes in interest rates (although, as noted previously, SVP wraps are not without their own risks).

Liquidity Risk

The cash surrender value of BOLI, whether in a general account or separate account, is one of the least liquid assets on a bank's balance sheet. Additionally, the bank generally does not receive any cash flow from the BOLI investment until the death of the insured. There are typically only two ways to extract liquidity from a BOLI policy before the death of the insured: surrender the policy or borrow against the policy. Both of these tactics may have significant tax consequences and fees. Bank management and the board of directors should consider the institution's liquidity profile when purchasing BOLI as well as the level of BOLI assets when making other liquidity decisions.

Operational Risk

Operational risk in BOLI transactions most often arises from the complex structures of the contracts. General account BOLI is less complex than separate account or hybrid BOLI, with only two parties engaging in the contract and fewer variables. However, general account BOLI policies include potentially complex factors such as the interest-crediting rate, expense charges, and mortality costs.⁷ Separate account BOLI introduces a host of other complexities, including third parties (the separate account investment manager and any SVP wrap provider), additional investment options, terms of the SVP wrap, CSV provisions, and mortality options. Management must clearly understand all the contractual language to ensure that the policies provide the expected benefits and that the institution is and will remain able to comply with any covenants in the contracts. Further, tax and other laws, as well as accounting rules, may change over time, and these changes may negatively affect the original appeal and financial advantage of BOLI.

Legal Risk

The purchase and retention of BOLI exposes a community bank to a variety of legal and compliance risks. Life insurance is a complicated product, governed by myriad state insurance laws. The purchase of BOLI, which by definition is life insurance on an employee, also introduces employment law, tax law, and reporting considerations. Various Federal Reserve regulations, such as Regulations O and W, which address transactions with insiders and affiliates, may also apply to aspects of BOLI transactions. Because of the complexity of BOLI products and the potentially significant legal and compliance risks, institutions should consult with counsel on BOLI legal and regulatory issues.

Reputational Risk

A bank faces reputational risk from virtually all the products and services it offers. However, because a bank owning BOLI will benefit from the death of its employees, it must actively

⁷ Mortality cost is the pure cost of the life insurance death benefit. It is based on the face amount of the policy and the insured's mortality likelihood.

manage and mitigate potential perception issues that could arise. Longer-tenured bankers may recall the controversy over so-called “janitor’s insurance” in the early 2000s, where companies were purchasing insurance on very junior-level employees without their knowledge. In response to this issue, Congress passed the Pension Protection Act of 2006. Section 863 of the act amended the Internal Revenue Code to require that the employer, before the contract is issued, notify the insured in writing that the employer intends to procure insurance coverage, including the maximum face value for which the person could be insured; obtain the insured’s written consent to the coverage and to the possible continuation of the coverage after the insured terminates employment; and inform the insured in writing that the employer will be the contract beneficiary.⁸ To mitigate reputational risk and potentially significant adverse tax consequences, management and the board of directors must ensure that each covered employee has given informed consent before the institution purchases the insurance. Passive disclosures through employee handbooks or newsletters are not sufficient.

Risk-Based Capital Treatment Under the Revised Regulatory Capital Framework

The complex distinctions between general account BOLI and separate account BOLI also extend to the risk-based capital treatment under the regulatory capital framework that was revised in July 2013.⁹ Because the obligor for general account BOLI is the insurance company, general account BOLI is treated as a corporate exposure under the capital framework and is risk-weighted at 100 percent. This is consistent with the risk-based capital treatment under the 2004 interagency statement cited previously.

However, the CSV of separate account BOLI is supported by segregated investments. Under the revised capital framework, an investment in a separate account must be treated as if it were an equity exposure to an investment fund. Banks holding separate account BOLI will be required to use one of three

Look-Through Approaches

Full Look-Through: The bank calculates the risk-weighted asset amount for its pro-rata share of each exposure held by the investment fund in the separate account. This requires detailed knowledge about all account investments.

Simple Modified Look-Through: The bank calculates the risk-weighted asset amount by applying to its CSV the highest applicable risk weight for any exposure in the separate account.

Alternative Modified Look-Through: The bank calculates the risk-weighted asset amount based on the investment limits by risk weight category in the separate account agreement, without regard to the actual composition of the investments.

look-through approaches to value these assets, each of which is subject to a risk-weight floor of 20 percent: the full look-through approach, a simple modified look-through approach, or an alternative modified look-through approach. The box above provides a brief summary of these approaches.¹⁰ The presence of an SVP wrap further complicates the calculation of risk-based capital for separate account BOLI. The carrying value of the investment in the separate account attributable to the SVP wrap must be treated as an exposure to the provider of the protection and risk-weighted as a corporate exposure, with the balance of the exposure risk-weighted by using a look-through approach.

Summary

BOLI offers many benefits to a community bank, but it is not without risk. BOLI may fund employment benefits to company executives, provide compensation to a company in the event of an executive’s death, and offer tax advantages not generally available in other investment alternatives. However, the purchase of BOLI or any other insurance product should be aligned with the objectives of bank management, director-approved risk guidelines, and the bank’s risk profile. It is imperative that management understands both the benefits and risks of its insurance decisions and that it appropriately identifies, quantifies, and actively manages all risks. Because of the complexity of life insurance, bank management should seek qualified tax, insurance, and legal advice when considering BOLI purchases. ■

⁸ Pension Protection Act of 2006, Pub. L. No. 109–280, 120 Stat. 790 (2006), available at www.gpo.gov/fdsys/pkg/PLAW-109publ280/pdf/PLAW-109publ280.pdf.

⁹ See “Federal Reserve Board Approves Final Rule to Help Ensure Banks Maintain Strong Capital Positions,” Board of Governors of the Federal Reserve System press release, July 2, 2013, available at www.federalreserve.gov/newsevents/press/bcreg/20130702a.htm. See also 78 FR 62018 (October 11, 2013), available at www.gpo.gov/fdsys/pkg/FR-2013-10-11/pdf/2013-21653.pdf.

¹⁰ A full discussion of the three look-through approaches under the revised risk-based capital rules is beyond the scope of this article.

Loan and OREO Accounting Guidance ... for the Good Times

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Assume a bank owns a hotel that is considered a start-up and the book value after write-downs is \$600,000. The bank is financing the sale, and the property sells for \$1,000,000, for a \$400,000 gain. The buyer makes an adequate down payment (25 percent of the sales price for this type of property) of \$250,000 and will repay the remaining balance on a 12-year amortization (a customary schedule for the type of property). At consummation, the transaction qualifies for full accrual treatment. The loan and gain on the sale are reflected on the bank's books as shown in Figure 1.

Figure 1

Debit	Cash	\$250,000	
	Loans	\$750,000	
Credit	OREO		\$600,000
	Gain on sale		\$400,000

Future payments will be accounted for as amortizing P&I payments on the loan.

Now consider a scenario in which the buyer provides only a 15 percent down payment (\$150,000), but recovery of the cost of the property is reasonably assured if the buyer defaults. Assuming the same amortization schedule, the bank would use the installment method, since the down payment for this type of property is not adequate. Using this method will delay full recognition of the gain until the down payment requirement is met. The entries are shown in Figure 2.

Figure 2

Debit	Cash	\$150,000	
	Loans	\$850,000	
Credit	OREO		\$600,000
	Gain on sale		\$60,000*
	Deferred gain		\$340,000
*Down payment (\$150,000) × Gain on sale (\$400,000)/Sales price (\$1,000,000)			

As future payments are made, all interest payments can be recognized as interest income (assuming the loan is at market rate)² and a portion of the deferred gain can be recognized. For example, the entries in Figure 3 would be used if the borrower made a \$60,000 principal reduction during the first year.

Figure 3

Debit	Cash	\$60,000		
	Deferred gain	\$24,000		
Credit	Loans		\$60,000	(Balance reduced to \$790,000)
	Gain on sale		\$24,000*	
*Payment (\$60,000) × Gain on sale (\$400,000)/Sales price (\$1,000,000)				

At some point, the buyer will have made payments that are sufficient to satisfy the down payment requirements. At that time, and assuming all other criteria are met, the bank may recognize the remaining deferred gain under the full accrual method.

While the full accrual and installment methods are more commonly used, a bank may also use the following methods when appropriate:

- The *reduced-profit method*, though seldom used, is similar to the installment method in accounting for the gain on sale. However, it is typically used when the down payment requirement is met, but the loan amortization schedule does not meet the full accrual method requirements.
- The *cost recovery method* is typically used when the sale does not qualify under the full accrual, installment, or reduced-profit method. If this method is used, no profit or interest income is recognized until either the buyer's aggregate payments exceed the seller's cost of the property

² A below-market rate results in the need to discount the loan to its fair value, effectively reducing the sales price and any gain (or increasing any loss).

- sold or there is a change to another accounting method.
- The *deposit method* is used when a sale is not consummated. ASC 360-20-40-7 details that the following four conditions must be met for a sale to be consummated: 1) parties are bound by a contract, 2) consideration has been exchanged, 3) permanent financing has been arranged, and 4) all conditions precedent to closing the sale have been performed. Using this method, a bank does not recognize a sale, the asset remains in OREO, and no income or profit can be recognized. The deposit method can also be used for dispositions that could be accounted for under the cost recovery method.

Evaluating TDRs

Bankers have had many questions about the proper accounting treatment for TDRs. The banking regulatory agencies have emphasized that, if done prudently, loans modified in a TDR may be in the best interest of both the borrower and the bank. Regulatory sources also make clear that not all TDRs are “bad” loans. In fact, some TDRs can be maintained on accrual status at the time of modification.

Likewise, a TDR designation does not necessarily make the loan subject to an adverse classification. Regulators have issued interagency guidance to further clarify the accounting and classification treatment of both collateral- and non-collateral-dependent TDRs. Refer to SR letter 13-17, “Interagency Supervisory Guidance Addressing Certain Issues Related to Troubled Debt Restructurings.”³ A detailed discussion of this guidance is beyond the scope of this article, but bankers with questions about TDRs are encouraged to review the guidance.

Under GAAP, any loan modified in a TDR is an impaired loan. Although a loan retains a TDR designation for accounting purposes for life, regulatory reporting requirements allow for a narrow reporting exception. In general, if a TDR borrower complies with the modified loan terms and the loan yields at least a market interest rate when the loan is modified, the loan does not have to be reported as a TDR on the Call Report in calendar years subsequent to the year in which it was restructured. This is only a reporting exception, as the loan is considered TDR for life for accounting purposes (that

is, until it is paid in full or otherwise settled, sold, or charged off). Refer to the “Troubled Debt Restructurings” entry of the Call Report Glossary for accounting guidance.

Summary

Just as the credit crisis called for bankers to adapt to a changing environment, improving trends in credit also bring a new set of challenges. It is imperative for bankers to equip themselves with the resources and knowledge required for accounting challenges and complexities. By familiarizing themselves with all available methods of accounting, bankers can be better prepared to ensure compliance, properly document gains and losses, and manage different conditions related to both the bank and the borrower. ■

Additional Resources

In addition to the Call Report Glossary instructions, regulatory examination handbooks, specific ASC guidance, SR letters already mentioned, and their own accountants, banks may find the following resources helpful:

Federal Reserve Supervision and Regulation (SR) Letters:

- SR letter 12-10, “Questions and Answers for Federal Reserve-Regulated Institutions Related to the Management of Other Real Estate Owned (OREO)”
- SR letter 09-7, “Prudent Commercial Real Estate Loan Workouts”

Federal Reserve “Ask the Fed” teleconferences, in which bankers can participate and view archived presentations:

- “Interagency Supervisory Guidance Addressing Certain Issues Related to Troubled Debt Restructurings,” November 14, 2013
- “Accounting Hot Topics” (includes discussion of nonaccruals), August 13, 2013
- “More Answers to Your OREO Accounting Questions,” December 12, 2012
- “Challenges with Troubled Debt Restructuring,” October 19, 2011

For additional information on SR letters and “Ask the Fed” teleconferences, please refer to www.federalreserve.gov/bankinforeg/topics/topics.htm and www.stlouisfed.org/BSR/askthefed/public-users/login.aspx.

³ See SR letter 13-17, “Interagency Supervisory Guidance Addressing Certain Issues Related to Troubled Debt Restructurings,” available at www.federalreserve.gov/bankinforeg/srletters/sr1317.htm.

Congress Passes the Homeowner Flood Insurance Affordability Act of 2014

On March 21, 2014, President Obama signed into law H.R. 3370, the Homeowner Flood Insurance Affordability Act of 2014 (HFIAA).¹ The law repeals and modifies certain provisions of the Biggert–Waters Flood Insurance Reform Act of 2012 (BWA) and makes other changes to the National Flood Insurance Program (NFIP).

Congress enacted the BWA, in part, to address the NFIP's growing deficit. The BWA directed the Federal Emergency Management Agency (FEMA) to phase out subsidies and grandfathered rates and implement actuarially sound pricing for flood insurance to reflect the actuarial risk of floods. Some policyholders — those with subsidized policies for nonprimary residences, for businesses, for properties with severe repetitive loss, for properties whose cumulative flood insurance payments exceeded the properties' fair market value, and for properties substantially damaged or improved — were scheduled for premium increases of 25 percent per year until full-risk rates were achieved beginning in 2013 or at policy renewal. For policies that covered newly purchased properties, policies for which coverage had lapsed, or new policies covering an existing property for the first time, subsidies were eliminated and full-risk rates were imposed at the end of 2013. Moreover, after updating flood insurance rate maps (FIRMs) in some parts of the country, FEMA began publishing preliminary notices with premiums that had increased substantially as a result of the remapping activities. Many policyholders affected by these changes expressed concerns that the new premiums were unaffordable. Congress passed the HFIAA to address those concerns and implement other changes to the NFIP.

The legislation has been closely watched by community banks because of concern that borrowers could default on their mortgages if the flood insurance premiums became unaffordable. Real estate sales in areas with significant rate increases were also being adversely affected because some potential homebuyers could not afford the new premiums.

¹ See www.gpo.gov/fdsys/pkg/BILLS-113hr3370enr/pdf/BILLS-113hr3370enr.pdf.

The HFIAA's key provisions include the following:

- Section 3 repeals the provision in the BWA that eliminated subsidies on properties purchased after July 6, 2012, on properties with no insurance on that date, and on properties for which the policy lapsed as of that date, unless the lapse occurred because the property owner was no longer required to retain coverage. As a result, FEMA must refund any excess premiums paid by policyholders after July 6, 2012. Subsidies will continue to be phased out for pre-FIRM nonprimary residences, business properties, properties experiencing severe repetitive loss, or properties that were substantially damaged or improved. This section also implements the ability of a purchaser to assume the seller's policy at existing premium rates.

“ This legislation has been closely watched by community banks because of concern that borrowers could default on their mortgages if the flood insurance premiums became unaffordable. ”

- Section 4 repeals the provision of the BWA that phased out grandfathered rates. Grandfathering allows certain property owners to be protected from a future rate increase that results from a property being remapped into a higher-risk zone. Grandfathering will also apply when a property eligible for grandfathered rates is sold to a new owner.
- Section 5 limits rate increases to 18 percent per year for individual policies, except for nonprimary residences, business properties, properties experiencing

severe repetitive or cumulative loss, or properties that are substantially damaged or improved. For the exceptions, rate increases are limited to 25 percent per year until full-risk rates are achieved. For any individual class of properties, rate increases are limited to 15 percent per year.

- Section 6 clarifies rates for properties newly mapped into areas with special flood hazards. For the first year, the property is charged the preferred risk premium, after which full-risk rates are phased in, but increases cannot exceed the limits in section 5 above.
- Section 8 applies an annual assessment of \$25 per policy on all NFIP primary homes and \$250 on second homes and commercial properties. The assessment expires after risk-based premiums are fully implemented. The assessment is designed to help fund the costs of the HFIAA.
- Section 13 clarifies that flood insurance is not required for a nonresidential detached structure on a residential property. However, lenders have the discretion to require insurance on these structures.
- Section 15 modifies the definition of “substantial improvements to a property” from 30 to 50 percent of its fair market value. A substantial improvement triggers full-risk rates, though the rate increases are phased in at 25 percent per year until full-risk rates are achieved.
- Section 24 requires FEMA to designate a flood insurance advocate to ensure fair treatment of policyholders.
- Section 25 changes the effective date for the mandatory escrow requirement from July 6, 2014, to January 1, 2016. For loans that are subject to the

escrow requirement but originated prior to January 1, 2016, the banking agencies must issue a regulation requiring lenders and servicers to notify borrowers of the option to escrow flood premiums. Section 25 also expands the types of properties exempt from the escrow requirement to include business purpose loans secured by residential real estate, home equity lines of credit, loans shorter than 12 months, nonperforming loans, subordinate loans secured by the same residential real estate, and loans secured by a condominium covered by a condominium association policy.

- Section 26 requires FEMA to establish guidelines that provide alternative mitigation measures for buildings that cannot be elevated, including building materials and flood proofing.
- Section 28 requires FEMA to clearly communicate to individual property owners the cost of full risk-based premiums, whether or not the owners pay the full actuarial rates.
- Section 30 requires FEMA to consult with local communities before undertaking a remapping and to discuss the mapping models FEMA will be using. This section also requires FEMA to notify congressional representatives of affected districts, prior to issuance of any preliminary map, about community outreach schedules and the estimated number of properties that will be affected by proposed map changes.

Additional information on the HFIAA and its implementation is available on FEMA's website at www.fema.gov/flood-insurance-reform. ■

REGULATORY RECAP

Consumer Affairs (CA) Letter

The following CA letter that has been published since the last issue of *Community Banking Connections* applies to community banking organizations. In general, letters that contain confidential supervisory information are not included. A complete list of CA letters can be found at www.federalreserve.gov/bankinfo/reg/caletters/caletters.htm.

CA Letter 14-2, “Revised Interagency Large Institution CRA Examination Procedures and Consolidation of Interagency CRA Examination Procedures and Supporting Materials”

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.cbcrfs.org/feedback.cfm.



Community Banking in the 21st Century

Federal Reserve to Cohost Second Annual Community Bank Research Conference in September

The Federal Reserve System and the Conference of State Bank Supervisors (CSBS) will host their second annual community banking research and policy conference, “Community Banking in the 21st Century,” at the Federal Reserve Bank of St. Louis on September 23–24, 2014.

Community bankers, academics, policymakers, and bank supervisors will discuss the current challenges and opportunities facing community banks. Research of note will be presented, along with the findings of a new comprehensive survey being conducted this spring and summer with the participation of community bankers across the country. The survey includes opportunities for bankers to share information and insights about the current trends and demographics affecting their banks, the impact of the new

qualified mortgage rule, how new services and technologies will affect their businesses, and the scope of impact of compliance costs.

Guest speakers will include St. Louis Fed President James Bullard, Kansas City Fed President Esther George, Federal Reserve Governor Jerome “Jay” Powell, CSBS Chairman Candace Franks, and Rebeca Romero-Rainey, chairman and CEO of Centinel Bank of Taos, NM.

Because of the high level of interest in the conference, all presentations and paper discussions will be webcast live both days. More information will be coming soon via the conference website at www.stlouisfed.org/cbrc2014.



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