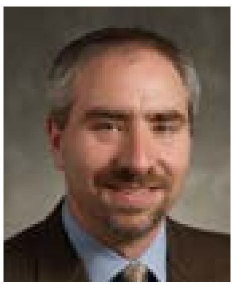
Banking IN THE NINTH

MARCH 2015

NINTH DISTRICT HIGHLIGHTS

Improving the Examination Experience of State Member Banks



Ron Feldman

I identified a commitment to continuous improvement as a strength of our supervision of state member banks (SMBs) in the December 2014 edition of *Banking in the Ninth.* I will describe a recent improvement effort in this column. Specifically, we charged a group of experienced staff with suggesting ways to improve the examination experience of SMBs. We identified areas where we can improve our communication and examination management. I will summarize the review itself, lay out the lessons we learned and conclude with next steps.

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Review of the SMB examination experience

Some aspects of a bank examination may inherently create challenges for banker-bank supervisor interaction. Examinations can disrupt bank operations, for example. Examination findings can, at times, lead to disagreements. But other aspects of a bank examination may detract from the SMB experience without enhancing supervisory results. We asked a group of seasoned examiners to identify precisely those features of SMB examinations that we can improve without compromising examination effectiveness. The group conducted its own analysis and received feedback from SMBs and examiners. I want to thank participating SMBs for providing candid and very helpful feedback.

Lessons learned from the review

We learned much from the review, but I will highlight four key lessons learned.

The examination experience for SMBs is generally sound. We certainly have room to improve, but many key features of the examination process are working well. Areas of strength I noted in the last *Banking in the Ninth* help make the examination experience a generally positive one for SMBs.

The effectiveness of communication often defines the examination experience for SMBs. Feedback suggests that we do not sufficiently explain the examination process. Bankers sometimes need better context for the information we request, to choose one example. Questions that we ask bankers may seem unnecessary, even if not particularly problematic. For example, we may ask if the bank offers a certain product or service, even if the bank historically has not offered it or does not intend to offer it. I see analogy to a medical checkup. Checkups often start with a confirmation of behaviors that have not changed for many years. Nonetheless, doctor and patient should have

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SAFETY AND SOUNDNESS UPDATE

Remember to Make AOCI Election in Your March 31 Regulatory Filing

Banks and thrifts have a very important election to make in their March 31, 2015, regulatory report. The new capital rules allow nonadvanced approaches institutions to exclude most elements of their accumulated other comprehensive income (AOCI) from regulatory capital. But institutions must choose to receive the exclusion. Institutions must indicate their AOCI opt-out choice in the March 31, 2015, regulatory report. Enter “1” for yes to opt out, or enter “0” for no. An institution’s parent holding company that files a March 31, 2015, FR Y-9C report must make the same AOCI opt-out election as its subsidiary depository institution(s).

Data Provided for Regulatory Reports: What Is Confidential?

By Paul Ljung, Risk Supervisor

Ninth District banking institutions provide the Federal Reserve Bank of Minneapolis with regulatory report submissions. Virtually all regulatory report data become public. We hold a small amount of regulatory report data confidential. We describe which data we make public and which we hold confidential in this article. We also summarize how we maintain security of confidential data. Note that this article does not discuss the treatment of confidential supervisory information gathered through examination and supervisory processes.

Public and confidential data

Federal regulations and Federal Reserve System policies dictate which regulatory reporting data we must make public.[1] Data we collect fall into four general categories: financial, structural, monetary policy and supervisory. There are different publication practices for each of these categories.

Financial

Financial data are composed of standardized balance sheets, income statements and supporting detailed information on specific assets, liabilities and capital components. Examples include the Consolidated Reports of Condition and Income for a Bank with Domestic Offices Only (FFIEC 041) and the Parent Company Only Financial Statements for Small Holding Companies (FR Y-9SP). Banking companies are required to provide these data either quarterly or semi-annually, and the Federal Reserve publishes the data at the institution level.

Structural

Structural data are information on the companies' activities, ownership and organization. We collect and maintain structural data about all institutions regulated by the Federal Reserve through the Annual Report of Holding Companies (FR Y-6) and the Report of Changes in Organizational Structure (FR Y-10). Institutions frequently ask us about the public nature of the insider and shareholder data provided in the FR Y-6. We make the names, positions and ownership interests of holding company officers and directors public. We also make the names of shareholders owning 5 percent or more of a holding company public. However, for both the FR Y-6 and FR Y-10, holding companies may request confidential treatment for other information.

Monetary policy

We collect monetary policy data through mandatory reports and voluntary surveys for the purposes of monitoring economic indicators and implementing monetary policy decisions. Examples include the Report of Transaction Accounts, Other Deposits and Vault Cash (FR 2900/Q) and the Weekly Report of Selected Assets and Liabilities of Domestically Chartered Banks and U.S. Branches and Agencies of Foreign Banks (FR 2644). We publish these data only on an aggregated "macro" level. We do not release these data by individual institutions.

Supervisory

Supervisory data focus on monitoring compliance with specific banking regulations or federal mandates. Examples include the Bank Holding Company Report of Insured Depository Institutions' Section 23A Activity with Affiliates (FR Y-8) and the Liquidity Monitoring Report (FR 2052b). We do not release supervisory data to the public in any manner.

How we make information public

The Federal Reserve uses a variety of methods to make public data available. We publish financial data and certain FR Y-10 data at ffiec.gov/nicpubweb/nicweb/nichome.aspx. We do not publish the FR Y-6, but will make that report public in response to a request via the Freedom of Information Act. The Federal Reserve System publishes aggregated monetary policy data in Statistical Releases and the Federal Reserve Bulletin.

Ensuring data security

Ensuring the security and appropriate release of the data we receive is a key concern. The Statistical & Structure Reporting unit takes precautions to ensure the integrity and security of data even before we receive it. We limit access to the Internet Electronic Submission and Reporting Central applications to specific individuals authorized by the reporting organization. Reporting Central complies with enhanced federal information security standards and provides additional safeguards against threats of unauthorized access.

Once we receive the data, we follow comprehensive policies and procedures to ensure that we process and store the data appropriately. Reserve Bank staff and management participate in regular training sessions, conduct access reviews and are audited for compliance with established data handling procedures.

[1] Individual respondents may, in most instances, request confidentiality for certain financial and structural data provided to the Federal Reserve that would otherwise be made available to the public. Please contact a Statistical & Structure Reporting analyst at mpls.statistics@mpls.frb.org or (888) 887-0926 for more information.

Agricultural Bank Survey (2014)

The supervision department of the Federal Reserve Bank of Minneapolis conducts an annual survey of state member banks (SMBs) with agricultural loan concentrations. We ask presidents or senior agricultural loan officers at agriculturally focused SMBs about borrower financial conditions, bank underwriting practices, farmland values and other factors affecting the agricultural economy. This article summarizes the major survey results, identifies challenges facing agricultural bankers revealed by the survey and outlines steps bankers should take to address these challenges. We found that agricultural conditions remained generally sound in 2014, but are entering a period of change for which bankers must be prepared as prices for crops fall and borrowers have begun to reduce working capital.

Survey results

Bankers with customers primarily engaged in crop production generally noted increasing stress on borrower cash flow. These bankers indicated that most borrowers met loan repayment terms due to effective marketing or existing working capital in 2014. A significant percentage of these agricultural bankers, however, expect that borrowers will struggle to break even in 2015. Bankers with livestock producing customers (whether cattle, dairy or swine) were more optimistic, noting that conditions were "awesome" or "unbelievable."

Most bankers indicated that farmland values have stabilized over the past year, while about a fifth noted some degree of decline. Bankers uniformly noted limited farmland sales activity. The limited land sale activity involves local purchasers funding the acquisition with debt, in contrast to reports in prior years, which pointed to cash purchases.

About two-thirds of bankers noted an increase in loan growth in 2014, concentrated in crop production. Several bankers found that with this increase in 2014, agricultural lending had returned to more normal levels, with dormant operating lines seeing more use. Over 80 percent of the bankers planned to keep loan underwriting the same despite the changing conditions.

The survey results reveal a number of challenges facing agricultural banks in the coming year, including tightening borrower cash flow, increasing loan demand and worsening loan performance. Proactive actions from bankers could help mitigate potential adverse results from these challenges. We discuss these steps below, some of which bankers self-identified in the survey.

Responses to challenges

Several bankers reportedly have responded to changing conditions by monitoring problem borrowers more closely and reviewing significant borrowing relationships more regularly. Bankers reported linking frequency and intensity of monitoring to the level of risk posed by individual borrowers. Banks should closely monitor problem credits and make sure to risk focus ongoing credit reviews in response to emerging concerns in the agricultural sector. We next discuss additional steps banks should take as they review 2015 operating lines in an effort to prevent future problems from emerging.

First, agricultural banks should ensure that they have strong formal agricultural loan policies. Banks should incorporate internal agricultural lending practices and procedures into a formalized agricultural loan policy. An overall agricultural lending policy is critical during a review of operating lines, as it articulates clear underwriting expectations that management can enforce uniformly. Agricultural loan policies should contain loan-to-value guidelines as well as minimum debt service coverage, permissible loan structures and borrowers' financial reporting expectations. Policies should also outline considerations for lenders when responding to a borrower experiencing short-term cash flow

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a common understanding of the answers to the questions and why the questions should be asked. We need to improve with regard to the latter.

Useful internal Reserve Bank divisions of supervisory work are irrelevant to bankers. We divide examination work to achieve efficiencies and ensure effectiveness. We have separate safety and soundness and consumer examination teams, for example, recognizing the separate supervisory focus of these teams. A banker reasonably sees that both examinations are done by the Federal Reserve and should expect that we share information and understanding of the SMB across internal groups. A banker would expect that information given to one part of our supervisory function flows through to all. Our division of labor does not and should not matter much to banks. We have begun to address this issue through a "one-stop shopping" relationship contact and the use of procedures and technology to facilitate the sharing of information. We must take additional steps to ensure that our internal separation of duties does not diminish the examination experience or the overall relationship.

We must continue to tailor examination interactions for each bank. Bankers reasonably expect examiners to understand local markets and bank strategy within the market, particularly with regard to the products that banks offer to execute that strategy. We have processes and procedures in place to achieve that outcome. Indeed, some examination activities, such as assessing bank performance with regard to the Community Reinvestment Act, require deep local knowledge. We can better integrate our understanding of a bank and its community into all of our supervisory activities.

Next steps

We received helpful feedback on the many aspects of the examination process that are already effective and thoughtful suggestions for the areas where we can improve. We would like to get more feedback from banks and holding companies we supervise. Please send your feedback on our supervisory process to mpls.src.outreach@mpls.frb.org. I view our responsiveness to this feedback as a priority for 2015 and beyond.

—Ron Feldman
Executive Vice President, SRC

Adjustable Rate Mortgage Disclosures

By Catherine Minor, Senior Examiner

Several Ninth District banks introduced, or reintroduced, adjustable rate mortgage (ARM) loans recently. Regulations around ARMs have important distinctions from other mortgage loans, many of which have changed over the past few years. We discuss key consumer requirements unique to ARM loans and conclude with some references to help your institution comply with the requirements.

Disclosure requirements for ARM loans

Banks should make sure they understand key disclosure requirements for ARMs before issuing them. These requirements include but are not limited to the following:

Calculating the annual percentage rate (APR) for ARM loans. Some banks get tripped up by ARM calculations for loans where the introductory rate is not based on the note's formula; the formula rate is considered the fully indexed rate. For example, a bank might offer an ARM with an introductory rate of 2.5 percent for the first six months, even though the fully indexed rate under the contract at origination would be 3.25 percent. In such a case, a blended APR must be disclosed. This blended APR reflects multiple payment streams: one payment amount based on the introductory rate for the time it is in effect under the contract and another based on the fully indexed rate for the remaining term. In our example, then, where a 30-year ARM has an introductory rate of 2.5 percent for six months and a fully indexed rate of 3.25 percent, the loan would have an APR based on six payments at 2.5 percent and 354 payments at 3.25 percent.

Interest rate and payment summary for ARM loans (effective 2011). Regulation Z requires creditors to present interest rate and payment information for mortgage loans in a table. The table for ARM loans shows the payment under specific interest rate scenarios. Many banks typically show the rate at consummation, the maximum rate in the first five years (beginning at the first payment date) and the maximum rate that may apply during the life of the loan. These disclosures help show the borrower the contractual impact on the loan payment if the interest rate increases rapidly.

Other disclosure requirements for ARM loans

Customers must receive disclosures for ARM loans that are not required for fixed rate mortgage loans. They receive an ARM program disclosure that describes the product's terms and features when they request an application. Borrowers also receive subsequent disclosures alerting them at the time of the initial interest rate change and again whenever a change in the payment amount occurs. Banks must send notifications in advance of the rate change and include information about the new payment amount and interest rate. Amendments to Regulation Z effective in January 2014 changed the timing and content of the adjustment notices.

Other disclosures required in mortgage transactions, such as the good faith estimate under the Real Estate Settlement Procedures Act and the private mortgage insurance disclosures under the Homeowners Protection Act, differ from fixed rate disclosures because of an ARM loan's variable rate.

ATR requirement for ARM loans (effective 2014)

The ability-to-repay (ATR) determination differs for ARM loans compared to other mortgages because an ARM loan's payment may change. Most significantly, a creditor evaluates a borrower's ATR by considering income, assets and debt obligations, including the monthly payment of the new loan. To determine ATR on an ARM, banks must:

- Use substantially equal monthly payments that would fully amortize the loan over its term, even if the contract terms require a different payment from the borrower.
- Calculate the monthly loan payment for purposes of ATR using the greater of the fully indexed rate or the introductory rate.

As an example, assume that the fully indexed rate on a 15-year ARM loan is 3.75 percent and the introductory rate for the first 12 months is 4.35 percent. The bank must use the introductory rate of 4.35 percent in calculating substantially equal monthly payments that amortize the loan over the 15 years to determine ATR.

An electronic version of the regulation, commentary and appendixes is available at consumerfinance.gov/eregulations/1026.

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shortfalls. Policies should establish parameters for when the bank will roll unpaid operating debt into term debt versus when lenders should pursue other options, such as guarantees or curtailing further advances. The Federal Reserve's guidance on expectations for risk management of agricultural credit risk provides guidance on desired features of bank policies.[1]

Second, bankers should reemphasize the importance of cash flow analysis during this review. The lender should evaluate the borrower's assumptions regarding production and pricing, both revenues and expenses, when analyzing a borrower's financial condition, in order to identify those customers who might experience strained cash flow. The banker can then work with the borrower throughout the year to evaluate options for addressing any shortfall that materializes. Regulators encourage banks to work with agricultural borrowers to develop responsible and effective means of addressing financial weaknesses. Banks should consider not only the availability of other collateral to support debt when rolling operating loans into term debt, but also the bank's and borrower's willingness to liquidate the collateral to pay debt should it become necessary.

Finally, banks should review their capital position and ensure its adequacy against their loan portfolio risk.

Agriculture, particularly crop production, could face a challenging near-term future. The use of prudent risk management techniques will enable agricultural bankers to meet the upcoming challenges and have a firm base to support future growth opportunities.

[1] See Supervision and Regulation Letter SR 11-14, Supervisory Expectations for Risk Management of Agricultural Credit Risk.