

The Regulatory Focus

Phone: 614-728-8400

Fax: 614-644-1631

Email: Web.dfi@com.ohio.gov



A Message from Superintendent Allard

Welcome to the Autumn edition of The Regulatory Focus. As you know, since February 2011, I have served as Deputy Superintendent for Banks and Savings and Loan Associations and Savings Banks. Earlier this year, I was honored to be appointed as Superintendent of DFI. In this new role, I look forward to continued interaction with the banking industry, providing information on current regulatory topics, participating at outreach events and updating you on changes as a result of recently passed legislation.

Later this year, we have a full slate of outreach events planned, including a one-day training session for Bank Directors on October 26 featuring banking attorney and consultant Philip Smith, and regional roundtables - dates and locations will be provided in the near future. And, for those planning for next year, the 2018 Ohio Bankers Day program will be held on April 12, 2018. Last, but certainly not least, we will be partnering with the Ohio Bankers League to participate in their upcoming regional training sessions on statutory changes resulting from the enactment of Bank Modernization legislation.

I would like to take this opportunity to personally thank both current and former members of the Ohio Banking Commission and the Ohio Savings and Loan Associations and Savings Banks Board (see page 4).

These boards have been invaluable in various ways, and the members provide an important advisory

role to the Division. As a result of legislation, the two boards will be combined into one, and I look forward to working with the current members to make this transition.

I hope you find this edition of The Regulatory Focus of value, as it includes articles on Commercial Real Estate Lending & Concentrations, changes to Pledging for Public Funds and the addition of Strategic risk to the examination focus.

If you have any questions on these or any other topics, please feel free to contact me directly at Kevin.Allard@com.ohio.gov or 614-728-2631.

In This Issue:

- Superintendent Message.....1
- Real Estate Lending.....2
- Public Funds.....3
- Strategic Risk.....4

Commercial Real Estate Lending & Concentrations: Common Misconceptions

Commercial real estate (CRE) lending is a topic that no one in the banking industry can escape. Whether attending a seminar, listening to a roundtable discussion or simply reading industry news, the risks associated with CRE lending and the need for commensurate risk management practices are guaranteed to be part of the dialogue. Despite the various sources of information, misconceptions about the guidance and examiner expectations still exist.

Misconception #1

CRE concentrations, in excess of regulatory thresholds, are cause for supervisory action.

While it is true that higher concentrations in CRE lending will lead to increased regulatory scrutiny, CRE concentrations in excess of regulatory thresholds will not automatically lead to supervisory action. Examiners are tasked with evaluating the totality of the situation, and a number of factors will be considered in addition to the concentration level. For example, does the lending staff have adequate experience and expertise to manage the risk within the portfolio? Are proper systems in place to identify, measure, monitor and control the heightened level risk from the concentration? Is aggregate compensation received commensurate with heightened exposure? Are concentration levels within board approved limits and is the board monitoring the exposure on a regular basis?

Misconception #2

CRE concentrations below regulatory thresholds are not a cause for supervisory concern.

As stated above, CRE concentrations in excess of regulatory thresholds will not automatically lead to supervisory action. The reverse is also true, as CRE concentrations below regulatory thresholds may still be a cause of supervisory concern. Again, it is up to examiners to evaluate the whole situation and consider factors in addition to the concentration level. For example, has lending activity been steady or is it growing? Is the portfolio comprised of loans within the bank's general lending area and the lending expertise of management? Does the strategic plan call for growth outside

of historical norms? Is the bank's management information systems scalable to accommodate planned growth? Has the board established appropriate policies and parameters to control the risk?

Misconception #3

Nothing in the CRE guidance is applicable to owner-occupied nonfarm nonresidential properties.

Although it is technically true that owner-occupied properties were excluded from interagency guidance, because the income or value of the property is not the primary source of repayment, the concept of establishing sound risk management principles for this segment of the loan portfolio is not so different from non-owner occupied properties. Just like the non-owner occupied portfolio, the board should establish limits and receive regular updates on the portfolio's performance; management information systems should be sophisticated enough to identify, measure, monitor and control portfolio risk; and the portfolio should be sufficiently stressed to quantify the impact of changing economic conditions on asset quality, earnings and capital. Additionally, in situations in which the characteristics of the owner-occupied portfolio mirror those of the non-owner occupied portfolio, it may be prudent to combine the portfolios and obtain a holistic view.

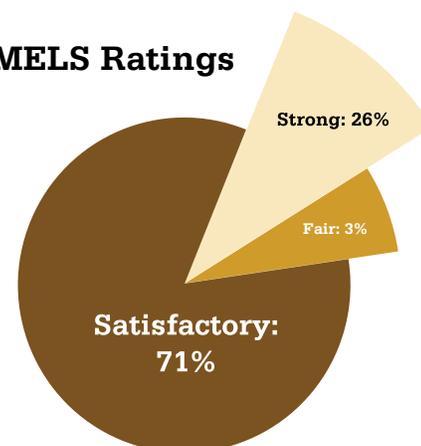
In summary, examiners evaluate whether the general risk management processes for CRE are appropriate for the complexity of your bank's portfolio. The regulatory guidance does not establish limits, but instead promotes sound practices and capital levels to engage in CRE lending in a safe and sound manner. Management and board oversight, portfolio management, management information systems, market analysis, credit underwriting standards, portfolio stress testing and sensitivity analysis, and the credit review function should all be tailored to your specific needs, and will be analyzed as such. If ever in doubt about supervisory guidance, please reach out to your state or federal regulators and ask for clarification.

FY 2017: Another Banner Year

Fiscal Year 2017 (July 1, 2016 – June 30, 2017) was another great year for Commerce and the financial industry. The Division of Financial Institutions and its stakeholders had a strong FY 2017, including positive CAMELS ratings and welcoming two new state-chartered institutions.

Read more in the Commerce Annual Report:
http://www.com.state.oh.us/documents/comm_AnnualReport2017.pdf

CAMELS Ratings



Big Changes in Pledging to Public Funds are Coming

On July 1, 2017, the pooling method by which most financial institutions collateralize public deposits was changed significantly. It was replaced with the Ohio Pooled Collateral System (“OPCS”). The new program requires pooled securities to be pledged to the Treasurer of State (“Treasurer”) for all state and local public deposits. It shifts the burden for managing pledged collateral from the public units to the Treasurer, who is the sole administrator and monitor of OPCS.

Public depositories have an important choice to make. They may elect either pooled pledging using this new program, or single issue pledging to secure the uninsured portion of public funds. The procedures for single issue pledging remain the same, and no action by the financial institution is needed.

On July 1, 2017, OPCS became fully functional. A financial institution may start using the OPCS immediately if it meets the minimum requirements under § 135.182 of the Ohio Revised Code (codes.ohio.gov/orc/135.182). If a financial institution wants to request a grace period until December 31, 2017, (or at a later date as otherwise determined by the treasurer) in which to transition to OPCS, a certified letter of intent must be submitted to the Treasurer no later than June 30, 2017, affirming the financial institution’s commitment to apply to OPCS. If a financial institution does not want to use OPCS for pooling, it must be compliant with the specific pledge method as of July 1, 2017, described in Ohio Revised Code § 135.18 (codes.ohio.gov/orc/135.18) and § 135.37 (codes.ohio.gov/orc/135.37). Specific pledging can be cumbersome depending upon the volume and volatility of the deposit levels. This method requires specific securities, with a market value of 105 percent, to be pledged to the uninsured portion of individual public deposits.

Institutions participating in the OPCS will collateralize deposits with a pool of securities with a market value of at least 102 percent of the uninsured deposits. OPCS allows for lower collateral amounts under certain conditions. Based upon the consent of the public unit and an analysis of the depository by the Treasurer’s Office, the collateral rate for the financial institution could be as low as 50 percent. This could mean fewer securities required, thereby potentially increasing liquidity.

For a financial institution to qualify for lower collateral thresholds, the Treasurer’s Office will conduct an

evaluation of publicly available financial information to assess the condition of the institution. A quarterly analysis will be conducted thereafter to monitor the institution. The Treasurer’s Office is not entitled to, and should not request, any confidential information arising from an examination from regulatory agencies or the financial institution. This would include ratings, findings and/or the existence, contents or termination of any informal, non-public enforcement action (e.g., Board Resolution or Memorandum of Understanding). The Division will not provide any confidential examination-related information to the Treasurer.

On a daily basis, participating institutions will upload public deposit information to the Treasurer’s Office through a secure portal or SFTP (Secure File Transfer Protocol) connection. The collateral trustee will provide collateral detail daily, and it will be priced by the treasurer’s office. The Treasurer’s Office will monitor balances and collateral coverage for any shortfall. Some institutions use a Letter of Credit (“LOC”) from the Federal Home Loan Bank to collateralize public funds. This can still be done, but the LOC would be pledged to the Treasurer instead of the public entities.

It is important financial institutions understand the new program when deciding which method is right for them. For more information, questions or concerns, please contact Lizz Lewis at the Treasurer’s Office at **614-995-3773** or **constituentsaffairs@tos.ohio.gov**.



Strategic Risk to Be Added to Examination Process

The current examination process, along with the analysis of the CAMELS components, includes a review of six risk areas. The current risk areas reviewed include:

- Credit risk
- Legal risk
- Market risk
- Operational risk
- Reputational risk
- Liquidity risk

The examination process, like the banking industry, continues to evolve and changes are being made to the process in order to stay relevant with risks affecting the banks under supervision. One of these changes involves the risk management section and risk matrix in the Report of Examination. The Ohio Division of Financial Institutions is implementing the assessment of strategic risk and will be removing reputational risk from the examination process.

Strategic risk arises from adverse business decisions, improper implementation of decisions or lack of responsiveness to industry changes. This risk is a function of the compatibility of an organization's strategic goals, the business strategies developed to achieve those goals, the resources deployed to support the goals and the quality of implementation. The resources needed to carry out business strategies are both tangible and intangible. They include communication channels, operating systems, delivery networks, and managerial capacities and capabilities. The organization's internal characteristics must be evaluated against the impact of economic, technological, competitive, regulatory and other environmental changes.

The Office of Comptroller of Currency also reviews strategic risk in its examination process and defines strategic risk as "the risk to current or anticipated earnings, capital, or franchise value arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to industry changes." Strategic risk focuses on more than just an analysis of your bank's written strategic plan. Other considerations include whether the board has adopted policies that are consistent with the bank's business strategies, initiatives are supported by sufficient capital, and goals are effectively articulated and communicated. Strategic risk also incorporates how bank management analyzes external factors that affect the bank's strategic direction.

Actions that could affect strategic risk include entry into a new market, the opening of a branch or loan production office, initiation of a new loan product, deciding to cease or not offer a product or service. Entering new lines of business without a well-defined strategy, thorough due diligence, appropriate risk controls or sufficient capital are common pitfalls. All community banks need some degree of strategic planning tailored to each bank's size and complexity.

Starting this summer, examiners begin evaluating the level and trend of strategic risk, as well as the adequacy of risk management, similar to what is done with the other risk areas of credit, market, liquidity, operational and legal. The risk evaluation will begin during the pre-examination scoping process and continue through the on-site portion of the examination.

How To Contact Us

77 South High Street
21st Floor
Columbus, Ohio 43215-6120

Tel: 614-728-8400
Fax: 614-644-1631
TTY/TDD: 800-750-0750

www.com.ohio.gov/fiin
E-mail: webdfi@dfi.com.ohio.gov

Kevin Allard, Superintendent
Kevin.Allard@com.ohio.gov
614-728-2631

Sheila Schroer, Chief Examiner
Sheila.Schroer@com.ohio.gov
614-644-6228

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Ohio Banking Commission

Kevin Allard: Chairman, Division of Financial Institutions

John Brown: President/CEO, Security National Bank, Springfield

Mark Klein: President/CEO, The State Bank & Trust Co., Defiance

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