90 Day Note

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A Look to the Future

By: Jerry Sutherin, President & CEO, Young & Associates, Inc.

On January 31, 2018, I was fortunate to have the opportunity to purchase Young & Associates, Inc. from Mr. Gary Young, the company's founder and current Chairman. Nearly 40 years ago, Gary created this organization with a vision of providing community banks with consulting services that were typically cost-prohibitive to perform internally. Since its inception in 1978, Young & Associates has evolved from a small start-up organization offering select outsourcing and educational services to one of the premier bank consulting firms with clients nationwide and overseas. We now offer consulting, education, and outsourcing services for nearly every aspect of banking.

From the outset of our acquisition discussions, Gary and I agreed that the greatest asset of the company is its employees. Over the years, not only has Gary developed unique servicing platforms for the industry but more importantly, he has assembled an employee base that is second to none. These employees provide a level of expertise and service to our clients that remains unparalleled in the community banking industry.

To quote Gary, "I founded Young & Associates with the goal of assisting community banks while maintaining a family atmosphere that valued and respected the people that I work with." Going forward, it is my primary objective to carry on this legacy that Gary has created. I look forward to making this a seamless transition building on the solid foundation that Gary has built over the years. With the work of our employees and support of our clients, there is no doubt that Gary's legacy will continue for years to come.

Although the ownership of Young & Associates, Inc. has changed, the company's name, mission, personnel, quality of service, and structure will not change in any way. Gary now serves as Chairman of the Board and will remain actively involved with the business through January 2019, providing the same high-quality service while also assisting me with the transition. In addition to ensuring a smooth internal transition, Gary and I remain focused on making sure that the relationship with our clients remains strong. Existing and new clients are encouraged to contact me, Gary, or any of our consultants to discuss this transition and how we might be able to earn your business. ❑

Liquidity Risk Management

By: Martina Dowidchuk, Senior Consultant

Does your liquidity management meet the standards of increased regulatory scrutiny?

What was once deemed acceptable is gradually coming under a more rigid review, and financial institutions need to be prepared to show that their liquidity risk oversight complies with both supervisory guidance and sound industry practices.

The liquidity risk may not be among the areas of community banks' immediate concern given the abundance of liquidity in the banking industry today. However, the history shows that liquidity reserves can change quickly and the changes may occur outside of management's control. A bank's liquidity position may be adequate under certain operating environments, yet be insufficient under adverse environments. Adequate liquidity governance is considered as important as the bank's liquidity position. While the sophistication of the liquidity measurement tools varies with the bank's complexity and risk profiles, all institutions are expected to have a formal

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liquidity policy and contingency funding plan that are supported by a liquidity cash flow forecast, projected liquidity position analysis, stress testing, and dynamic liquidity metrics customized to match the bank's balance sheets.

Some of the common liquidity risk management pitfalls found during annual independent reviews include:

Cash Flow Plan

- Lack of projected cash flow analysis
- Inconsistencies between liquidity cash flow assumptions and strategic plan/budget
- Lack of documentation supporting liquidity plan assumptions
- Overdependence on outdated static liquidity ratios and lack of forward-looking metrics
- Lack of back-testing of the model

Stress Scenarios

- Stress testing of projected cash flows not performed
- Stress tests focusing on a single stress event rather than a combination of stress factors
- Stress tests lacking the assessment of a liquidity crisis impact on contingent funding sources
- Insufficient severity of stress tests

Contingency Funding Plan Document

- Contingency funding plan failing to address certain key components, such as the identification of early warning indicators, alternative funding sources, crisis management team, and action plan details
- Lack of metrics defined to assess the adequacy of primary and contingent funding sources in the baseline and stressed scenarios

Liquidity Policy

- Inadequate risk limits or lack of acceptable levels of funding concentrations defined in the liquidity policy
- Liquidity policy failing to address responsibilities for maintenance of the cash flow model, model documentation, periodic assumption review, and model validation

Management Oversight

- ALCO discussions related to liquidity management not containing sufficient detail and not reflected appropriately in the ALCO meeting minutes
- Lack of periodic testing of the stand-by funding lines
- Lack of liquidity model assumption review or documentation of such review
- Lack of periodic independent reviews of the liquidity risk management process

If you are interested in an independent review of your existing liquidity program and a model validation or are looking for assistance with developing a contingency funding plan, liquidity cash flow plan, and liquidity stress testing, please contact me at 1.800.525.9775 or mdowidchuk@younginc.com. Young & Associates, Inc. offers an array of liquidity products and services that can help you to ensure compliance with the latest regulatory expectations. ❑

Changes to the Appraisal Threshold

By: Kyle Curtis, Senior Consultant

The OCC, Federal Reserve Board, and FDIC (collectively, the agencies) have adopted a final rule to amend the agencies' regulations requiring appraisals of real estate for certain transactions. The final rule increases the threshold level at or below which appraisals are not required for commercial real estate

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transactions from $250,000 to $500,000. The final rule defines commercial real estate transaction as a real estate-related financial transaction that is not secured by a single 1-to-4 family residential property. It excludes all transactions secured by a single 1-to-4 family residential property, and thus construction loans secured by a single 1-to-4 family residential property are excluded. For commercial real estate transactions exempted from the appraisal requirement as a result of the revised threshold, regulated institutions must obtain an evaluation of the real property collateral that is consistent with safe and sound banking practices.

The agencies have adopted a definition of commercial real estate transaction that excludes construction loans secured by single l-to-4 family residential properties. Specifically, the final rule defines commercial real estate transaction as a real estate-related financial transaction that is not secured by a single 1-to-4 family residential property. This definition eliminates the distinction between construction loans secured by a single l-to-4 family residential property that only finance construction and those that provide both construction and permanent financing. Under the definition in the final rule, neither of these types of loans will be commercial real estate transactions; they will both remain subject to the $250,000 threshold. However, a loan that is secured by **multiple 1-to-4 family residential properties** (for example, a loan to construct multiple properties in a residential neighborhood) would meet the definition of commercial real estate transaction and thus be subject to the higher threshold.

Evaluations

With the increase in the threshold, it is expected that many institutions will now utilize internal staff to prepare evaluations for commercial transactions that are less than $500,000, so it might be time to revisit the *Interagency Appraisal and Evaluation Guidelines* (Federal Register, Vol. 75, No. 237), as well as the *Interagency Advisory on Use of Evaluations in Real Estate-Related Financial Transactions* (FDIC, FIL 16-016). While the Guidelines state that an evaluation is not required to be completed by a state-licensed or state-certified appraiser or to comply with USPAP, the evaluation preparer should, however, be knowledgeable, competent, and independent of the transaction and the loan production function of the institution. Evaluations may be completed by a bank employee or by a third party. In smaller communities, bankers and third-party real estate professionals have access to local market information and may be qualified to prepare evaluations for an institution.

An evaluation should provide a reliable estimate of the market value of the property and, therefore, the approach or approaches used in an evaluation should be appropriate to the property being valued, and the intended use, so it may be appropriate to omit one or more of the three approaches to value. If the income approach is the primary approach for a tenant-occupied, income-producing property, it may be appropriate to omit the sales comparison approach and the cost approach. Similarly, if the sales comparison approach is the primary approach for a single family residence or an owner occupied commercial property, it may be appropriate to omit the cost approach and the income approach.

The Guidelines provide information regarding the minimum content that should be contained in an evaluation. Unlike an appraisal report that must be written in conformity with the requirements of USPAP, there is no standard format for documenting the information and analysis performed to reach a market value conclusion, but like an appraisal report, the evaluation should contain sufficient information to allow a reader to understand the analysis that was performed to support the value conclusion and the institution's decision to engage in the transaction.

Young & Associates, Inc. offers a Third-party Appraisal Review service designed to provide financial institutions with a qualified, independent review of appraisals, consistent with the requirements listed in the *2010 Interagency Appraisal and Evaluation Guidelines*. For more information on this article or the interpretation of the appraisal guidelines, contact Kyle Curtis at kcurtis@younginc.com or 330.422.3445. ❑

40 YEARS
1978 - 2018

Assessing Management Skills in Agricultural Borrowers

By: Robert Viering, Senior Consultant & Lending Department Manager

In our loan review practice we have seen an overall deterioration in farm financial results. However, we have noted that there are borrowers that are still providing reasonable returns and acceptable debt service coverage ratios. Our anecdotal observations have been confirmed by data from farm financial databases from farms in the Midwest. In his blog post in the December 19, 2017 *Corn + Soybean Digest,* Dr. David Kohl observed, "Regardless of farm size or enterprise, the gap between the top one-third of economic performers and the bottom one-third is widening. Among the most profitable, common practices include strong production, a drive towards efficiency, and an executed marketing and risk management." My interpretation of his comment can be simplified to: Management skills count.

In our loan review client banks, management skills may be a part of the bank's risk rating model, but how management skills are determined varies widely. All too often most borrowers are rated as having good management skills even if their financial results put them in the bottom third of financial performance. Based on my 30+ years as a banker and now as a loan review professional, management skills are what separates the top and bottom producers. The question becomes, how do we assess the management skills of our borrowers? While there are no hard and fast rules, there are several attributes that can often help in making an assessment of management skills.

"All too often most borrowers are rated as having good management skills even if their financial results put them in the bottom third of financial performance."

The following are items to consider when assessing management skills:

- **Production competency.** On the production side, you will want to honestly assess how their level of production compares to others with similar operations. As an example, if they are consistently producing more bushels of corn per acre than similar farms in your market, then their skills should be rated higher than an operation with more variable results or certainly better than those that are consistently below their peers. You will want to consider if their equipment line/livestock production facilities are appropriate for the scale and sophistication of their operation.
- **Financial competency.** Questions for you to consider to determine financial competency include: Are you provided accurate, thorough, and timely financial information? Are the cash-flow projections reasonable and based on sound assumptions (you will need to back test borrower's cash flows to actual results to assess this attribute)? Does the producer understand the financial implications of their decisions?
- **Risk management.** Risk management is about protecting what you have and limiting your downside. Among the items to assess include whether they are carrying adequate crop insurance. This can include whether they can cover the difference between what insurance pays and what they expected to produce. Other questions that are important to consider include: Does the borrower have a marketing plan? Do they make good use of hedging strategies? A good marketing plan can help pick up some additional income while limiting the downside of market volatility.
- **Intangible skills.** There are a few other items that should be considered that are difficult to quantify but are important to consider. Among the items to ask are: Are they willing to make tough decisions? This is often about expenses and includes the ability to reduce family living, reduce labor costs (even if it means a family member may have to leave the operation), or any other decisions that may not be popular or easy but may be required to succeed. Do they have a long-term vision of where they want to go? Even if they are not considering doing anything different, that is still a strategy that has its risks. Are they realistic in their understanding of their operation's strengths and weaknesses? Are they open to taking advice from outside experts to improve their operation? Do they have any trusted advisors that they use? If applicable, do they have a plan to transition to the next generation? If so, do they have an understanding of the next generation's strengths/weaknesses and the risks in their transition plan?

Agriculture is like all other types of business: good management is critical to long-term success and especially to getting through more challenging times like today.

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As a bank, having a good understanding of the borrower's management skills is an important aspect of knowing the level of risk in a borrower. We encourage banks to make a thorough assessment of a farm operator's management skills, especially today as management skills can often be the difference between long-term success and just surviving, or even the difference between just surviving and having to quit farming.

For more information on this article, contact Bob Viering at bviering@younginc.com or 1.800.525.9775. ❑

The CFPB in the Future

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

With the change in management of the CFPB, we are seeing changes in how they operate. When they published their Regulatory Agenda for Fall 2017 (late as usual – it appeared in January 2018), they restated what Section 1021 of the Dodd-Frank Act specified as the objectives of the Bureau, including:

- Providing consumers with timely and understandable information to make responsible decisions about financial transactions
- Protecting consumers from unfair, deceptive, or abusive acts and practices and from discrimination
- Addressing outdated, unnecessary, or unduly burdensome regulations
- Enforcing federal consumer financial law consistently in order to promote fair competition, without regard to the status of a covered person as a depository institution
- Promoting the transparent and efficient operation of markets for consumer financial products and services to facilitate access and innovation

They stated that their work in pursuit of those objectives can be grouped into three main categories:

1. Implementating statutory directives
2. Other efforts to address market failures, facilitate fair competition among financial services providers, and improve consumer understanding
3. Modernizing, clarifying, and streamlining consumer financial regulations to reduce unwarranted regulatory burdens

Implementing Statutory Directives

In this area, the CFPB is continuing efforts to facilitate implementation of critical consumer protections under the Dodd-Frank Act. They listed three efforts under way. They include:

- Regulation C (Home Mortgage Disclosure Act)
- Mortgage servicing changes
- Continuing to improve the TRID portion of Regulation Z

The CFPB also listed other projects that are "in the works," but probably nowhere near completion.

Other Efforts To Address Market Failures, Facilitate Fair Competition among Financial Services Providers, and Improve Consumer Understanding

In this area, the CFPB said they were considering rules, such as:

- Payday loans, auto title loans, and other similar credit products
- Debt collection
- Overdraft programs on checking accounts
- Prepaid financial products
- Modernizing, streamlining, and clarifying consumer financial regulations

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Many of the regulations are approaching 50 years old and are out of date with the current world. For instance, Regulation B allows you to turn down a customer for not having a land line phone in the home. That was fine in the 1970s, but probably not relevant now. Updating this and many other regulations is overdue, including looking at the effectiveness of some of the more recent changes, which they say they will be doing.

Conclusion

We will have to wait and see what happens. As with all bureaucracies, and based on their past performance, changes are likely to appear slowly. In general, it appears that "new regulations" may slow down a bit, giving us in the industry a chance to catch up.

Young & Associates, Inc. offers a wide variety of compliance services to help your bank satisfy these compliance requirements. If we can help you "catch up" or improve your response to any of the regulations, we stand ready to assist. Please contact Karen Clower, Compliance Operations Manager, at kclower@younginc.com or 330.422.3444 and she will be happy to discuss our services with you. ❑

The Value of Internal Audit Through a Fresh Set of Eyes

By: Jeanette McKeever, CCBIA, Consultant & Internal Audit Operations Manager

There is risk in every aspect of the banking industry and the regulatory environment seems to continually change. As to the governance and control functions of the banking industry, it may be refreshing to the board of directors, audit committee, and executive management to have their internal audit function re-assessed and validated though a fresh set of eyes to assure that the controls in place are functioning as intended.

A strong internal control system, including an independent and effective internal audit function, is part of sound corporate governance. The board of directors, audit committee, senior management, and supervisors must be satisfied with the effectiveness of the bank's internal audit function, that policies and practices are followed, and that management takes appropriate and timely corrective action in response to internal control weaknesses identified by internal auditors. An internal audit function provides vital assurance to a bank's board of directors (which ultimately remains responsible for the internal audit function, whether in-house or outsourced) as to the quality of the bank's internal control system. In doing so, the function helps reduce the risk of loss and reputational damage to the bank.

All internal auditors (whether in-house or outsourced) must have integrity and professional competence, including the knowledge and experience of each internal auditor and of team members collectively. This is essential to the effectiveness of the internal audit function.

We encourage bank internal auditors to comply with national professional standards, such as those issued by the Institute of Internal Auditors, and to promote due consideration of prudent issues in the development of internal audit standards and practices.

The scope of the internal audit function's activities should ensure adequate coverage of matters of regulatory interest within the bank's audit plan. Regular communication by the audit committee, management, and affected personnel is crucial to identify the weaknesses and risk associated to assure that timely remedial actions are taken.

Young & Associates, Inc. can independently assess the effectiveness and efficiency of the bank's internal controls and processes to provide value and assurance that the internal control structure in place operates according to sound principles and standards.

For more information on how we might provide internal audit services specific to your bank's needs, whether it is outsourced or co-sourced, please contact me at 1.800.525.9775 or e-mail jmckeever@younginc.com. ❑

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Capital Planning System

Assess capital adequacy in relation to your bank's overall risk and develop a customized capital plan for maintaining appropriate capital levels in all economic environments. Addresses the impact of growing cybersecurity risks, as well as the impact of the anticipated tax reduction from a capital planning perspective.

Allows you to:

Develop a base case scenario in which minimum capital adequacy standards are established.

Identify and evaluate risk for your bank. Parameters in this analysis have been field-tested in our work with banks over the years and closely resemble adequacy standards established in consent orders.

Stress test capital by loan classification (as recommended by the FDIC and OCC).

Perform contingency planning for stressed events. All assumptions are stressed to determine the amount of capital needed and possibilities for increasing capital are examined.

Generate your capital plan in as little as 1 day. Data from the Microsoft® Excel spreadsheets can be easily transferred directly into a Word document that can be customized to fit the unique circumstances at your bank.

First Year License Fee (#304) – $1,095

Update/Annual License (#306) – $495

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

HMDA Survival Toolkit (#294) – $595

Ensure that your bank's HMDA data is acccurate prior to submission and that bank policies and procedures comply witht the January 2018 requirements.

Includes:

- **2018 HMDA Survival Guide:** A consolidation of the 2015 Final Rule, 2017 amendments, and the Official Commentary
- **Customizable HMDA Policy:** Updated to incorporate the new requirements effective January 1, 2018
- **HMDA PowerPoint Presentation:** Designed to train staff on the new HMDA requirements. Customize to fit your bank's HMDA process.
- **Data Integrity:** Includes the banking agencies' transaction testing guidelines and designated key data fields
- **Compliance Review Model:** Excel spreadsheet designed to facilitate a review of your compliance with the new HMDA requirements
- **Sample HMDA Review Report Template:** Document your compliance review with this report template. Edit to include the review scope, relevant findings, and recommendations regarding data integrity, as well as disclosure and notice requirements.
- **Reference Guide:** Provides links to CFPB's resources for HMDA filers and other agency information

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

Customizable Bank Policies

Young & Associates, Inc. has developed over 95 practical bank policies designed specifically for community banks that will ease the burden of developing bank policies from scratch.

- **Bank Secrecy and Anti-Money Laundering Policy (#109) - $350**
- **Customer Identification Program Policy (#217) - $195**
- **ADA Website Accessibility Accommodations (#327) - $125**
- **Cybersecurity (#313) – $195**
- **Identity Theft (#224) – $250**
- **Complete List of Available Policies –** management, lending, and compliance topics