The Regulatory Focus

Ohio Department of Commerce
Division of Financial Institutions

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John Kasich Governor | **Andre T. Porter** Director | **Charles Dolezal** Superintendent | **Kevin Allard** Deputy Superintendent

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New Definition of Investment Grade

As a result of new regulations issued by the federal banking agencies, effective January 1, 2013, all depository institutions must utilize the new definition of investment grade as part of the decision making process for security purchases. An investment grade security is now defined as having a low probability of default and repayment of principal and interest is expected (i.e. fundamental credit analysis).

The new regulations were required by Section 939A of the federal Dodd-Frank Act which mandated federal banking regulators to amend the regulatory definition of investment grade for securities purchases to no longer reference external credit ratings.

The new regulations specifically exclude "Type 1" securities (U.S. Treasuries, agency securities, and municipal obligations) from the investment grade criteria. Municipal bonds should still be subject to an initial credit assessment and ongoing review consistent with the risk profile of the bond and overall portfolio.

External credit ratings may be used as part of the pre-purchase review. However, the rating must be augmented with a due diligence process that is appropriate for the institution's risk profile and for the size and complexity of the instrument.

With exception for Treasury and Agency securities noted above, the credit risk assessment for confirming investment grade should determine that the risk of default is low and consistent with bonds of similar credit quality.

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> **"Ohio institutions are expected to have an appropriate risk management framework for the level of risk in the investment portfolio."**

Rental Property Loans

In the past, many bankers and regulators considered all 1-to-4 family residential mortgage loans as homogeneous consumer credits. Whether the mortgages were on traditional owner-occupied homes or investor-owned residential rental properties (RRP), the risk exposure was often viewed to be similar because of the collateral.

Some community bankers perceived profitable business niches and specialized in loans to RRP investors. As long as the loans were secured by homes with adequate loan-to-value (LTV) ratios, the risk of loss appeared to be minimal. In fact, as escalating home prices enticed lenders to offer ever-higher LTV loans and cash-out refinancing opportunities to traditional homebuyers, RRP investors were favored with similar terms.

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New Definition of Investment Grade continued...

Additionally, institutions must verify the capacity of repayment, by assessing the operating performance of the issuer. Lastly, institutions must validate the spread to U.S. Treasuries consistent with bonds of similar credit quality. Structured securities (securities that rely primarily on cash flows and performance of underlying collateral for repayment) require more sophisticated analyses to properly assess credit risk including an understanding of the security's architecture and the underlying pool of assets.

Ohio institutions are expected to have an appropriate risk management framework for the level of risk in the investment portfolio. This includes implementing a portfolio oversight process that ensures the risk remains in line with Board-approved risk tolerances.

Ohio bankers are encouraged to review the January 30, 2013 "Ask the Fed" archived webinar on this topic at
http://www.stlouisfed.org/BSR/askthefed/

A free registration is required.

Breach in Emergency Communications Systems Quickly Addressed

The Emergency Communication System (ECS) is used by Reserve Bank Districts and state banking departments to notify depository institutions of operational status in the event of a natural or other disaster. Most Ohio banking organizations are registered on the system. On February 4, 2013, the Federal Reserve notified users of ECS that contact information had been obtained and posted on the internet by an outside group that exploited a temporary vulnerability in a vendor website product.

The vulnerability was quickly addressed and the Federal Reserve is recommending all ECS users log into the system as soon as possible to update passwords and validate information in the system. ECS remains fully operational and continues to be an important communication tool in the event of a widespread operational disaster.

Rental Property Loans continued...

Weak financial and real estate market conditions in recent years have demonstrated that RRP loans have a significantly higher risk of default and loss than loans secured by owner-occupied properties. Many of the RRP investors owned multiple properties financed with loans from several financial institutions, and bankers were not always aware of the borrower's global debt exposure. As market values for residential properties fell, highly-leveraged RRP investors were no longer able to profitably sell some of their holdings to cover cash flow deficiencies. They began to default on their loans and defer maintenance on their properties. In many cases, bankers were forced to foreclose or accept deeds in lieu of foreclosure, and ultimately incurred significant losses on the disposition of those neglected rental properties. Some institutions with concentrations of RRP loans have experienced significant asset quality problems stemming from weak underwriting and credit administration practices, and one Ohio state-chartered institution failed as a direct result of this type of lending.

It has become clear that RRP lending requires significantly more enhanced credit risk management practices than owner-occupied mortgage lending. RRP loans are essentially commercial in nature and should be subject to the same rigorous credit risk management practices as commercial real estate (CRE) lending. Loan and credit administration policies should have specific standards for investor-owned RRP loans, including:

- Prudent LTV limits,
- Loan terms and maximum amortization periods,
- Minimum borrower hard equity investments,
- Global cash flow analysis,
- Personal guarantees,
- Ongoing submission and analysis of borrower financial statements and rent rolls,
- Loan covenants requiring minimum borrower financial performance, and
- Periodic inspection of collateral properties.

The Board of Directors should evaluate their risk appetites for RRP loans and establish prudent concentration limits. Information systems must be able to identify and measure the amount of holdings in RRP loans and provide meaningful monitoring reports for management and the board. In addition, internal loan review and risk identification processes should treat investor property loans as CRE loans.

The Office of the Comptroller of the Currency recently issued guidance to national banks and federal savings associations regarding this type of lending. OCC Bulletin 2012-27 may be helpful as you consider the appropriate credit risk management procedures for your bank: http://www.occ.gov/news-issuances/bulletins/2012/bulletin-2012-27.html

A Word About Derivative Transactions

A recent change in Ohio law reinforces the ability of Ohio banks to engage in derivative transactions. The law (Ohio Revised Code Section 1109.22) went into effect on March 22, 2013 and clarifies the need to consider credit exposure from derivatives transactions under the applicable lending limit law. The change was required by Section 611 of the Federal Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

The Division recently issued an administrative guideline for lending limits and credit exposure from derivative transactions, which is available on the Division's website at
http://www.com.ohio.gov/fiin/docs/fiin_AdministrativeGuidelineBSI.pdf

The Division will take credit exposure from derivative transactions into account when reviewing Ohio chartered institutions' compliance with applicable lending limit statutes and regulations.

From the Director …

As you may know, Governor John R. Kasich recently appointed Commerce Director David Goodman as Director of the Ohio Development Services Agency. David did an outstanding job in leading the Department of Commerce and serving the citizens of Ohio for the past two years.

Director

Andre T. Porter

I am honored that Governor Kasich has appointed me as the new Director of the Department of Commerce – with this being my first week on the job.

Please allow me to briefly introduce myself. Most recently, I served as a Commissioner at the Public Utilities Commission of Ohio and assisted in the regulation of Ohio's public utilities. Prior to that, I was an attorney in private practice focused on real estate taxation and public utilities law, in addition to providing general counsel for public agencies. I plan to put my private and public sector experience to work at the Department of Commerce.

I'm especially looking forward to working with Ohio's state-chartered financial institutions as we pursue common sense ideas that ensure the safety and soundness of our institutions and grow Ohio's economy. Throughout the department, we will continue to provide extraordinary customer service by ensuring a regulatory environment exists for job creation and safeguarding Ohioans.

Since the last issue of ***The Regulatory Focus***, the Financial Institutions Tax (FIT) reform bill was signed into law and went into effect this calendar year. FIT made the state tax system fair for all, particularly community banks that do business primarily in Ohio. Governor Kasich proposed the tax reform initiative so that community banks will pay less and you will have more money to invest in local businesses – creating jobs in our communities.

I am looking forward to the Ohio Bankers Day Conference on June 6 and hope to meet you there! Until then, please know that Superintendent Dolezal and I want to hear any thoughts and ideas you may have. Please feel free to call or email me at 614-466-1286 or andre.porter@com.ohio.gov

Sincerely,

Andre T. Porter

From the Superintendent…

Welcome to our Spring edition of ***The Regulatory Focus***. As we are all waiting for Mother Nature to realize that it is indeed Spring and a temperature which reflects that, we continue to focus on the many projects under way at the Division. As the Financial Institutions Tax (FIT) has moved through the Legislature and is now law, we are working towards modernizing Ohio's banking statutes. Our goal is for laws that are simplified, current and easier to understand.

Superintendent

Charles Dolezal

This year's Ohio Bankers Day program is coming together quite nicely and we are offering an exciting new format and location. The Conference will be held on Thursday, June 6 at The Hilton Downtown in Columbus.

The program format has been changed slightly to include two main sessions and three breakout sessions. The first main session will feature Federal Reserve Board Governor Sarah Bloom Raskin, while in the second session we will hear from a panel of Ohio banking industry experts who will be discussing alternative directions for community banks who are facing challenges. The breakout sessions will include risk management - avoiding fraud; a community bank town hall discussion; and banking modernization and an update on the 130th General Assembly.

We hope you will mark your calendar and join us on June 6. Registration forms will be coming soon.

If you have any questions or comments, feel free to contact me directly at Charles.Dolezal@com.ohio.gov or (614) 644-7501.

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Bring Your Own Device (BYOD):

Mobile Phones

The increased popularity of mobile phones has some banks considering a "Bring Your Own Device" (BYOD) policy. While some senior management and bank personnel may prefer to use a single device for business and personal communication, it requires extra support and expertise by the bank's IT Department for multiple operating systems and devices.

Before adopting a BYOD policy, the institutions should complete a risk assessment to identify all potential vulnerabilities to the IT system. The BYOD policy should:

- Require staff to immediately notify bank management if their smart phone is misplaced or stolen.
- Allow bank management to wipe data from the device if a compromise is suspected, including any personal data.
- Implement strong user authentication on these devices as four-digit passwords may not provide enough protection.
- Limit the number of tries to enter the password. After a certain number of tries, the device should be locked and possibly wiped of all data.
- Encrypt data on the device if possible. Some smartphone operating systems offer built-in encryption, while others may require the purchase of third-party software.

It is a management decision to implement and adopt new technology and policies; however, the benefits must be weighed with the costs, and ensure that appropriate polices and controls are in place.

The Division will be reviewing BYOD policies during upcoming IT examinations.