



Banking in the Ninth

December 2011

Ninth District Highlights

The Federal Reserve Board recently issued supervisory expectations for management of agricultural credit risk (SR 11-14). The guidance is both evolutionary and an important break from prior practice.

The substance of the guidance builds on both Federal Reserve experience with agricultural banks, particularly during the farm crisis of the 1980s, and prior Federal Reserve guidance. Indeed, the guidance is cast as a “reminder.”

The break from practice comes before the text of the guidance. In an impossible-to-miss box, the supervisory letter reads:

Applicability to Community Banking Organizations: This letter applies to all banking organizations with significant exposure to agriculture-related credit risk, including those with \$10 billion or less in consolidated assets.

This sentence seems mundane. It is not. It answers the question, “Does this guidance apply to me or not?” The language the Federal Reserve has used historically to answer this question has more typically been, “This guidance should be applied as appropriate to all banking organizations supervised by the Federal Reserve, taking into account each organization’s size, nature, and complexity.”

This historical approach continues to have a place in supervisory guidance. Sometimes guidance really does apply to all banks. Implementation of the guidance is key to right-sizing supervision of community banks.

Sometimes, however, the thrust of guidance is sufficiently tangential to the vast majority of community banks, or alternatively large banks, that the historical approach confuses the issue. In these cases, the clarity of the new box and language should help.

One sentence at the start of supervisory guidance will not eliminate ambiguity.



Ron Feldman

Continued on back page

SAFETY and SOUNDNESS UPDATE

A Reminder on Sound Underwriting

Lending requires risk-taking; prudent lending requires a careful and critical assessment of risk. Bankers and bank supervisors, we can say in retrospect, underestimated the risk of loans, particularly those related to land values, before the financial crisis. Net credit losses for Ninth District banks nearly *quadrupled* from 2000 to 2010. This is not the first time we have underestimated risk (e.g., the downturn in agriculture-related loans in the 1980s that led to many

bank failures). Bankers also report that while post-crisis loan growth remains weak, competition for qualified loans is fierce.

Both factors motivate this article’s review of a few key underwriting processes banks should use when evaluating borrower repayment prospects. Breakdowns in stressing the risk of repayment and assessing the strengths/limitations of guarantors and collateral lead to many of our findings on credit administration. Banks

with effective processes in the following areas are less likely to have such findings or experience significant problem loan volumes.

Repayment stress testing—Analyzing historical and prospective cash flow in relation to the required principal and interest payments (debt service ratio) serves as an underwriting starting point. Stress testing goes further by assessing a borrower’s ability to repay the loan according to the contractual

Continued inside

SAFETY and SOUNDNESS UPDATE continued

terms under adverse conditions. We expect stress tests to consider factors such as these:

- Unexpected reductions in revenue.
- Unfavorable movements in market interest rates, especially for borrowers with high debt burdens.
- Deterioration of the value of collateral, guarantees or other potential sources of principal repayment.

Global cash flow analysis—Banks often structure loans with a principal or affiliated company guaranteeing a borrower's debt. Banks must assess the level of strength provided by the guarantor(s)—both at initial un-

derwriting and in ongoing assessments such as annual reviews—to understand the risk of the loan. We have found that such reviews may find guarantor limitations: Consider a guarantor deriving a significant portion of cash flow from the sale of lots in one development.

Collateral analysis—Banks must understand the value of collateral—whether collateral is the primary or secondary source of repayment—to understand the risk of a loan. Understanding the value of collateral requires a bank to answer some basic questions:

- What is it?
- Where is it?

- What is its condition?
- What is it worth (and what is it worth if the bank must liquidate it)?

Important breakdowns can occur in collateral analysis when those producing the loans also carry out the collateral assessment; objectivity is critical. Banks also should not let their collateral analysis become outdated. Management should review their answers to the questions at least annually for operating lines and perhaps less frequently for term loans.

Any questions from state member banks regarding the discussion above can be directed to their relationship manager.

APPLICATIONS FILING TIPS

This column—which will run frequently in this newsletter—focuses on current events in applications. The objective of the column is to provide information that speeds and facilitates the processing of applications filed with the Federal Reserve. The last column focused on requests for confidential treatment of certain information submitted in an application and E-Apps, the Federal Reserve's online system for submitting applications electronically. This quarter, we focus on two cases in which applicants sometimes provide us with too little information. The first case concerns business plans associated with a change in control of a bank. The second concerns the Interagency Biographical and Financial report, a form required with many application filings.

Change in Business Plan at Target Acquisition

We receive many applications in which an existing or proposed bank holding company or an individual seeks to acquire control of a bank. The Federal Reserve's review of such applications covers many features of the transaction, including the banking organization's financial condition, managerial resources and future prospects. One key element of the review involves the proposed business plan for the organization to be acquired. However, we find that some applicants do not provide the Federal Reserve with sufficient information for us to complete our analysis. A filing should fully describe the business plan, including a discussion of the business lines to be focused on by management, a description of any changes resulting from the proposed acquisition and identification of the proposed senior management officials of the target and their principal responsibilities. With regard to the latter component, the discussion must be sufficiently detailed to demonstrate that the proposed management team has the competence and experience to successfully implement the proposed business plan. We expect the applicant to provide résumés or similar discussion for proposed senior management officials that describe their experience, past responsibilities and education that have prepared them for their proposed responsibilities.

Questions on the newsletter can be directed to Mpls.Src.Outreach@minneapolis.frb.org. Please contact the same email address to update your subscription address or preference (email or hard copy delivery).

Interagency Biographical and Financial Reports

Individuals complete IBFRs. Applicants file an IBFR to provide supporting financial and employment data, typically with a notice of a change in control or a notice of a change in director or senior executive officer. Our experience has shown that individuals, with some frequency, provide financial statements that are too dated or do not provide requested financial information on business interests representing significant portions of their net worth. Not providing the requested information can result in delays in processing related notices and applications. The instructions for the IBFR state that the financial statements from individuals must have “as of” dates of not more than 90 days prior to the date the IBFR is submitted. Please note that Schedule D of the financial statement portion of the IBFR directs individuals to submit year-end financial statements, including profit and loss and cash flow statements for the last two years for each business interest in which the individual has an interest equal to 10 percent or more of the individual's net worth.

SIMPLIFYING RESERVES ADMINISTRATION

The Federal Reserve is proposing to simplify the rules governing the administration of reserve requirements in order to reduce the administrative and operational cost for both depository institutions and the Federal Reserve. These changes should reduce the burden on community banks. The Federal Reserve greatly values input from banks and the public more generally. We encourage you to comment on the Federal Register notice documenting the four proposed reserve simplifications. It was published for public comment on Oct. 18, 2011, with a 60-day comment period and can be found at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>. We highlight the key changes below. If you want additional information, please call Jean Garrick (612-204-5862).

Proposed simplifications:

1. Create a common maintenance period for all depository institutions.

Currently, some depository institutions satisfy their reserve requirements on a one-week maintenance period while others satisfy their requirements on a two-week maintenance period. Managing the dual system imposes costs on depository institutions that switch between maintenance periods as well as on the Federal Reserve. Adopting a common two-week maintenance period would provide greater flexibility for depository institutions that currently have a one-week maintenance period.

2. Sunset the contractual clearing balance program.

The Federal Reserve pays interest on reserve balances. The ability to pay cash to depositories eliminates the need to provide earnings credits redeemable for Federal Reserve services. Earnings credits existing on the sunset date would remain in effect and would be allowed to be used over the following 52 weeks.

3. Create a “penalty-free band” around reserve requirements to replace carryover.

A “band” of either a percentage or a dollar amount around each depository institution's reserve requirement would be more straightforward than the current arrangement of carryover and routine waiving of deficiency fees for small or infrequent deficiencies. Only balances that fall outside the “band” would be considered either deficiencies or excesses. The proposed simpler calculation would allow interest on reserves payments to be made more quickly.

4. Replace as-of adjustments with “direct compensation.”

Explicit payments and charges are less administratively burdensome for depository institutions and the Federal Reserve than as-of adjustments. Eliminating transaction-based as-of adjustments and replacing them with direct compensation would allow the Federal Reserve to remedy transaction errors in a more timely manner. As-of adjustments resulting from deposit report revisions would be eliminated.

CONSUMER AFFAIRS UPDATE

Under the Servicemembers Civil Relief Act (SCRA), lenders must provide certain lending-related accommodations for members of the armed forces. The law's primary provisions are:

- *Interest rate reduction.* Upon receiving written notice and a copy of an individual's military orders, a bank must reduce an existing loan's interest rate to 6 percent during the period of military service. For mortgage loans, the reduced interest rate is extended for one year after military service.
- *Foreclosure limitations.* A lender may not foreclose on a service member's real property during military service and the nine months thereafter without a court order or written agreement of the service member. The rule applies to property owned prior to military service. Failing to comply with this requirement voids the sale or foreclosure.

Failing to include a loan's service charges, renewal charges and fees when calculating the maximum rate of 6 percent is a common SCRA error. In addition, banks need to remember to forgive rather than defer interest above the 6 percent threshold. Although many banks reduce the interest rate, they often fail to reduce the corresponding periodic payment amount by the amount of the forgiven interest.

An institution can protect itself from violating the SCRA's foreclosure limitations by confirming prior to initiating foreclosure proceedings that the borrower is not on active military duty. The Department of Defense's Manpower Data Center provides a website that financial institutions can use for confirming a borrower's current military status. Access to the data center is at <https://www.dmdc.osd.mil/scra>.

The bottom line for lenders: Appropriate controls and procedures are critical for ensuring compliance with SCRA's requirements given the rule's complexities.

We encourage you to review the following additional SCRA-related guidance:

- Consumer Affairs letters 11-6 and 05-3, <http://www.federalreserve.gov/boarddocs/caletters/>
- *Consumer Compliance Outlook*, Second Quarter 2011, <http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/2011/>

Feldman from cover

What should banks and bank holding companies do when they remain unsure how to comply? Institutions supervised by the Federal Reserve should contact us. On the safety and soundness side, state member banks and select holding companies have relationship managers charged with answering questions. Some of these institutions also direct questions to specific consumer exam contacts; however, all of our supervised entities can also call the consumer hotline at 612-204-6500 with compliance-related questions.

I can understand the reluctance that some bankers have in asking supervisors questions. The contact should, however, make life easier for bankers. It may clarify whether an elaborate plan or process or engaging a consultant is necessary. In most cases, it is not. Contact may dispel the need to create elaborate new processes or hire additional staff or consultants.

Feel free to call or write with any comments or questions you have. I can be reached at Ron.Feldman@mpls.frb.org or 612-204-5000.

Ron Feldman
Senior Vice President, SRC