90 Day Note

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# Ag Lending in 2017

*By: Bob Viering, Senior Consultant*

In our loan review practice, we have an opportunity to work with ag banks throughout the Midwest. In general, our findings are similar to what you may have read from many ag economists. Working capital is dwindling quickly, and the debt to asset ratio is increasing as is short-term debt. Many banks have been refinancing intermediate- and long-term assets to fix working capital declines and carryover debt. Some borrowers have sold land to reduce debt. We have seen many instances where borrowers have been able to reduce input costs and, most importantly, cash rents to bring them back to the point where they are either producing positive debt service coverage or are coming much closer to positive debt service coverage than they were in 2014. But overall, balance sheets are weakening and repayment is a continuing challenge. Credits that were barely a pass credit in better times have, in many cases, dropped to Special Mention or Substandard. Solid pass credits from a couple of years ago are now one weak year from a criticized level.

For many bankers, having struggling ag borrowers is a relatively new experience. I have more recently been through the experience in working with struggling ag borrowers while working at a western bank that had many cattle ranches that were severely impacted by low cattle prices and drought conditions. Many of the lessons learned there are just as applicable to the situation many of us face here in the Midwest.

As you head into renewal season, here are a few items to consider:

1. **Complete information is critical.** There is an old Russian proverb, "Trust but verify." This is good to keep in mind when analyzing your borrower. As things get tougher, there is a temptation by some borrowers to not include every liability or to see some liabilities as something not worth mentioning. When short-term borrowing gets tougher, some borrowers will turn to using the local co-op for some inputs, borrowing from family and friends, or using online lenders (FinTech has hit agriculture too) or credit cards. At renewal time at our bank, we would send out a renewal package that had not only financial statement requests but a complete debt schedule form and inquiry about other loans or bills from any source, including family. We ran a new credit bureau report and compared it to prior ones to see if any new credit card or other type of debt was taken out since the last renewal and looked for any significant increases in balances, especially on credit cards. We completed a new UCC search for the same reason. In the end, we wanted to be sure that all debts were accounted for and had a source of repayment.

2. **Restructure only if it helps.** Often we see banks terming out any carryover debt or being quick to term out short-term debt to improve working capital. Before you restructure debt, make sure the underlying problem is fixed.

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## Inside This Issue:



Carryover debt usually occurs because the farmer didn't make enough from crop/livestock sales to pay all term debt, operating lines, and living expenses. Given that revenue isn't likely to grow in the next few years, improving cash flow is about expense control. Has the operation cut input costs, cash rents (this is the big one), and living costs to a level they can produce enough profits to cover their debt payments and family living? If so, then they are a perfect candidate for a restructure. If those tough choices have not been made and the operation won't operate profitably, then you are likely to find yourself with even more carryover, more debt, and far fewer options not far down the road.

3. **Income taxes may become an issue.** Section 179 deductions were very helpful to reduce/eliminate income taxes in the past. But with far fewer pieces of equipment being purchased, those deductions have decreased significantly. Prepaying expenses and holding over grain sales can put off taxes for a while but, at some point, the timing can get tougher and some operations will now show taxable income when their accrual earnings may be negative. Those tax payments are often not planned for and can create a significant cash outflow at exactly the wrong time. It's important that you encourage your borrowers to work with their tax professionals to plan as far ahead as possible to minimize any tax consequences.

4. **Be empathetic and be realistic.** Many of your borrowers were on top of the world a few short years ago. Everything they did went well and equipment dealers (and friendly bankers) made expansion with few tax consequences a reality. With today's reality of weak (if any) earnings and less ability to add debt, it has become a very stressful time for many farmers and their families. It's a lot tougher to be a banker too. Good bankers help their customers succeed. It's not always easy and it's often stressful, but letting customers operate unprofitably and not trying to help them make tough decisions usually only makes the problem get worse. It's so important to be empathetic with your borrowers and to have a thick skin when they get mad. They may seem like they're mad at you when they are really frustrated about their current situation. However difficult the conversation may seem today, it's a far easier conversation than to have to tell someone that they have to quit farming and start over.

Ag lending is a key part of many banks' loan portfolios and is important to their local market. Even in these tough times, it's critical to work with your customers and do all you can to help them succeed. At Young & Associates, Inc., we work with many banks with ag portfolios. If we can help you with your loan review, policy reviews, process/underwriting reviews, and improvement plans, give us a call at 1.800.525.9775 or send an email to bviering@younginc.com. ❑

# Regulatory Initiative Provides Good Reminder of Importance of Credit Policies

*By: Tommy Troyer, Executive Vice President*

A look back over recent issues of the *90-Day Note*, or a more general scan of industry news and regulatory comments, would reveal the industry's focus on underwriting standards and possible industry-wide changes in underwriting standards over the last several years. As we have noted previously, for any individual community bank, the important consideration is not simply how conservative or liberal underwriting standards are or whether underwriting standards are loosening or tightening. Instead, the question that is critical for the ultimate health and profitability of the bank focuses much more on whether underwriting standards, and any changes in underwriting standards, are accurately understood and monitored, consistent with an institution's risk management capabilities, and regularly assessed to ensure that the risk/return calculus and the institution's level of capital are appropriate for the loan portfolio's characteristics.

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The above considerations, as well as overall industry trends in risk appetite and underwriting standards, are quite naturally of interest to regulators as well. In addition to other regulatory tools (such as loan officer surveys) for measuring underwriting standards, the OCC has launched within the last year an initiative to try to standardize and collect assessments of underwriting practices during safety and soundness examinations. We have heard OCC leadership discuss this initiative at banking conventions and have heard from clients who have had OCC safety and soundness exams over the last year. While the OCC's overall approach to assessing underwriting can be informative or, at the minimum, a great reminder of critical factors for controlling credit risk, our intention here is to highlight an aspect of controlling underwriting standards and credit risk that should not be, but sometimes is, overlooked: *the role of credit policies*.

## The Important Role of Credit Policies

Credit policies represent perhaps the most important tool for the board of directors and bank management to define underwriting standards and credit risk appetite. While it can be appropriate for some details of underwriting criteria to be maintained outside of formal loan policy, it is not appropriate or effective to employ an overly generic credit policy that provides little specific detail about the characteristics of credits the institution desires to originate. The OCC's assessment of an institution's underwriting considers the range of important factors one might expect (for example, loan structure, presence of appropriate covenants, etc.). Importantly, this assessment also extends to whether loan policy provides enough detail and information to control these important characteristics of credit underwriting. Without a policy that defines the bank's limits on factors such as amortization periods, collateral advance rates, etc., underwriting standards can loosen and credit risk can grow without the intention or even the knowledge of the board. An appropriately detailed policy sets limits on the extent of any loosening that might occur and, assuming exception tracking and reporting is effective, allows for the board to receive better information about any changes in underwriting quality.

"Credit policies represent perhaps the most important tool for the board of directors and bank management to define underwriting standards and credit risk appetite."

Some institutions try to avoid having too much specificity in policy because they do not want to create too many policy exceptions or provide examiners or auditors with more opportunities to "catch" them in violation of their own policy. There certainly is such a thing as a policy that is too specific or detailed to be effective, as at a certain level of detail it is not possible for lenders and analysts to actually know or easily find all of the policy requirements. However, it is also important to recognize the risks that come with overly generic policies, primarily, the inability to effectively control the terms of credit extended and the possibility of regulatory concern about the bank's effectiveness in defining risk appetite and controlling risk.

The amount of detail is certainly not the only factor that determines the effectiveness of a credit policy. The content of the actual details certainly matters (a well-defined minimum debt service coverage ratio of 0.75 and maximum collateral advance rate against work-in-process inventory of 150%, for two extreme examples, are specific but do not effectively control credit risk). The organization and consistency of policy also matter, as a credit policy can only be effective if it is a usable tool for lenders and credit personnel.

Many credit policies at community banks have been in place for a long time, with small or ad hoc updates put in place as needed. Young & Associates, Inc. offers a policy review service that takes advantage of our exposure to the credit policies of many community banks around the country to evaluate the adequacy of a bank's policy and to make recommendations for enhancements. We will not tell you what your risk appetite should be, but we can and will assess the content of your policy against regulatory expectations, compare your specific risk limits to what is common across the industry so that you can have better information about where your risk appetite stands relative to peers, and evaluate the effectiveness of your policy's layout, language, and internal consistency.

If you would like to discuss the importance of credit policies or believe your institution may benefit from a policy review, please contact Tommy Troyer at ttroyer@younginc.com or 1.800.525.9775. ❑

# Capital Market Commentary

*By: Stephen Clinton, President, Capital Market Securities, Inc.*

## Market Update

The current expansion began in June 2009 and has now continued for 88 months, making it the fourth longest period of growth since the data has been recorded. The third quarter growth in the U.S. economy was 2.9%. A tight job market, increasing wages, and low oil prices are aiding the economic growth. Additionally, stronger export growth added to the GNP. Corporate profits are expected to grow and businesses are showing interest in business expansion after sitting on the sidelines for some time.

The following summarize certain issues we think are worth watching:

- Retail sales in September were up 2.7% from the prior year. Consumer spending, the primary driver for the U.S. economy, accounts for two-thirds of GDP.
- The number of Americans applying for first-time unemployment benefits was reported at a four-decade low in early October. Initial jobless claims have now remained below 300,000 for seven years, the longest streak since 1970. Job growth has been spurred by a hiring streak that surpassed its previous record in March and is now at 70 straight months. Unemployment is now at 5%.
- Median household incomes have risen, increasing 5% in the last year. This has led to the consumer confidence reading hitting its highest point in nine years.
- The Fed continues to remain cautious. Despite fueling expectations for rising interest rates, the Fed has boosted rates only once since the last recession.
- Home-price growth accelerated in August, as a lack of inventory and low interest rates helped push prices to near record levels. The S&P CoreLogic Case-Shiller Indices covering the entire nation rose 5.3% in the 12 months ending in August.
- Inflation has remained below the Fed's 2% annual target for more than four years, but has shown signs of firming recently. Now expectations are building that inflation may move above the Fed's target.
- Mr. Trump's November election will usher in a new President who will have party majorities in both the House and Senate. This should help the new Administration enact programs and policies more readily.

Short-term interest rates remain historically low with the 3-month T-Bill ending September at 0.26%. The 10-year T-Note ended September at 1.56%, down 71 basis points from year-end 2015. This has led to a significant reduction in the slope of the yield curve.

The stock market performance in 2016 has been positive. The Dow Jones Industrial Index closed September up 5.07% for the year. The Nasdaq Index closed up 6.08%. The Nasdaq Bank index ended September up 5.15%. Larger U.S. bank pricing struggled, ending the first three quarters of 2016 down 3.05%.

The dichotomy between big bank pricing and smaller bank pricing can be seen by comparing pricing multiples for each. Since 1995, banks in the S&P Bank Index averaged a price-to-earnings multiple of 14.1. Currently they average 12.0. Conversely, smaller banks had a historical average of 15.9 and are now trading at a multiple of 17.8.

## Interesting Tid Bits

- **New Competition.** Goldman Sachs, the Wall Street giant, recently began offering consumer loans. An online consumer lending platform was rolled out offering personal loans up to $30,000.
- **CFPB.** Thanks to a lawsuit brought by nonbank mortgage lender PHH Mortgage, a three-judge panel recently ruled that the single director structure of the CFPB was unconstitutional and limited the CFPB's ability to ignore statute of limitations governing administrative enforcement actions.



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- **The Big Get Bigger.** It was recently reported that since Dodd-Frank was passed in 2010, large banks have grown by 30%. The six largest U.S. banks now hold assets of approximately $10 trillion. There are now at least 1,500 fewer banks with assets under $1 billion than prior to the financial crisis.
- **Boom in Global Trade.** The S&P 500 is up nearly nine-fold since October 1986. Among factors cited to explain this dramatic growth is the acceleration of global trade spurred by various trade agreements.
- **Merger and Acquisition Activity.** In the first nine months of the year, there were 185 bank and thrift announced merger transactions. This compares to 195 deals in the first three quarters of 2015. The median price to tangible book for transactions involving bank sellers was 129% which is down from the 141% median recorded in 2015.

### Capital Market Services

Young & Associates, Inc. has been a resource for banks for 38 years. Through our affiliate, Capital Market Securities, Inc., we have assisted clients in a variety of capital market transactions. For more information on our capital market services, please contact Stephen Clinton at 1.800.376.8662 or sclinton@younginc.com. ❑

## Final Overtime Rule – Effective Date is December 1

Financial institutions should have already begun taking the steps to implement the new rules published by the Department of Labor (DOL) in the spring of 2016. The Final Overtime Rule applies to institutions covered by the Fair Labor Standards Act (FLSA) with an annual gross volume of sales made or business done of $500,000 or more and will have a significant impact on your business. *The effective date is December 1, 2016.*

Employers need to take the necessary steps to ensure compliance with the DOL and FLSA. Young & Associates, Inc. has developed a recorded webinar and a customizable policy for your financial institution. These products outline the steps needed to classify/reclassify employees, as well as detail time tracking requirements. Both the webinar and policy have been extensively researched and written specifically for financial institutions. There are several parts to this regulation, as well as several options for employers to be both compliant and cost-effective.

Being prepared and notifying employees of any changes will reduce the risk of damage to employee morale. Your institution needs to process the information in the regulation, determine what changes are necessary in your institution, and update internal pay and time tracking procedures by 12/1.

For more information or to order, click here or call or 1.800.525.9775. ❑

### FLSA Overtime Rule Products

- Overtime Final Rule and FLSA Implications for Financial Institutions Webinar – $225
- Fair Labor Standards Act (FLSA) – Overtime Rule Policy – $225
- FLSA Overtime Rule Package – $350 (Save $100!)

*See page 9 for more details.*

## Implementing a Threat Intelligence Program

*By: Mike Detrow, CISSP, Senior Consultant and Manager of IT*

As part of its continued focus on cybersecurity, the Federal Financial Institutions Examination Council's (FFIEC) September 2016 Information Security Handbook emphasizes the need for institutions to implement procedures for obtaining, monitoring, assessing, and responding to evolving threat and vulnerability information.

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Institutions have typically implemented a number of preventative controls such as firewalls, intrusion prevention systems, and antivirus applications to protect their information systems. However, these systems are not always effectively managed and monitored. Even in cases where perimeter devices are well managed and monitored, it is not uncommon to see security weaknesses within the internal network such as missing patches, system misconfigurations, and default passwords. Advanced attacks may not be prevented by perimeter network controls alone and may only be identified through information obtained from external intelligence sources and by monitoring internal detection systems.

An advanced attack typically follows these general steps to achieve the attacker's goal:

1. Active and passive reconnaissance is performed to learn about the target organization and to identify weaknesses.
2. Based on the identified weaknesses, the attacker obtains or develops malicious code and attempts to deliver this code to the organization through social engineering techniques, exploitation of vulnerable services or applications, or other means.
3. If the attacker is successful, malware and/or backdoors are then installed on the organization's systems for the attacker to establish control.
4. If needed, privilege escalation is performed through exploiting vulnerable systems or misconfigurations.
5. The attacker performs the intended activities, such as data exfiltration from the organization's information systems.

To comply with the FFIEC's guidance, financial institutions must implement a Threat Intelligence Program that documents the following:

- **Employee Responsibilities.** Employee responsibilities for monitoring, analysis, response, and reporting should be clearly defined to ensure accountability and appropriate approval for any recommended changes. In addition, the responsibilities for monitoring accounts with administrative capabilities should be documented to ensure independence.


- **Monitoring Threat Intelligence Sources.** External threat intelligence sources may include the Financial Services Information Sharing and Analysis Center (FS-ISAC), hardware vendors, or software vendors. Internal sources may include intrusion prevention systems, intrusion detection systems, firewall logs, server event logs, antivirus alerts, or a Security Information and Event Management (SIEM) system.

  The process for monitoring internal systems begins with the development of a network activity baseline, or in other words, an understanding of the normal daily activity within the institution's IT environment. Once the institution understands the baseline, monitoring systems can be implemented and tuned to provide alerts to activity that is outside of the baseline and requires additional analysis.

A list of the intelligence sources that are monitored and the procedures for monitoring these sources should be documented. Monitoring procedures may indicate that emails are sent to specific employees when an alert is issued or they may indicate that an employee reviews a system management console on a daily basis. Monitoring procedures may also indicate the process for determining the applicability of an alert to the institution's environment.

- **Analysis and Response.** Analysis and response procedures should identify the steps to be taken to assess the risk of a specific threat, determine a mitigation strategy, and implement the mitigation strategy.
- **Reporting.** Reporting procedures should identify the type and frequency of reports that will be provided to the board of directors to evaluate the effectiveness of the threat intelligence program. Reports may include a list of the threat notifications received, applicability to the financial institution, and management's responses to the applicable threats.



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## Conclusion

By implementing a Threat Intelligence Program and actively monitoring evolving threats, institutions can prevent or limit a threat's impact on the institution and its customers.

Young & Associates, Inc., has developed Threat Intelligence Program templates to assist with the implementation of a Threat Intelligence Program. For more information, see page 9 or click here ❑

# New Prepaid Rule

*By: Bill Elliott, CRCM, Senior Consultant and Manager of Compliance*

On October 5, 2016, the CFPB issued a final rule amending Regulations E and Z to create comprehensive consumer protections for prepaid financial products. The result of this rule is that many of you may not continue to offer these accounts, and those of you who do not currently offer the accounts may not want to start. The purpose of this article is not to talk you into or out of these products, but to give you the basic facts so that you can make the best decision for your institution.

The Prepaid Rule runs 1,501 pages, so we can only do an overview in this article. You may also want to look at the following: http://www.consumerfinance.gov/policy-compliance/guidance/implementation-guidance/prepaid

Another site worth your time might be: http://www.consumerfinance.gov/policy-compliance/rulemaking/final-rules/prepaid-accounts-under-electronic-fund-transfer-act-regulation-e-and-truth-lending-act-regulation-z/

## Prepaid Accounts

The Prepaid Rule adds the term "prepaid account" to the definition of "account" in Regulation E. Payroll card accounts and government benefit accounts are prepaid accounts under the Prepaid Rule's definition. Additionally, a prepaid account includes a product that is either of the following, unless a specific exclusion in the Prepaid Rule applies:

1. An account that is marketed or labeled as "prepaid" and is redeemable upon presentation at multiple, unaffiliated merchants for goods and services or usable at automated teller machines (ATMs); or
2. An account that meets *all* of the following:
   a. Is issued on a prepaid basis in a specified amount or is capable of being loaded with funds after issuance
   b. Whose primary function is to conduct transactions with multiple, unaffiliated merchants for goods or services, to conduct transactions at ATMs, or to conduct person-to-person (P2P) transfers
   c. Is not a checking account, a share draft account, or a negotiable order of withdrawal (NOW) account

There are exceptions to the rule. Under the existing definition of account in Regulation E, an account is subject to Regulation E if it is established primarily for a personal, household, or family purpose. Therefore, an account established for a commercial purpose is not a prepaid account.

## Pre-Acquisition Disclosures

The Prepaid Rule contains pre-acquisition disclosure requirements for prepaid accounts. The requirements are detailed. However, there often will be a reseller of these products, meaning that the seller must prepare this disclosure for you. This "short form" disclosure includes general information about the account.

Outside but in close proximity to the short form disclosure, a financial institution must disclose its name, the name of the prepaid account program, any purchase price for the prepaid account, and any fee for activating the prepaid account.

There is also a long form disclosure which sets forth comprehensive fee information as well as certain other key information about the prepaid account.

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The Prepaid Rule includes a sample form for the long form disclosure. The long form disclosure must include a long laundry list of items that details every nook and cranny of the account's use.

The Prepaid Rule also requires financial institutions to make disclosures on the access device for the prepaid account, such as a card. If the financial institution does not provide a physical access device for the prepaid account, it must include these disclosures on the website, mobile application, or other entry point the consumer uses to electronically access the prepaid account.

All these disclosures are in addition to your standard Regulation E initial disclosure. The initial disclosures must include all of the information required to be disclosed in the pre-acquisition long form disclosure.

## Error Resolution and Limitations on Liability

Prepaid accounts must comply with Regulation E's limited liability and error resolution requirements, with some modifications. This may or may not be your problem, depending on who owns the account. But if your third-party vendor must give the customer these rights, the cost will likely go up, possibly making selling these cards a problem.

## Periodic Statements and the Periodic Statement Alternative

The Prepaid Rule requires financial institutions to provide periodic statements for prepaid accounts, such as payroll accounts. However, a financial institution is not required to provide periodic statements for a prepaid account if it makes certain information available to a consumer, such as:

- Account balance information by telephone
- Electronic account transaction histories for the last 12 months
- Written account transaction histories for the last 24 months

## Overdraft Credit Features

The Prepaid Rule amends Regulations E and Z to regulate overdraft credit features that are offered in connection with prepaid accounts. It adds the term "hybrid prepaid credit card" to Regulation Z and sets forth specific requirements that apply to hybrid prepaid-credit cards. Doing something like this will materially increase your costs. Of course, there are many more rules on the subject that we cannot include in this article.

## Effective Dates

The Prepaid Rule is generally effective on October 1, 2017.

## What Should You Do?

Over the next few months, you need to talk with any existing companies that you do business with for this kind of product. They may still be struggling with how they are going to approach this, so you may not get all your answers immediately. But you need to know what your role is going to be after October 1, 2017 so that you can make the best decision for your institution. And all new product offerings, whether internal or external, need to be examined carefully to make sure that you can comply with the rules.

For more information about this article, contact Bill Elliott at 1.800.525.9775 or compliance@younginc.com. ❑

## FLSA Overtime Rule Products

### Final Overtime Rule and FLSA Implications of Financial Institutions Webinar (#320) – $225

This Webinar focuses on the Final Overtime Rule, including FLSA wage and hour implications. It also provides instructions in terms of next steps/options, recommendations for implementation, and the impact to your institution moving forward. The webinar is approximately 45 minutes in length and will allow you to create a comprehensive plan to address the new law.

### Fair Labor Standards Act (FLSA) – Overtime Rule Policy (#321) – $225

Designed to be a management tool to help institutions address the most recent FLSA changes, specifically, the Final Overtime Rule. The language contained in this policy supports the changes, and can easily be integrated into your policy manual. Provides you with a background of the pertinent exemptions criteria necessary to re-evaluate job classifications. Includes sections on overtime approval and violation, payroll recordkeeping and retention, and the timekeeping process. Management can easily prepare language for communicating this change to employees by utilizing the section on communication planning.

### Final Overtime Rule Package (#322) – $350
***Save $100!***

Although both the Final Overtime Rule Webinar and Policy can be purchased separately, these two products have been designed to go hand-in-hand and are a perfect complement to one another. They can be purchased as a package at a $100 savings.

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### Military Lending Policy (#323) – $150

This policy outlines the objective of the Military Lending Act to extend protections to a broader range of closed-end and open-end products. Includes information on the MAPR, disclosure requirements, limitations, and interpretations of the Department of Defense.



### Cybersecurity Assessment Workbook (#310) – $249

Evaluate your institution's Inherent Risk Profile and identify your current Cybersecurity Maturity Level using the FFIEC's Cybersecurity Assessment Tool. Allows you complete the tool and generate the needed summaries for analysis and board reporting.

- **Inherent Risk Profile:** Includes 5 worksheets for the 5 categories of inherent risk identified in the Cybersecurity Assessment Tool. Includes a summary worksheet to identy an Overall Inherent Risk Profile.
- **Cybersecurity Maturity Level:** Includes 5 worksheets for the 5 domains identified by the Cybersecurity Assessment Tool. A summary worksheet for each of the five domains allows the reviewer to identify the maturity level for each domain.

***Easy to Use and Understand***

All required data entry is completed through the use of simple drop down boxes and provisions are included to allow the reviewer to enter notes and comments as needed throughout the workbook. Colorful summaries simplify analysis and can be included for board reporting.

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### Threat Intelligence Program (#324) – $299

***Includes:***

- **Threat Intelligence Program:** Documents the requirements for the institution's threat intelligence program, including threat intelligence sources, the monitoring process, the analysis and response process, documentation requirements, and the reporting process
- **Threat Tracking Summary Worksheet:** Microsoft® Excel-based workbook for tracking threat notifications and responses
- **Threat Tracking Detail Worksheet:** Microsoft Word-based worksheet for tracking details about the threat analysis and response process performed for each specific threat
- **Information Systems Event Management Policy**: Policy template that documents the requirements for information systems event management procedures
- **Event Management Procedures for Specific Systems Worksheet:** Excel-based workbook for documenting the event management procedures for each information system

***System Requirements: Microsoft Word 2007 and Excel 2007 or higher***