Supervisory Spotlight

A Regulator's Perspective on Issues Facing Western Banks

Financial Institution Supervision and Credit
FEDERAL RESERVE BANK
OF SAN FRANCISCO

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Greetings!

In early August, I made time to watch our athletes compete in the 2016 Olympic Games in Rio. As always, I was impressed by the superb talent of all of the competitors, which got me thinking about how much preparation must go into excelling at that level of competition. Foresight, planning, repetition, tenacity, and coachability all play a part in an athlete's ultimate preparation and success. In this regard, world-class community bankers are not all that different from world-class athletes. In my many years as a bank supervisor, I have found that the bank leaders who have foresight, are open to supervisory guidance and suggestion, and are prepared to respond to multiple eventualities are the ones who can prevail over adversity and rise above the competition. As we begin the eighth year of the current economic expansion, preparation for the next economic cycle becomes more important.

The lead article in the Second Issue 2016 of *Community Banking Connections* (*CBC)* kicks off the "importance of preparation" theme by drawing an analogy between preparing for weather events and economic events. In "Preparing Now to Weather Conditions Ahead," Bill Spaniel identifies some storm clouds that may be building in the generally sunny banking skies and reminds us of the importance of solid underwriting practices, experienced personnel, effective management information systems, and sufficient capital buffers in weathering economic storms.

One cloud in particular, commercial real estate (CRE) concentrations, continues to build on the horizon. In the last two issues of *Supervisory Spotlight*, I discussed the building levels of CRE lending concentrations in the 12th District. Fortunately, the number of institutions with very high levels of CRE concentrations is still relatively constrained, but if CRE loan growth in the District remains as strong as it has been in recent quarters, we will see a further increase in the number of banks with very high concentration levels. As I mentioned in the last issue of *Supervisory Spotlight*, the Federal Reserve, OCC, and FDIC issued an interagency *Statement on Prudent Risk Management for Commercial Real Estate Lending* in December 2015 (SR letter 15-17). In this Statement, the agencies highlight several CRE risk management activities that proved successful during difficult economic cycles.

One particular risk management activity that I think is especially important is performing good market and scenario analyses of the CRE loan portfolio. Bank management teams at institutions that are highly concentrated in CRE loans are expected to have robust processes in place to monitor changes in real estate market conditions across their CRE lending footprints, including comprehensive scenario analysis. As part of their overall assessment of the institution's CRE risk management program, examiners will ask to see such analysis, and they will want to see how this information is being used by the Board of Directors to determine and implement the institution's CRE lending strategy, as well as in its overall strategic and capital planning discussions. Fortunately, there are a number of resources that bank management teams can use to help them conduct monitoring and analysis of this type, and some of them are even free. For example, on June 29, the Federal Reserve hosted an *Ask the Fed* session that provided a *Deep Dive into Multifamily Commercial Real Estate*. Another *Ask the Fed* session in October will feature staff from this Reserve Bank talking about CRE conditions in the West. You can access archived presentations and subscribe to be notified of future events here.

An area where the importance of preparedness cannot be overstated is cybersecurity. The FFIEC's Cybersecurity Assessment Tool, or CAT, which was released in mid-2015, is designed to help community financial institutions determine their inherent level of cybersecurity risk and assess the appropriateness of their cybersecurity preparedness given their identified risks. Importantly, the CAT is designed to balance the level of detail needed by risk managers and IT experts with the higher-level information that will be more valuable to executives and board members. The *CBC* article, "Less Risky Business: An Overview of a New Cybersecurity Assessment Tool," discusses how bankers can use this optional tool to help ensure that their cybersecurity preparedness (or "maturity") is aligned with their risk profile.

Contingency funding planning also requires a high degree of foresight and planning, as it is often when liquidity is needed most urgently that it may not available without prior preparation. One source of both strategic and contingency funding is the Federal Reserve's discount window. The *CBC* article, "The Federal Reserve's Discount Window: What It Is and How It Works," provides a good primer on the types of borrowing programs, eligibility criteria, collateral and margins, and documentation requirements. Even if you don't intend to borrow from the Federal Reserve in the ordinary course of business, you should consider executing the necessary documents for contingency purposes in the event that a liquidity need unexpectedly arises. You can get more information about the San Francisco Fed's Discount Window through the Federal Reserve's discount window website.

As always, I appreciate feedback and suggestions for topics that are of particular concern to you or your institution.

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