

# Client Alert

October 2017

## Presentations Reveal 2017 Regulatory Concerns

Recently, we attended various presentations by state and federal regulators concerning issues that they are focusing on for upcoming examinations. We have discussed these matters below. For ease of consideration, we have separated these into matters presented by the Office of the Comptroller of the Currency (OCC), on one hand, and state regulators, along with the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve Board, on the other hand (collectively, "State Bank Regulators").

Even if you are with a national bank or federal savings bank, you should consider the matters presented by the State Bank Regulators and vice versa. Our experience is that many of the concerns unique to one regulator become focus points for other regulators both because the regulators seek consistency among agencies and regulatory concerns, to some extent, are universal.

### A. State Bank Regulators.

1. **Liquidity Risk:** The State Bank Regulators emphasized that they believe liquidity is an increasing risk for all banks and community banks in particular. They recognize that the "Liquidity Coverage Ratio" applicable to money center banks is distorting the market for deposits. This impact, coupled with rebounding alternative investments and modest interest rate increases by the Federal Reserve Board, are starting to be felt. The State Bank Regulators have noticed a trend of less on balance sheet liquidity and increased reliance on non-core funding. At a minimum, banks should do the following:

- **Contingency Funding Plan:** Banks should have a written contingency funding plan in place that addresses how the bank will handle a liquidity crisis. Specifically, the plan should address ways to improve the bank's liquidity position and maintain adequate sources of stable funding given a bank's anticipated liquidity and funding needs under various crisis scenarios. The plan should designate specific individuals and steps to be taken in the event that liquidity falls to moderate/critical levels outlined in the plan. In addition, the plan should be reviewed and evaluated periodically as the bank's liquidity position shifts.
- **Stress Testing:** The bank should conduct stress testing to determine how different scenarios impact the bank's liquidity position. This stress testing should be documented by the bank. The OCC has suggested that liquidity should be stressed every six months. We are starting to hear the same from State Bank Regulators especially for banks growing quickly or experiencing strength growth in non-owner occupied commercial real estate.

We expect that the State Bank Regulators will ask to review the bank Contingency Funding Plans and stress testing as part of the next exam cycle. In addition, the FDIC's Summer 2017 issue of Supervisory Insights featured an article on "*Community Bank Liquidity Risk: Trends and Observations from Recent Examinations.*" This article can be found at the following link and is recommended reading for all community bankers:

<https://www.fdic.gov/regulations/examinations/supervisory/insights/index.html>

**2. Three High Risk Factors:** The State Bank Regulators emphasized that, in general, banks that failed during the Great Recession had three factors in common:

- fast loan growth,
- high levels of concentrations (especially non-owner occupied CRE and within that asset type, acquisition, development and construction lending), and
- significant reliance on non-core funding.

We have seen, and expect to continue to see, the State Bank Regulators focusing on these issues as part of the next exam cycle. If your bank's strategic plan includes significant loan growth or concentrations, we recommend having a conversation with your regulator to discuss these issues in advance of the bank's next exam. If the bank is relying on non-core funding in any material way (20% - 30% or more of its funding), the bank should have a written plan in place to reduce such reliance.

**3. Compliance and CRA Issues:** Compliance remains a hot button issue for the State Bank Regulators, although they did note that banks as a whole are doing much better on compliance. On September 28, 2017, the Dallas Region of the FDIC released its quarterly newsletter, which addresses a number of items, including the more frequently cited compliance violations. A link to that newsletter is set forth below:

[https://www.hunton.com/Media/Dallas\\_DCP\\_Newsletter\\_September\\_2017.pdf](https://www.hunton.com/Media/Dallas_DCP_Newsletter_September_2017.pdf)

In addition, the State Bank Regulators focused on redlining risk in mergers and acquisitions. For example, this can cause problems for a buyer if the buyer does not consider the bank's pro forma footprint following an acquisition.

**4. Disaster Preparation:** The State Bank Regulators commended the response of their banks to Hurricanes Harvey and Irma. In Texas, there were 54 counties impacted by Hurricane Harvey, and 646 branches were impacted. However, the State Bank Regulators emphasized that the disaster preparation plans these banks had in place worked well. For those banks not impacted, the State Bank Regulators emphasized that they should have a disaster preparation plan in place.

In addition, on October 2, 2017, the Texas Department of Banking (the "TDB") sent Industry Notice 2017-10 called "*Texas Department of Banking Provides Support and Guidance for Financial Institutions and Borrowers Affected by Hurricane Harvey – Home Equity Loans and Home Repairs*," which provides additional guidance to banks about the options and potential problem areas of extending new loans and renewing or modifying existing consumer loans. The notice can be found on the TDB's website ([www.dob.texas.gov](http://www.dob.texas.gov)).

**5. CECL:** The State Bank Regulators are beginning to provide tools for community banks on implementing CECL. A summary of two useful tools is set forth below:

- **Conference of State Bank Supervisors Tool:** On September 27, 2017, the TDB sent Industry Notice 2017-9 called "*CSBS Current Expected Credit Losses (CECL) Readiness Checklist Tool*." The notice can be found on the TDB's website ([www.dob.texas.gov](http://www.dob.texas.gov)).

The notice explains that the Conference of State Bank Supervisors developed a tool, called the “*CECL Readiness Checklist Tool*,” to help financial institutions prepare for the changes associated with CECL. A link to the *CECL Readiness Checklist Tool* is set forth below:

<https://www.csbs.org/regulatory/resources/Pages/JobAids.aspx>

The tool was developed to provide a framework that a financial institution could use to plan for accounting changes. This optional tool was developed in response to comments from financial institutions, particularly small, noncomplex financial institutions, that a set of steps to prepare for CECL would be helpful. The TDB emphasized that use of this tool is not mandatory.

- **Interagency Guidance:** The federal bank regulators have put together interagency guidance entitled “*Frequently Asked Questions on the New Accounting Standard on Financial Instruments – Credit Losses*.” Specifically, Question 22 of this guidance discusses what institutions should do to prepare for the implementation of CECL. A link to the guidance is set forth below:

<https://www.fdic.gov/news/news/financial/2017/fil17041a.pdf>

The OCC emphasized that banks do not need to buy a dedicated CECL model.

**6. Cybersecurity:** The State Bank Regulators again emphasized the importance of cybersecurity for banks of all sizes. The State Regulators reiterated their fidelity to the interagency FFIEC “Cybersecurity Assessment Tool,” to help banks identify their risks and determine their cybersecurity preparedness. According to the FFIEC, this assessment provides a repeatable and measurable process for financial institutions to measure their cybersecurity preparedness over time. While the regulators indicated that completing this assessment was voluntary, the message was loud and clear that banks need to be doing at least this much in the area of cybersecurity. If the FFIEC assessment is not used, then the bank should have some other comparable or better assessment completed to measure its risk.

In addition, the FDIC has a cybersecurity challenge online, called the “*Cyber Challenge: A Community Bank Cyber Exercise*,” which banks are encouraged to view to learn about operational risk issues and the potential impact of information technology disruptions on common banking functions.

If your bank has not yet completed either the FFIEC assessment or some other comparable assessment, it should do so as soon as possible. Banks should keep a written record that the assessment was completed and have an understanding of their level of cybersecurity risk and exposure.

**7. FDIC Training Videos:** The FDIC maintains a “*Technical Assistance Video Program*,” which is a series of educational videos designed to provide useful information to bank directors, officers and employees on areas of supervisory focus and regulatory changes. At a minimum, we recommend that each new bank director view the “*New Director Education Videos*.” A link to these videos is set forth below:

<https://www.fdic.gov/regulations/resources/director/video.html>

These videos can also be incorporated into the bank’s director training program.

**B. National Banks.**

**1. Concentrations:** We are seeing significant supervisory and enforcement activity, from coast to coast, related to commercial real estate concentration risk management, specifically compliance with the CRE interagency guidance issued in 2006 (available at <https://www.occ.treas.gov/news-issuances/bulletins/2006/bulletin-2006-46.html>). That guidance contains two bright-line CRE exposure tests: (i) 100 percent or more of total risk-based capital in construction, land development, and other land loans and (iii) 300 percent or more of total risk-based capital in total CRE loans.

The OCC has said that these percentages should not be viewed as hard limits. The OCC has also said that there are banks with exposures that exceed one or more of these limits that do not have enforcement actions in place. Nonetheless, the OCC is clearly subjecting banks that exceed these concentration ratios to the highest levels of supervisory scrutiny. Higher scrutiny is warranted, according to the OCC, because high CRE concentrations have historically been the single largest contributor to bank failures. At a recent conference, one of the OCC's Deputy Comptrollers provided an analogy as follows: he said that if he were a regulator of swimmers he would not have anything to tell Michael Phelps because Michael Phelps has perfect systems and mechanics. He said that the 100 percent level (and he did say that he was more concerned with the 100 percent level than the 300 percent level) is for the Michael Phelps of banks – those banks with perfect systems. Later in the program, he said that if you dropped Michael Phelps in the Atlantic Ocean, he would drown. His point is: too much is still too much.

National banks that intend to increase their CRE concentrations to levels that approach these limits should (i) ensure that monitoring, reporting, and risk management practices are effective and well documented; (ii) the concentrations are adequately stress-tested (see below); (iii) the Board is well apprised of the risks and rewards of such a strategy and have approved the CRE expansion strategy (and set reasonable upper risk tolerances in the risk appetite statement); (iv) the strategy is communicated to the local examination team prior to implementation; and (v) CRE concentration levels are raised gradually.

**2. Underwriting:** Senior management at the OCC has expressed concerns that underwriting is becoming “too liberal.” Some changes in underwriting standards may be appropriate given the generally positive state of the U.S. economy and increasing interest rates, but the OCC is clearly concerned that some banks are loosening underwriting standards beyond what is prudent. These same senior managers have said that “these are the good times” and that banks make “the worst strategic mistakes during the good times.” Bank supervision is challenging when the industry is generally doing well. While striking the appropriate balance in underwriting standards is difficult (and we have heard regulators acknowledge that they sometimes need to do a better job of communicating what is meant by “liberal” underwriting standards), national banks that are looking to make material changes to their underwriting standards should discuss such changes, and their potential impact, with their boards of directors.

**3. Disaster Preparation:** In response to Hurricane Harvey, the OCC issued a news release encouraging national banks and federal savings associations to work with affected customers. The release can be found on the OCC's website at <https://www.occ.treas.gov/news-issuances/news-releases/2017/nr-occ-2017-100.html>. A similar interagency release was put out in the wake of Hurricane Irma (see <https://www.occ.treas.gov/news-issuances/news-releases/2017/nr-ia-2017-104.html>). While these releases provide some specific examples of ways in which banks can “work with” their customers (e.g. waiving fees, restructuring loans, providing payment extensions that generally do not exceed 90 days, etc.), such accommodations must be “consistent with sound banking practices.” Our clients have recognized that these directives can be inconsistent with one another, and, therefore, are sometimes hesitant to provide a customer with an accommodation out of a fear of regulatory criticism or of the application of a “troubled debt restructuring” label. The OCC has acknowledged this issue and, in public

discussion, appears to be less focused on second-guessing specific customer accommodations and more focused on making sure that banks have (i) processes and procedures in place for quickly and accurately determining the impact of a disaster on the bank's condition and operations and (ii) having reasonable, board-approved guidelines in place to govern the bank's approach to reviewing and approving specific customer concessions.

**4. Cybersecurity:** The OCC has, once again, listed cybersecurity as one of the agency's supervisory priorities for the coming 2018 fiscal year (the entire supervision operating plan may be found at <https://www.occ.treas.gov/news-issuances/news-releases/2017/nr-occ-2017-113.html>). At a recent conference, one of the OCC's Deputy Comptrollers said that cybersecurity would likely remain a priority "forever." All indications are that cybersecurity will remain a supervisory priority for the OCC for the foreseeable future.

**5. Stress Testing:** Stress testing is clearly a continued supervisory focus of the OCC. While we have heard from senior OCC management that banks are not expected to purchase models or hire consultants to conduct stress tests, stress tests should be conducted at a level of sophistication commensurate with the bank's risk profile, size, and complexity. The OCC appears particularly interested in the stress testing of concentrations, and ensuring that the results of those stress tests are sufficiently reviewed and discussed by management with the board.

**6. ALLL:** The OCC acknowledges that a bank's calculation of the allowance for loan and lease losses will likely change somewhat as a result of CECL (specifically when it comes to the weightings of the various components of the ALLL calculation). The OCC does not believe, however, that CECL adoption should generally result in material reductions in overall ALLL levels. Relatedly, the OCC appears generally skeptical of the ability of accountants to adequately support their recommendations for reductions to ALLL. If a national bank's accountant recommends a material reduction in the bank's ALLL that the bank feels is not adequately supportable, the bank should consider involving the OCC in those discussions with their accountant.

Of course, this client alert does not cover every regulatory concern. It does address some of the more notable recent issues from such presentations. As always, we would be happy to discuss the details or provide further information if you need for us to do so.

Jacque Kruppa and Carleton Goss are attorneys in the Financial Institutions Corporate and Regulatory practice group at Hunton & Williams LLP. This article presents the views of Ms. Kruppa and Mr. Goss and do not necessarily reflect those of Hunton & Williams or its clients. The information presented is for general information and education purposes. No legal advice is intended to be conveyed; readers should consult with legal counsel with respect to any legal advice they require related to the subject matter of the article. Ms. Kruppa and Mr. Goss write and speak frequently on topics of interest to community bankers. Ms. Kruppa may be reached at (214) 468-3347 or [jkruppa@hunton.com](mailto:jkruppa@hunton.com). Mr. Goss may be reached at (214) 468-3330 or [cgoss@hunton.com](mailto:cgoss@hunton.com).

## Contacts

**Peter G. Weinstock**  
[pweinstock@hunton.com](mailto:pweinstock@hunton.com)

**Carleton Goss**  
[cgoss@hunton.com](mailto:cgoss@hunton.com)

**Jacque Kruppa**  
[jkruppa@hunton.com](mailto:jkruppa@hunton.com)