Supervisory Insights

Devoted to Advancing the Practice of Bank Supervision

Vol. 15, Issue 1 Summer 2018

Inside

FDIC

Supervisory Insights

Supervisory Insights is published by the Division of Risk Management Supervision of the Federal Deposit Insurance Corporation to promote sound principles and practices for bank supervision.

Supervisory Insights is available on-line by visiting the FDIC's website at www.fdic.gov. To provide comments or suggestions for future articles, request permission to reprint individual articles, or request print copies, send an e-mail to SupervisoryJournal@fdic.gov.

Issue at a Glance

Volume 15, Issue 1 Summer 2018

Articles

Oil and gas (O&G) lending is a complex and highly specialized business. The steep drop in oil prices beginning in 2014 tested the risk management practices of insured banks active in O&G lending and other banks operating in geographic areas that depend on the O&G industry. This article shares FDIC observations from its surveillance efforts and supervisory activities relative to these institutions.

Credit risk grading systems are integral to credit risk management. Loan grades inform credit approvals, pricing, portfolio monitoring, and credit loss allowance levels – current methods and future Current Expected Credit Loss approaches. This article illustrates how strong credit grading systems incorporate clearly identifiable processes and establish a sound governance framework.

Regular Features

This feature provides an overview of recently released regulations and other items of interest.

Letter from the Director

Supervisory Insights is entering its fifteenth year of publication. The journal has sought to provide a forum for discussing how bank regulation and policy are put into practice in the field, and has committed to communicating information about emerging issues that banks and bank supervisors are facing. The Summer 2018 issue continues this mission by reviewing bank lending to the highly specialized oil and gas (O&G) industry and examining bank credit risk grading systems.

The steep drop in oil prices beginning in 2014 tested the risk management practices of insured banks active in O&G lending and other banks operating in geographic areas that depend on the O&G industry. "Oil Price Volatility and Bank Performance: A View from the Supervisory Process" shares observations from FDIC surveillance efforts and supervisory activities, including on-site examinations. These observations can be a useful resource to banks with direct or indirect exposure to the O&G sector, as they consider capital planning, loan loss reserve practices, and strategic planning more generally.

The information and analysis presented in the article "Credit Risk Grading Systems: Observations from a Horizontal Assessment" are drawn from examiner observations about the loan risk-rating systems at selected large state nonmember banks. Credit risk grading systems are integral to a bank's ability to identify, monitor, and control risk, and vary greatly across the banking industry. The article illustrates how strong credit grading systems incorporate clearly identifiable processes and establish a sound governance framework. Strengthening risk grading frameworks and assessing data availability and accuracy can enhance a bank's ability to proactively identify risk during times of economic stress.

This issue of *Supervisory Insights* also includes an overview of recently released regulations and other items of interest.

We hope you read both articles in this issue and find the information interesting and useful. We encourage our readers to provide feedback and suggest topics for future issues. Please email your comments and suggestions to SupervisoryJournal@fdic.gov.

Doreen R. Eberley
Director
Division of Risk Management Supervision

Oil Price Volatility and Bank Performance: A View from the Supervisory Process

The steep drop in oil prices that started in mid-2014, following a five-year boom, tested the risk management practices of insured banks active in oil and gas (O&G) lending as well as other insured banks operating in areas that depend on the O&G industry. During the lead-up and ensuing period of volatility and elevated uncertainty in oil prices, the FDIC's surveillance and supervision programs focused on monitoring O&G industry trends, quantifying the amount of risk that was building in insured banks with O&G exposure from stress in the sector, and assessing bank management's actions to mitigate the risk.

It is not uncommon for booms in certain industries or market sectors to give rise to an environment of loosened underwriting, and the FDIC anticipated that growth in the exploration and production (E&P) and O&G supporting services sectors was leading to building risk in insured banks. O&G commitments in the Shared National Credit (SNC)[1] portfolio were increasing. Moreover, substantial loan growth was noted at banks in energy-hub states; however, O&G loans were not readily quantifiable from regulatory data. Accordingly, the FDIC set out to quantify these loans and study insured banks' exposure to oil price volatility. This article summarizes what the FDIC learned from these efforts, which included SNC Program reviews and on-site safety-and-soundness visitations and examinations of banks, primarily community banks, operating in geographic areas characterized by high levels of O&G activity.

O&G lending is a complex and highly specialized business due to the capital-intensive nature of O&G E&P activities, global supply and demand forces, and geopolitical uncertainty. O&G market fluctuations can adversely affect the financial condition of borrowers reliant on the O&G industry, directly or indirectly,[2] and their ability to repay loans.

For example, for the period 1980-1994, 1,617 insured commercial and savings banks were closed or received FDIC financial assistance. Bank failures during this period were highly concentrated with nearly 60 percent in five states: California, Kansas, Louisiana, Oklahoma, and Texas. A variety of factors contributed to the bank failures; however, the incidence of failure was particularly high in states characterized by severe economic downturns, such as in Oklahoma and Texas related to the collapse in oil prices and real estate values. Further, bank failures were generally associated with regional recessions that had been preceded by rapid regional expansions.[3]

1 The SNC Program is governed by an interagency agreement among the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency and is designed to review and assess risk in the largest and most complex credits shared by multiple financial institutions. Results of the SNC Program are released annually on a joint agency basis. A SNC is generally any loan or formal commitment, and any asset such as real estate, stocks, notes, bonds, and debentures taken as debts previously contracted, extended to borrowers by a federally supervised institution, its subsidiaries, and affiliates, that aggregates to $100 million or more (new global commitment threshold effective January 2018; was formerly $20 million or more) and which is shared by three or more unaffiliated federally supervised institutions.

2 Banks' indirect exposures may occur through relationships with customers such as motels, restaurants, and other local businesses that provide services to O&G workers.

3 See FDIC, *History of the Eighties - Lessons for the Future*, volume 1, pages 13, 15, 16, 19, and 306-308, 1997, https://www.fdic.gov/bank/historical/history/.

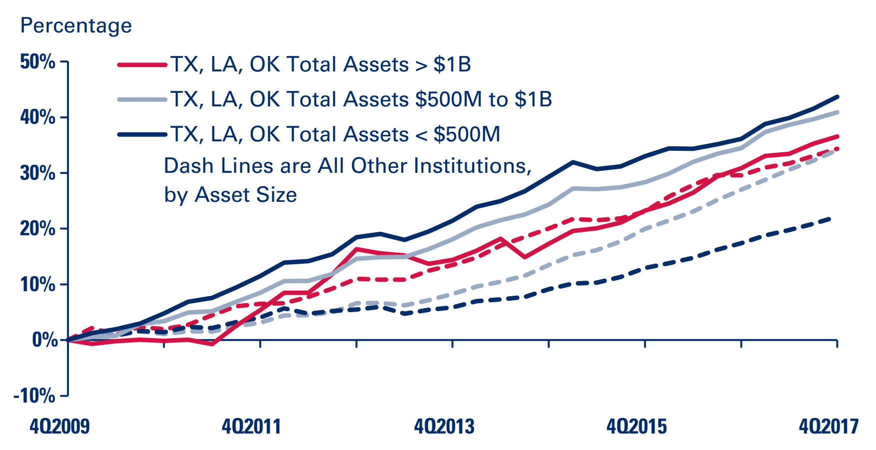
Oil and Gas Lending

continued from pg. 3

Banks now appear better positioned against the effects of lower and more volatile oil prices. Overall, relatively few FDIC-supervised banks have become severely stressed by the developments in the O&G sector during the past few years, in part due to healthier capital levels and stronger risk management practices going into the most recent oil price downturn.

That said, examination findings and financial data suggest that banks with significant direct lending exposure to the O&G sector have seen greater increases in problem assets than other banks. Banks also may have indirect exposure to stress in the O&G sector if they operate in geographic areas with relatively heavy concentrations of O&G activity. At banks where these issues appear to be relevant, FDIC safety-and-soundness visitations and examinations have included a focus on identifying the extent of direct and indirect O&G exposures and discussing management of the risks of such exposures with bankers. The oil price slide initially exposed some underwriting weaknesses. However, the conclusion from these supervisory activities is that, for the most part, banks have taken steps to mitigate stress from oil price volatility. These topics are explored at greater length in the remainder of this article.

Chart 1: Asset Growth for Institutions in Energy-Dependent States vs. All Other Institutions



Source: FDIC, Merger Adjusted, Indexed to 4Q2009.

Growth Precedes Pressure on Oil Prices

Leading up to and into 2014, when Spot West Texas Intermediate (WTI) crude oil prices reached more than $100 per barrel, investments in O&G exploration increased and SNC O&G commitments were growing. The high, sustained oil prices drove SNC O&G commitments up more than 27 percent between the 2012 and 2014 SNC review periods.

Additionally, many geographic areas experienced economic expansion driven in part by technological advances in hydraulic fracturing ("fracking")[4] and oil production activity. Several of the O&G geographies that were booming going into 2014 were rural markets served by many community banks.

Banks in O&G geographies often had above average growth during the boom period, as shown in Charts 1, 2, and 3. The charts measure asset, loan, and deposit growth rates from the fourth quarter of 2009 for banks headquartered in Texas, Oklahoma, and Louisiana[5] against the growth rates for all other banks in the nation.

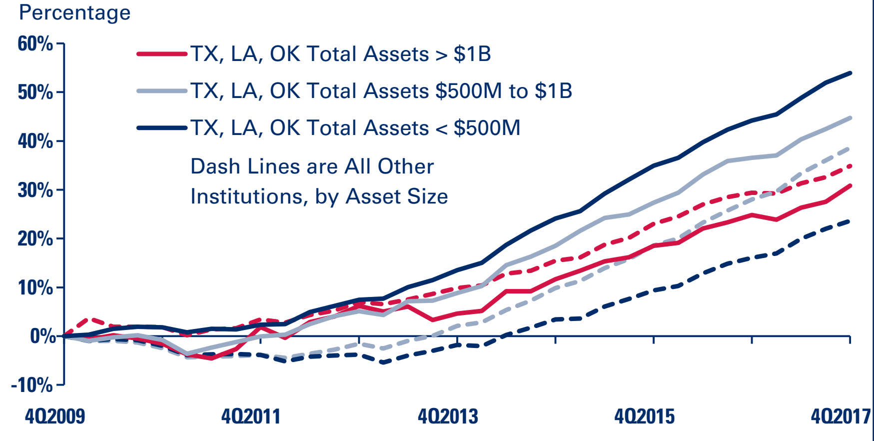
[4] A process whereby rock is fractured by a pressurized liquid to stimulate a natural gas, oil, or geothermal well to maximize extraction.

[5] A subset of states exposed to O&G that reflected a high concentration in bank failures related to the 1980s oil busts. Although North Dakota is another O&G exposed state (it has had three oil booms, with the most recent one being its largest, by far), the charts in this article focus on the subset of three states (Texas, Louisiana, and Oklahoma) where O&G-related banking problems were generally historically concentrated.

The FDIC has included the energy sector as part of its regional economic analyses and risk discussions for many years, as fracking flourished and oil-related rig counts, production, and employment rose. The energy sector was frequently on the FDIC's agenda at banker outreach meetings in energy-concentrated areas. Conversations with bankers during the most recent boom period suggested that bank personnel remembered the economic stress and resultant strain on banks that accompanied the oil bust in the early 1980s.

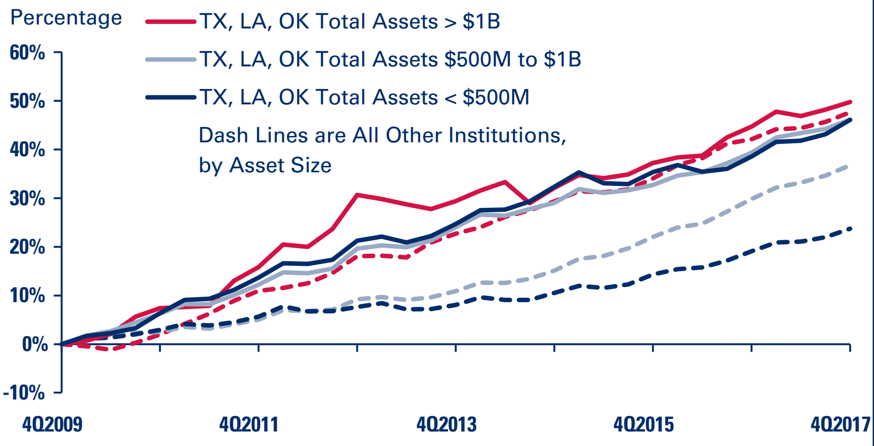
Recent history also provided a reminder of how volatile oil prices can be. The daily spot price of WTI crude oil reached its historic high of $145 per barrel in July 2008. Within seven months, as the financial crisis played out, the daily spot price of WTI crude oil had dropped nearly 77 percent, reaching $34 per barrel in February 2009. The low prices, however, were not prolonged as daily spot WTI crude oil prices then staged a dramatic five-year recovery and reached $107 per barrel in June 2014.[6] However, in mid-June 2014 prices fell sharply downward, this time largely because of the growing supply glut, which added to the uncertainties about supply and demand fundamentals and how long a low price environment would persist.

Chart 2: Loan Growth for Institutions in Energy-Dependent States vs. All Other Institutions



Source: FDIC, Merger Adjusted, Indexed to 4Q2009.

Chart 3: Deposit Growth for Institutions in Energy-Dependent States vs. All Other Institutions



Source: FDIC, Merger Adjusted, Indexed to 4Q2009.

[6] Daily spot WTI oil prices per the U.S. Energy Information Administration, https://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=pet&s=rwtc&f=d.

continued from pg. 5

Supervision Planning and Activities

The most recent oil price decline began to take shape around the time the 2014 SNC review was concluding. Planning for and executing the 2015 SNC review, therefore, included a focus on O&G lending. The FDIC also readily recognized that the oil price decline could pose a notable risk to many banks, particularly if the drop became severe or lasted for an extended period. The agency anticipated the repercussions would not only affect syndicated O&G credits, but could pose credit quality risk at smaller banks operating in or near economies supported by O&G businesses.

Communication was critical to staying ahead of the risk. FDIC staff collaborated with other banking regulators to identify institutions most exposed to oil price volatility, either directly or indirectly. FDIC divisions responsible for safety-and-soundness supervision and deposit insurance and research collaborated, including on monitoring information from Consolidated Reports of Condition and Income (Call Reports), the U.S. Energy Information Administration, the Bureau of Economic Analysis, the Bureau of Labor Statistics, other publishers of analyses and statistics, and media coverage. Metrics, topics, and forecasts assessed included production area geographies and characteristics, rig counts, oil supply and demand figures, and O&G-related employment levels and trends.

With consideration of this information and of lending activity and trends during the expansion years, staff prioritized and, beginning in late 2014, conducted off-site reviews and on-site visitations and examinations of numerous banks operating in geographic areas characterized by high levels of O&G activity. The FDIC ultimately evaluated hundreds of potentially affected banks, primarily from Texas to North Dakota, throughout and surrounding the oil-rich Bakken, Eagle Ford, and Permian Basin areas.

Generally, the subject banks, which were predominantly community banks, were in sound financial condition, with healthy capital levels and fairly low levels of problem assets, when the oil price decline began. However, a bank's current financial performance and condition (for example, low levels of nonperforming loans and charge-offs) is not necessarily indicative of the level of risk present or of the quality of risk management. As such, supervisory staff employed a heightened focus on assessing bank management's identification and risk management of O&G exposures, because a bank's ability to navigate stress in the O&G sector depends greatly on the quality and administration of its O&G credit policies and approach to risk management.

From a forward-looking perspective, it was important for the FDIC to evaluate the overall quality of loan underwriting for O&G-related credits. Amongst considerations was the extent to which loan underwriting practices considered the potential for oil prices declining markedly and staying "low for long." It was also important for the FDIC to gauge the potential indirect effects as a result of stress on O&G support businesses and their local economies.

Accordingly, FDIC examiners documented assessments of bank management's policies and procedures regarding direct loans to oil production, servicing, and other oil-related companies. They also determined the segments of the loan portfolio that could be indirectly exposed to O&G sector stress, for example, those loan segments supporting oil-related workers and their households and localities. Further, examiners assessed bank management's O&G lending strategies under a scenario of continued low energy prices or further reductions in energy prices, which could affect loan quality, the adequacy of capital, and reserves for loan and lease losses.

As mentioned, O&G lending is complex and highly specialized. Going into 2014, the FDIC's subject matter experts in the affected regions had a deep knowledge of the O&G sector and related lending, in part via participation in the SNC review processes. To reinforce the quality of on-site and off-site assessments of risk management practices of FDIC-supervised banks that were, potentially, the most vulnerable to the oil price downturn, subject matter experts shared their knowledge with other FDIC examiners. In addition, in 2016, banker roundtables in states such as Texas, Oklahoma, and Louisiana included discussions about oil lending issues.

Extent of O&G Related Lending and Quality of Risk Management Frameworks

Determining the extent of O&G-related lending and the quality of bank underwriting were key to effective assessments. Analysts typically categorize oil industry activities into four sectors: 1) the E&P sector, which is also known as the upstream sector; 2) the mid-stream sector, which is transportation; 3) the downstream sector, which is refineries and retail operations; and 4) the support and service (S&S) sector, which is also known as the oilfield services sector.

O&G SNC commitments continued to grow following the onset of the oil price slide. By the 2015 SNC review, O&G commitments had grown to approximately $480 billion, with the E&P sector continuing to represent the largest share. While the dollar volume of SNC commitments to the mid-stream sector was higher than the dollar volume to the S&S sector, the S&S sector was anticipated to encounter issues sooner. The 2015 SNC review focused on the E&P and S&S sectors.[7] By the first quarter 2016 SNC review, O&G commitments had reached roughly $502 billion.[8] Increases in outstanding loan volumes reflected borrowers' drawdowns on remaining senior commitments as industry revenues decreased and liquidity pressure intensified. By the 2017 SNC review, the effects of bankruptcy-driven restructures and periodic collateral revaluations

[7] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, "Shared National Credits Review Notes High Credit Risk and Weaknesses Related to Leveraged Lending and Oil and Gas," November 5, 2015; https://www.fdic.gov/news/news/press/2015/pr15089.html.

[8] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, "Joint Release/Shared National Credit Review Finds Risk Remains High, but Underwriting and Risk Management Improve," July 29, 2016; https://www.fdic.gov/news/news/press/2016/pr16059.html.

continued from pg. 7

to control reserve-based borrowing lines were reflected in reduced commitments for the E&P sector and service subsectors.[9] Nonetheless, the preceding growth in the E&P and S&S sector lending had resulted in an increase in SNC O&G loans distributed to banks.

Meanwhile, findings from bank safety-and-soundness visitations and examinations that had a heightened focus on O&G risk management (again, primarily covering community banks) revealed that lending to the S&S sector comprised the largest share of their O&G direct lending (and was more prevalent in the smaller banks). The upstream (E&P) sector represented the second largest share of O&G lending for these banks. Downstream refining and retailing loans and midstream transportation loans accounted for the smallest shares of direct O&G lending.

By dollar volume, most of the direct O&G lending reviewed was in larger banks. Overall for institutions examined with a heightened focus on O&G risk management, as a proportion of aggregate assets, direct O&G loans were generally 5 percent or less, and concentrations in direct O&G lending appeared moderate. Examination findings suggest that only a handful of FDIC-supervised banks, concentrated in the FDIC's Dallas Region,[10] had more than 25 percent of loan volume held in direct O&G lending.

With regard to risk management, it was critical that bank management consider how a continuation of current low energy prices, or further reductions in energy prices, could affect loan quality and the adequacy of loan loss reserves and capital going forward. If the effects were expected to be material, bank management needed to consider whether new or enhanced risk-mitigating steps were necessary to position the bank to navigate continued stressful conditions in the energy sector. When such issues appeared inadequately considered or addressed by bank management, examiners made recommendations for corrective action.

At some banks, weaknesses in risk management frameworks were evident. Some common areas of weakness overall included, but were not limited to:

- Limited coverage of O&G lending exposures in loan policies;
- Significant indirect exposures not tracked or monitored; and
- Qualitative allocations for O&G exposures not considered in the allowance for loan and lease losses (ALLL) analysis.

Moreover, some banks with little or no prior experience in O&G lending entered the market during the boom, which fostered competition and loosening of credit terms. And, some institutions evidenced poor risk selection. From an underwriting perspective, concerns identified included, amongst others:

- Loan policy exceptions;
- Weak financial covenants that did not instill sufficient financial discipline;

[9] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, "Joint Release/Reviews of Shared National Credit Portfolio Find Risk Remains High," August 2, 2017; https://www.fdic.gov/news/news/press/2017/pr17058.html.

[10] The FDIC's Dallas Regional Office is responsible for supervisory activities associated with banks headquartered in Arkansas, Colorado, Louisiana, Mississippi, New Mexico, Oklahoma, Tennessee and Texas. The majority of Dallas Region banks with O&G activities are in Texas and Louisiana.

- Borrowers with high leverage and low levels of liquidity or that were not sufficiently experienced;
- Insufficient review and/or verification of engineering reports;
- Overly optimistic oil price estimates that led to swollen borrowing bases,[11] resulting in over-lending not supported by cash flows; and
- Insufficient price hedging strategies that exacerbated the problem.

In some cases underwriting and credit administration weaknesses in non-energy lending were also exposed by the general economic downturn that accompanied the oil price slide. While the direct and indirect impact of the oil price decline was fairly contained, the robust economic conditions leading into the downturn in some areas led some banks to be lax in underwriting. While not widespread, the issue contributed to increased loan classifications in some banks.

Some Stress on Banks' Performance Metrics Set in Motion by Oil Price Slide

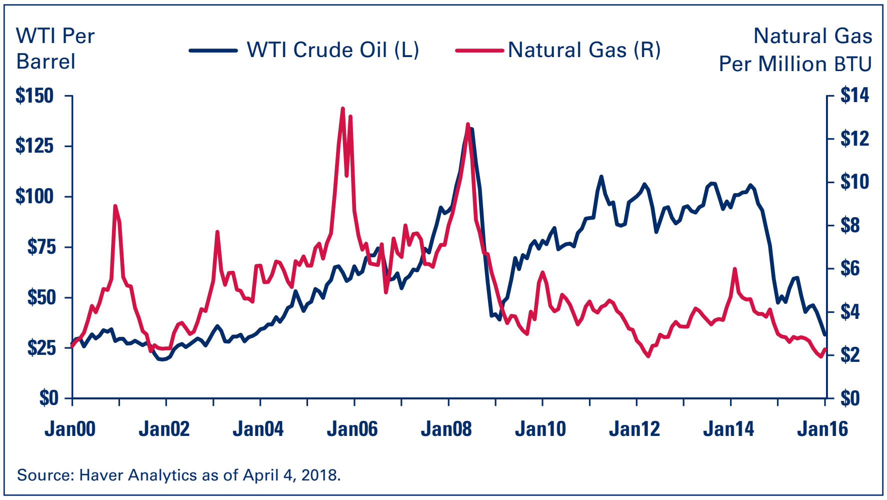
Daily spot WTI crude oil prices ultimately dipped into the low $40s per barrel in March 2015 and bottomed out in the mid $20s in first quarter 2016.[12] Chart 4 depicts the monthly average spot prices for WTI crude oil and the price slide into 2016.

During the downturn, it was unclear how low oil prices might drop and how long the downward pressure on oil prices would last. Near- and long-term forecasts varied widely. Although lower oil prices may translate into economic growth as consumers and businesses take advantage of lower fuel prices, drops in oil prices can prompt oil companies and service firms to enact cost-saving measures, including cutting jobs and capital spending.

Call Reports Reveal Ramp Up of Reserves, Delinquencies, and Losses in O&G-Dependent Areas

Call Report data are lagging and do not contain line items specific to O&G lending. Nonetheless, Call Report indicators for banks headquartered in O&G geographies continued to be closely monitored for signs of emerging risk. For example, increases to loan-loss reserve allocations related to O&G were initial signs of the adverse effects of O&G price declines that banks experienced. Several banks announced such reserve increases in their public quarterly performance releases.

Chart 4: Monthly Average Spot Prices for West Texas Intermediate (WTI) Crude Oil and Natural Gas



Source: Haver Analytics as of April 4, 2018.

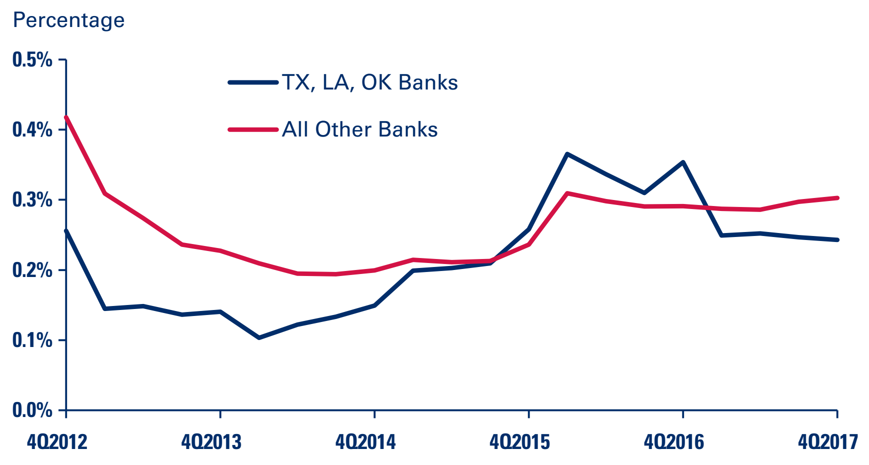
[11] In E&P lending, the primary source of repayment is the cash flows from the extraction of O&G reserves. An independent, third party reserve engineering report serves as the primary tool to estimate the future cash stream and establish a "borrowing base," which is a collateral base agreed to by the borrower and lender that is used to limit the amount of funds the lender advances to the borrower.

[12] Daily spot WTI oil prices per the U.S. Energy Information Administration, https://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=pet&s=rwtc&f=d.

continued from pg. 9

Chart 5 depicts the ratio of provision expenses for loan and lease losses[13] to average assets. In the three select energy-dependent states, banks began increasing provision expenses earlier in 2014 as compared to banks in other states. The ratio of provision expenses to average assets peaked in 2016 and began declining in 2017 as the energy sector adapted to the lower prices. Although many other industries are important to these three states, it is reasonable to assume that deterioration in the O&G sector was a factor in increased provision expenses.

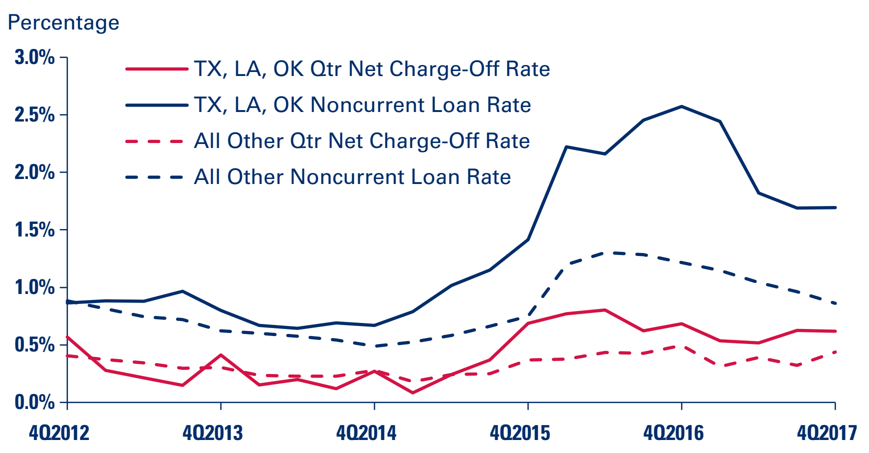
Chart 5: Provision Expenses to Average Assets for Select Energy-Dependent States (All Institutions)



Source: FDIC.

As discussed in the FDIC's second quarter 2016 *Quarterly Banking Profile*, stress in energy sector loans was a leading cause of an increase in the total volume of noncurrent commercial and industrial (C&I) loans for the banking industry as a whole.[14] Similar to trends for provision expenses, the increase in noncurrent loans and charge-offs was more pronounced for banks headquartered in areas with meaningful reliance on the energy sector.

Chart 6: Commercial and Industrial Loan Performance for Select Energy-Dependent States vs. All Other States



Source: FDIC.

For example, Chart 6 depicts C&I loan performance trends for banks headquartered in Texas, Oklahoma, and Louisiana, and shows that, in aggregate, noncurrent C&I loan rates and net C&I loan charge-off rates increased more for banks in those states than for banks in the other states. While performance trends appear manageable, it is reasonable to assume that stress in the O&G sector was a factor in the deteriorated loan performance. Consistent with the outlook for the improving O&G sector, noncurrent and charge-off rates have also more recently improved, but remain higher than rates for all other banks.

[13] To properly apply U.S. generally accepted accounting principles, each bank must maintain an allowance for loan and lease losses (ALLL) to cover estimated credit losses associated with its loan and lease portfolio. At least quarterly, bank management must evaluate the collectability of the portfolio and make entries to maintain the balance of the ALLL on the balance sheet at an appropriate level. Additions to, or reductions of, the ALLL resulting from such evaluations are made through charges or credits to the provision for loan and lease losses account of the income statement.

[14] Opening Statement Second Quarter 2016, *FDIC Quarterly Banking Profile*, August 30, 2016; https://www.fdic.gov/news/news/speeches/spaug3016.html.

Supervisory Findings

SNC Review Findings

As it would take time and resources to assess the large swath of banks potentially affected by the O&G price downturn, the 2015 SNC review process served as an initial indicator of whether and to what degree deterioration was emanating from the O&G sectors.

The 2015 SNC review[15] found that O&G-related credits were in the early stages of a downturn. The report noted that the significant decline in oil prices was adversely affecting many O&G E&P companies, increasing adversely classified commitments in that subsector. The report further noted that from 2010 to 2014, aggressive acquisition and exploration strategies funded by term debt raised leverage levels, elevating those borrowers' susceptibility to a protracted decline in oil prices. The report also found that a general lack of protective covenants in reserve-based loans further exacerbated the situation. The report also disclosed that banks were showing flexibility in working with borrowers experiencing problems.

Results of the next SNC review, published in July 2016, reported ongoing growth of credit risk in the O&G portfolio. Classified O&G borrowers totaled $77.0 billion, or 27.0 percent of total classified commitments, compared to $38.2 billion, or 16.7 percent of total classified commitments, in 2015. Stress was apparent particularly for non-investment grade and unrated E&P and energy service companies.[16] The ensuing SNC reviews (third quarter 2016 and first quarter 2017)[17] found again that a high level of credit risk in the portfolio stemmed, in large part, from distressed borrowers in the O&G sector.

SNC O&G loan losses for insured banks accumulated to approximately $7 billion from mid-2012 to early 2018. Senior secured lending positions and a more recent rebound in oil prices that has boosted recovery rates have served to temper losses in the E&P sector.

Results for Examinations with a Heightened Focus on O&G Risk Management

Of banks that were reviewed with a heightened focus on O&G risk management, which were primarily community banks, few developed financial problems of supervisory concern as a result of the extended oil price downturn. In addition, the banks identified with O&G-related lending ultimately comprised a much smaller group than initially anticipated, due, in part, to a lesser than expected impact from select levels of O&G-related employment and counties surrounding shale areas in the examination prioritization scheme. It is noted, however, that for the subject banks that had more than

[15] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, "Shared National Credits Review Notes High Credit Risk and Weaknesses Related to Leveraged Lending and Oil and Gas," November 5, 2015; https://www.fdic.gov/news/news/press/2015/pr15089.html.

[16] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, "Shared National Credit Review Finds Risk Remains High, but Underwriting and Risk Management Improve," July 29, 2016; https://www.fdic.gov/news/news/press/2016/pr16059.html.

[17] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, "Joint Release/Reviews of Shared National Credit Portfolio Find Risk Remains High," August 2, 2017; https://www.fdic.gov/news/news/press/2017/pr17058.html.

continued from pg. 11

one examination with a heightened focus on O&G risk management since June 30, 2015, classified direct O&G loans increased between examinations, reflecting the lag in loan performance. Aggregate dollars of direct O&G loans, on the other hand, decreased.

The vast majority of the banks remain satisfactorily rated. As illustrated previously, Call Report indicators for banks headquartered in O&G geographies showed increases in loan-loss reserve allocations beginning in 2014 in light of their exposure. In some cases, bankers boosted reserves in response to supervisory recommendations. Ratings that were less than satisfactory or worse in 2016 or 2017 were infrequent and occurred at only a slightly higher rate than for the general population of insured banks.

Banks with more than 10 percent of the loan portfolio dedicated to direct O&G lending, concentrated in the FDIC's Dallas Region, experienced more financial stress and supervisory downgrades than banks reviewed with less O&G exposure. Meanwhile, banks with less than 10 percent of lending in direct O&G loans, but with indirect O&G lending of more than 10 percent of loans, also experienced modestly higher supervisory downgrades as compared to banks with lower O&G exposure levels. This statement is also true of asset quality assessments. Trends such as these (higher rates of supervisory downgrades and increased levels of adversely classified assets) are typical for banks working out of credits to distressed sectors. Indirect O&G lending did not appear to cause significant financial stress on the affected banks.

Among the banks that were satisfactorily rated, more than a third had one or more Matters Requiring Board Attention (MRBA) listed in the report of examination;[18] this is slightly higher than the rate experienced at other examinations in the aggregate. Those MRBA most commonly related to lending and credit administration, board and management oversight, apparent violations, and liquidity. These categories generally align with the categories most commonly noted at other satisfactorily rated banks in the aggregate.

Supervisory Issuances Related to O&G Lending

Lending associated with O&G activities is a potentially complex activity that requires prudent underwriting, appropriate structuring, experienced and knowledgeable lending staff, and sound loan administration practices. Further, for banks doing business in areas where the economy is dependent on O&G activity, knowledge and prudent management of geographic, industry, and borrower

[18] MRBA are a subset of supervisory recommendations, which are an FDIC communication intended to inform the institution of the FDIC's views about changes needed in its practices, operations, or financial condition to help directors prioritize their efforts to address examiner concerns, identify emerging problems, and correct deficiencies before the bank's condition deteriorates (or to keep the bank viable if conditions already deteriorated). A principal purpose of supervisory recommendations is to communicate supervisory concerns to a bank so that it can make appropriate changes in its practices, operations, or financial condition and thereby avoid more formal remedies in the future, such as enforcement actions. See "Statement of FDIC Board of Directors on the Development and Communication of Supervisory Recommendations," https://www.fdic.gov/about/governance/recommendations.html and "FDIC Risk Management Manual of Examination Policies," Section 16.1, https://www.fdic.gov/regulations/safety/manual/section16-1.pdf.

concentrations is critical. Guidelines, examination manuals, and other documents produced by the federal banking agencies, including the FDIC, are intended to be a useful resource for bankers in this respect.

In July 2016, the FDIC issued an advisory, *Prudent Risk Management of Oil and Gas Exposures*,[19] reminding bank management to maintain prudent risk management practices around O&G lending. In addition to reminders about risk management practices and the importance of maintaining adequate capital, the advisory provides suggestions to senior management and boards of banks operating in markets dependent on O&G industries for quantifying and monitoring indirect exposures, not just direct exposures. The publication also reminds FDIC-supervised banks that they are encouraged to work with borrowers who are adversely affected by a severe or protracted downturn in commodity prices, provided the efforts are part of a well-conceived workout plan, coupled with effective internal controls to manage those loans. Previously issued Financial Institution Letters on this topic contain further information.[20]

In July 2016, the FDIC also issued an update to Section 3.2 of its *Risk Management Manual of Examination Policies* (Manual) which contained an expanded discussion of O&G lending to assist FDIC examination and supervision staff in their review and analysis of O&G lending practices. The revisions, found in the "Oil and Gas Lending" portion of Section 3.2, update and explain current guidance on risk management considerations for FDIC-supervised banks with O&G credit exposures. The revised section focuses primarily on reserve-based lending to borrowers engaged in E&P activities and covers important topics such as reserve engineering reports, discount rates, price decks, loan structure and covenants, borrowing base determinations, borrower and financial analysis, loan policies, and classification guidelines. The Manual is publicly available on the FDIC's website.[21]

The FDIC published an article entitled "Credit Risk Trends and Supervisory Expectation Highlights" in the Winter 2016 edition of *Supervisory Insights*.[22] The article identifies trends in credit risk in three areas, one of which is O&G lending. The article emphasizes to bankers and examiners the importance of long-standing principles of sound risk management practices, including the close monitoring of all credit concentrations.

[19] FDIC, Prudent Risk Management of Oil and Gas Exposures, (FIL-49-2016), July 27, 2016; https://www.fdic.gov/news/news/financial/2016/fil16049.html.

[20] "Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers," (FIL-5-2010) February 12, 2010 (https://www.fdic.gov/news/news/financial/2010/fil10005.html), "Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts," (FIL-61-2009) October 30, 2009 (https://www.fdic.gov/news/news/financial/2009/fil09061.html), and "Interagency Statement on Meeting the Needs of Creditworthy Borrowers," (FIL-128-2008) November 12, 2008 (https://www.fdic.gov/news/news/financial/2008/fil08128.html).

[21] Risk Management Manual of Examination Policies; https://www.fdic.gov/regulations/safety/manual/.

[22] Leeza Fridman, Lisa A. Garcia, Rae-Ann Miller, Camille C. Schmidt, and Kenneth A. Weber, "Credit Risk Trends and Supervisory Expectation Highlights," *Supervisory Insights, Winter 2016*; https://www.fdic.gov/regulations/examinations/supervisory/insights/siwin16/si_winter_16-article01.pdf.

Oil and Gas Lending

continued from pg. 13

Conclusion

The inherent volatility of commodities prices makes doing business in the O&G sector challenging, and energy-related analyses continue at the FDIC. During the past few years, banks have exhibited flexibility in working with borrowers exposed to the O&G sector. Overall, only a small number of FDIC-supervised banks exhibited supervisory concerns as a result of impacts from the oil price slide. Banks that experienced the most financial stress were more likely to be engaged in higher volumes of direct O&G lending, and the number of banks materially impacted by indirect O&G lending was less than initially anticipated. Oil prices rebounded somewhat in 2017 and, during the first quarter of 2018, had generally settled in a range in the low-to-mid $60s per barrel. This is well below prices experienced during the boom years. However, production advancements allow companies to operate profitably within price ranges much lower than those experienced during the most recent boom years. In addition, the industry has reduced operating costs and increased merger and acquisition activities as companies continue to move toward optimizing their operations.

Nevertheless, the ongoing recovery and uncertainty in O&G prices may continue to challenge banks with direct or indirect exposure to this sector. For banks doing business in O&G dependent areas or that have out-of-territory lending related to O&G, prudent management of geographic, industry, and borrower concentrations continues to be warranted. That, combined with a strong financial condition going into a downturn, will provide banks with a buffer against adverse impacts from any future oil price volatility.

Lisa A. Garcia
Senior Examination Specialist
Division of Risk Management Supervision
LiGarcia@fdic.gov

Kenneth A. Weber
Senior Quantitative Risk Analyst
Division of Risk Management Supervision
KWeber@fdic.gov

Credit Risk Grading Systems: Observations from a Horizontal Assessment

This article is drawn from examiner observations about the loan risk grading systems at selected large state nonmember banks and is intended to illustrate credit grading systems, policies, and processes that were observed to be effective, repeatable, well-governed, and able to mature with business model changes. While much of the discussion is most relevant to larger or more complex banks, some smaller banks may find the topics to be of interest as well. As usual with *Supervisory Insights*, the article is intended as an informational resource for interested persons and does not create new requirements or establish new supervisory expectations.

Effective management of the lending function is central to the business of banking. In turn, an effective risk evaluation process is a pre-requisite for successful lending. Banks' processes for risk rating or grading loans help management make informed lending decisions and monitor risk on an ongoing basis. The implications of grading processes are far-reaching and can extend to approving credits, setting loan terms, monitoring the loan portfolio and mitigating risk, establishing an appropriate allowance for credit losses, maintaining adequate capital, and strategic planning more broadly.

Banks employ a wide range of practices when measuring credit risk and assigning credit grades. For community banks, the process may involve a straightforward approach using expert judgment to map credits to regulatory rating definitions, (i.e., Pass, Special Mention, Substandard, Doubtful, and Loss).[1] Community banks often apply broad judgmental factors to grade credits using these definitions and may rely less on quantitative measures. As the size and complexity of operations of an institution increases, more sophisticated methodologies may be applied to measuring and monitoring credit risk. For example, a bank may develop unique internal scorecards or expected loss models for significant portfolios that numerically rank-order credit risk. Additionally, some banks may adopt more complex methodologies to support Current Expected Credit Losses (CECL) adoption.

How Banks Use Credit Grading Systems

There is no one correct system for grading loans, and as noted, approaches vary widely across banks of different sizes and levels of complexity. Regardless of the size and complexity of an institution, credit grading systems are integral to ongoing credit portfolio risk monitoring because they enable management to differentiate risk by individual credit facility, relationship, or portfolio; to monitor movement between credit risk grades over time;

[1] *FDIC Risk Management Manual of Examination Policies*, Section 3-2 – Loan Classification and Definitions; https://www.fdic.gov/regulations/safety/manual/section3-2.pdf. Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, FDIC, "The Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions," Attachment 1 – Classification Definitions, October 29, 2013; https://www.fdic.gov/news/news/financial/2013/fil13051a.pdf. Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, FDIC, "Uniform Retail Credit Classification and Account Management Policy," June 12, 2000, Footnote 1; https://www.fdic.gov/regulations/laws/rules/5000-1000.html#fdic5000uniformpf.

continued from pg. 15

and to allocate reserves to plan for potential loss.

Effective loan risk grading helps management minimize credit risk both at origination and on an ongoing basis. Credit risk grading systems are often used as part of the credit underwriting and approval processes by providing input for determining the appropriate structure of a credit facility (e.g., term, fixed/variable, guarantor support, etc.), as well as how to best price the loan based on risk. On an ongoing basis, an effective credit risk grading system can provide a framework to ensure that riskier credits are reviewed more frequently, which can result in early identification of developing problems and lead to timely risk mitigation efforts including credit restructuring, obtaining additional collateral, or attaining guarantor support. Credit risk grading systems also provide a key input for management information systems (MIS),[2] which allow senior executives and board members (Board) to more readily aggregate and assess risk in support of strategic decision-making. For example, risk grade analyses can help shape underwriting criteria, loan growth plans, and a bank's overall risk appetite.

Institutions use credit risk grades to determine the appropriate level of the allowance for credit losses.[3] Looking ahead, credit risk grading could play a role as banks implement the CECL methodology. The Frequently Asked Questions (FAQs) on the New Accounting Standard on Financial Instruments – Credit Losses issued by the FDIC on December 19, 2016, notes that CECL requires banks to measure expected credit losses on financial assets when similar risk characteristics exist. According to the FAQs, loans can be segmented by credit grades to meet the risk characteristic requirement.[4]

Horizontal Assessment

The FDIC analyzed the credit risk grading programs at 16 large state nonmember banks representing a range of commercial and commercial real estate lending activities and geographic markets.[5] These institutions had differing programs in terms of the number of risk grades, definitions associated with each risk grade, and methodologies to assign grades. The following is an overview of examiner observations from the horizontal analysis.

[2] Michael McGarvey. "Credit Management Information Systems: A Forward-Looking Approach," *Supervisory Insights*, Winter 2017, page 5; https://www.fdic.gov/regulations/examinations/supervisory/insights/siwin17/si-winter-2017.pdf.

[3] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, FDIC, National Credit Union Administration, "Interagency Policy Statement on the Allowance for Loan and Lease Losses," Attachment 1 – Loan Classification and Credit Grading Systems, December 13, 2006; https://www.fdic.gov/regulations/laws/rules/5000-4700.html#fdic5000interagencypso.

[4] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, FDIC, National Credit Union Administration, "Joint Statement on the New Accounting Standard on Financial Instruments - Credit Losses," June 17, 2016; https://www.fdic.gov/news/news/press/2016/pr16051a.pdf. Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, FDIC, National Credit Union Administration , "Frequently Asked Questions on the New Accounting Standard on Financial Instruments – Credit Losses," December 19, 2016, Question 8; https://www.fdic.gov/news/news/financial/2017/fil17041a.pdf.

[5] The analysis was conducted on state nonmember banks with total assets greater than $10 billion. Information was collected through normal target examination processes.

Importance of Risk Grading Definitions

Several of the credit grading programs reviewed had grades with risk categories that were extremely broad or that used terms to describe credit risk that were not well defined. For example, banks would describe a risk grade "4" as acceptable risk with acceptable debt service coverage capability but not define the term acceptable or tie the definition to financial metric thresholds. Several credit grading processes were not transparent to an independent reviewer. That is, the process for assigning grades to specific credits was not obvious or intuitive based on a review of definitions and other available information. Opaque grading processes make it challenging for credit reviewers to assess the appropriateness of grading, which limits the ability of the second line of defense to affirm risk. Certain credit grading processes did not consistently rank-order risk. For example, a loan with better performance and financial metrics was graded lower or classified as riskier than loans with worse performance or financial metrics. The following sections highlight the importance of clear risk grade definitions and grading methodologies that rank-order risk.

Use of Expert Judgement

In general, smaller institutions used expert judgment based systems wherein a loan officer or relationship manager assigns a grade based on their judgment and knowledge of the credit. A primary challenge of an expert judgment system is ensuring that the criteria for grading credits is clear and that grades are applied consistently so that the process is repeatable. The following examples demonstrate instances where expert judgment can result in credit grading that is not accurate or directionally consistent:

Example 1:
Two loans are secured by similar properties that are ten blocks apart in a major metropolitan area. The credits are generally structured the same (i.e., term, rate, etc.) but have different guarantors. The guarantors have similar liquidity positions. The loans are serviced by different relationship managers. The following table compares important financial metrics and levels of guarantor support for each loan.

Property Type	Risk Grade	Guarantor	Loan-to-Value	Bank Debt Service Coverage Ratio
1 – Apartment building	5 – Lowest Pass	Unlimited	56.96%	1.66
2 – Apartment building	4 – Acceptable	Limited – Carve Outs[6]	57.41%	1.31

In this example, the loans have consistent repayment histories and similar loan-to-value (LTV) ratios. Loan 1 has unlimited guarantor support whereas Loan 2 has only limited guarantor support. Additionally, Loan 1 has more cash flow available to service the debt. It is unclear why Loan 1 was assigned a lower risk grade, given its stronger guarantor support and debt service coverage. The process relied on expert judgment, allowing relationship managers to assign any grade, and did

[6] Limited carve outs in these examples refer to a guaranty that is limited to bad acts that create limited liability on the debt to the extent of losses are caused by fraud or misrepresentation, gross negligence or willful conduct, failure to maintain insurance, and failure to pay taxes.

continued from pg. 17

not apply any thresholds in terms of financial metrics or other factors to help define the risk grades or better inform their decision. Further, the loan review function did not compare grades in the portfolio to determine whether grading was consistent and appropriately rank-ordered risk.

Example 2:
Two loans are secured by similar properties and have the same guarantor. The credits are generally structured the same (i.e., term, fixed, etc.) and have the same relationship manager. The following table compares important financial metrics and levels of guarantor support for each loan.

Property Type	Risk Grade	Guarantor	Loan-to-Value	Bank Debt Service Coverage Ratio
1 – Mixed Use Building – retail and apartments	4 – Acceptable	Unlimited	70.72%	1.31
2 – Mixed Use Building – retail and apartments	5 – Lowest Pass	Unlimited	56.98%	1.79

The loans have consistent repayment histories. Loan 2 has more collateral support, based on a lower LTV ratio, and substantially more cash flow available to service the debt. These credits are serviced by the same relationship manager and were graded within days of each other. It is unclear why Loan 2 was given a lower risk grade given the stronger collateral and cash flow support. This risk grading system was also expert judgment based, and the risk grades assigned by the relationship manager do not appear directionally consistent.

These examples are intended to suggest the importance of having clear definitions and thresholds for credit risk grades, as well as a robust credit review function to determine whether grading is conducted transparently and consistently, that is, so an independent reviewer of the process can understand how grades are assigned based on available policies and documentation. This independent review function provides necessary internal controls so that management and boards can rely on internal reports documenting the levels and trends of credit risk.

Use of Scorecards and Models

Certain banks in the horizontal assessment used scorecards or modeled approaches to assign credit grades. In general, as banks grew in size and complexity, management would transition from an expert judgment based system to a quantitative scorecard or modeled approach with qualitative adjustments. A standardized scorecard or modeled approach may be employed to promote consistency in assigning credit grades across a bank's geographic footprint, since relationship managers in different locations may not grade credits similarly based on a myriad of factors. Scorecard or modeled approaches might eliminate the inconsistencies noted in Examples 1 and 2.

Scorecard and modeled approaches were generally more transparent and repeatable than expert judgment systems, but these approaches require considerable staff expertise and training, as well as substantial historical data to support the approaches. The horizontal assessment observed that scorecard and model approaches were more effective when lending staff were involved in development and implementation to ensure that the quantitative approach or qualitative adjustments are able to capture idiosyncratic risks unique to the bank's credits. Examples of scorecard and modeled approaches ranged from a simple spreadsheet that applies well-supported weighting factors on financial and qualitative metrics, to a more complex expected loss approach using statistical modeling to generate probability of default, loss given default, and exposure at default values. In most of the institutions reviewed, the scorecards or models were subject to the bank's model risk management framework and validated appropriately.

Some institutions purchase credit grading scorecard and statistical models from external vendors. Vendor models can be expensive, but may be less resource intensive for an institution in other ways, such as requiring fewer model development staff. Such products range from basic models that are relatively inflexible and limit customization to more advanced models that allow an institution to customize parameters to better align with the institution's unique risk factors. Additionally, some of these vendor models use public rating agency data to risk grade credits. Such ratings may not be reflective of a bank's borrowers, may not be updated as rapidly as a bank requires, or may not have the same sensitivity to macroeconomic market changes as a bank's loan portfolios.

Institutions that implemented third-party models relied on both their model risk management and vendor or third-party risk management frameworks to assess models and vendors before, during, and after deployment, and often ran the models in parallel with old credit risk grading systems during testing.

Data Usage and Retention

Prior to development of an expert judgment, scorecard, or modeled credit risk grading approach, management may want to determine data needs such as:

- What data such as debt service coverage ratios (DSCR), LTV ratios, net operating income (NOI), credit bureau scores, vacancy rates, etc. are required;
- How many years' worth of data are necessary;
- Whether the bank has sufficient internal data for the desired approach;
- How data such as DSCR or NOI are calculated;
- Whether data obtained from a merger or acquisition are complete, need to be quality checked, or should be transformed to align with the bank's data;
- How often information needs to be refreshed;
- Whether the bank has the capability to retain data; and
- What data should be retained.

Credit Risk Grading Systems

continued from pg. 19

Certain institutions used financial metrics such as DSCR and LTV provided by external vendors. External vendors can offer large, geographically diverse data sets, but these records may be challenging to filter to align with a bank's credit profile and market. Other institutions relied entirely on internal data, and some banks used a blended approach combining internal and external metrics. No matter what borrower or collateral information is used, consistent calculations of financial metrics such as DSCR will enhance credit grade accuracy and facilitate a transparent and repeatable system. Similarly, qualitative adjustments made to calculations should be clear and well supported to aid assessments by the credit review function. The following example highlights some questions that could be considered when evaluating data accuracy and consistency.

Example 3: A loan relationship manager in office X calculates a DSCR for a non-owner occupied multi-family credit using projected rents and an average of the last three years' expenses. The loan relationship manager in office Y calculates a DSCR for a similar property using actual rents and expenses from the prior year.

- Are those two DSCRs comparable?
- Are the relationship managers using similar source documents such as quarterly income statements?
- Are the relationship managers making similar qualitative adjustments such as adjustments for management fee estimates?
- Are those adjustments reasonable and well supported?
- Do the adjustments tie back to historical income statements or some other source?
- Would an independent party be able to easily replicate the calculation?
- Would using different calculation methods as inputs potentially skew or statistically bias scorecard or model results?
- Does the way one DSCR is calculated versus another alter the overall risk position of a portfolio or alter ongoing trend analysis?
- Do different calculations materially impact Board reports, and if so, does the Board still receive sufficient information to make accurate and timely strategic decisions or react to risk profile changes?

As noted in the Winter 2017 *Supervisory Insights Journal* article on Credit Management Information Systems, additional data challenges "may occur when a bank converts to a new data processing system, or acquires another institution that may have different data management and reporting capabilities."[7] Being aware of data availability and integrity shortcomings before developing a new credit risk grading system can help management determine resource allocation, better inform credit risk grading project timelines, and limit the potential costs and scale of data remediation work.

For certain modeled or scorecard approaches analyzed by the FDIC's supervisory team, banks placed

[7] Michael McGarvey. "Credit Management Information Systems: A Forward-Looking Approach," *Supervisory Insights*, Winter 2017, page 9; https://www.fdic.gov/regulations/examinations/supervisory/insights/siwin17/si-winter-2017.pdf.

heavy weight on collateral values, which were generally not refreshed as often as borrower financial information. In certain cases, collateral values were not refreshed, even after market conditions had changed materially or a borrower's operating income had changed substantially. Using stale collateral values with up-to-date financial metrics could skew results and result in risk not being identified appropriately. When using relevant and up-to-date borrower and collateral information, scorecard or modeled approaches can provide additional insight into a bank's risk position because the results can be sensitivity tested to reflect more benign or severe financial stress.

Several institutions that relied on internal data were not retaining their historical borrower information in a database or other centralized repository. The lack of retention made testing, ongoing performance monitoring, or redeveloping scorecard or modeled approaches time consuming and costly because management teams had to search loan files, re-enter borrower information, and quality check inputs. The retention issues highlight the importance of assessing data needs prior to implementing a scorecard or modeled approach. Depending on the loss estimation approach a bank adopts under the FASB CECL issuance,[8] assessing and retaining available data may become a high priority to ensure a bank is able to implement the planned approach.

Governance and Risk Management Process

The horizontal review assessed whether grade definitions established a risk management framework that rank-ordered risk and provided timely and accurate individual risk grades for pass, criticized, and classified credits. The reviewers observed that certain banks were able to assess grade accuracy well by comparing key borrower financial metrics (i.e., DSCR, LTV ratio, etc.) and the internal grades across loans of a similar type. Grading inaccuracies, grading practices that do not align with bank policies, or instances of grading that are not directionally consistent as noted in the tables accompanying Examples 1 and 2 were of concern, particularly if inconsistencies understated the bank's overall risk position. The horizontal review also noted that override rates or data on how often grades are adjusted or replaced can provide useful information about the reliability of the grading system to senior management. Several grading systems reviewed had significant rates of grade overrides or management did not track overrides. Consistently overriding credit grades could result in a bank exceeding Board-established risk appetite limits, since it is challenging to determine if the grading system is working as intended if grades are altered or if the volume of changes are not tracked. Based on the FDIC's supervisory experience and the results of the horizontal assessment,

[8] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, FDIC, National Credit Union Administration, "Joint Statement on the New Accounting Standard on Financial Instruments - Credit Losses," June 17, 2016; https://www.fdic.gov/news/news/press/2016/pr16051a.pdf. Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, FDIC, National Credit Union Administration , "Frequently Asked Questions on the New Accounting Standard on Financial Instruments – Credit Losses," December 19, 2016; https://www.fdic.gov/news/news/financial/2017/fil17041a.pdf.

continued from pg. 21

banks were encouraged to implement credit risk grading systems with such features as:

- Board-approved lending or credit administration policies with clear grade definitions that tie narrative phrasing such as "acceptable risk" to quantitative financial factors (e.g., metrics or thresholds). These financial factors should reflect the risk of default and credit losses.
- Comprehensive internal or external data sets and robust data governance frameworks.
  - Data sets that are periodically assessed for quality, including missing data, and refreshed regularly. Data gaps that are remediated timely, and historic data are retained.
  - Data that are organized logically, and controls are maintained to prevent users from manipulating the data.
  - Data definitions, such as how a DSCR was calculated, to ensure consistent application across the organization. Data are subject to quality assurance checks.
- Independent loan review functions that assess both pass and criticized or classified credits and ensure that loan grading methodologies are applied accurately and timely across the organization.
- Vendor management and model risk management programs that can be leveraged to select external data sets and/or models, as appropriate.
- Weights applied to grading factors in scorecards or models that are well documented and supported.
- Well-supported adjustments or overlays to expert judgment, scorecard, or modeled grading systems. Adjustments or overlays can generally be tied to historical borrower information such as income statements and are reviewed independently for appropriateness.
- Methods to track grade overrides. Override rates can be used to periodically assess the grading system accuracy.

Existing Regulations and Guidance

There is no regulatory requirement that mandates a credit risk grading system be structured in a particular way. However, the approach for a bank's credit risk grading system should align with the bank's size and complexity to facilitate accurate risk identification, measurement, monitoring, and reporting.[9] There are existing rules and regulatory statements that address credit risk management processes that may be of particular interest in this context. For example, *Appendix A to 12 CFR Part 364 of the FDIC's Rules and Regulations* (Appendix A) notes that banks should have internal controls and information systems that provide for effective risk assessment, timely and accurate reporting, and procedures to safeguard and manage assets.[10] Appendix A describes a broad framework for credit risk management and loan review that is further detailed in other Statements of Policy.

[9] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, FDIC, "Appendix A to Part 364 – Interagency Guidelines Establishing Standards for Safety and Soundness," October 28, 2015; https://www.fdic.gov/regulations/laws/rules/2000-8630.html#fdic2000appendixatopart364.

[10] Ibid.

For example, the *Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions*[11] expands on the broad framework in Appendix A noting that banks should establish a system of internal controls used to ensure the ALLL is maintained in accordance with GAAP and supervisory guidance. Effective internal controls include an effective loan grading system that is consistently applied, identifies different risk characteristics and loan quality problems accurately and timely, and prompts appropriate administrative actions. The Policy Statement further notes that banks should maintain written supporting documentation for loan grading systems or processes.[12]

Similarly, the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* highlights the importance of having policies and procedures that outline an effective loan review system, which includes a loan classification or credit grading system to identify, monitor, and control asset quality problems.[13] Attachment 1 of the Statement of Policy notes that each bank should ensure its loan review system includes:

- *A formal loan classification or credit grading system in which loan classifications or credit grades reflect the risk of default and credit losses and for which a written description is maintained, including a discussion of the factors used to assign appropriate classifications or credit grades to loans;*
- *Identification or grouping of loans that warrant the special attention of management or other designated "watch lists" of loans that management is more closely monitoring and documentation supporting those designations;*
- *A mechanism for direct, periodic, and timely reporting to senior management and the Board on the status of loans meriting special attention or adversely classified and actions taken by management; and*
- *Documentation of the bank's historical loss experience for each group of loans with similar risk characteristics.*[14]

---

[11] During the transition to CECL, the Policy Statement on Allowance for Loan and Lease Losses Methodologies and the Interagency Policy Statement on the Allowance for Loan and Lease Losses still apply.

[12] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, FDIC, National Credit Union Administration, Securities and Exchange Commission, "Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions," July 2, 2001; https://www.fdic.gov/regulations/laws/rules/5000-4650.html#fdic5000psalll.

[13] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, FDIC, National Credit Union Administration, "Interagency Policy Statement on the Allowance for Loan and Lease Losses," December 13, 2006; https://www.fdic.gov/regulations/laws/rules/5000-4700.html#fdic5000interagencypso.

[14] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, FDIC, National Credit Union Administration, "Interagency Policy Statement on the Allowance for Loan and Lease Losses," Attachment 1 – Loan Classification and Credit Grading Systems, December 13, 2006; https://www.fdic.gov/regulations/laws/rules/5000-4700.html#fdic5000interagencypso.

Credit Risk Grading Systems

continued from pg. 23

As is typical with Statements of Policy, the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* articulates the principles the agencies look to in examining and supervising banks for safety-and-soundness. Application of these principles depends on individual circumstances, including the scope and complexity of an institution's operations.

Conclusion

Credit risk grading systems vary greatly across the banking system, but are integral to a bank's ability to identify, measure, monitor, and control risk. Risk grading can impact the adequacy of allowances for credit losses and, looking ahead, may assist in the implementation of the CECL accounting standard. Boards rely on accurate risk grade information and trend analyses to make enterprise-wide strategic decisions. Risk grading systems should reflect the size and complexity of a bank's lending activities, while sufficiently measuring risk. Effective credit risk grading systems rely on timely and accurate data, are transparent and repeatable, and rank-order risk appropriately through all definitions and grades. Strengthening risk grading frameworks and assessing data availability and accuracy now may enhance a bank's ability to identify risk early during times of economic stress.

Sandra Macias
Examination Specialist
Division of Risk Management Supervision
smacias@fdic.gov

Overview of Selected Regulations and Supervisory Guidance

This section provides an overview of recently released regulations and other items of interest, arranged in reverse chronological order. Press Release (PR) and Financial Institution Letter (FIL) designations are included so the reader can obtain more information.

ACRONYMS and DEFINITIONS	
CFPB	Consumer Financial Protection Bureau
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
FRB	Federal Reserve Board
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
Federal bank regulatory agencies	FDIC, FRB, and OCC
Federal financial institution regulatory agencies	CFPB, FDIC, FRB, NCUA, and OCC

Subject	Summary
Consolidated Reports of Condition and Income (FIL-39-2018, FIL-40-2018, July 17, 2018)	The federal bank regulatory agencies are implementing additional burden-reducing revisions that will be made to all three versions of the Call Report effective June 30, 2018. These revisions consist of removing or consolidating data items, adding new or raising certain existing reporting thresholds, and reducing the frequency of reporting certain data items. In addition, two sections of the *Economic Growth, Regulatory Relief, and Consumer Protection Act* affect reporting in the June 2018 Call Report. These sections apply to reciprocal deposits and acquisition, development, or construction loans for high volatility commercial real estate exposures. See https://www.fdic.gov/news/news/financial/2018/fil18040.html
Interagency Forms: Implementation of Updated Interagency Forms (FIL-38-2018, July 11, 2018)	The FDIC is implementing revisions to the Interagency Biographical and Financial Report, Interagency Bank Merger Act Application, Interagency Notice of Change in Control, and Interagency Notice of Change in Director or Senior Executive Officer based on recommendations from representatives of the federal bank regulatory agencies. Changes are being made to improve the clarity of the requests; reflect new laws, regulations, capital requirements, and accounting rules; delete information requests that have been determined to be unnecessary; and add transparency for filers. See https://www.fdic.gov/news/news/financial/2018/fil18038.html
Agencies Post Public Sections of July 2018 Plans (PR-45-2018, July 9, 2018)	The FRB and FDIC released the public portions of four foreign banking organizations' resolution plans. The public portions of the resolution plans are available on the FDIC and FRB websites. In addition, the FDIC received and posted the public sections of separate resolution plans from 41 large insured deposit institutions. See https://www.fdic.gov/news/news/press/2018/pr18045.html

Regulatory and Supervisory Roundup

continued from pg. 25

Subject	Summary
Agencies Issue Statement Regarding the Impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (PR-44-2018, July 6, 2018)	The federal bank regulatory agencies issued a statement detailing the rules and reporting requirements immediately affected by the enactment of the *Economic Growth, Regulatory Relief, and Consumer Protection Act*. The changes affect company-run stress testing, resolution plans, the Volcker Rule, capital rule risk weighting for high volatility commercial real estate exposures, extension of examination cycles for certain qualified institutions, the inclusion in liquidity coverage ratio rules of municipal obligations as high-quality liquid assets, and other provisions. See https://www.fdic.gov/news/news/press/2018/pr18044.html
Home Mortgage Disclosure Act: Statement on the Implementation of the Economic Growth, Regulatory Relief, and Consumer Protection Act (FIL-36-2018, July 5, 2018)	The FDIC is releasing a statement on the implementation of the *Economic Growth, Regulatory Relief, and Consumer Protection Act* amendments to the *Home Mortgage Disclosure Act* (HMDA). The statement provides information on the formatting and submission of HMDA data collected in 2018, as well as makes note of upcoming guidance that will be provided by the CFPB. See https://www.fdic.gov/news/news/financial/2018/fil18036.html
FDIC Announces Meeting of Advisory Committee on Community Banking (PR-42-2018, July 5, 2018)	The FDIC will hold a meeting of the Advisory Committee on Community Banking on July 11, 2018. FDIC senior staff will brief Committee members on recent legislation, as well as other regulatory burden-reduction initiatives. Staff will also discuss various supervisory policy issues and provide information on community bank research. The agenda for the meeting and a link to the webcast are available at https://www.fdic.gov/communitybanking/2018/2018-07-11-agenda.html. See https://www.fdic.gov/news/news/press/2018/pr18042.html
Regulators Extend the Next Resolution Plan Filing Deadline for 14 Domestic Firms (PR-41-2018, July 2, 2018)	The FRB and FDIC extended the next resolution plan filing deadline for 14 domestic firms by one year to December 31, 2019, to allow additional time for the agencies to provide feedback to the firms on their last submissions and for the firms to produce their next plan submissions. See https://www.fdic.gov/news/news/press/2018/pr18041.html
Agencies Seek Comment on Proposed 2019 Resolution Plan Guidance (PR-40-2018, June 29, 2018)	The FDIC and FRB are seeking public comment on revised resolution plan guidance for the eight largest, most complex U.S. banks. The proposed guidance would apply beginning with the July 1, 2019, resolution plan submissions of the firms and updates the agencies' expectations for how a firm's resolution strategy should address derivatives and trading activities, as well as the firm's payment, clearing, and settlement activities. See https://www.fdic.gov/news/news/press/2018/pr18040.html
Community Bank Webinar: Current Expected Credit Losses Methodology Q&A Webinar for Community Bankers (FIL-34-2018, June 26, 2018)	The federal bank regulatory agencies, in conjunction with the Financial Accounting Standards Board, the U.S. Securities and Exchange Commission, and the Conference of State Bank Supervisors, will host an interagency webinar on July 30, 2018, focusing on questions received from community bankers about the new credit losses accounting standard. See https://www.fdic.gov/news/news/financial/2018/fil18034.html
Agencies Release List of Distressed or Underserved Nonmetropolitan Middle-Income Geographies (PR-38-2018, June 25, 2018)	The federal bank regulatory agencies announced the availability of the 2018 list of distressed or underserved nonmetropolitan middle-income geographies, where revitalization or stabilization activities are eligible to receive *Community Reinvestment Act* (CRA) consideration under the community development definition. The criteria for designating these areas in accordance with CRA regulations are available on the FFIEC website (https://www.ffiec.gov/cra). See https://www.fdic.gov/news/news/press/2018/pr18038.html

Subject	Summary
Agencies Issue Host State Loan-to-Deposit Ratios (PR-37-2018, June 15, 2018)	The federal bank regulatory agencies issued the host state loan-to-deposit ratios that will be used for determining compliance with Section 109 of the *Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994*. These ratios replace the prior year's ratios. Section 109 prohibits a bank from establishing or acquiring a branch or branches outside its home state primarily for the purpose of deposit production. See https://www.fdic.gov/news/news/press/2018/pr18037.html
Newly Formed Money Smart Advance Team Will Get Early Access to, Training on, Updated Money Smart for Adults (FIL-32-2018, June 7, 2018)	The FDIC formed the new Money Smart Advance Team (MSAT), which will operate through Winter 2019. Banks that engage in financial education activities and join the MSAT will gain early access to the updated instructor-led *Money Smart for Adults* curriculum, as well as other benefits. See https://www.fdic.gov/news/news/financial/2018/fil18032.html
Volcker Rule: Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds or Private Equity Funds (FIL-31-2018, June 4, 2018)	The FDIC, FRB, OCC, U.S. Securities and Exchange Commission, and U.S. Commodity Futures Trading Commission have requested comment on a proposed rule that would amend the Volcker Rule to provide banking entities with clarity about what activities are prohibited, improve supervision and implementation of the rule, and simplify compliance. This FIL is applicable to all FDIC-insured depository institutions that have, or are controlled by a company that has, $10 billion or more in total consolidated assets or total trading assets and trading liabilities that are more than 5 percent of total consolidated assets. See https://www.fdic.gov/news/news/financial/2018/fil18031.html
Joint Final Rule: Securities Transactions Settlement Cycle (FIL-30-2018, PR-33-2018, June 1, 2018)	The FDIC and OCC issued a final rule to shorten the standard settlement cycle for securities purchased or sold by FDIC-supervised and OCC-supervised institutions from three days to two days. The final rule mirrors the standard settlement cycle set out in a final rule adopted by the U.S. Securities and Exchange Commission and is followed by registered brokered dealers in the United States. See https://www.fdic.gov/news/news/financial/2018/fil18030.html
Summary of Deposits Survey: Filing for June 30, 2018 (FIL-27-2018, May 15, 2018)	The Summary of Deposits (SOD) is the annual survey of branch office deposits as of June 30 for all FDIC-insured institutions, including insured U.S. branches of foreign banks. All institutions with branch offices are required to submit the survey to the FFIEC's Central Data Repository (CDR) by July 31, 2018. SOD Reporting Instructions and access to the CDR are available at https://www.fdic.gov/regulations/resources/call/sod.html. See https://www.fdic.gov/news/news/financial/2018/fil18027.html
Bank Secrecy Act: Customer Due Diligence and Beneficial Ownership Examination Procedures (FIL-26-2018, May 11, 2018)	The FFIEC released the customer due diligence (CDD) and beneficial ownership sections of the *FFIEC Bank Secrecy Act/Anti-Money Laundering Examination Manual*. The sections will be incorporated into the next manual update, but are available in advance at the following links: CDD https://www.fdic.gov/news/news/financial/2018/fil18026a.pdf Beneficial Ownership for Legal Entity Customers https://www.fdic.gov/news/news/financial/2018/fil18026b.pdf See https://www.fdic.gov/news/news/financial/2018/fil18026.html

continued from pg. 27

Subject	Summary
Deposit Insurance Coverage Seminars: Free Nationwide Seminars for Bank Officers and Employees (FIL-25-2018, May 9, 2018)	The FDIC will conduct four identical live seminars on FDIC deposit insurance coverage for bank officers and employees between May 24, 2018 and November 26, 2018. In addition to a comprehensive overview of FDIC deposit insurance rules, the seminars include deposit insurance coverage information on signature card requirements for joint accounts, prepaid cards, bank trade names, health savings accounts, 529 plan accounts, and 529 Achieving a Better Life Experience plan accounts. The presentation will also provide an overview of the Electronic Deposit Insurance Estimator, the BankFind Directory, and the Financial Institution Employee's Guide to Deposit Insurance. See https://www.fdic.gov/news/news/financial/2018/fil18025.html
Banker Teleconference: Implementation and Transition of the Current Expected Credit Losses (CECL) Methodology for Allowances and Related Adjustments to the Regulatory Capital Rules and Conforming Amendments to Other Regulations (FIL-23-2018, May 4, 2018)	The federal bank regulatory agencies will host an interagency conference call on May 15, 2018, to address certain proposed changes to the capital rules, including: (1) the definition of a new term, Allowance for Credit Losses; (2) revised definition of carry value for available-for-sale debt securities and purchased credit deteriorated assets; (3) mechanics of the proposed CECL transition provision; and (4) new disclosure and regulatory reporting requirements. See https://www.fdic.gov/news/news/financial/2018/fil18023.html
Advisory: FDIC Conducting Testing of Standardized Export of Imaged Loan Documents (FIL-22-2018, April 24, 2018)	The FDIC is developing and testing a standardized export of imaged loan documents to streamline examination processes. This initiative is anticipated to improve efficiencies during on-site examination activities and provide additional opportunities for conducting examination activities off-site. The FDIC will conduct a teleconference on May 16, 2018, for FDIC-supervised institutions interested in learning more about the project. See https://www.fdic.gov/news/news/financial/2018/fil18022.html
Electronic Fingerprinting for Background Checks Related to Applications (FIL-21-2018, April 17, 2018)	The FDIC is moving to electronic fingerprinting to facilitate background checks performed in connection with applications and notices submitted to the FDIC, including applications for federal deposit insurance, notices of acquisition of control, requests for participation in the banking industry by individuals with certain criminal conviction, and notices to replace board members or senior management in certain institutions. The FDIC will begin using the new process during second quarter 2018. See https://www.fdic.gov/news/news/financial/2018/fil18021.html
Regulatory Capital Rule: Implementation and Transition of the Current Expected Credit Losses (CECL) Methodology for Allowance and Related Adjustments to the Regulatory Capital Rules and Conforming Amendments to Other Regulations (FIL-20-2018, PR-26-2018, April 17, 2018)	The federal bank regulatory agencies are jointly issuing a notice of proposed rulemaking to amend the capital rules in response to forthcoming changes to U.S. generally accepted accounting principles set forth in Accounting Standards Update No. 2016-13, Topic 326, Financial Instruments – Credit Losses, which introduces the CECL methodology. The proposed rule adds allowance for credit losses as a newly defined term in the capital rules, revises the definition of carrying value to maintain the current treatment of credit losses on available-for-sale debt securities, provides an optional three-year transition arrangement that allows institutions to phase in any adverse day-one regulatory capital effects of CECL, amends the definition of eligible credit reserves, and revises disclosure requirements for certain banking organizations. An estimation tool to help community banking organizations evaluate the potential impact of the proposal on regulatory capital ratios is available at https://www.fdic.gov/regulations/capital/index.html. See https://www.fdic.gov/news/news/financial/2018/fil18020.html

Subject	Summary
Consolidated Reports of Condition and Income (FIL-18-2018, April 12, 2018)	The federal bank regulatory agencies are implementing revisions to several Call Report schedules this quarter in response to changes in the accounting for equity securities and other equity investments. The instructions for Schedule RC-R, Regulatory Capital, have been revised to incorporate the banking agencies' November 2017 final rule extending the transition provisions applicable during 2017 for certain regulatory capital deductions, risk weights, and minority interest limitations for non-advanced approaches institutions. See https://www.fdic.gov/news/news/financial/2018/fil18018.html
FFIEC Issues Joint Statement: Cyber Insurance and its Potential Role in Risk Management Programs (FIL-16-2018, April 10, 2018)	The FFIEC issued a statement to provide awareness of the potential role of cyber insurance in financial institutions' risk management programs. The statement does not contain any new regulatory expectations, but discusses the benefits of cyber insurance that may not be fully covered through a general liability policy. The statement is available at https://www.fdic.gov/news/news/financial/2018/fil18016a.pdf. See https://www.fdic.gov/news/news/financial/2018/fil18016.html
FDIC Forum: Use of Technology in the Business of Banking (FIL-15-2018, April 5, 2018)	The FDIC will host a forum on the *Use of Technology in the Business of Banking* on May 7, 2018 in the FDIC's Sheila C. Bair Auditorium, 3501 Fairfax Drive, Arlington, VA. The forum will be webcast live and recorded for on-demand access after the event. Panels will focus on emerging technologies that are transforming banking operations, the impact of emerging technologies on retail banking, and consumer financial data access. Additional information on the forum is available at https://www.fdic.gov/news/conferences/techforum/. See https://www.fdic.gov/news/news/financial/2018/fil18015.html
Appraisal Threshold for Commercial Real Estate Loans (FIL-14-2018, PR-23-2018, April 2, 2018)	The federal bank regulatory agencies jointly adopted a final rule titled *Real Estate Appraisals* that amended the previous rule on real estate appraisals. The final rule increases the appraisal threshold for commercial real estate transactions. Under prior thresholds, all real estate-related financial transactions with a value of $250,000 or less, as well as qualifying business loans secured by real estate that are $1 million or less, did not require appraisals. The final rule creates a new definition of, and separate category for, commercial real estate transactions and raises the threshold for requiring an appraisal from $250,000 to $500,000 for those transactions. The final rule is available at https://www.fdic.gov/news/board/2018/2018-03-20-notice-sum-c-fr.pdf. See https://www.fdic.gov/news/news/financial/2018/fil18014.html
Revisions to the Consolidated Reports of Condition and Income for June 2018; Webinar on April 5, 2018 (FIL-12-2018, FIL-13-2018, March 30, 2018)	The federal bank regulatory agencies have finalized additional burden-reducing revisions that will be made to all three versions of the Call Report effective June 30, 2018. The agencies will conduct a banker webinar on April 5, 2018, to discuss the upcoming changes, including revisions to the reporting of equity securities taking effect March 31, 2018, instructional changes resulting from the regulatory capital transitions rule, and reporting implications of the recently enacted tax lax. See https://www.fdic.gov/news/news/financial/2018/fil18013.html
FFIEC Provides Update on Examination Modernization Project (FIL-11-2018, March 22, 2018)	The FFIEC announced an update on the status of its *Examination Modernization Project*, which seeks to identify and assess ways to improve the community bank safety-and-soundness examination process. FFIEC members plan to highlight and reinforce regulator communication objectives before, during, and after examinations; leverage technology and shift, as appropriate, examination work from on-site to off-site; continue to tailor examinations based on risk; and improve electronic file transfer systems to facilitate the secure exchange of information between institutions and supervisory offices or examiners. Further information on the *Examination Modernization Project* is available at https://www.ffiec.gov/press/pr032218.htm. See https://www.fdic.gov/news/news/financial/2018/fil18011.html

Regulatory and Supervisory Roundup

continued from pg. 29

Subject	Summary
FFIEC Revised *A Guide to HMDA Reporting: Getting It Right!* (FIL-10-2018, March 5, 2018)	The FFIEC revised *A Guide to HMDA Reporting: Getting It Right!* to reflect the October 2015 *Home Mortgage Disclosure Act* (HMDA) final rule, as amended in 2017. The Guide provides a summary of key HMDA provisions, including information about data collection, reporting, and disclosure requirements, and is available at https://www.ffiec.gov/hmda/pdf/2018guide.pdf. See https://www.fdic.gov/news/news/financial/2018/fil18010.html
***FDIC Consumer News* Features Tips on Protecting Assets (PR-17-2018, March 5, 2018)**	The Winter 2018 *FDIC Consumer News* includes information about protecting valuables using safe deposit boxes and home safes, guarding against criminals who place hidden recording devices near automated teller machines and retailer checkout registers, and new credit reporting standards that may help consumers improve credit scores and qualify for loans under more favorable terms. The Winter 2018 *FDIC Consumer News* is available at https://www.fdic.gov/consumers/consumer/news/cnwin18/. See https://www.fdic.gov/news/news/press/2018/pr18017.html
FDIC Provides Q&As for Consumers as Part of *National Consumer Protection Week* (PR-16-2018, March 5, 2018)	The FDIC will post a question and answer (Q&A) on a different banking topic each weekday of *National Consumer Protection Week*, which runs from March 4 through March 10, 2018. The five Q&As, covering mobile banking, credit and debit card security precautions, safe deposit boxes, credit reports, and debt collectors, along with other consumer information, are accessible at https://www.fdic.gov/consumers/consumer/information/ncpw/index.html. See https://www.fdic.gov/news/news/press/2018/pr18016.html
Agencies Communicate Updated Expectations for Next Resolution Plans for Two Domestic Banks (PR-15-2018, March 1, 2018)	The FDIC and FRB communicated updated expectations for the next resolution plans of two domestic bank holding companies, CIT and Citizens Financial Group. As with the expectations issued to the 16 domestic firms in March 2017, the agencies are requiring the firms to focus on progress made in addressing service disruptions and firm employee departures during a potential resolution. The two firms' next resolution plans are due on December 31, 2018. See https://www.fdic.gov/news/news/press/2018/pr18015.html
FDIC Encourages Consumers of All Ages to Set and Achieve Savings Goals (PR-11-2018, February 23, 2018)	The FDIC is encouraging people to use *America Saves Week*, which runs between February 26 and March 3, 2018, as an opportunity to develop or review their financial goals. The FDIC offers resources to institutions interested in supporting savings and to individuals of all ages who are interested in learning more about saving. Information about *America Saves Week* and savings-related resources from the FDIC is available at https://www.fdic.gov/consumers/assistance/protection/depaccounts/savings/savings.html. See https://www.fdic.gov/news/news/press/2018/pr18011.html
Final Rule to Remove References to Credit Ratings from the FDIC's International Banking Regulations (FIL-9-2018, February 15, 2018)	On February 14, 2018, the FDIC Board of Directors adopted a final rule amending the FDIC's international banking regulations related to permissible investment activities and the pledging of assets. The final rule removes references to external credit ratings and replaces them with appropriate standards of creditworthiness. The changes in the FDIC Rules and Regulations Part 347, Subparts A and B, are consistent with Section 939A of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act). See https://www.fdic.gov/news/news/financial/2018/fil18009.html
FDIC Releases Economic Scenarios for 2018 Stress Testing (PR-9-2018, February 6, 2018)	The FDIC released the economic scenarios that will be used by certain financial institutions with total consolidated assets of more than $10 billion for stress tests required under the Dodd-Frank Act. The baseline, adverse, and severely adverse scenarios include key variables that reflect economic activity, including unemployment, exchange rates, prices, income, interest rates, and other salient aspects of the economy and financial markets. See https://www.fdic.gov/news/news/press/2018/pr18009.html

Subject	Summary
Agencies Seek Comment on Proposed Amendments to Swap Margin Rule (PR-08-2018, February 5, 2018)	The FRB, FDIC, OCC, Farm Credit Administration, and Federal Housing Finance Agency issued a notice of proposed rulemaking to amend swap margin requirements to conform with recent rule changes that impose new restrictions on certain qualified financial contracts (QFCs) of systemically important banking organizations. Under the proposed amendments, legacy swaps entered into before the applicable compliance date would not become subject to the margin requirements if they are amended solely to comply with the requirements of the QFC Rules. The deadline for submitting comments is April 23, 2018. See https://www.fdic.gov/news/news/press/2018/pr18008.html
Community Bank Webinar: Implementation Examples for the Current Expected Credit Losses Methodology (FIL-8-2018, February 2, 2018)	The FDIC and FRB, in conjunction with the Financial Accounting Standards Board, the U.S. Securities and Exchange Commission, and the Conference of State Bank Supervisors, will host a webinar to discuss how smaller, less complex community institutions can implement the Current Expected Credit Losses methodology. The webinar is scheduled for February 27, 2018, and materials will be archived for future viewing. See https://www.fdic.gov/news/news/financial/2018/fil18008.html
Agencies Complete Assessment of Resolution Plans of 19 Foreign-Based Banks (PR-06-2016, January 29, 2018)	The FRB and FDIC communicated their expectations to 19 foreign-based banking organizations for the firms' next resolution plans. Resolution plans, required by the Dodd-Frank Act and commonly known as living wills, must describe the company's strategy for rapid and orderly resolution under bankruptcy in the event of material financial distress or failure of the company. The 19 foreign banking organizations submitted plans in December 2015, and the next resolution plans for these companies are due no later than December 31, 2018. See https://www.fdic.gov/news/news/press/2018/pr18006.html
CRA Consideration for Community Development Activities in the U.S. Virgin Islands and Puerto Rico Following Hurricane Maria (FIL-7-2018, PR-4-2018, January 25, 2018)	The FDIC, in coordination with the FRB and OCC, is issuing a statement to clarify that a financial institution located outside the U.S. Virgin Islands and Puerto Rico, designated as disaster areas, will receive consideration for community development activities that revitalize or stabilize these areas, as long as the institution has been responsive to the community development needs and opportunities of its own assessment area(s). See https://www.fdic.gov/news/news/financial/2018/fil18007.html
New Tax Law: Accounting and Reporting Instructions (FIL-6-2018, January 18, 2018)	The federal bank regulatory agencies are issuing an Interagency Statement to provide guidance to institutions on certain accounting and reporting implications of the new tax law, which was enacted on December 22, 2017. In accordance with U.S. generally accepted accounting principles, the changes enacted in the new tax law are relevant to the preparation of financial statements and regulatory reports (e.g., the Consolidated Reports of Condition and Income or Call Report) for December 31, 2017. See https://www.fdic.gov/news/news/financial/2018/fil18006.html
***Supervisory Insights* Journal: Winter 2017 Issue Now Available (FIL-5-2018, PR-2-2018, January 10, 2018)**	The Winter 2017 issue of *Supervisory Insights* features two articles of interest to examiners, bankers, and supervisors. The first article illustrates how banks may strengthen their credit Management Information Systems, and the second article summarizes results of the FDIC's *Credit and Consumer Products/Services Survey*. *Supervisory Insights* – Winter 2017 issue is available at www.fdic.gov/supervisoryinsights. See https://www.fdic.gov/news/news/financial/2018/fil18005.html
Revisions to the Consolidated Reports of Condition and Income for March and June 2018 (FIL-2-2018, FIL-4-2018, January 5, 2018)	The federal bank regulatory agencies have finalized additional burden-reducing revisions that will be made to all three versions of the Call Report effective June 30, 2018. Call Report revisions to address changes in the accounting for equity securities and other equity investments will take effect March 31, 2018. See https://www.fdic.gov/news/news/financial/2018/fil18004.html

continued from pg. 31

Subject	Summary
Consolidated Reports of Condition and Income for Fourth Quarter 2017 (FIL-1-2018, January 2, 2018)	The federal bank regulatory agencies have issued supplemental instructions pertaining to the Consolidated Reports of Condition and Income for the December 31, 2017, report date. One new topic, Credit Losses on Financial Instruments, was added to the supplemental instructions for December 2017. See https://www.fdic.gov/news/news/financial/2018/fil18001.html
Collaborative Relationships with Minority Depository Institutions (FIL-64-2017, PR-102-2017, December 22, 2017)	The FDIC has developed a resource guide to describe ways that financial institutions, including community banks, can partner with minority depository institutions to the benefit of all institutions involved, as well as the communities they serve. The resource guide is available at https://www.fdic.gov/regulations/resources/minority/collaboration/resource-guide.pdf. See https://www.fdic.gov/news/news/financial/2017/fil17064.html
Home Mortgage Disclosure Act: Statement on Institutions' Good Faith Compliance Efforts (FIL-63-2017, December 21, 2017)	The FDIC issued a statement regarding the evaluation of financial institutions' compliance with HMDA. For HMDA data collected in 2018 and reported in 2019, the FDIC does not intend to require data resubmission unless data errors are material. In addition, the FDIC does not intend to assess penalties with respect to errors in data collected in 2018 and reported in 2019. FDIC examination staff will give credit to institutions' good faith compliance efforts, and the approach will help institutions identify compliance weaknesses. See https://www.fdic.gov/news/news/financial/2017/fil17063.html
Agencies Announce Shared National Credit Definition Change (PR-101-2017, December 21, 2017)	The federal bank regulatory agencies announced that, effective January 1, 2018, the aggregate loan commitment threshold for inclusion in the Shared Nation Credit (SNC) program will increase from $20 million to $100 million. Further, starting in 2018, annual SNC results will be reported after the third quarter examination, reflecting data as of June 30. See https://www.fdic.gov/news/news/press/2017/pr17101.html
Agencies Release Annual CRA Asset-Size Threshold Adjustments for Small and Intermediate Small Institutions (PR-100-2017, December 21, 2017)	The federal bank regulatory agencies announced the annual adjustment to the asset-size thresholds used to define small bank, small savings association, intermediate small bank, and intermediate small savings association under the *Community Reinvestment Act* regulations. The asset-size threshold adjustments are effective January 1, 2018. Current and historical asset-size thresholds are posted on the FFIEC's website at https://www.ffiec.gov/cra. See https://www.fdic.gov/news/news/press/2017/pr17100.html
Agencies Announce Joint Determination for Living Wills (PR-99-2017, December 19, 2017)	The FDIC and FRB announced that the resolution plans of the eight largest and most complex domestic banking organizations did not have weaknesses severe enough to trigger a resubmission process that could result in more stringent requirements. The agencies also jointly determined that the plans of four firms have "shortcomings," which are less-severe weaknesses that require additional work in their next plan. See https://www.fdic.gov/news/news/press/2017/pr17099.html
FDIC Releases History of Agency's Response to the Financial Crisis (PR-97-2017, December 18, 2017)	The FDIC released a history of the financial crisis focusing on the agency's response and lessons learned from its experience. The history, titled *Crisis and Response: An FDIC History, 2008-2013*, is organized into two parts. The first is an account of the origins of the crisis and the FDIC's unprecedented use of emergency authorities to respond to financial market illiquidity and the problems of systemically important financial institutions. The second documents the FDIC's responses to the challenges the agency faced in carrying out its core missions of bank supervision, deposit insurance, and failed-bank resolution. *Crisis and Response* is available on the FDIC's website at https://www.fdic.gov/bank/historical/crisis/index.html. See https://www.fdic.gov/news/news/press/2017/pr17097.html

Subject	Summary
Major Disaster Examiner Guidance (FIL-62-2017, December 15, 2017)	The federal financial institution regulatory agencies, in consultation with the Conference of State Bank Supervisors, have jointly issued guidance outlining the supervisory practices to be followed in assessing the financial condition of insured depository institutions affected by a disaster that results in the President declaring an area a major disaster with individual assistance. See https://www.fdic.gov/news/news/financial/2017/fil17062.html
Single Resolution Board and Federal Deposit Insurance Corporation sign Cooperation Arrangement (PR-95-2017, December 14, 2017)	The FDIC and the Single Resolution Board, the central resolution authority within the European Banking Union, have concluded a Cooperation Arrangement. This arrangement provides a basis for the exchange of information and cooperation in resolution planning and the implementation of such planning for financial institutions with cross-border operations. See https://www.fdic.gov/news/news/press/2017/pr17095.html

Federal Deposit Insurance Corporation
Washington, DC 20429-9990

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE, $300

FIRST CLASS MAIL

Postage & Fees Paid
FDIC
Permit No. G-36

Subscription Form

To obtain a subscription to ***Supervisory Insights***, please print or type the following information:

Institution Name ______________________

Contact Person ______________________

Telephone ______________________

Street Address ______________________

City, State, Zip Code

Please fax or mail this order form to: FDIC Public Information Center
3501 North Fairfax Drive, Room E-1022
Arlington, VA 22226
Fax Number (703) 562-2296

Subscription requests also may be placed by calling 1-877-ASK-FDIC or 1-877-275-3342
or go to https://service.govdelivery.com/service/multi_subscribe.html?code=USFDIC