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State of North Dakota DEPARTMENT of FINANCIAL INSTITUTIONS

A MESSAGE FROM COMMISSIONER ENTRINGER

Cybersecurity – What else would a regulator talk about?

Seriously though, it is a topic not only on the minds of regulators but I am certain it is on your mind and hopefully on the minds of your business customers as well.

First, I want you to be on the lookout for our Executive Leadership on Cybersecurity Seminar on May 11, 2016, in Bismarck at the Ramkota Inn. The seminar is presented in conjunction with CSBS with the goal to heighten awareness among CEOs that the management of an institution's cybersecurity risk is an executive level issue that requires CEO involvement. The seminar is not a technical program but is designed for CEOs, senior executives and board members. Registration information will be forthcoming in February.

Second, I could not talk about cybersecurity without mentioning the FFIEC Cybersecurity Assessment Tool ("CAT"). If you have had an examination since June 2015, more than likely the team discussed the CAT with you; if you are due for an examination in 2016 you can expect to have that conversation with the examination team during your examination. The emphasis during the examination is to clearly explain the expectation that your institution should, at a minimum, be in compliance with the baseline statements found in Appendix A of the CAT. If you have any questions regarding the expectations feel free to contact Chief Examiner Lise Kruse.

Third, I would encourage that your institution participate in a service similar to FS-ISAC (Financial Services Information Sharing and Analysis Center). FS-ISAC is a "resource for cyber and physical threat intelligence." The primary complaint we have heard from those institutions that have become a member of FS-ISAC is that the volume of alerts is overwhelming; just be aware that you have the capability to manage those alerts so you don't receive so many without sacrificing important information. While we are not endorsing FS-ISAC, we would encourage participation in some service or group that gives your institution a heads up on cyber and physical threats.

Finally, I would like to wish all of you a healthy, happy and prosperous 2016.

FACTS & FIGURES

As of December 31, 2015:

- Average Adversely Classified Items Coverage Ratio: 13.28%
- Average Adversely Classified Assets/Total Assets: 1.31%
- Average Adversely Classified Loans/Total Loans: 1.67%
- Average Past Due & Nonaccrual Loans/Total Loans: 1.29%

Averages are of the 69 North Dakota state-chartered banks.

North Dakota Banks

As of year-end 2015, all North Dakota state-chartered banks had a composite rating of 1 or 2; compared to 92 percent 3 years ago and 82 percent 5 years ago.

Although the composite ratings are 1 or 2, we are seeing increased classification numbers in the agricultural sector.

High Volatility Commercial Real Estate (HVCRE)

The Conference of State Banking Supervisors (CSBS) has issued a job aid to help you with HVCRE reporting. The tool can be found here.

Agricultural Economy

Exposure to the agricultural sector is one of our highest concerns and we are seeing increases in internal and regulatory classifications of agriculture-related loans. Low commodity prices have hampered many farmers' cash flow positions in 2014 and 2015, necessitating debt restructures and eroding working capital and balance sheet equity. Although most borrowers were able to offset low commodity prices with favorable yields in 2015, projections suggest 2016 will present ongoing cash flow challenges. Examiners will continue to utilize our 1987 agricultural credit policy (again outlined in the 1996 FDIC FIL-61-96). Overall, each lending relationship will be reviewed in its totality, considering such factors as the borrower's historical performance and financial strength, value of collateral, and other repayment sources. Also, loans secured by *inspected* grain and/or livestock will generally be withheld from adverse classification. We do have certain expectations for your management of these credits, and you should consider the following best practices:

- Complete year-end summaries as soon as possible. This will identify shortfalls early on so that a strategy can be developed before 2016 lines of credit are established. Compare cash flow projections to actual results to determine why shortfalls occurred.
- Make sure your loan presentations and analysis are thorough, including aggregation of inter-related borrowers for potential concentrations.
- Obtain regular balance sheets, income information, and cash flow projections. Timely and accurate financial information will improve the ability to address potential challenges.
- Track operating advances to ensure actual expenses are in line with planned budgets.
- Ensure liens on collateral are properly perfected.
- Segregate and amortize carryover debt.
- Take advantage of guaranty programs through FSA and/or BND.
- Consider lower loan-to-value thresholds for RE, used M&E, and beet stock. Be aware that rising interest rates could impact RE values since cap rates will also rise.

Banks are always exposed to risk and examiners review how this risk is managed. A proactive management team who has established proper risk controls and responds to challenges is always viewed favorably.

Top 3 violations cited 2012-2015

- BSA (27.1%)
- Appraisal/evaluations (17.4%)
- Regulation O (13.0%)
- Pledging (12.7%)
- Legal Lending Limit (7.4%)

Risk Perspective

The OCC and Federal Reserve Bank of Minneapolis (FRB) have identified areas of concern and risks facing the banking industry, including:

- **Strategic Risk**: Many banks continue to face challenges growing revenues to meet target rates of return in a slow-growth, low interest rate environment.
- **Credit Risk**: Banks are easing credit underwriting standards and practices, including structure, terms, pricing, collateral, guarantors, and loan controls in response to competitive pressures and growth objectives.
- **Interest Rate Risk**: The ongoing low interest rate environment poses additional concerns as banks reach for yield by loosening underwriting and extending asset duration trends. The low interest rate environment continues to pressure net interest margins as asset yields decline and the cost of funds has stabilized at historic lows.
- **Cyber Security Risk**: Cyber threats, reliance on service providers, and resiliency planning remain industry concerns, particularly in light of increasing global threats.
- **Bank Secrecy Act Risk**: Bank Secrecy Act risk continues to increase as criminal behaviors and technology use evolve.
- The FRB also listed Agricultural Credit, Vendor, and Consumer Compliance Risks.

For the full OCC report, click here. For the full FRB report, click here.

CSBS reports that state examiners across the country are also finding more relaxed underwriting standards and credit administration practices. Banks' pursuit of new lending opportunities has become increasingly aggressive, resulting in increased use of out-of-territory purchased loans.

Correction:

The prior newsletter had an error for the new risk-weighting asset rules for all other loans: The 150% risk weighting only applies to loans that are on NA or Past Due over 90 Days. It does not apply to TDR. The TDR reference in the 1-4 Family loans, however, is correct.

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