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The Regulatory Focus

A Message from Superintendent Kevin Allard

Welcome again to **The Regulatory Focus**.
As Superintendent, it is very important to me that the division continues to be accessible to you as a regulator, and that we strengthen and improve our relationships with regulated entities and stakeholders. In 2018, our continued emphasis will be placed on outreach and training opportunities, specifically regional round tables and our Ohio Bankers Day program. Through regular meetings with industry trade associations, use of social media, and improved functionality of our website, our priority is to keep Ohio's banking industry connected and informed. If you have any suggestions in this regard, please feel free to contact me.

As you know, our 2018 Ohio Bankers Day program is coming up April 11 and 12 at The Hilton Columbus at Easton. I am very excited about this year's program. We will have speakers and panel discussions on topics not only important from a banking perspective, but continue to be top of mind for society as a whole. The general session will include discussions on the economy and commercial real estate, as well as what bankers need to know about insider fraud.
After, we will provide three learning labs, the first will discuss how community banks can plug into Fintech ideas and build an innovation capacity. The second lab will be a panel discussion on the effects of the opioid epidemic on the workplace and community. Lastly, the third session will focus specifically on what banks should do to prepare for an active aggressor, which differs from a bank robber. With management succession always being of concern, our luncheon speaker will focus on preparing the Millennial generation to be the next wave of leaders.

I look forward to seeing many of you at our Bankers Day program, and if you have any questions on these or any other topics, please feel free to contact me directly at **(614) 728-2631** or **email at Kevin.Allard@com.ohio.gov.**

In This Issue:

"Getting to Know You"
By Ingrid White

I have gotten to know many Ohio bankers already in my brief four months as Deputy Superintendent for Banks, but for those I have not met, this will serve as a short introduction. Although I'm originally from Columbus, I left 24 years ago to follow my military husband to England, Boston and then New Hampshire. In my early law firm career, I was assigned to work with many bank clients on corporate and compliance matters, such as developing GLB-compliant privacy statements and policies, and NDIP programs. I joined the New Hampshire Banking Department in the fall of 2008, where I answered legal questions for the bank and credit union examiners, drafted rules and legislation, and handled consumer complaints. (Fortunately, during the recession, New Hampshire did not suffer any bank failures, although we did have to liquidate a state-chartered trust company, which was running a Ponzi scheme. When I left the Department in 2017, the unwinding of that company was still ongoing.) In 2012, I was promoted to the General Counsel for the Department, and in 2013 I was appointed by Governor Hassan as the Deputy Commissioner. One of the highlights of my career at the Department was being involved in the passage of Senate Bill 188 (2015) which significantly modernized and streamlined New Hampshire's banking laws.

Since joining the Ohio **Division of Financial Institutions,** I have learned the problems facing Ohio bankers, and bank regulators, are very much the same as those facing New Hampshire bankers and regulators. Although we are now in a very different economic environment than nine – or even three – years ago, struggles remain much the same. Aging work forces, regulatory burden, and competition from new technologies and nonbank financial services, all work together to put stresses on community banks. Examiner training, staff retention, knowledge transfer, and keeping up with technology advancements are top of mind across state bank regulatory agencies. Adding to the top of the pile are newer issues such as implementing CECL, marijuana banking, virtual currency and blockchain technologies. Not to mention liquidity tightening, funding source issues, interest rate risks, and other general marketplace concerns that are ever-present, in whatever form they might currently be taking.

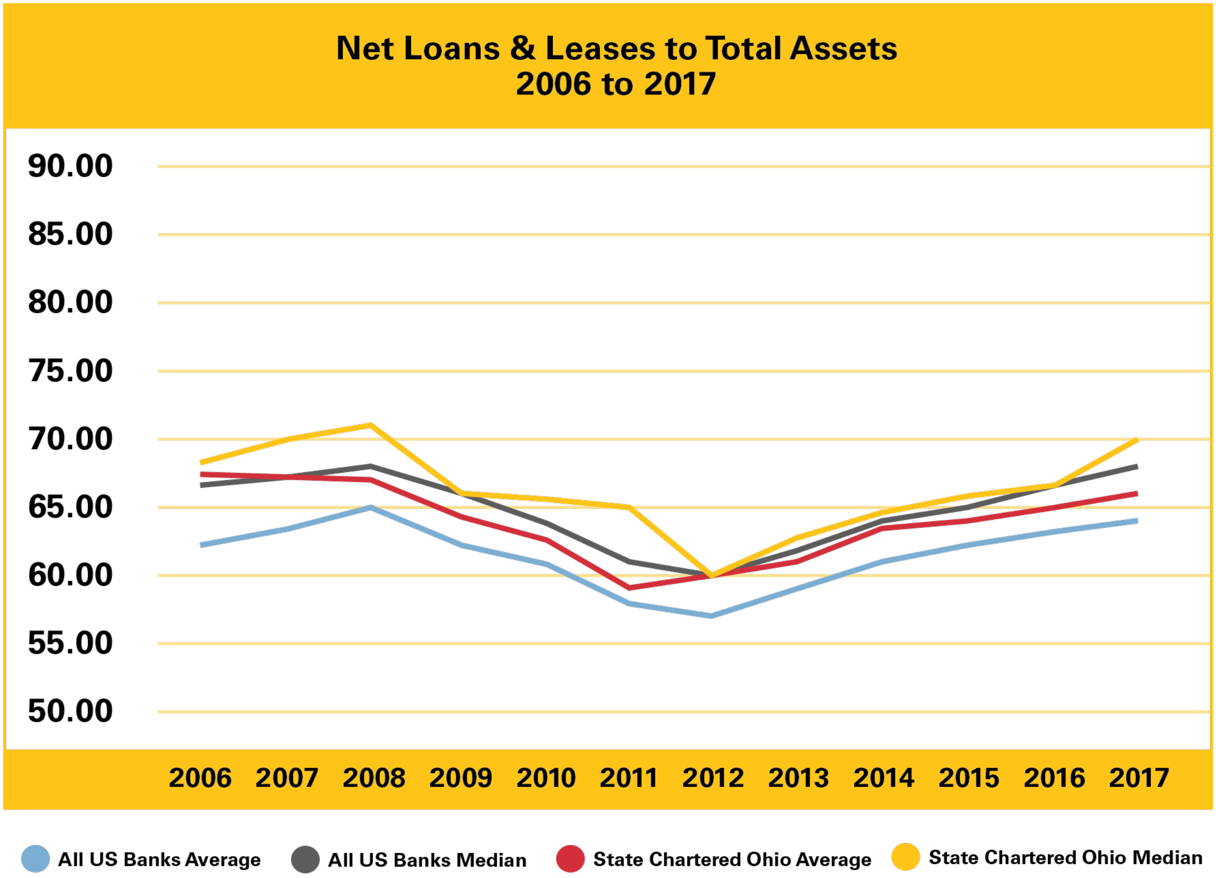
Community banking is a challenging and exciting industry, and such a vital part of the local and state economy. I feel privileged to have landed at an agency that takes its role as bank supervisor seriously and retains such a well-trained staff of professional examiners. I hope to continue the tradition in Ohio of open, transparent and frequent communication with industry. I have met many of you at the five roundtable discussions last fall and will meet many more of you at the Banker's Day on April 11 and 12. Please come up and say "hello" when you see me and feel free to reach out to me any time for any reason.

Liquidity in Post-Recession Banking
By John Johnson, Case Manager

During the post-recession era (2013 to 2017), the Ohio Division of Financial Institutions has noted liquidity changed significantly on a statewide level. During the recession, state banks experienced a variety of new liquidity issues including evaporation of on-balance sheet liquidity, frozen financial markets, and unprecedented Federal Reserve Bank intervention. As the crisis was continuing and management teams were focused on controlling problem loans, management teams built up significant liquidity buffers, and ratios improved both on a statewide and national level. During the recovery – and with cleaner balance sheets – state banks have been putting their excess liquidity to work by making new loans.

Liquidity in Post-Recession Banking *cont'd*

The chart below demonstrates both the national and Ohio state-chartered averages and medians for net loans and leases to total assets (%) from 2006 to 2017. As of 2017, the ratios are at or nearing the pre-recession (2006 to 2008) era levels.



Source: SNL Financial Data 2017

Liquidity Risk

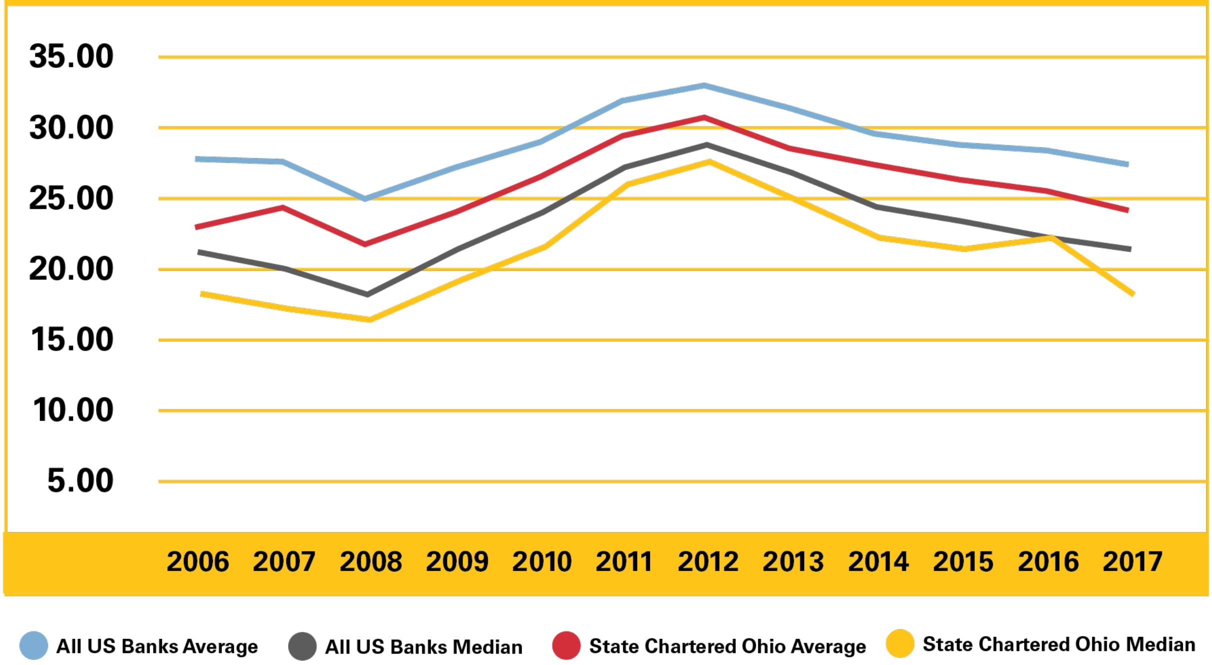
It is important to note liquidity risk is inherent to banking and liquidity risk can only be managed, not eliminated. Additionally, liquidity risk is impacted by almost every other risk type (credit, market (or interest rate risk), operational, etc.). Liquidity risk has increasingly become a focus for state and federal regulators. The FDIC included pertinent discussion on liquidity risk, contingency funding plans (CFP), and forecasting techniques in the Supervisory Insights (Summer 2017 edition) which can be found here: Supervisory Insights - Summer 2017 - Liquidity.

As banks have grown loans and deployed excess liquidity, the overall level of liquidity risk has risen across the industry. This is most evident in the levels of on balance sheet liquidity as compared to total assets or total liabilities. These ratios peaked in 2012 with the average Ohio state-chartered institution holding liquid assets of 30.58% of total liabilities or 26.48% of total assets. The following charts demonstrate the change in the liquidity ratios over time.

Liquidity Ratio

(Cash & Balances Due + Securities + Fed Funds Sold & Repos + Trading Account Assets - Pledged Securities) / Total Liabilities

2006 to 2017

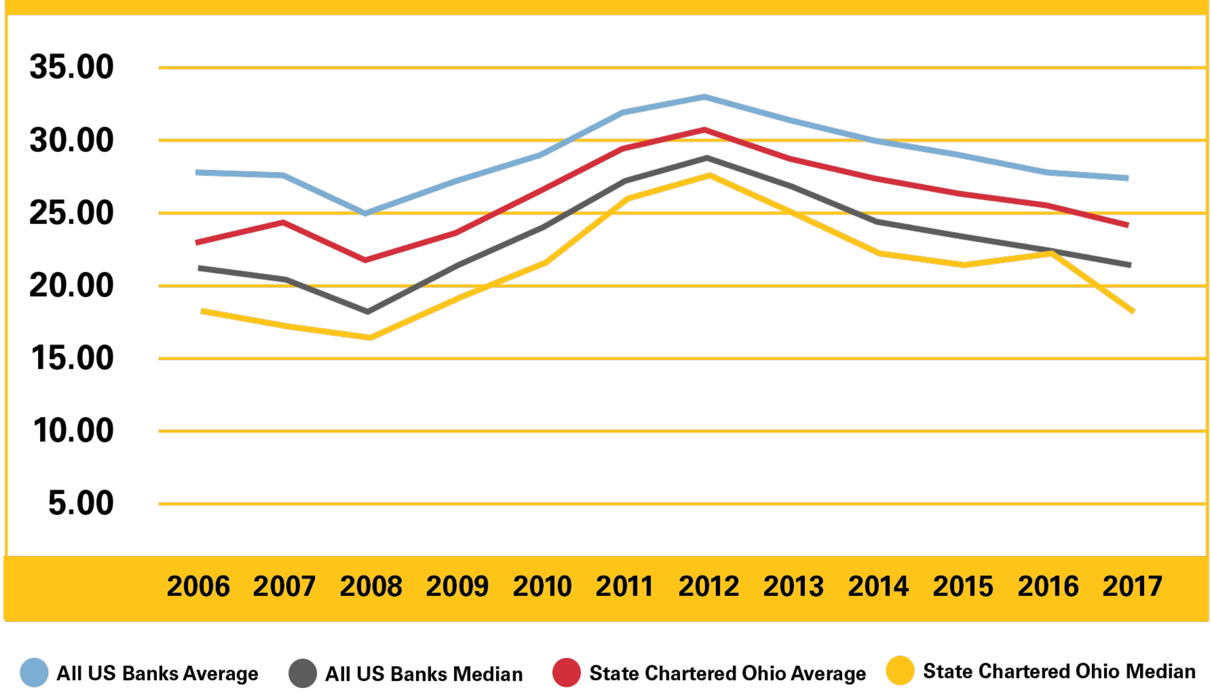


Source: SNL Financial Data 2017

Liquid Assets to Total Assets

(Cash & Balances Due + Securities + Fed Funds Sold & Repos + Trading Account Assets - Pledged Securities) / Total Assets

2006 to 2017



Source: SNL Financial Data 2017

Measuring and Managing Liquidity Risk

As noted earlier, liquidity risk is inherent to banking and cannot be eliminated, but it can, and must, be managed. As liquidity management, products, and methods have evolved, so to has the management and regulatory approach. The days of utilizing only standard ratio analysis are a distant memory. In today's environment, strong management teams are taking a fivefold approach:

1.) Measure; 2.) Monitor; 3.) Mitigate; 4.) Test; and 5.) Manage & Analyze

1. Measure

The traditional liquidity measurement method was to perform ratio analysis to determine the level of liquidity. Various ratios were often considered, and threshold limits were set by bank policy. While these traditional measures are important and tell a significant story about liquidity, they are inherently historical and only tell what 'has happened.' Most banks still use ratio analysis to some extent. Regulatory agencies also reference such ratios in examination reports; however, regulators are now placing more reliance than ever on bank management's forward-looking analyses.

The primary forward-looking measure of liquidity is the 'sources and uses of funds' report or cash flow projection. The report typically projects cash inflows and outflows over set time horizons out to one year to measure potential periodic 'gaps' in liquidity. Depending on the sophistication and level of risk at the institution, this approach may include scenario-based forecasting, various stress tests; and analysis to link the projections and stress tests to the bank's CFP. Scenarios often considered include various growth rates, interest rates, or balance sheet scenarios. The ending result of the projections is to review any liquidity needs or 'gaps' to determine if any adjustments are necessary.

2. Monitor

Like any risk category, measurement of the risk is insufficient on its own. The board should establish appropriate policies, procedures, and limits. Some limits will always be needed for the traditional measurement techniques, but more and more banks are establishing indicators or 'triggers' based on the results of the forward-looking projections. The triggers are typically set to a more conservative level than the policy limits and allow management teams to make decisions prior to violating limits. This allows for active and forward-looking management decisions to be made, rather than reactionary management techniques in response to traditional or historical measures.

3. Mitigate

All institutions should have a formal contingency funding plan (CFP) defining strategies for addressing liquidity shortfalls in emergency situations. The 2008 Interagency Policy Statement on Liquidity Risk Management defines what a bank's CFP should contain. A CFP is essential in times of a contingency scenario or liquidity crisis. Like a disaster recovery plan, the CFP should be set and approved before a crisis so the management team has specific action points depending on the level of crisis.

4. Test

Another essential element of liquidity management is to consider and test any liquidity sources, especially contingent sources. Testing allows management to familiarize themselves with the procedures for obtaining funds from the source, the length of time to obtain funds, and provides assurance that the source is, in fact, available. Lack of testing could lead to gaps in funding in a genuine contingency situation.

5. Manage & Analyze

Finally, strong liquidity management includes appropriate analysis and management of funding sources, including concentrations in funding. Over reliance on a particular source can be devastating to a bank's balance sheet if the source becomes unavailable. Management should manage and monitor any funding concentrations. Potential funding concentrations could include: large depositors; public funds; wholesale funding; and brokered deposits.

The Ohio Division of Financial Institutions analyzes and measures funding concentrations from a single source when the source represents 10% or more of total assets. When funding concentrations are noted, you can find them on the Concentrations page of the division's report of examination. Management should monitor concentrations at the board's directive, and the board should be reviewing and establishing controls and limits for such concentrations. Concentrations increase the level of inherent risk, so management and the board should also adopt appropriate controls and provide for appropriate contingencies when concentrations are identified.

Managing for Tomorrow

The balance between the 'right' amount of liquidity and the desired level of earnings is an ongoing struggle for all institutions. With appropriate forward-looking analysis, boards and management teams can be confident their bank is prepared with the appropriate cash flows, risk management practices, and mitigants to not only make money today, but to handle the stress of tomorrow.

Ohio Welcomes its Fourth Trust-Only Bank

By Cindy Leveringston and Sheila Schroer

On February 12, corporation authority was granted to Western Reserve Trust Company in Cleveland, becoming the fourth trust-only bank chartered by the state of Ohio, joining Johnson Trust Company, PNC Ohio Trust Company, and Farmers Trust Company. The Ohio Division of Financial Institutions currently regulates 13 banks with trust departments, combined these entities manage over $52 billion in trust assets.

Western Reserve Trust Company founders are very experienced in law, estate planning, charitable gifting, and account administration. Located in the Warehouse District in Cleveland, Western Reserve Trust Company intends to specialize in administrative services. The name 'Western Reserve' has historical meaning - prior to Ohio becoming a state, the northeast corner of the state belonged to the state of Connecticut, and they called that territory their 'Western Reserve.'

Many states offer a 'trust company' bank charter, as does the Office of the Comptroller of the Currency. A trust company can be chartered in much the same way as a de novo depository bank, but it is not authorized by its charter to accept deposits, therefore, it is not required to carry deposit insurance. As a result, state-chartered trust companies are only regulated by their state chartering authority and not by a federal counterpart. Like depository banks, state-chartered trust companies are not overseen by the SEC, but trust companies that manage ERISA plans do still have compliance requirements supervised by the U.S. Department of Labor, Employee Benefits Security Administration.

In Ohio, trust companies are required to maintain at least $3 million in capital. A de novo trust company may be formed by five natural persons or by another company, such as a bank holding company. The proposed directors and senior officers of a trust company must be experienced, ethical, and pass stringent background checks. Pro forma financial statements and a business plan of the trust company are reviewed, and written policies and procedures for compliance with Ohio Revised Code Section 1111 and various laws, such as the Bank Secrecy Act, must be in place before a charter will be granted.

A trust company is required to file quarterly Call Reports with the division, similar to those filed by other banking institutions. The division conducts trust examinations of all supervised trust departments and trust companies on a 12 to 24 month cycle. Examinations are conducted based on the Uniform Interagency Trust Rating System ("UITRS"). Under the UITRS, the fiduciary activities of financial institutions are assigned a composited rating based on an evaluation of rating of five essential components of an institution's fiduciary activities. The five component parts of the confidential MOECA rating are (M)anagement; (O)perations Internal Controls and Audit; (E)arnings; (C)ompliance; and (A)sset Management. A Composite and component rating are assigned based on a one to five numerical scale. It is not derived by computing an arithmetic average of the component ratings.

Additionally, Ohio offers a Family Trust Company charter. In September 2016, the Ohio Family Trust Company Act was enacted, which allows for the formation of trust companies wishing to exclusively serve family clients. Under O.R.C § 1112, a family trust company can choose to be either licensed or unlicensed. An unlicensed family trust company is not subject to supervision by the division, so long as it files an annual certification and meets certain criteria. A licensed family trust company submits to examinations on a 36-month cycle and other supervision by the division. To date, no family trust companies have been licensed.

Ohio Banking Commission
(Not all are pictured)

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Fred DeBiasi, President/CEO, American Savings Bank, Middletown
Robert Lameier, President/CEO, Miami Savings Bank, Miamitown
William Martin, President/CEO, Mercer Savings Bank, Celina
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