FEDERAL RESERVE SYSTEM

COMMUNITY BANKING
CONNECTIONS™
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Third Quarter 2012

The Importance of Community Banking:
A Conversation with Chairman Ben Bernanke

For the inaugural issue of Community Banking Connections, *a Federal Reserve System publication focused on community banking, staff asked Chairman Ben Bernanke for his perspectives on the benefits that community banks bring to the U.S. economy and the various challenges that they face today.*

Vision for Systemwide Community Bank Outreach Effort

Q Why has the Federal Reserve decided to launch this publication aimed at community banks? What is your vision for this publication, as well as the Federal Reserve's overall effort to enhance communication with community banks? What response do you hope/expect to see from community banks?

Chairman Ben Bernanke

A Given the Federal Reserve's role in promoting a strong economy and in supervising banks of all sizes, we strongly believe that it is important to communicate with as many people as possible through a variety of mechanisms. Community banks play an important part in the financial system and in our economy, and community bankers have raised concerns about a number of issues in recent years, including the slow economic recovery and the potential impact on them as regulatory reforms are implemented. We felt it was important, therefore, to enhance our avenues of communications with community banks, which we generally define as those banks with $10 billion or less in total assets.

We hope this publication, as well as other efforts, such as our advisory councils, will provide an effective opportunity to foster enhanced communication between the Federal Reserve and community bankers. We also hope it will inform and clarify expectations and give a better sense of the Federal Reserve's perspectives on supervisory matters. We want to hear from readers that may have varied perspectives on the subject matter. This publication will be successful if it provides useful insights and promotes greater dialogue, rather than just being a bunch of words on paper that get lost in the shuffle.

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Interest Rate Risk Management at Community Banks

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

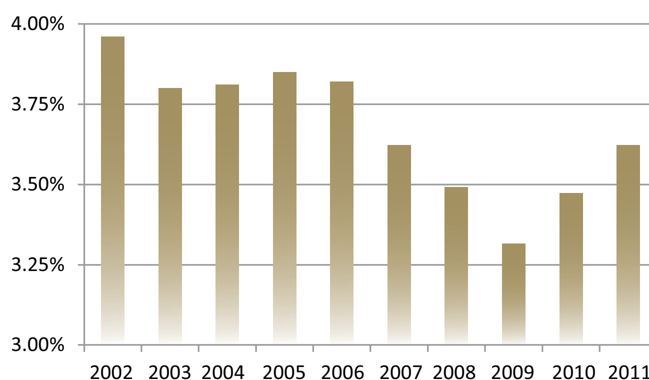
Over the past few years, the banking industry has faced significant earnings challenges. Community bank profitability has been under pressure due to increases in nonaccrual loans, credit losses, other-than-temporary impairment (OTTI) charges, and loan workout expenses. Many banks have responded to these earnings challenges by "tightening their belts," but, understandably, cost-cutting measures can go only so far for community banks that are committed to meeting the needs of local families and businesses with a level of service that differentiates them from larger banking organizations.

To meet the challenge of generating positive earnings and more suitable returns for their stakeholders, many banks have lengthened asset maturities or increased assets with embedded optionality. These actions serve to increase interest rate risk exposures and, thus, the need for more robust risk management programs. The purpose of this article is to provide an overview of the current banking landscape and to discuss key interest rate risk management activities and concepts for community banks. More detailed discussions of specific interest rate risk management elements are planned for subsequent articles.

The Current Landscape

During the credit downturn, problem loan losses and accompanying provision expenses were the most significant contributors to net losses at community banks. Lying further beneath the surface of these net losses was significant contraction of net interest margins. While net interest margins have begun to improve following reductions of nonperforming assets and repricing of term deposits at today's lower rates, margins continue to lag levels achieved in the past decade, as illustrated in Figure 1.

Figure 1: Net interest margins
U.S. banks with assets <$10b



Source: Reports of Condition and Income

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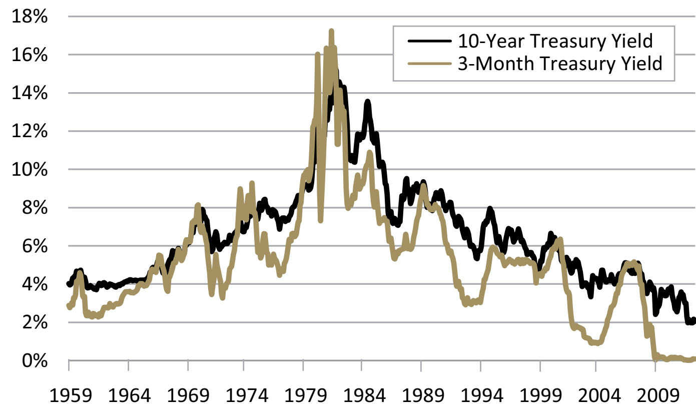
By historical standards, interest rates across the maturity spectrum are low and have been for some time, as illustrated by the depiction of short- and long-term Treasury rates in Figure 2.

Low interest rates, coupled with business contraction, have created an environment where bankers face difficult choices to maintain earnings performance. Some have elected to pursue new business lines that generate different sources of interest income or additional noninterest income, although these business lines may create new operational, credit, liquidity, and legal risks to those firms. Others have chosen to extend asset maturities and/or increase holdings of bonds with embedded options, thereby widening spreads but taking on greater interest rate risk. This trend is illustrated by the increase in assets with maturities or repricing terms greater than three years as a percentage of total assets (Figure 3).

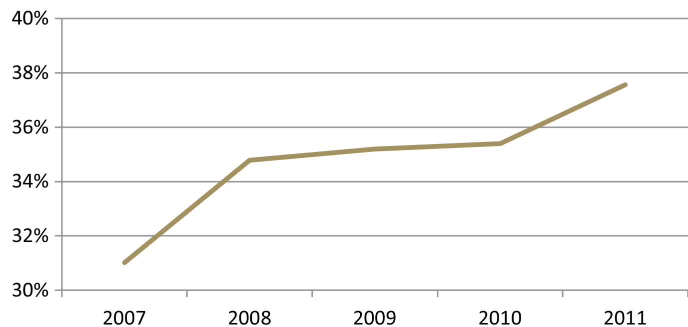
Those institutions extending asset maturities without a corresponding shift in liabilities are particularly exposed to significant upward movements in interest rates, which is not as uncommon as often perceived. In fact, the overnight federal funds rate experienced a change of 300 basis points or more over a 12-month period 15 percent of the time between 1955 and 2008.[1] It was in response to the pressure banks faced to generate earnings and increase assets with longer maturities, while also shortening their liability maturities, that financial institution regulators issued an *Interagency Advisory on Interest Rate Risk* (interagency advisory) in 2010 and, earlier this year, a follow-up document, *Interagency Advisory on Interest Rate Risk Management: Frequently Asked Questions* (FAQs).[2] The interagency advisory and FAQs are applicable to banks of all sizes and complexities.

Figure 2: Ten-year and three-month Treasury yields



Source: Federal Reserve Bank of New York

Figure 3: Assets maturing or repricing > three years/ total assets (U.S. banks with assets < $10b)



Source: Reports of Condition and Income

Common Interest Rate Risk Exposures

Generally speaking, interest rate risk is the risk that an adverse outcome will result from changes in interest rates. While interest rate risk can arise from various sources, four key types of interest rate risk are common to community bank balance sheets:

- **Mismatch/Repricing Risk:** The risk that assets and liabilities reprice or mature at different times, causing margins between interest income and interest expense to narrow.
- **Basis Risk:** The risk that changes in underlying index rates used to price assets and liabilities do not change in a correlated manner, causing margins to narrow. For example, loans priced off national prime rates might not

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[1] Discussed in greater detail in the Federal Deposit Insurance Corporation's Winter 2009 *Supervisory Insights* article, "Nowhere To Go But Up: Managing Interest Rate Risk in a Low-Rate Environment."

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

Community Banks, Fed Connect Through the Community Depository Institutions Advisory Council

by Gavin Miller, Supervisory Financial Analyst, Board of Governors, and Cynthia Course, Principal – Policy and Implementation, Federal Reserve Bank of San Francisco

How does the Federal Reserve Board of Governors (Board) know what is on the minds of community bankers? Board members have always sought the views of community bankers in a variety of ways to learn more about the state of the economy and banking conditions. More recently, the Board decided that it would be useful to have a more formal, systematic way to communicate with and understand the issues that are of greatest concern to smaller financial institutions and the communities they serve.

The Board established the Community Depository Institutions Advisory Council (CDIAC) in 2010 as a mechanism for community banks, thrift institutions, and credit unions with assets of $10 billion or less to provide input to the Board on the economy, lending conditions, and other issues. At the same time that the Board established the CDIAC, the 12 Federal Reserve Banks established similar local advisory councils, and one member of each Reserve Bank's council is selected to serve on the Board's CDIAC. This article provides additional information on the CDIAC's structure, membership, and purpose.

History

The Board has a long track record of seeking input from industry and public representatives on matters that fall within its mandate. Before the Board formed the CDIAC, the Thrift Institutions Advisory Council (TIAC) played a similar advisory role. The Board created the TIAC in 1980 to advise on the implementation of the Monetary Control Act of 1980. Over time, the TIAC also advised the Board on broader issues, such as the economy and financial markets.

By 2010, however, much had changed: not only had the TIAC's original purpose been met, but the percentage of deposits held by thrifts had declined significantly. At the same time, the Dodd-Frank Wall Street Reform and Consumer Protection Act reaffirmed the Federal Reserve's role in community bank supervision and added a broader focus on maintaining financial stability. Also, experience during the financial crisis reminded the Board that credit imbalances could occur in local markets and that smaller institutions encounter financial and operational challenges that are very different from those encountered by larger institutions. Thus, the Board decided to refocus its community-based advisory council and widen its institutional and geographical scope by replacing the TIAC with the new CDIAC.

Reserve Bank Councils

Reserve Banks historically have worked with community banking organizations not only because of their supervisory responsibilities but also because the Reserve Banks provide financial services to banking organizations in their Districts. Reserve Banks use contact with community banking organizations to better understand local market dynamics and have employed a variety of mechanisms to increase their understanding of community banking perspectives. Those local initiatives are continuing today. So, when the Board of Governors introduced the CDIAC program in 2010, the Reserve Banks were able to supplement their existing communication channels.

By early 2011, each Reserve Bank had identified a cross-section of senior officers representing community banks, thrift institutions, and credit unions to serve on the local councils. These councils generally comprise between nine and 12 members, who bring diverse backgrounds and perspectives to those meetings. Each member will generally serve for a staggered three-year term, although interim turnover may occur as a result of changes in individual depository institution management, asset growth, or mergers. Importantly, one member from each local council represents the council at the semiannual Board CDIAC meetings in Washington, D.C.

One benefit of the regionalized structure of the CDIAC program is that it provides an opportunity for all local councils to discuss the same issues with institutions of varying size, charter type, and location. This approach helps to ensure a robust discussion and consideration of a variety

of perspectives on current issues at the subsequent Board CDIAC meetings.

Local Reserve Bank councils meet at least twice a year, usually a few weeks before the Board CDIAC meetings, but they may meet more frequently. Generally, local councils have some flexibility in setting their own meeting agendas, and members may raise discussion topics that are not formally on the agenda. However, the agendas for the local council meetings that precede the semiannual Board CDIAC meetings have a consistent core of agenda topics provided by the Board to ensure that perspectives on significant topics are heard from all areas of the country. The Board members are therefore able to track trends in these issues across the United States over time, while local councils retain the flexibility to add topics to their agendas to reflect issues of interest.

John Evans, chief executive officer of D.L. Evans Bank in Burley, Idaho, chairs the Federal Reserve Bank of San Francisco's CDIAC. Evans says: "After attending three local council meetings, two as chairman of the council, I believe the members are giving excellent input to the leadership of the San Francisco Fed. I appreciate that the Fed wants input from community institutions, and I believe that Fed officials are listening and that positive changes will result from our meetings."

The primary purpose of the CDIAC, however, is to ensure that the perspectives of community institution members are understood not just locally but also in Washington.

The Board's Council

After the local councils hold their semiannual meetings, a member from each council attends a two-day CDIAC meeting with the Board at its headquarters in Washington, D.C. These meetings provide an opportunity for members to have discussions both among themselves and with the Board members and senior staff.

On the first day of each meeting, the local council representatives have an opportunity to share and discuss with each other their councils' perspectives on the questions provided by the Board to the local councils. The goal is to develop a response to each question that includes appropriate regional nuance. These viewpoints are summarized and provided to the Board members. On the second day, the council members meet with the Board members and senior Board staff from the divisions responsible for monetary affairs, research, and bank supervision.

"The CDIAC provides us with timely, actionable, ground-level information about local economic and banking conditions from the unique perspective of community institu-

Want to Know More?

The Reserve Banks and the Board maintain information about their respective councils on their websites.

Board of Governors: www.federalreserve.gov/aboutthefed/cdiac.htm

Atlanta: www.frbatlanta.org/about/atlantafed/cdiac.cfm

Boston: www.bostonfed.org/bankinfo/firo/cdiac/

Chicago: www.chicagofed.org/webpages/people/cdiac.cfm

Cleveland: www.clevelandfed.org/About_Us/officers_and_boards/bac.cfm#cdiac

Dallas: www.dallasfed.org/fed/contact.cfm

Kansas City: www.kansascityfed.org/publicat/aboutus/BoardsAndCouncils2011.pdf

Minneapolis: www.minneapolisfed.org/about/whoweare/cdcouncil.cfm

New York: www.newyorkfed.org/aboutthefed/ag_communitydepository.html

Philadelphia: www.philadelphiafed.org/about-the-fed/directors-and-councils/councils/community-depository-advisory-council.cfm

Richmond: www.richmondfed.org/about_us/who_we_are/advisory_councils/community_depository_institutions/index.cfm?WT.si_n=Search&WT.si_x=3

San Francisco: www.frbsf.org/federalreserve/people/officers/depository.html

St. Louis: www.stlouisfed.org/about_us/cdiac.cfm

tions," Federal Reserve Board Governor Elizabeth A. Duke says. "Members boil down the wide-ranging Reserve Bank council discussions into rich feedback from across the industry and across the country. That feedback helps us to stay in touch with local trends."

Evans adds, "Being able to meet and discuss community banking issues with Chairman Bernanke and the Board of Governors was quite an experience. The Chairman and the Governors want to hear about issues affecting community financial institutions. I was very impressed by the fact that this group of executives and Federal Reserve officials are determined to improve our financial system."

Making a Difference

The CDIAC program provides an opportunity for community depository institutions to share their first-hand knowledge and experience on wide-ranging economic, operational, and supervisory issues with senior Federal Reserve officials at the local and national levels. These ongoing discussions provide a particularly useful and relevant forum for improving the Federal Reserve's understanding of the effect of legislation, regulation, and examination activities on all community banking organizations, regardless of the supervising agency.

The first Board CDIAC meeting was held in the spring of 2011, and a total of three meetings have been held thus far. Results of the feedback from the initial meetings are already apparent. For example, at the first CDIAC meeting, members suggested that the Federal Reserve should be clearer about the applicability of its rules and guidance to community institutions. Based on this feedback from the CDIAC and other sources, the Federal Reserve now indicates more explicitly which institutions are subject to its supervisory guidance. In particular, new supervisory letters explicitly state whether and how the guidance applies to community institutions. Although this change is relatively simple, it should help those institutions to avoid spending the time to read and understand supervisory guidance that does not apply to them.

In addition, the local Reserve Bank councils, with aggregate membership representing more than 130 community financial institutions, have met at least three times to discuss current concerns about the economy, banking and lending conditions, and other issues.

Evans notes that one of the top benefits of the CDIAC is the opportunity to make a positive difference in the financial industry. "CDIAC members are 'Main Street' bankers that help communities throughout the nation prosper. With a strong community financial institution system, our communities can grow and prosper. I recommend that community bankers and credit union executives get involved with their CDIACs and give positive recommendations for improvement to our financial system."

If community banking organizations are interested in learning more about their local councils or contributing to the dialogue, they are encouraged to contact their local Reserve Bank or council members to share ideas or raise issues for discussion at future meetings. ■

How Can We Connect with You?

What banking topics concern you most? What aspects of the supervisory process or the rules and guidance that applies to community banks would you like to see clarified? What topics would you like to see covered in an upcoming issue of *Community Banking Connections*?

With each issue of *Community Banking Connections*, we aim to highlight the supervisory and regulatory matters that affect you and your banking institution the most, providing examples from the field, explanations of supervisory policies and guidance, and more. We encourage you to contact us with any ideas for articles, so that we can continue to provide you with topical and valuable information.

Please direct any comments and suggestions to www.communitybankingconnections.org/contact.cfm.

Uncovering the Mystery of an Appraisal

by Virginia Gibbs, Manager, Board of Governors

At a recent Federal Reserve conference for community bank examiners, a significant amount of time was devoted to the discussion of banks' appraisal function and compliance with the Federal Reserve's appraisal regulation, including appraisal review practices.[1] Several examiners noted that when evaluating commercial real estate loans, they occasionally do not find adequate documentation of appraisal reviews.

When examiners evaluate a credit and the accompanying loan file, they are trying to determine whether the bank has:

1. Reviewed the reasonableness of the facts and assumptions in the appraisal, and
2. Concluded that the appraisal provides a credible opinion of value to support the credit decision.

Examiners rely on a bank's review to assist them in understanding both the credit and the appraisal. For examiners, the appraisal review provides valuable information about a bank's assessment of its collateral risk in the event that bank management has to consider the property as a secondary source of repayment. This article seeks to clarify the discussion of appraisal reviews in the *Interagency Appraisal and Evaluation Guidelines* and to assist bankers in understanding supervisory expectations for appraisal reviews.[2]

The Mystery of Appraisals

When reading a riveting mystery, it can be tempting to jump right to the last chapter of the book to learn the ending. Of course, if you just skip right to the end, not only do you miss out on the twists and turns of the plot, but you also miss how and why the mystery was solved. Some bankers may be tempted to take a similar approach to reviewing an appraisal report. For example, some bankers may prefer to just consider the appraisal transmittal letter, in which the appraiser sets forth his or her opinion of the property's market value with an overview of the appraisal assignment. However, bankers should avoid this temptation and instead read beyond the transmittal letter to confirm that the appraiser solved the valuation "mystery" (i.e., answered the valuation question about the property) and that the information and analysis support the property's market value as presented in the appraisal report.

In discussing appraisal reviews at the recent examiners' conference, an examiner recounted his experience evaluating a land loan and the accompanying appraisal. When he read the appraisal, the examiner discovered that the appraiser relied on completed lot sales (i.e., a buildable lot with site improvements), even though the subject property had no on-site improvements. While the appraisal did not provide an "as developed" market value of the subject property, the disparity between the conditions of comparable properties and the subject property implied that the subject property was "developed" land. Moreover, the appraisal included a description of the subject property as "wooded land," indicating to the examiner that the land was unimproved. The bank would have identified such disparities if it had performed a more detailed appraisal review.

Examiners have also observed that even when bankers perform appraisal reviews, such reviews sometimes lack the necessary support to indicate whether the reviewer's comments and questions were resolved prior to the credit decision or whether they were considered in the credit analysis. In one case, examiners found that a bank's reviewer had accepted an appraisal, but the bank's credit management function heavily discounted the appraiser's opinion of value in its impairment analysis of an existing credit. Credit management discounted the appraised value because the new appraisal was much higher than an appraisal from two years prior, and the bank had current information indicating that the project was stalled. In this situation, while the credit management team was correct in its collateral risk assessment, it should also have raised its questions with the appraisal reviewer, who, in turn, should have discussed the matter with the appraiser.

In both situations, the bank's approach to appraisal review indicated a weakness in risk management and a disregard for the importance of the appraisal review in the assessment of a credit's collateral risk.

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[1] Refer to the Federal Reserve Board's Regulation H (12 CFR 208 Subpart E) for state member banks and Regulation Y (12 CFR 225 Subpart G) for bank holding companies.

[2] See SR Letter 10-16, "Interagency Appraisal and Evaluation Guidelines," available at www.federalreserve.gov/boarddocs/srletters/2010/sr1016.htm.

The Regulatory Capital Proposals: Frequently Asked Questions

On June 7, 2012, the Federal Reserve Board invited comment on three proposed rules revising the regulatory capital rules for state member banks, bank holding companies, and savings and loan holding companies. Shortly thereafter, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation also published the proposals for comment. The agencies' proposals can be found at:

www.federalreserve.gov/newsevents/press/bcreg/20120607a.htm.

This article highlights frequently asked questions from community bankers that Board staff received at "Ask the Fed" and other outreach events.

1. To which institutions do the proposals apply?

The two proposals relevant to community banking organizations would apply to all banks, savings associations, and savings and loan holding companies, as well as bank holding companies that are currently subject to minimum capital requirements. Like the current regulatory capital rules, the proposals would not apply to bank holding companies that are subject to the Board's Small Bank Holding Company Policy Statement, which generally applies to bank holding companies with under $500 million in total assets.

Under section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act, or the act), the Board is required to establish consolidated capital requirements for all savings and loan holding companies. The act does not include a provision similar to that provided for small bank holding companies that would exempt small savings and loan holding companies from such requirements.

2. Why are the banking agencies proposing revising the capital rules for all banking organizations when the Basel Accord applies only to internationally active banks?

These revisions are designed to increase the resiliency of the U.S. banking system and help all banking organizations maintain strong capital positions, which will enable them to continue lending to creditworthy households and businesses in their communities even after unforeseen losses and during severe economic downturns. Specifically, the revisions would improve the quality and quantity of banking organizations' capital, enhance the risk sensitivity of the current rules, and address weaknesses identified over the past several years.

The recent financial crisis demonstrated that the level and quality of a banking organization's capital was a primary factor in its ability to withstand adverse conditions and continue lending to households and businesses. This is just as true for small institutions as it is for large ones. Not only will stronger capital add resilience to individual institutions, but all banking organizations, including community banking organizations, also benefit from the strengthening of the entire financial system. Aggregate additional capital held by all institutions should reduce volatility in financial markets and collateral valuations.

The proposals also address certain requirements of the Dodd-Frank Act and eliminate inconsistencies across the agencies' current capital standards. The revisions are designed to address the activities and risks most relevant for specific banking organizations, and while the proposed definition of capital would be largely consistent across banking organizations, certain prudential measures such as the supplementary leverage ratio, countercyclical capital buffer, and enhanced measures of counterparty credit risk apply only to large, complex banking organizations currently subject to the advanced approaches (Basel II) risk-based capital rule.

3. Is there a summary of the requirements relevant to community banks? If so, where is it located?

Because of the complexity of the proposals, not all of which necessarily apply to community banking organizations, the agencies developed two summaries to help direct smaller institutions to those sections of the proposals that are most likely to affect them. The summaries can be found in:

Addendum 1 in the notice of proposed rulemaking (NPR) titled *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions,* which contains a summary that discusses the proposed revisions to the definition of capital, the new minimum capital ratios, the capital conservation buffer, and the eligibility criteria for regulatory capital components. www.federalreserve.gov/newsevents/press/bcreg/bcreg20120607a1.pdf

Addendum 1 in the NPR titled *Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements,* which contains a summary of the proposed revisions to the calculation of risk-weighted assets relevant for community banks. www.federalreserve.gov/newsevents/press/bcreg/bcreg20120607a2.pdf

Additional information can be found in the "Ask the Fed" presentations, titled *Recent Proposals to Enhance Regulatory Capital Requirements: What You Need to Know*, which were presented on July 16, 2012, at the Federal Reserve Bank of Chicago and on July 18, 2012, at the Federal Reserve Bank of Kansas City.

4. Why were the capital proposals issued in three separate notices of proposed rulemaking (NPRs)?

The rulemaking was divided into three separate NPRs to reflect the distinct objectives of each proposal, to allow interested parties to better understand the various aspects of the overall capital framework, including which aspects of the rules would apply to which banking organizations, and to help interested parties better focus their comments on areas of particular interest. Together, the proposals would establish an integrated regulatory capital framework and address inconsistencies across the agencies' current capital standards.

5. How will community banks be affected by these proposals?

Based on our analysis, the Board expects that more than 90 percent of community bank holding companies that currently meet the existing regulatory capital minimums would also meet the fully phased-in minimum requirements. More than 80 percent would meet the fully phased-in requirements plus the capital conservation buffer. For those organizations that do not yet meet the minimums and buffer, the proposals include a lengthy transition period to allow them time to come into compliance largely through retention of earnings.

6. What are the new risk-based capital minimums?

The proposals would change both the definition of capital and the minimum risk-based capital ratios in order to ensure strong levels of high-quality capital across all subject institutions and to help them withstand periods of significant stress. The proposed rule defines regulatory capital components as common equity tier 1 capital, additional tier 1 capital, and tier 2 capital.

With respect to the risk-based capital ratios, the proposal would introduce a new minimum common equity tier 1 capital ratio of 4.5 percent and would increase the current minimum tier 1 capital ratio from 4 to 6 percent. The minimum total capital ratio would remain at 8 percent. In addition, the proposal sets forth stricter eligibility criteria for regulatory capital instruments that focus on improving their loss absorbency. The proposed minimums would be fully phased in by January 1, 2015.

7. How would the leverage ratio be affected by the proposals?

The proposals would maintain the current 4 percent minimum ratio of tier 1 capital to total average assets, using the revised definition of tier 1 capital as the numerator. The proposal would discontinue the 3 percent minimum ratio currently permitted for banking organizations with a CAMELS rating of "1" or bank holding companies with an RFI rating of "1" or that are subject to market risk capital requirements.

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The Importance of Community Banking *continued from page 1*

Q Can you say more about the value community banks bring to the economy?

A Certainly, community banks have a critical role in keeping their local economies vibrant and growing by lending to creditworthy borrowers in their regions. They often respond with greater agility to lending requests than their national competitors because of their detailed knowledge of the needs of their customers and their close ties to the communities they serve. Such lending helps foster the economy by allowing businesses to buy new equipment, add workers, or sign contracts for increased trade or services. Those effects are felt at a local level and may appear at first glance to be fairly modest, but when you multiply these effects across the thousands of community banks in the United States, you really see how the lending decisions they make help the broader national economy.

Challenges & Changes in Community Banking

Q What do you view as the biggest challenges facing community banking institutions?

A Community banks face a number of challenges, but we see examples across the country where banks are meeting those challenges.

One big concern for community banks is the narrowing of the range of profitable lending opportunities — because larger banks have used their scale to gain a pricing advantage in volume-driven businesses such as consumer lending, community banks have tended to specialize in other areas, such as loans secured by commercial real estate. As you know, certain types of commercial real estate lending have taken a large hit in the financial crisis and its aftermath, so community bankers are looking elsewhere for opportunities for lending, and sometimes coming up with other viable areas can be challenging. This is an especially important issue for community banks because their size and small geographic footprints have traditionally made them vulnerable to concentration risk.

The good news is that, for the most part, community banks appear to be meeting their challenges. On aggregate, profits of smaller banks were considerably higher in 2011 than in the previous year, nonperforming assets were lower, provisions for loan losses fell appreciably, and capital ratios improved. We hope to see further improvement this year as well.

Q You often refer to the "traditional" community banking model. What elements have kept the traditional model alive for so long, and is there a future for it? How do you think the community bank model will change to meet future challenges?

A Although community banks provide a wide range of services for their customers, their primary activities revolve around what I refer to as the traditional banking model — specifically, taking short-term deposits to fund longer-term investments, such as consumer lending and small business, agricultural, or commercial real estate loans. One element that has kept the traditional model alive for so long is that community banks know their customers — and likewise, their customers know them — which I believe fosters greater customer loyalty. Community banks are well positioned to go beyond the standardized credit models used by larger banks and to consider a range of factors when making credit decisions. In addition, community banks tend not to be as exposed to the risks arising from trading, market-making, and investment banking activities associated with the largest banks.

I see a very real need for continuation of the traditional community banking model. Indeed, I believe there is a real place for the customization and flexibility that community banks can exercise to meet the needs of local communities and small business customers. And while I don't know exactly what the future of community banking will look like, I am confident that the flexibility and creativity of community bankers will allow them to adapt their business model to prevailing financial and economic trends and conditions.

Q How do you view the balance between community banks needing to maintain strong risk management practices while still being able to meet the credit needs of their communities?

A I understand that there can be an apparent tension between community banks' desire to lend and their need to make prudent risk management decisions, but I do

not believe that there is a simple trade-off between the two. If anything, you can make a case that weak risk management may, over time, lead to less lending — and vice versa — because banks must maintain safe and sound operations in order to provide for the financial needs of their communities. For example, during this past crisis, many banks that were struggling to overcome operational deficiencies as a result of risk management weaknesses typically were not in a position to make a lot of new loans. Banks with stronger risk management, on the other hand, were more likely to have the financial wherewithal to continue lending through the crisis.

Communication with Community Bankers

Q Can you discuss how the Federal Reserve is working to clarify the applicability of its guidance to community banks?

A We have always understood that not all regulations and guidance apply to every size or type of financial institution; many provisions of the Dodd-Frank Act, for example, by statute apply only to the largest banks. And even when supervisory policies do apply to all institutions, our expectations are typically higher for larger, more complex institutions. We have realized, though, that we have not always communicated our specific expectations in this regard as clearly as we could have. The last thing we want is for community bankers to have to read through long and complex new supervisory policies that were never intended to impact their businesses. We have, therefore, been trying to provide greater clarity on whether new policies apply to community banks when those policies are issued.

> "Community banks are well positioned to go beyond the standardized credit models used by larger banks and to consider a range of factors when making credit decisions."

In response to a suggestion that was made by one of the members of our Community Depository Institutions Advisory Council (CDIAC; see related article), we are including at the beginning of each new piece of supervisory guidance a statement outlining which banks are affected. In particular, when issuing supervisory letters, we try to state specifically if and how new guidance will apply to community banks. That way, banks don't have to waste resources on requirements that don't apply to them. We also hope that it will provide greater clarification to our examiners, so that they don't inadvertently try to hold community banks to standards that are intended for the largest banks.

In addition, when the Board and the other federal banking agencies recently published notices of proposed rulemaking to revise our capital rules to implement the Basel III capital framework (see related article), we tried to make these very complex proposals as clear as possible for community bankers. While these proposals totaled 700 pages in length, many of the proposed revisions to the capital rules would only apply to the largest banking organizations. To help community banking organizations better understand the elements of the proposals that would apply to them, the agencies included summary addenda to two of the proposed rules to provide a guide for community banks and a comparison of the proposed rules to the current requirements. I look forward not only to receiving formal comments from community banks on the proposals but also to receiving informal feedback on whether they found these addenda to be helpful so that we can consider whether similar materials would be useful in future rulemakings.

Q We know there are great benefits to two-way communication between examiners and community bankers. How can both sides ensure that they have and maintain a strong, ongoing dialogue?

A I think we would all agree that two-way communication between regulators and community banks is critical. Not only must we clearly communicate our supervisory policies and expectations to banks, but we also need to listen to and understand banks' concerns. We expect our examiners to make objective assessments and to be as clear as possible in explaining to banks why they have reached particular examination conclusions. I've learned that most community bankers are not shy in raising issues where they may not agree with supervisory findings, and I encourage bankers to continue to be open and candid in sharing their views with examiners. In those rare situations where bankers and

examiners are unable to resolve disagreements, I encourage bankers to contact management at their local Reserve Bank and, if necessary, contact the Ombudsman here at the Board. Let me emphasize that the Board will not tolerate retaliation against banking organizations that file appeals or raise concerns about the supervisory process, and the Ombudsman has broad authority to investigate and report claims of retaliation or other unjustified reactions.

I should also mention that we have been very happy with the establishment of the CDIAC, which I mentioned earlier. In the less than two years of its existence, the CDIAC has helped ensure that this two-way communication is happening. We look forward to continued work with the council in the years ahead.

And, of course, I hope this publication and the related *Community Banking Connections* website* will provide yet another vehicle for community bankers and the Federal Reserve to communicate with each other on supervisory matters. It is critical to keep the communications channels open if supervisors and banks are to work together constructively.

Federal Reserve System Regulation

Q Some community banks have expressed concern about the burdens of regulatory compliance given the size and complexity of the Dodd-Frank Act. How is the Federal Reserve responding to that concern?

A Community bankers tell us repeatedly that they are concerned about the changing regulatory environment. They touch on a number of areas, but one particular worry is the implementation of the Dodd-Frank Act.

I certainly don't want to dismiss these concerns, but I think it is important to emphasize that the vast majority of the provisions of the Dodd-Frank Act do not apply to community banks at all. The Dodd-Frank Act was enacted largely in response to the "too-big-to-fail" problem, and most of its provisions apply only, or principally, to the largest, most complex, and internationally active banks. For example, to mitigate the threat to financial stability posed by systemically important financial institutions, the act required the Federal Reserve to implement enhanced prudential standards to regulate these institutions. We have proposed such standards, which, in conjunction with other elements of the Dodd-Frank Act, are designed to make these firms safer and to force large institutions to take into account the costs that their potential failure could impose on the broader financial system.

These new standards are not meant to apply to, and clearly would not be appropriate for, community banks. Indeed, the Dodd-Frank Act explicitly exempts community banks from these new enhanced standards, and we have no intention of applying them to smaller institutions.

> "One thing that I would like to emphasize in this regard is that community banks provide the Federal Reserve with unique insights into local economic conditions, which helps us to have a better understanding of the wider economy and to make better macroeconomic decisions."

Perhaps the bigger concern that community banks have expressed is that the more stringent requirements for larger institutions may not apply to smaller institutions now, but they might eventually do so in the future. That, however, is not our intent, and we will work to ensure that it does not happen. To give a tangible example, when the Federal Reserve and the other federal banking agencies recently published supervisory guidance on stress testing practices at large banks, we also issued a special one-page statement to make clear that our supervisory expectations for large bank stress testing — especially the types of firm-wide stress tests required under Dodd-Frank — do not apply to community banks.

Q How can the Federal Reserve strike the right balance between strong supervisory oversight and avoiding unnecessary costs and burden on community banks?

A Bank supervision requires a delicate balance, particularly now. The weak economy, together with loose lending standards in the past, has put pressure on the entire banking

* www.communitybankingconnections.org.

industry, including community banks. To protect banks from a possible "race to the bottom" and new problems down the road, and to safeguard the Deposit Insurance Fund, I believe that we as supervisors must insist on high standards for lending, risk management, and governance. At the same time, it is important for banks, for their communities, and for the national economy that banks lend to creditworthy borrowers. Lending to creditworthy borrowers, after all, is how banks earn profits. Getting that balance right is not always easy, but it is of utmost importance.

The Federal Reserve is taking a number of steps to help strike that balance. For example, we tailor our examination and supervision to the size, complexity, risk profile, and business model of each institution. For community banks in particular, our examiners are expected to take local market conditions into account when assessing a bank's management and credit decisions. We also have an intensive training program for our examiners that allows us to get messages out quickly to our staff in the field, and most of this training is targeted at our community bank examiners.

One of the main ways the Board ensures that our supervisory program is calibrated appropriately is through a supervision subcommittee that focuses on issues affecting smaller community and regional banks. Because of their professional backgrounds in community banking and bank supervision, I asked Governors Elizabeth Duke and Sarah Bloom Raskin to serve on this subcommittee. Its primary role is to improve our understanding of community and regional banking conditions and to review policy proposals for their potential effect on the safety and soundness of, and the regulatory costs imposed on, community and regional institutions.

Q How do other Federal Reserve functions support and provide insight to banking supervision, and vice versa?

A One of the lessons we learned in the wake of the financial crisis is that it is important to ensure that the various Federal Reserve functions — monetary policy, bank supervision, consumer protection, payment systems, research — work together more effectively to promote financial stability. I won't say we've got it exactly right yet, but I believe that communication and cooperation across the various Federal Reserve functions is much stronger than it was several years ago.

One thing that I would like to emphasize in this regard is that community banks provide the Federal Reserve with unique insights into local economic conditions, which helps us to have a better understanding of the wider economy and to make better macroeconomic decisions. The Federal Reserve's decentralized structure, in which supervision is conducted through 12 regional Reserve Banks, helps facilitate our understanding of local economies, as does our ongoing coordination with state banking regulators. This connection to local economies is vitally important to fulfilling both our supervisory and monetary policy responsibilities. ■

Note: Several Governors have given speeches this year on community banking issues. The speeches can be found at: www.federalreserve.gov/newsevents/speech/2012speech.htm.

Community Banking Connections: More Than a Publication

Community Banking Connections is published each quarter to provide additional insight on recent supervisory and regulatory developments related to community banking and is delivered right to your front door or inbox. But even more information is available on the *Community Banking Connections* website, located at www.communitybankingconnections.org.

The website houses much more than the online version of *Community Banking Connections*. It provides news on regulations and supervisory guidance, policy updates, information about outreach programs at the various Federal Reserve Banks and the Board of Governors, and additional resources.

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

You can access all of this information from your computer or mobile device. Be sure to bookmark it today!

Interest Rate Risk Management at Community Banks

continued from page 3

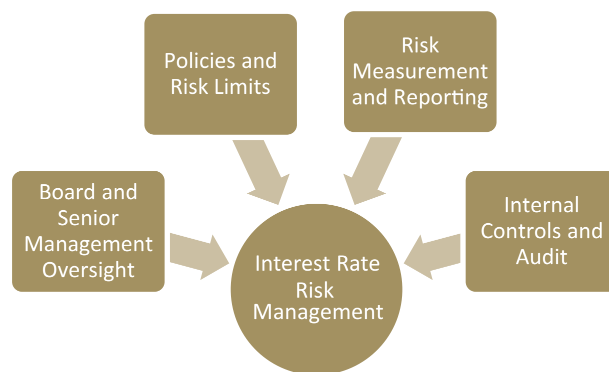
change in the same manner as certificates of deposit priced off U.S. Treasury rates.

- **Prepayment/Extension Risks:** The risk that asset repayments accelerate at a time when interest rates are low, resulting in diminished interest income and the need to reinvest repaid funds in lower-yielding assets. This risk intensifies when loan customers or bond issuers exercise their explicit call options to pay off the bank's asset prior to maturity and interest rates decline. The flip side of prepayment risk is extension risk, which stems from the lengthening of asset payoff rates in a rising rate environment, thereby reducing the funds available to invest at higher yields.
- **Yield Curve Risk:** The risk that nonparallel changes in the yield curve will disproportionately affect asset values or cash flows. For example, mortgage assets tend to be priced off 10-year U.S. Treasury rates. Suppose 10-year Treasury rates change significantly, while all other Treasury rates remain unchanged. The value and cash flows from mortgage loans and mortgage-related securities will also change significantly, but other assets and liabilities will not experience similar changes. Thus, banks with significant mortgage asset holdings would be exposed to greater yield curve risk than those with mortgage assets comprising a lower percentage of assets.

Key Risk Management Elements

Because banks are in the business of transforming short-term deposits into longer-term loans, they are inherently exposed to some degree of interest rate risk. Those exposures warrant risk management programs that allow the bank's management team and board of directors to appropriately identify, measure, monitor, and control these exposures. The rigor and expense applied to these programs should be commensurate with the size of the risk exposures and complexity of activities and holdings. Therefore, while there are elements of interest rate risk management that all banks should have in place, community banks would not necessarily need the same level of sophistication in their risk management practices as those that are in use at larger, more complex banking organizations. Figure 4 illustrates four key elements that are fundamental to every bank's interest rate risk management program:

Figure 4: Four key elements of a risk management program for interest rate risk



Board and Senior Management Oversight

A bank's board of directors is ultimately responsible for setting the institution's risk tolerance/appetite and overseeing the establishment of appropriate risk controls, both of which affect the level of interest rate risk exposure at the bank. While many community bank directors may have limited involvement with interest rate risk management in their own professional careers outside the institution, a bank's board is expected to have a collective fundamental working knowledge of the different types of interest rate risk, how business activities could create or change the bank's exposure, and how risk measurement reports can be used to identify exposures. In the past 15 years, significant progress has been made in the banking industry to develop interest rate risk and other training materials for directors, an example of which is the Federal Reserve System's Bank Director's Desktop.[3]

With this knowledge, directors can establish policies, risk limits, and management governance structures that foster

[3] The Bank Director's Desktop is available at www.bankdirectorsdesktop.org.

appropriate oversight of interest rate risk. Often, community bank boards charge management committees, or even board committees, such as an Asset/Liability Management Committee (ALCO), with risk measurement and monitoring responsibilities. When bank examiners evaluate board and senior management oversight, they assess the degree to which the board supports risk management activities by funding appropriate risk measurement tools and staff, establishing appropriate risk exposure limits (discussed below), and holding the ALCO accountable for implementing the board's guidance.

Policies and Risk Limits

Effective communication of the board's intentions regarding interest rate risk taking and risk management is important and should be accomplished through policies that are reviewed and updated periodically. Interest rate risk policies can be standalone documents or housed in a broader asset/liability management policy. At a minimum, board policies should describe the bank's risk tolerance/appetite; methods to identify, quantify, and report exposures; parties responsible for ongoing risk measurement and management; and the controls and risk limits necessary to ensure that the risk management function is operating appropriately. When bank examiners evaluate interest rate risk policies, these are the key components considered.

Perhaps the most significant component of a sound interest rate risk policy is the establishment of appropriate risk limits. Risk limits convey to staff how much exposure is acceptable before remedial actions should be taken to address an excessive risk position. Moreover, risk limits should reflect manageable constraints that are not excessively broad so that they provide a meaningful control.

For any risk limit to be useful, it must be understood by management and the board; be capable of being measured with existing risk measurement tools; and be stated relative to meaningful values, such as earnings or capital. For example, effective earnings exposure limits will communicate to bank personnel the maximum percentage of earnings (either net interest income or net income) that the board is willing to put at risk in certain interest rate shock scenarios (e.g., a parallel rate change of +300 basis points). Long-term interest rate risk exposures are best stated relative to a bank's capital level. Earnings and capital limits will allow management and the board to effectively determine whether earnings are adequate to sustain short-term earnings exposures and whether sufficient capital is in place to cover long-term risk exposures.

Risk Measurement and Reporting

Perhaps the most discussed interest rate risk management topic for community banks is risk measurement. Questions often arise regarding the types of tools or models that are needed, how to fine-tune those tools, and how often measurement reports should be provided to the ALCO and the board. At the most basic level, regulatory expectations require a bank's interest rate risk measurement tools and techniques to be sufficient to quantify the bank's risk exposure. Measurement techniques typically fall into two broad categories: short-term and long-term risk measures (Figure 5).

Figure 5: Common interest rate risk measurement techniques

Short-term measurement techniques should quantify the potential reduction in earnings that might result from changing interest rates over a 12- to 24-month horizon. Common measures include repricing gap (or "static gap") reports and earnings-at-risk (EaR) analysis.[4] While long-term net income simulations (up to five years) are occasionally used at com-

[4] EaR analysis calculates revenues and expenses based on various interest rate scenarios and assumptions established jointly by management and model vendors regarding price sensitivities, asset prepayments, reinvestment of cash flows, and deposit mix changes (among other factors). Net interest income or net income results from these calculations are then compared to a base case (no rate change) scenario to determine how much income exposure exists with each interest rate change scenario.

munity banks, the most common long-term measurement technique is some variation of economic value of equity (EVE).[5] While the interagency guidance states that simple static gap reporting may be sufficient for small banks with less complex interest rate risk profiles, regulators expect that management and directors of banks with more complex risk profiles will evaluate and actively manage earnings at risk and economic value exposures. Examples of increased complexity include elevated levels of assets with embedded options, increased mortgage banking activities, or the use of financial derivatives.

Once management and the board have determined the appropriate measurement tools for evaluating interest rate risk exposures, a decision must be made regarding reporting frequency. This decision should also be based on a bank's inherent risk profile. Banks with low interest rate risk profiles typically provide risk measurement reports to the ALCO and the board at least quarterly. As a bank's risk profile increases, either through an elevated EaR or economic value exposure or increased holdings of more complex assets, reporting frequency to the ALCO or the board should also increase. It is not uncommon for community banks with moderate and high risk exposures to provide monthly reports to the ALCO and quarterly reports to the full board of directors.

"As community banks have increased their use of interest rate risk models, examiners have expected management teams to take greater steps to ensure that data, assumptions, and output are reasonable and accurate."

Regardless of reporting frequency, sufficient information should be provided to allow decision-makers to evaluate the sources of exposures and identify potential noncompliance with risk limits. In situations where interest rate risk exposures exceed the bank's risk limits, senior management should also provide a report to the board detailing actions planned to return the bank to an acceptable risk level, and subsequent meetings should include updates to those action plans. It is important to document policy exceptions and resulting action plans in board and ALCO minutes. During examinations, examiners will evaluate the adequacy of the risk measurement tools to quantify the institution's risk exposures, controls, and accuracy of assumptions used to generate model results (if an interest rate risk model is being used), as well as the appropriateness of information reported to management committees and the board.

Internal Controls and Audit

The interagency advisory and subsequent FAQs attempt to bring greater clarity to regulatory expectations about internal controls and audit requirements. Examiners have long expected all banks to maintain appropriate controls over risk measurement and reporting processes. Generally speaking, these controls include secondary reviews of data accuracy in risk measurement tools, reporting of compliance with policy limits, and periodic review and documentation of the reasonableness of assumptions used in risk measurement tools. As community banks have increased their use of interest rate risk models, examiners have expected management teams to take greater steps to ensure that data, assumptions, and output are reasonable and accurate. At a minimum, an independent review of data inputs, key assumptions,[6] the accuracy of ALCO and board reports, and policy compliance should be conducted annually.

An independent review does not necessarily need to be conducted by a consultant or external party, but the reviewer must be independent of interest rate risk management activities and have sufficient understanding of accounting, modeling, and risk management requirements to be competent to complete the review. For community banks with increasing balance-sheet complexity or scope of activities, adequate in-

[5] EVE analysis computes expected cash flows related to asset and liability accounts, given various interest rate scenarios based on assumptions established jointly by bank management and model vendors. These cash flows are discounted to arrive at present values of bank equity, and these present values are compared with discounted economic values of bank equity for a zero interest rate change scenario to express the risk exposure as a percent change in EVE.

[6] Key assumptions for interest rate risk models could include asset prepayment speeds, nonmaturity deposit assumptions, and interest rate price sensitivities for significant balance-sheet accounts. Price sensitivities refer to the percent change for asset or liability pricing for a 100-basis-point change in the underlying interest rate (e.g., rates for savings accounts may increase 15 basis points for every 100-basis-point increase in interest rates).

dependence and competency often require contracting with an outside party. As with any type of independent review or audit, results should be reported to the board, and action plans should be developed to address identified weaknesses.

Common Pitfalls

One of the unique opportunities examiners have is to observe both best practices and common weaknesses at a broad cross-section of banks. At community banks, three common deficiencies in interest rate risk management tend to recur and are often cited in examination reports as matters requiring board attention.

First, many examiners have reported that they often find gaps between board-prescribed risk limits and the risk measurement tools used to quantify risk exposures. For example, a bank policy may specify a risk limit in terms of EVE, but the bank's risk measurement tool may not measure EVE exposures. While not every risk measure captured by the measurement tool requires a risk limit, the risk limits established by the board should be routinely calculated and reported. If the risk limit can't be captured by the risk measurement tool in place, the board should determine whether a new, appropriate, and calculable limit should be established or whether a new risk measurement tool is needed.

Second, many examiners have evaluated assumptions used in interest rate risk models and determined that default or industry standard assumptions provided by the vendor have never been evaluated or customized by the bank's management team. While certain vendor-provided assumptions may be appropriate for some banks, the management team should evaluate the reasonableness of those assumptions before accepting them for use in a given model.

Third, many banks have not incorporated independent or third-party reviews to ensure the integrity of their interest rate risk management programs. Since 2010, this has been perhaps the most prevalent interest rate risk matter identified by examiners, as community bank management teams work to comply with the guidance set forth in the interagency advisory.

Conclusion

Community banks face a number of formidable challenges in the current economic environment. However, with appropriate interest rate risk management programs, the inherent interest rate risks that are intrinsic to banking can be managed effectively for given levels of capital and earnings. ■

Statement to Clarify Supervisory Expectations for Stress Testing by Community Banks

On May 14, 2012, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency issued a joint statement clarifying that community banking organizations (banks, savings associations, and bank and savings and loan holding companies with $10 billion or less in total assets) are not required or expected to conduct the types of stress testing required of larger organizations.

In particular, community banking organizations are not required or expected to conduct the enterprisewide stress tests required of larger organizations under the Board's capital plan rule, the proposed rules implementing Dodd-Frank Act stress testing requirements, or as described in the recently issued stress testing guidance for organizations with more than $10 billion in total consolidated assets.

The agencies note that all banking organizations, regardless of size, should have the capacity to analyze the potential impact of adverse outcomes on their financial condition.

The full text of the statement is available at www.federalreserve.gov/newsevents/press/bcreg/20120514b.htm.

Uncovering the Mystery of an Appraisal *continued from page 7*

Appraisal Review Policy and Process

Banks are expected to have an appropriate appraisal review policy, considering property type and transaction risk, that confirms compliance with the appraisal regulation. Moreover, the appraisal review should assess whether the appraisal contains sufficient information and analysis to support the appraiser's opinion of the property's market value. As discussed in the *Interagency Appraisal and Evaluation Guidelines*, a bank's appraisal review policy should achieve the following four objectives:

1. Address the independence, educational and training qualifications, and role of the reviewer;
2. Reflect a risk-focused approach for determining the depth of the review;
3. Establish a process for resolving any deficiencies in appraisals or evaluations; and
4. Set forth documentation standards for the review and resolution of noted deficiencies.

If a bank employee reviews appraisals, the individual should possess the requisite education, expertise, and competence to perform the review, commensurate with the complexity of the transaction, type of real property, and market. Further, the individual should be capable of assessing whether the appraisal contains sufficient information and analysis to support the bank's credit decision. If a bank has limited in-house expertise to perform appraisal reviews, it may decide to engage a third party to perform the appraisal review function or engage a second appraiser to perform an appraisal review.[3] While outsourcing the appraisal review function is an option, bank management remains responsible for determining the quality and assessing the adequacy of the appraisal review and, more important, whether to accept the appraisal.

Independence in the appraisal review process is just as important as independence in engaging the appraiser and ordering the appraisal. Bank employees who review appraisals should be independent of the transaction; have no direct or indirect interest, financial or otherwise, in the property or transaction; and be independent of and insulated from any influence by loan production staff. For community banks with limited in-house expertise, there may be challenges in achieving absolute lines of independence between the appraisal review function and the credit decision. As noted in the guidelines, the appraisal review may be a part of the originating loan officer's credit analysis, as long as that officer abstains from directly or indirectly approving the loan.

The depth of the review should be sufficient to ensure that the valuation methods, assumptions, data sources, and conclusions are reasonable, well-supported, and appropriate for the transaction, property, and market. Therefore, a bank's policy for appraisal reviews should address the expectations for an appraisal review based on the size, type, and complexity of the credit transaction and property. For example, when a rural property is appraised, the identification of the property's market should be an important element of the appraiser's identification and selection of comparable sales. In a rural market, there may be few or infrequent market transactions within a short distance of the subject property. Therefore, the review of a rural property appraisal should not just evaluate the selection of a comparable sale in relation to the distance between the subject property and the comparable sale but should also consider if the comparable sales are an indicator of the market in which the subject property competes.

A key element of the appraisal review policy is the documentation requirements for a review, which will vary depending on the type, risk, and complexity of the transaction. Therefore, the policy should require sufficient documentation of appraisal reviews to be included in loan files.

The reviewer may ask the appraiser to consider new information or to perform additional analytical work. The bank should have adequate internal controls to ensure that the communications between the reviewer and the appraiser do not result in any coercion or undue influence on the appraiser. The reviewer is likely to have questions for the appraiser, and such dialogue should occur to promote an understanding

[3] If a bank engages an appraiser to perform an appraisal review, the appraiser must perform the review in accordance with the Uniform Standards of Professional Appraisal Practice (USPAP), "Standard 3: Appraisal Review, Development and Reporting." However, a review appraiser may perform a USPAP Standard 3 review with or without providing an opinion of the property's value. For instance, the review appraiser may only be expressing an opinion on the quality of the appraisal report (i.e., completeness, relevance, appropriateness, and reasonableness) without providing a second opinion on the property's market value.

of the appraisal. Therefore, the documentation in the loan file should provide an audit trail of the review process and the appraiser's responses, including any changes that the appraiser may make to the property's market value. Further, if there are deficiencies in the appraisal that cannot be resolved with the appraiser and a second appraisal becomes necessary, the documentation should address the reasons for obtaining and relying on the second appraisal.

Reviewing a CRE Property Appraisal

The review of a commercial real estate (CRE) property appraisal should cover much more than the appraiser's opinion of the property's market value. It should also involve an assessment of the appropriateness of the appraiser's market information, data sources, analysis, and assumptions. The review should consider whether:

- The appraisal reflects the terms and conditions of the appraisal assignment that the appraiser agreed to meet in accepting the appraisal assignment from the bank. An engagement letter between the bank and the appraiser can facilitate communications between the two. A typical engagement letter will address the appraiser's scope of work; the property and property rights being appraised; and the bank's requirements for report format, property inspection, and definition of market value.
- The discussion of current market conditions and probable future market trends addresses both rising and declining value trends. This discussion should address the market for the type of property being appraised and not just general market conditions.
- The quantity and quality of the data support the analysis.
- The opinion of the property's market value reflects expected future market conditions, including any limiting conditions due to lack of data.
- The appraiser appropriately considered the three valuation approaches (i.e., cost, sales comparison, and income), explaining the reasons that an approach was relied upon or omitted. The appraisal should include an assessment of the inherent advantages and disadvantages of the three approaches and the relevance to the subject property.[4]
- The appraisal addresses the intended users and use of the appraisal.
- The appraisal provides the effective date of the opinion value.
- The appraiser discloses the extent to which the subject property and comparable properties were inspected and who performed the inspection.
- The value of furniture, fixtures, and equipment is disclosed separately from the value of the real property.
- In cases when an appraisal includes other value opinions, such as going concern or value in use or special value to a specific property user, the appraisal report clearly identifies and discloses these value opinions separately from the opinion of the real property's market value.
- The appraisal includes the sales history of the subject property over the past three years.

In discussing with bank management the performance and collateral support for a particular CRE loan, bank examiners will often address the adequacy of the bank's appraisal function, including the bank's appraisal review practices. Some of the most common weaknesses that examiners have identified in appraisals are items that bankers may detect in the course of their own reviews. Some of these weaknesses include the following:

- The appraisal does not value the correct property rights (i.e., fee simple, leased fee, and leasehold interest).
- The appraisal includes the value of personal property, fixtures, or the business in the overall opinion of the market value of the real property.
- The appraisal does not address any negative property features or market conditions.
- The appraisal describes deteriorating or weakening market conditions but does not relate these conditions to the opinion of market value.
- The appraisal does not explain the reasons for excluding a valuation method (i.e., sales comparison, cost, and income approaches).
- The appraisal does not reflect an analysis of sales contract, including terms, conditions, and concessions.
- The appraisal does not reflect an analysis of any prior sales of the property being appraised that have occurred within the past three years.
- The information and data presented in the appraisal do not support the key assumptions.
- The appraisal does not include any reasonableness test of key assumptions. For instance, is the marketing period used in the income approach realistic in relation to current market conditions?

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[4] In accordance with the Scope of Work rule of USPAP, an appraiser "must be prepared to support the decision to exclude any investigation, information, method, or technique that would appear relevant to the client, the intended user, or the appraiser's peers." Refer to "Scope of Work Acceptability" and USPAP Advisory Opinion 29, An Acceptable Scope of Work.

- The appraisal relies predominantly on data at the high end of the range of the market information.
- The sell-out rate (e.g., for a residential development) or vacancy rate (e.g., for an office building) appears to be overly optimistic.
- The descriptions of the property and improvements do not match the photographs in the appraisal. For an appraisal of a residential land development, for example, has the appraiser assumed that the lots are ready for home construction, even though the infrastructure (e.g., utilities, streets, sidewalks) has not been completed?
- Comparable properties are dissimilar to the property being appraised, in terms of market, location, or property features. For example, land zoned for residential development should not be compared with sales of land zoned for commercial use.
- The capitalization rate (or "cap rate") does not reflect the requirements of investors for a similar type of property.
- The appraisal reflects gross rents instead of net rents.
- The appraisal reflects contract rents and not market rents.
- For a residential tract development, the appraisal does not consider appropriate deductions and discounts for marketing and holding costs and entrepreneurial profit for the entire project over the sales absorption period.

Confirming the Ending to the Mystery

Just like a good mystery with an ending that is supported by the clues throughout the story, an acceptable appraisal report will present sufficient information and analysis to support the appraiser's conclusion about the property's market value, as well as comply with USPAP and the Federal Reserve's appraisal regulation. An appraisal should do much more than provide a number — it should tell the story behind that number. The appraisal review should confirm that this is indeed the case, and bank management should view the appraisal review as confirmation that the appraisal supports the valuation conclusion.

Understanding the "mystery" of individual appraisals can provide valuable information to support a bank's overall appraisal function. A robust appraisal review process confirms the adequacy of a bank's appraisal function, supports the bank's practices for engaging competent and qualified appraisers, and ensures that appraisals provide sufficient support and information for the bank to understand its collateral risk. By understanding its collateral risk, a bank can make a more informed credit decision, appropriately mitigate identified risk, and better serve its borrower as well as bank shareholders. ■

REGULATORY RECAP

Supervision & Regulation (SR) Letters & Other Announcements

SR Letters

The following SR letters that are applicable to community banking organizations have been released in 2012. Letters that contain confidential supervisory information are not included. All SR letters can be found at www.federalreserve.gov/bankinforeg/srletters/srletters.htm.

SR Letter 12-12/CA Letter 12-11, "Implementation of a New Process for Requesting Guidance from the Federal Reserve Regarding Bank and Nonbank Acquisitions and Other Proposals"
SR Letter 12-11/CA Letter 12-10, "Guidance on a Lender's Decision to Discontinue Foreclosure Proceedings"
SR Letter 12-10/CA Letter 12-9, "Questions and Answers for Federal Reserve-Regulated Institutions Related to the Management of Other Real Estate Owned (OREO)"
SR Letter 12-6, "Inactive Supervisory Guidance"
SR Letter 12-5/CA Letter 12-3, "Policy Statement on Rental of Residential Other Real Estate Owned (OREO) Properties"
SR Letter 12-4, "Upgrades of Supervisory Ratings for Banking Organizations with $10 Billion or Less in Total Consolidated Assets"
SR Letter 12-3, "Interagency Guidance on Allowance Estimation Practices for Junior Lien Loans and Lines of Credit"
SR Letter 12-2, "Questions and Answers on Interagency Advisory on Interest Rate Risk Management"

The Regulatory Capital Proposals: Frequently Asked Questions *continued from page 9*

8. How would the proposals revise the prompt corrective action framework?

The proposals would revise the prompt corrective action (PCA) framework for insured depository institutions by incorporating the new minimum regulatory capital ratios; modifying the definitions of tier 1 capital and total capital, as well as the calculation of risk-weighted assets, consistent with other parts of the proposal; and updating the definition of tangible common equity with respect to the critically undercapitalized PCA category. The proposals would not change existing requirements and limitations on banking organizations' activities within the PCA categories, but it would change the minimum thresholds within each of those categories. Specifically, with regard to the thresholds and as summarized in the table below:

- The tier 1 column would be revised to reflect the increased minimum tier 1 ratio of 6 percent;
- The common equity tier 1 column would be *added* to reflect the new common equity tier 1 ratio; and
- For leverage, the current exception that permits the lower 3 percent threshold if certain criteria were met would be removed.

There are no changes to the total risk-based capital column as the proposal does not revise this minimum.

The proposed changes to the current minimum PCA thresholds and the introduction of a new common equity tier 1 capital measure would take effect January 1, 2015.

9. How would the proposed capital conservation buffer interact with the proposed revisions to the PCA framework?

The proposed capital conservation buffer would function as a separate regime from the PCA framework and is designed to give banking organizations incentives to retain rather than distribute capital as their risk-based capital ratios approach the minimum required ratios. Specifically, a banking organization would need to hold a buffer of 2.5 percent of risk-weighted assets in common equity tier 1 capital in addition to its minimum risk-based capital requirements in order to avoid restrictions on capital distributions and discretionary bonus payments to executive officers.

As the buffer shrinks, the banking organization would be subject to increasingly stringent restrictions on capital distributions and discretionary bonus payments to executive officers. The buffer is designed to act as a shock absorber and help banking organizations survive stressful periods. Therefore, under the proposal, a bank would be allowed to use up to 50 basis points of its capital conservation buffer and still be considered well capitalized. While subject to restrictions on capital distributions and discretionary bonus payments, a bank with a capital conservation buffer between 0 and 2 percent of risk-weighted assets would be adequately capitalized for PCA purposes provided that it meets the minimum regulatory capital ratios.

The capital conservation buffer would be phased in between 2016 and 2018.

continued

Proposed PCA Levels for Insured Depository Institutions

	Total Risk-Based Capital (RBC) Measure	Tier 1 RBC Measure	Common Equity Tier 1 RBC Measure	Leverage Measure
Well Capitalized	≥ 10	≥ 8	≥ 6.5	≥ 5
Adequately Capitalized	≥ 8	≥ 6	≥ 4.5	≥ 4
Undercapitalized	< 8	< 6	< 4.5	< 4
Significantly Undercapitalized	< 6	< 4	< 3	< 3
Critically Undercapitalized	Tangible Equity (defined as tier 1 capital plus non-tier-1 perpetual preferred stock) to Total Assets ≤ 2			

Note: Amounts measured in percent

10. Will trust preferred securities continue to be included in tier 1 capital under the proposals?

Under the proposals, trust preferred securities would not qualify for inclusion in tier 1 capital because such securities would not comply with the eligibility criteria for additional tier 1 capital instruments. The agencies believe that trust preferred securities, which are not perpetual and allow for the accumulation of interest payable, are not sufficiently loss-absorbent on a going concern basis to be included in tier 1 capital. However, trust preferred securities could qualify for inclusion in tier 2 capital if they meet the proposed eligibility criteria for tier 2 capital instruments.

The exclusion of trust preferred securities from the tier 1 capital of bank holding companies and savings and loan holding companies is consistent with section 171 of the Dodd-Frank Act, which requires that such instruments issued by these organizations with $15 billion or more in total consolidated assets be phased out over a period of three years beginning in 2013. In addition, the agencies proposed that trust preferred securities issued by bank holding companies and savings and loan holding companies under $15 billion in total consolidated assets be phased out over a 10-year period beginning in 2013.

11. Under the proposals, how will gains and losses on available-for-sale debt securities be treated?

Unlike under the current rule, under the proposals, unrealized gains and losses from available-for-sale debt securities would flow through to common equity tier 1 capital. This effect is phased in over five years.

12. Why is the treatment of gains and losses on available-for-sale debt securities being revised?

The agencies believe that this treatment better reflects an organization's ability to absorb losses and remain a going concern at a particular point in time. If unrealized losses were neutralized and permitted to flow through to common equity tier 1, then an institution's loss absorption capacity would be overstated. Such an approach is also consistent with the increased focus by both supervisors and market participants on an institution's tangible common equity as a better gauge of its financial strength.

The agencies recognize that including unrealized gains and losses related to certain debt securities whose valuations primarily change as a result of fluctuations in a benchmark interest rate could introduce substantial volatility in a banking organization's regulatory capital ratios. Likewise, the agencies recognize that such potential volatility could influence banking organizations' investment decisions.

As a result, the agencies are seeking specific feedback from commenters on this proposed treatment, particularly the extent to which it could lead to excessive volatility in regulatory capital, as well as alternatives the agencies should consider.

13. How are interest-only residential mortgages treated under the proposals?

Under the proposal, residential mortgages would be divided into two categories (category 1 or category 2) based on whether they meet certain prudential underwriting criteria and product characteristics. An interest-only residential mortgage would be considered a category 2 mortgage because it does *not* require regular periodic payments that do not: (i) result in an increase of the principal balance; (ii) allow the borrower to defer repayment of the principal of the residential mortgage exposure; or (iii) result in a balloon payment.

During the recent market turmoil, the U.S. housing market experienced significant deterioration and unprecedented levels of mortgage loan defaults and home foreclosures. The causes for the significant increase in loan defaults and home foreclosures included inadequate underwriting standards; the proliferation of high-risk mortgage products, such as so-called pay option adjustable rate mortgages, which provide for negative amortization and significant payment shock to the borrower; the practice of issuing mortgage loans to borrowers with unverified or undocumented income; and a precipitous decline in housing prices, coupled with a rise in unemployment.

As a result, the agencies proposed a risk-weight framework that would assess risk-based capital based on the risk inherent in a residential mortgage. Specifically, residential mortgages in both categories would be assigned a risk weight based on their loan-to-value (LTV) ratio, determined at the time of origination.

Category 1 mortgages would be first-lien amortizing mortgages that have been prudently underwritten and have more conservative product features. Such mortgages would be assigned to risk weight categories ranging from 35 percent to 100 percent based on the associated LTV. Category 2 mortgages would be considered riskier exposures, such as interest-only, balloon, or negative amortization mortgages. Category 2 mortgages would be assigned risk weights ranging from 100 percent to 200 percent based on the LTV.

The agencies recognize that certain types of residential mortgages, such as interest-only and balloon mortgages, are important products for community banking organizations. As a result, the agencies are seeking input regarding how to adequately reflect the risks of such exposures.

14. How do I submit a comment letter to the Federal Reserve Board?

The Federal Reserve Board has extended the comment period to October 22, 2012. You may submit comments by any of the following methods:

- **Agency website:** www.federalreserve.gov. Follow the instructions for submitting comments at www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.
- **Federal eRulemaking Portal:** www.regulations.gov. Follow the instructions for submitting comments.
- **E-mail:** regs.comments@federalreserve.gov. Include docket number R-1442 in the subject line of the message.
- **Fax:** (202) 452-3819 or (202) 452-3102.
- **Mail:** Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551.

All public comments are available on the Board's website at www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons. ■

Outreach Connections

The Board of Governors and the Federal Reserve Banks reach out to the community banks in their Districts through various programs and resources. In addition to live hosted events, many of these programs and resources are available online. Following is an overview of just a few of these outreach programs, with links to access more information or to subscribe.

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

***Consumer Compliance Outlook* and Outlook Live** — *Consumer Compliance Outlook* is a quarterly Federal Reserve System publication dedicated to consumer compliance issues. The online version of the publication is available at www.consumercomplianceoutlook.org. In addition to the publication, the System hosts "Outlook Live," a popular webinar series that digs deeper into consumer compliance topics of interest. Each webinar is archived for future reference. *Outlook* and "Outlook Live" are available at: www.consumercomplianceoutlook.org.

FedLinks: Connecting Policy with Practice — *FedLinks* is a single-topic bulletin prepared specifically for community banks. Still under development, each bulletin will provide an overview of a piece of key supervisory guidance, explain the purpose of the guidance, explain how it relates to other guidance, and discuss implementation expectations as appropriate at community banks. It will be available at www.communitybankingconnections.org.

Partnership for Progress — Launched in June 2008, P4P is the Federal Reserve's outreach and technical assistance program for minority-owned and de novo banking institutions. This program helps these institutions confront their unique challenges, cultivate safe and sound practices, and compete more effectively in today's marketplace. It combines one-on-one guidance, workshops, and an extensive interactive web-based resource and information center at www.fedpartnership.gov/.

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