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SVP Commentary on…

The Supervisory and Industry Response to Regulatory Initiatives

Banking institutions occupy a unique and vital place in the U.S. economy. They remain principle suppliers and allocators of credit, continue to be vehicles for transmitting monetary policy, and are the core institutions in which deposits and savings of individuals, partnerships, and corporations are held. They are imbued with a high degree of public trust and consequently are closely supervised. In recent conversations with bankers, several have expressed concern about the rising regulatory burden, in light of new legislation—such as the *USA PATRIOT Act*, the *Sarbanes-Oxley Act*, and the *Fair and Accurate Credit Transactions Act*—and their implementing regulations. This is to be expected, since increased rulemaking typically follows excesses emanating from prolonged economic expansions or periods of rapid growth. Throughout history, bubbles have been followed by significant contractions, which have in turn been followed by new laws, new rules, and new regulations designed to curb the excesses of the era just ended. While the current economic cycle has been somewhat atypical for financial in-

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The Importance of Effective Credit Cultures at Community Banks

by Thomas H. McManus, Senior Examiner

What is credit culture? Why is credit culture, particularly at community banks with limited resources, an important element in the credit risk management process?

Credit culture is the critical micro piece of the credit risk management process, since an appropriate credit culture determines not only a bank's profitability but also its very survival. A sample of risk profiles for more than 1,000 community banks tracked over the past eight years shows a significant increase in portfolio credit risk. The increase reflects cyclical factors, but also results from community banks taking more risk to grow their portfolios and maintain earnings.[1] Closer to home, at least four community banks that served Third District customers in the early 1990s no longer exist. Although each bank had different causes for their ultimate demise, each shared a common characteristic: their existence was short-lived because their CEOs and boards of directors failed in their responsibility to establish a fundamental and critical element of credit risk management—an effective credit culture.

Credit Culture Defined

So what is this thing we call credit culture? How do we define it? There are numerous definitions. Some people define credit culture as simply "the way things get done around here." I define credit culture more narrowly as the sum of all the characteristics of an organization's unique behavior in its extension of credit. It not only encompasses the tangible written policies and procedures, but also intangible, such as ideas, traditions, skills, attitudes, philosophies, and standards. Credit culture is developed over time, and then communicated and passed on. It is the true spirit behind the rules.

Credit culture concepts remain as immutable and relevant today as they were over thirty years ago.

Evolving Enterprise Risk Management Practices

The banking environment has changed dramatically from both an industry and regulatory perspective. Banking has evolved into a fiercely competitive business. Separate business line-specific risk management practices continue to evolve into consolidated enterprise risk management (ERM) frameworks, the purpose of which is to evaluate and manage the uncertainties the enterprise faces as it enhances value to shareholders. Arguably, some ERM frameworks are simply too complex for many community banks, given their traditional nature, structure, and business lines. However, creating an ERM framework does provide even the smallest institutions with a structured and disciplined approach to aligning strategy, processes, people, technology, and knowledge.

Community banks, more often without the resources of larger regional and national competitors, are expected by their boards of directors to effectively manage and compete in today's changing environment. Pressure to enhance shareholder value can lead to slippages in credit practices, such as approving marginal credits, waiving personal guaranties and other standards, and irrational pricing. That is, of course, unless an organization has a carefully defined and disciplined credit culture, supported by its board, as its first line of defense against imprudent credit and pricing decisions. In fact, credit culture concepts remain as immutable and relevant today as they were over thirty years ago.

The Essentials of Credit Culture

How can CEOs promote good credit decisions fostered by a strong credit culture? P. Henry Mueller, the former chairman of the credit policy com-

[1] John Barrickman, "Management Strategies/Asset Quality Ratings: Critical Tools for Managing Portfolio Credit Risk," *RMA Journal*, March 2003, p. 72.

mittee and chief lending officer of Citicorp and Citibank, New York, has offered 20 self-evident essentials of good banking.[2] These essentials apply to the credit culture of any institution, regardless of size:

- Continuing commitment to excellence.
- Logical framework for day-to-day decision making.
- Sound value systems that will not break down under change.
- Uniform and consistent approach to risk taking.
- A common credit language.
- Business cycle perspective on the bank's credit experience.
- Supremacy of the bank's objectives over individual profit center goals.
- Candid and frank communication at all levels.
- Awareness of every transaction's effect on the bank.
- A portfolio with integrity and few exceptions.
- Individual accountability for decisions and actions.
- Balance of long-term insight with short-term view.
- Respect for credit basics.
- Common-sense reality checks against market practices.
- Encouragement of independent judgment over the herd instinct.
- Constant mindfulness of the bank's risk taking parameters.
- Realistic approach to markets and budgeting.
- An understanding of what the bank expects and the reasons behind its policies.
- Credit systems with early warning capabilities.
- Expectation that problems are identified early and that no tolerance for surprises exists.

The most significant determinant in developing an optimal culture is top management's unwavering commitment to credit quality.

Underpinnings of Strong Credit Cultures

Policy, process, auditing, and behavior are the underpinnings of a strong credit culture. As the starting point, credit **policy** provides a philosophical framework for day-to-day credit decisions. Policy will guide officers in balancing the bank's earnings objectives. **Process** is the line-driven operational arm of credit extension and credit strategy. Through the delegation of authority, a strong credit process will provide a policing mechanism for the integrity of the credit apparatus. **Auditing** is responsible for ensuring adherence to credit policy, procedures, and business plans. **Behavior** is related to the values held by bank employees. Each credit officer should be expected to reflect conservative risk-taking attitudes and a commitment to excellence. Exceptions to policy should be few and well documented when approved.

Each type of credit culture has its own characteristics with a driving force, which sets the priorities, stated or unstated, and produces a credit environment with different success factors.[3] There are several determinants of a bank's credit culture that are beyond the scope of this article. However, the most significant determinant in developing an optimal culture is top management's unwavering commitment to credit quality. Any uncertainty or ambiguity opens the door for arguments to stretch, bend, or eliminate policies.

The CEO is Key

Banking is a business built on knowledge and behavior. The behavior of middle managers and credit officers reflects the attitudes of senior managers, particularly the attitude of the CEO in a community bank. Like the captain of a ship, the CEO is the conscience and protector of the bank's value system and sets the bank's tone and direction. A sense of what the CEO will or will not tolerate spreads like wildfire; if the CEO says or does nothing, that also sends a message.

Delicate nuances become important because acceptable credit practices depend on such intangibles as philosophies and attitudes. It is up to the CEO to send clear and suitable signals appropriate for the credit culture

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[2] P. Henry Mueller, "Credit Policy: The Anchor of the Credit Culture," *The Journal of Commercial Lending*, July 1994, pp. 1 - 5.

[3] John McKinley, *How to Analyze Your Bank's Credit Culture* (Philadelphia: Robert Morris Associates, 1990), pp. 29 - 33.

Bank-Owned Life Insurance: Risks, Rewards, and Other Considerations

by Anne L. Maxwell, CPA, Quality Manager

A bank generally purchases life insurance products for business continuity, as an employee benefit (including compensation in the form of life insurance to facilitate estate planning for bank executives), and to fund its expected exposure under employee compensation and benefit programs. A bank may also purchase life insurance to insure the life of a borrower or a group of borrowers. Banks traditionally purchased life insurance products in one of two forms: key-person life insurance or split-dollar life insurance arrangements. Becoming more prevalent is the banking industry's version of corporate owned life insurance (COLI), generally referred to as bank-owned life insurance (BOLI). A summary of key-person life insurance and split-dollar life insurance arrangements appears in Exhibit 1 to provide context. However, this article will specifically focus on BOLI, its risks, rewards, and other considerations.

What is BOLI?

BOLI is a life insurance policy purchased to insure the life of certain bank employees, usually officers and other highly compensated employees. The policies may also be used to fund employee pension and benefit plans, with the bank using the death benefit proceeds to cover pension and benefit plan obligations for non-insured employees. BOLI is usually used as part of a nonqualified retirement/benefit plan[1] to fund current and deferred benefits to key executives.

By definition, BOLI is "bank-owned" and the cash surrender value (CSV) of the policy, net of surrender charges, is a bank asset. Premium payments cover three components—the investment, coverage of mortality risk, and sales commissions—while the policy itself has two components—an investment feature and a death benefit. Since the bank owns the policy, the bank receives the proceeds from the death benefit, accrues revenue from investment earnings, and bears the risk of investment losses. The CSV—the amount the bank would recoup after surrender charges, but before taxes, if it were to liquidate its BOLI holdings—is a savings element in a whole life or universal life policy, and is not taxed as it increases in value. In addition, death benefits paid to the bank are not taxed.

[1] The difference between a "qualified" and "nonqualified" plan refers to whether the plan can receive favorable IRS tax treatment. It is essential that a BOLI policy meet the IRS definition of an insurance policy in order to qualify for tax-advantaged treatment. Nonqualified plans permit flexibility in the design of benefit programs, and can discriminate in favor of company executives and other key employees. The trade off for flexibility is the loss of tax advantages associated with the qualified plans.

Exhibit 1. Key-Person Insurance and Split-Dollar Life Insurance Arrangements

Key-Person Insurance: When the death of a bank officer or other key person would be of such consequence to the bank as to give it an insurable interest, key-person life insurance insures the bank on the life of the individual. The bank generally pays the entire premium and is the beneficiary. The primary purpose of this type of insurance is to indemnify the bank against the potential loss of net income that may result from the death of the insured. Most key-person life insurance policies, payable to the bank, are either term or whole life. Term life insurance policies do not have a savings element, while whole life policies do.

Split-Dollar Life Insurance Arrangements: These are a form of additional direct executive compensation, whereby the bank pays part or all of the insurance premiums and the executive's beneficiary receives most or all of the death benefit. Split-dollar arrangements may include term insurance, whole life insurance, or a combination of both, and may or may not include a savings element.

BOLI can be classified as a general account or separate (variable) account product. The features of general and separate account BOLI are summarized in Exhibit 2.

Exhibit 2. BOLI Classifications on Insurance Company Books

Characteristic	General Account	Separate Account
Protection from Insurance Carrier Creditors	CSV is an unsecured obligation of the insurance company and available to general creditors in the event of the life insurer's insolvency.	Products invested by the insurer in assets that are segregated by state law and protected from general creditors. The bank selects the investment style but does not control the investments.
Interest Rate Risk	Interest rate risk inherent in the policy's interest crediting rate*, which is guaranteed by the insurer.	Interest rate risk is directly related to the performance of specific investments in the separate accounts. The BOLI holder assumes investment and price risk. Most separate account products generally have stable value wrappers to limit interest rate risk.
CSV Risk	CSV may fluctuate, depending upon returns from the insurer's general investment account.	CSV fluctuates depending upon returns from the underlying investments supporting the policies. The cash value potentially could be zero.
Qualified Investments	N/A	Underlying investments must be in bank-eligible securities.

* The interest-crediting rate is the gross yield on the policy, or the rate at which the cash surrender value increases before considering deductions for mortality costs, load charges, or other costs periodically charged against the policy's CSV.

BOLI Growth

While BOLI has been popular at many larger banks and bank holding companies, it is becoming increasing popular among that group of institutions, as well as at community banks. More than half the banks nationwide with assets between $100 million and $1 billion have reported BOLI policy purchases in their regulatory report filings.

An increasing number of banks and BHCs are reporting growth in the CSV of life insurance policies. [2] As reflected in Chart 1, as of September 30, 2003, 3,134 commercial and savings banks, or 38 percent of all banks, reported CSV. In addition, 41 percent of the BHCs reported CSV as of September 30, 2003. As reflected in Chart 2, the CSV of life insurance policies reported by commercial and savings banks increased significantly in recent years, totaling $58.0 billion by September 30, 2003.

In the Third Federal Reserve District, 125 of the 231 commercial and savings banks reported CSV amounts as of September 2003. The CSV of Third District policies increased from an aggregate $544 million in 2001 to over $1.3 billion in 2003, with an average reported amount of $10.2 million. In addition, 63 Third District bank holding companies reported CSV amounts as of September 30, 2003, with an aggregate investment of $871.2 million and an average investment of $13.8 million. Total BOLI exposure is likely higher both nationwide and in the Third District because the Call Report CSV reporting rules do not require

[2] While the CSV item on the Call Reports and Y reports also contains increases in value related to split-dollar life insurance arrangements, anecdotal evidence indicates that most of the reported amounts reflect BOLI growth.

Chart 1. Number of Commercial and Savings Banks Reporting CSV

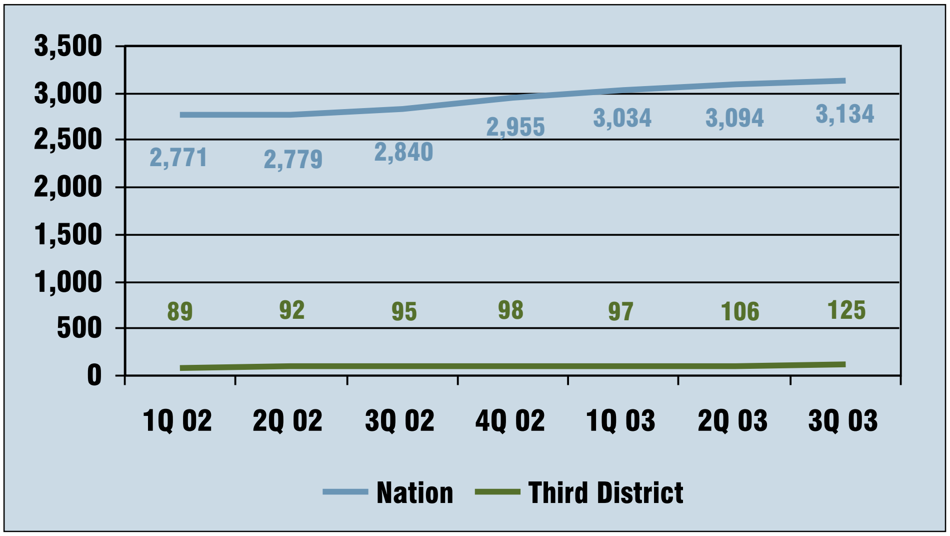
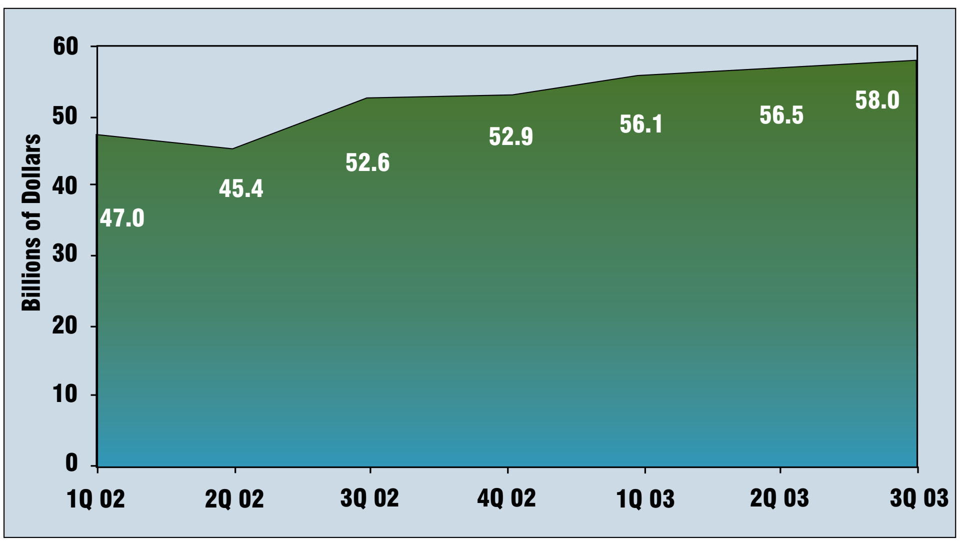


Chart 2. CSV Reported by Commercial and Savings Banks



reporting of BOLI holdings below certain thresholds.[3]

Concentrations of BOLI investments in some institutions are significant. As of September 30, 2003, 179 banks nationwide reported CSV greater than 25 percent of the sum of Tier I capital and ALLL, with 15 of those banks reporting CSV greater than 50 percent of Tier I capital and ALLL.

BOLI, According to Consultants[4]

BOLI was originally intended to be a tax-advantaged product used to fund employee pension and other retirement benefit plans for bank officers and other highly compensated employees. Over the years, however, a number of brokers and consultants have actively marketed additional product features. These marketing efforts and the manner in which financial institutions use BOLI have resulted in increased regulatory scrutiny and have raised Congressional interest about its use.

Consultants and brokers market BOLI as a core building block for a well-managed balance sheet. Funds invested in BOLI products offer insurance protection and a tax advantage, and consultants group BOLI's tax advantages with those of municipal bonds and other tax-advantaged structures.

Consultants list BOLI's attractions as including:

- Tax free investment returns and death benefits at the federal and, possibly, state level.
- Funding source for current and future benefit costs.
- Economic exposure efficiently offset.
- Authorized holding, within certain guidelines, at the bank and BHC level.
- Risks that are well within standard business risks in the bank's investment portfolio.
- Enhanced interest rate risk positions if structured appropriately.

Returns on BOLI investments can help offset costs of many benefits other than just pension plans. Some examples cited include medical

[3] The reporting threshold for the Call Report is any amount greater than $25,000 **and** more than 25 percent of "All Other Assets" in the "Other Assets" category. The reporting threshold for the FR Y-9 is amounts in excess of 25 percent of the "Other" component of "Other Assets."

[4] The Federal Reserve System does not endorse any statements about bank-owned life insurance made by brokers or consultants. This information is included here to provide an additional perspective about the product.

plans, post-retirement plans, excess deferred profit sharing, workers' compensation, company-paid life insurance, accident and disability insurance, and travel accident insurance.

Consultants indicate that BOLI could make economic sense for several reasons, including:

- Immediate and continuing increase in net earnings and ROE.
- Significant increases in net portfolio yields on debt and/or equity investments without changing portfolio investment risk.
- Option to select from a variety of investment strategies.
- Economic Value of Equity IRR mitigation as a stable value presents minimal present value rate sensitivity.
- Advantaged income tax treatment on the bank's books.

BOLI, According to Lawmakers

In 2002, *The Wall Street Journal* (WSJ) ran articles criticizing what has come to be called "janitors' insurance," due to certain companies' practices of purchasing life insurance on all of their employees without the employees' knowledge. On April 26, 2002, the WSJ reported that some banks had received as much as 10 to 15 percent of their net income from tax-free earnings on such insurance policy premiums.[5] On May 2, 2002, the WSJ reported that at least 150 to 200 of the nation's 600 publicly traded banks had purchased insurance on their employees, worth, in the aggregate, tens of billions of dollars.[6]

In response to public concerns about these and other insurance practices, several states passed legislation requiring employers to obtain employees' written consent before taking insurance on them. In some states, consent provisions apply to life insurance policies in general, while in others the provisions specifically address COLI. As of July 31, 2003, more than 30 states required written consent, including several states with provisions specific to COLI.[7]

Given legislators' concerns that COLI, whether in banks (BOLI) or other corporations, might be used inappropriately, an amendment was proposed to Congress's pension reform bill. On February 2, 2004, the Senate Finance Committee unanimously approved a proposal modifying the provisions in the *National Employee Savings and Trust Equity Guarantee Act of 2003*,[8] to allow BOLI benefits to remain tax free under the following circumstances:

- Policies are limited to highly compensated employees.
- Insured employees provide written consent to being insured.
- Insured employees are notified of the maximum face amount of the policy.
- Insured employees are notified that insurance coverage may continue after the insured terminates employment.
- Insured employees are informed that the employer will be the beneficiary of any proceeds payable upon the employee's death.

The committee rejected an amendment requiring companies to provide a breakdown of employee policies to the IRS. The proposal is expected to be submitted to the Senate for a full vote in the near term.

As of July 31, 2003, more than 30 states required written consent of the insured, including several states with provisions specific to COLI.

[5] Theo Francis and Ellen E. Schultz, "Many Banks Boost Earnings With 'Janitors' Insurance," *The Wall Street Journal*, April 26, 2002.

[6] Theo Francis and Ellen E. Schultz, "Big Banks Quietly Pile Up 'Janitors Insurance'" *The Wall Street Journal*, May 2, 2002.

[7] See Statement of Davi M. D'Agostino, Director, Financial Markets and Community Investment, General Accounting Office Testimony Before the Committee on Finance, U.S. Senate on October 23, 2003, *Business Owned Life Insurance: Preliminary Observations on Uses, Prevalence, and Regulatory Oversight*, GAO-04-191T at <www.gao.gov/new.items/d04191t.pdf>.

[8] See *Description Of Chairman's Modification To The "National Employee Savings And Trust Equity Guarantee Act Of 2003" As Marked Up September 17, 2003, As Scheduled For Markup By The Senate Committee On Finance on February 2, 2004* at <finance.senate.gov/sitepages/leg/012904modnes.pdf>.

The American Bankers' Association has indicated its support of the proposal so long as existing policies are grandfathered.[9] The insurance industry generally supported the proposal, but objected to the provision that requires employee approval of the amount of coverage.[10]

BOLI, According to the Regulators

In addition to considering the information in consultants' and brokers' sales pitches and potential legislative activity, bank management needs to consider regulatory guidance on BOLI risks, risk management, and accounting before making any decisions regarding BOLI purchases.

Only the amount that could be realized under the BOLI insurance contract as of the balance sheet date should be reported as an asset.

OCC Guidance.[11] In 2000, the OCC published formal guidance related to bank purchases of life insurance in Bulletin 2000-23, *Bank Purchases of Life Insurance - Guidelines for National Banks*.[12] In this bulletin, OCC staff noted that insurance purchases are not traditional banking activities, although they are viewed as incidental to banking. Staff noted that BOLI is a complicated, often risky product and should not be used solely for earnings management. They emphasized that bank management must ensure that the BOLI product structure does not pose a significant risk to the FDIC insurance fund and that the bank continues to comply with capital standards.

The OCC identified six risks inherent in the BOLI cash surrender value, including credit, transaction, interest rate, liquidity, compliance, and price. In mitigating these risks, bank management should ensure that BOLI activities are consistent with safe and sound banking practices and that senior management and the board provide effective oversight. Bank management should conduct a pre-purchase analysis of any insurance product to ensure that the bank understands the risks, rewards, and unique product characteristics. As described in more detail in Bulletin 2000-23, at a minimum, the pre-purchase analysis should include:

- Determination of need.
- Quantification of amount.
- Selection of vendor.
- Choice of carrier.
- Review of product characteristics.
- Analysis of benefits.
- Assessment of reasonableness of compensation provided to insured employees.
- Analysis of product risks and the bank's ability to monitor and respond to those risks.
- Determination of transaction's consistency with safe and sound banking practices.
- Evaluation of alternatives.
- Documentation of decision.

Joint Interagency Accounting Guidance. On February 11, 2004, the Board of Governors of the Federal Reserve System—along with the Office of Thrift Supervision, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation—issued *Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance*.[13] The BOLI-specific guidance states that only the amount that could be realized under

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[9] Katie Kuehner-Hebert, "Congress May Let Banks Keep Tax Break on Life Insurance," *American Banker*, January 30, 2004.

[10] Thompson Financial Insurance Solutions, "Senate Finance Panel Sets Monday Vote on COLI Rules; Bingaman Amendments Concern Industry," *Daily Insurance Reporter*, January 28, 2004.

[11] The OCC's guidance about bank-owned life insurance does not specifically apply to bank holding companies or state member banks, but is generally consistent with Federal Reserve guidance that is applicable to BOLI investments. This information is included here to provide an additional perspective about the product.

[12] See *Bank Purchases of Life Insurance – Guidelines for National Banks*, on the OCC web site at <www.occ.treas.gov/ftp/bulletin/2000-23.doc>.

[13] SR 04-4, *Accounting for Deferred Compensation Agreements*, which announces the release of and includes a link to the joint interagency guidance, is available on the Board of Governors' web site at <www.federalreserve.gov/boarddocs/SRLETTERS/2004/sr0404.htm>.

the BOLI insurance contract as of the balance sheet date should be reported as an asset. Because there is no right of offset, a BOLI investment should be reported separately from any deferred compensation liability. The *Interagency Advisory* provides additional details and examples on reporting of the deferred compensation liability related to the other aspects of individual deferred compensation arrangements.

When purchasing BOLI, the bank usually pays a single premium, which may be as much as several million dollars to over a billion dollars for large banks, depending on the nature of the policy. For reporting on the Call Report, the purchase of BOLI results in an increase in “other assets,” called “Cash Surrender Value of Life Insurance” or “CSV.” Over time, the CSV is adjusted to reflect performance of the underlying investment(s). Regardless of this accounting treatment, it is important to remember that BOLI is not a fund investment, but rather is an obligation of an insurer.

Federal Reserve Considerations. The Federal Reserve System has not publicly published specific examination guidance related to BOLI, believing that its guidance related to investments, other assets, insurance, and risk management is broadly applicable in this area. In addition to the general safety and soundness guidance in those areas, Federal Reserve examination staff expect that financial institutions considering the purchase of or already owning BOLI understand the implications of current and potential changes to tax laws, state insurable interest laws, other state or federal legal and regulatory requirements, and early liquidation penalties. In addition, financial institutions should consider the appropriateness of an executive’s total salary and compensation package, including compensation and benefits accruing from or funded by life insurance products and arrangements.

Because of the risks inherent in BOLI, the Federal Reserve currently requires a 100 percent risk weighting for both general account and separate account BOLI for risk-based capital purposes.

Risk Based Capital Considerations. Because of the risks inherent in BOLI, the Federal Reserve currently requires a 100 percent risk weighting for both general account and separate account BOLI for risk-based capital purposes. This requirement applies to both state member bank and bank holding company BOLI investments.

SR 95-51 Risk Considerations. Below is a summary of the risks arising from the purchase of BOLI in terms of the risk categories employed by the Federal Reserve System’s supervision staff for evaluating state member banks and bank holding companies.

- *Credit Risk.* The performance of any life insurance contract depends on the financial ability and paying capacity of the insurance company that underwrites the contracts. Consequently, banks should only deal with insurance companies highly rated by the rating agencies such as A.M. Best, Moody’s, and Standard & Poors. The bank should observe the usual credit management techniques of portfolio diversification and financial monitoring of the insurance company, and should have policies that provide guidelines for limiting BOLI concentrations and exposure to a single insurance company.

- *Liquidity Risk.* Since the objectives of BOLI involve long-term funding for deferred benefit programs, and because of the tax consequences and surrender charges, CSV should not be viewed as a liquid asset. The tax consequences of withdrawing the CSV from a BOLI policy discour-

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"Response to Regulatory Initiatives" *continued from page 1*

stitutions, characterized by relatively sound credit quality throughout the economic slowdown, weaknesses in other areas have prompted significant legislative activity. In this article, I will address two issues: why many consider regulations to be so-called "necessary evils" and how institutions can better ensure compliance in a changing regulatory environment.

Why Regulations?

A regulation is defined as a principle rule or law for controlling behavior. Prudential regulation is designed to ensure an efficient and competitive banking system, protect the banking system from a crisis, protect the public, increase institution solvency, and place certainty around transactions. It has historically consisted of a mixture of individual transaction monitoring, risk management processes, conflicts of interest, capital requirements, entry regulations, and compliance with law. Bankers must have a detailed understanding of banking regulations to successfully complete everyday operations, while bank customers need regulatory information to evaluate alternative financial services and the extent of regulatory protection provided.

The industry has traditionally adapted well to new regulation. Appropriate regulatory restraints are embedded in the core assumptions of most firms and are calculated in the cost of doing business. Management understands business parameters such as the kinds of products and services it can offer, restraints on market share, and what types of markets it can enter. However, financial crises can spur top-down regulatory change, which can alter the balance and level of costs. Regulators are challenged to balance these increased regulatory costs, or regulatory burden, against the need to ensure integrity in financial markets and public confidence.

The shifting profile of the banking sector reflects rising customer demands, new products, the growth of firms in scale and scope, increasingly rigorous stakeholder demands, and a global business environment. As a consequence, rising complexity and the need to effectively manage routine processes while adapting to change becomes key. Much of this is not new. Banking organizations have historically had their business defined by competition, customer preferences, regulations, and the ability to respond to the environment. However, advances in technology and global markets appear to have accelerated these trends, prompting uncertainty and rapid obsolescence of business models, while also spurring pockets of business failure. Confidence and innovation are critical to our economic system, and these business failures have shown us that competition can undermine prudent business behavior and that unbalanced entrepreneurial cultures, when left unchecked, can create often-fatal problems.

Banks will continue to face uncertainly, which will lead to both risks and opportunities, with the related potential to either erode or enhance value. The challenge for management will be to determine how much uncertainty to accept as it works to increase shareholder value. As always, management will need to ensure that it has adequate resources (people, technology, information), sound processes (hiring, training, resource allocation), and the right values (ethics and criteria by which priorities are established). But, management will also need to ensure that it has effective risk management and compliance programs.

Enterprise Wide Risk Management

So, what can help ensure effective regulatory compliance and the health of financial institutions? The costs and benefits of applying both existing and new regulations in this environment are the subject of constant debate as technology, market forces, and globalization continually affect the industry. Recently, the shift from banking to broader financial services-type products has increased both reputational and operational risk. As banking institutions transform, violations and noncompliance with laws can significantly impair a bank's reputation, value, earnings ability, and business opportunity.

This rapid pace of change makes market discipline and enterprise wide risk management core elements of an effective organization. While market discipline comes from outside the organization, through changes in stock valuation and shareholder-led initiatives, enterprise risk management must come from within. I believe that the most effective banking organizations of the future will be those that practice enterprise wide risk management and institute enterprise wide compliance programs.

An enterprise wide risk management framework is an approach to managing risk that is integral to an organization's strategic planning and tactical execution. The Committee of Sponsoring Organizations of the Treadway Commission, or COSO, which brought us *Internal Control – Integrated Framework*, is finalizing its enterprise wide risk management framework and expects to publish it early this year. The purpose of this framework will be to imbed a consistent "risk and control consciousness" throughout an organization and to create a commonly accepted model for discussing and evaluating an organization's risk management processes.[1]

The underlying premise of enterprise risk management revolves around the creation of stakeholder value, since effective risk management practices can help insulate an organization from costly legal and reputational risk that can adversely affect the bottom line. In a nutshell, an enterprise wide risk management framework will help management identify potential events that may affect the organization and set parameters around the company's appetite for risk. This will require that business line management perform regular evaluations of risks, given current and anticipated market conditions, and the effectiveness of controls, with individual business lines' assessments aggregated for the entire organization by a chief risk officer or an individual with similar perspectives. This enterprise wide perspective will allow senior management to more readily identify intracompany conflicts in risk management policies or philosophies as well as practices that in aggregate actually serve to increase, rather than mitigate, risk.

This rapid pace of change makes market discipline and enterprise wide risk management core elements of an effective organization.

Enterprise Wide Compliance

An enterprise wide compliance program is an integral part of the broader enterprise risk management framework. Enterprise wide compliance programs focus on two emerging areas of risk—legal and reputational risk. Given the recent publicity related to financial institutions' involvement with companies such as Enron and Parmalat, legal and reputational risks appear to be two of the more significant risks facing financial institutions today. Compliance risk management must address more than traditional "consumer compliance." Rather, an effective enterprise wide compliance risk management program must actively assess how compliance with *all* laws and regulations, as well as internal policies, procedures, and controls, could be enhanced across the organization as a whole. This requires constant reassessment of risks and controls, as well as frequent communication with business lines, to minimize the likelihood that the compliance program operates on autopilot and does not proactively respond to change in the organization. Enterprise wide compliance programs and processes do not supplant business line specific compliance processes, which are more transaction- or operationally-oriented but remain equally valuable. Rather, enterprise wide compliance programs supplement business line compliance programs by providing management and the board with a big-picture view of the organization's risks.[2]

Control Elements

Risk taking, execution, and innovation can still create competitive

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[1] For additional information on the COSO enterprise wide risk management framework, see COSO's web site at <www.coso.org>.

[2] For additional perspectives on enterprise wide risk management, see Federal Reserve Governor Susan Schmidt Bies' February 4, 2004 remarks at the Bond Market Association's Legal and Compliance Conference, *Enterprise-wide Compliance Programs*, at <www.federalreserve.gov/boarddocs/speeches/2004/20040204/default.htm>.

advantage, but competitive success depends primarily on management choices. I believe that an effective enterprise wide risk management framework will be characterized by four levers of control, all reflecting management choices: control systems, belief systems, boundary systems, and performance measurement systems.

Interactive **control systems**, such as a system of strong internal controls and corporate governance, complete with continual risk assessments, are generally recognized as the core of an enterprise risk management system. The output from these systems is communicated through the balanced scorecard and other dashboard indicators that assess performance across multiple spectrums, further ensuring that an enterprise perspective is embraced throughout the organization. However, the control system will not be effective without a strong **belief system**. The belief system is the underlying culture of the organization, and is a sum of its core values. The tone of the belief system must come from the top, and must be imbued throughout all levels of the organization. **Boundary systems** establish both cultural and control boundaries, setting behavioral and physical boundaries on what behavior is acceptable, what will be tolerated, and what will not. Finally, **performance measurement systems** must be established to ensure that performance consistent with enterprise risk management principles is rewarded by appropriate compensation and incentives.

Our Challenge

The challenge for financial services stakeholders (regulators, bankers, and the general public, alike) is to establish a regulatory framework that is resilient and responsive to rapid change. As in the past, future regulatory developments will be aligned with financial developments and innovation. As stakeholders, we must balance the organic and mechanistic aspects of regulations and operations, ensuring that financial institutions can operate effectively along the continuum between innovation and strong fundamentals, adding value to their shareholders and the national economy. You can contribute to this policy formulation process by providing comments to the Board of Governors and the other state and federal banking regulators on their notices of proposed rulemaking.[3] You can also contribute to this process by sharing your concerns with SRC officers at Bankers' Forums, Field Meetings, and other appropriate venues.

We look forward to hearing from you! ■

[3] Links to Federal Reserve System rulemaking proposals, other proposals, and information collection proposals are available on the Board of Governors' web site at <www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.

Call Report Modernization: The Future is Almost Here!

To improve the collection, validation, distribution, and use of Call Report data, the FFIEC Call Report agencies are modernizing the Call Report data collection process. The most significant change will be the development of a central data repository (CDR), which will be a shared resource for all those who rely upon Call Report data in their business.

With an aggressive development schedule, the agencies anticipate implementing the new system and related business procedures in time for submission of the September 2004 Call Report data. Throughout 2004, selected banks and Call Report software vendors will participate in pilot efforts to test the design and functionality of the new system. Industry briefings, updated instructions for data filing, and enrollment activities to establish access permissions for reporters will take place well in advance of implementation.

Once the CDR is implemented, financial institutions will transmit data through the Internet to the CDR. Since the new business model will require institutions to complete edit resolution before submitting data, they will need to begin their quarterly filing preparations earlier.

Check out the FFIEC's new website—www.FFIEC.gov/FIND—for progress reports, project details, future process changes, and other important information.

age conversions of these assets. Taxes are due on the entire CSV buildup within the policy and, in some instances, early withdrawal penalties may be assessed.

- *Market Risk.* When the investments are held in the insurance company's "general accounts," interest rate risk is inherent in the policy's "credited interest rate," which is based, in turn, upon the insurance company's own investment results. If the underlying investments are held in a "separate account," interest rate risk is directly related to the performance of the specific investments held in the separate accounts. In either instance, the CSV buildup can be based on either fixed or floating rate returns, and the CSV can fluctuate depending upon the returns from the underlying investments supporting the policies.

- *Operational and Legal Risks.* Transactions must be executed properly regarding conversions or claims being made on the policies to ensure timely receipt of benefits. In addition, contractual language should be clearly understood to ensure that the policies provide the expected benefits. Management must remember that BOLI's appeal and financial advantage could be adversely affected by changes in the tax or other laws and be prepared to take appropriate action, if necessary.

Risk Management Considerations. Bank management should exercise sound risk management practices when deciding to purchase BOLI, as it would with any investment product. At a minimum, the bank should have board-approved written policies that address:

- Program objectives.
- Pre-purchase analysis independent of that obtained from the firm selling the product.
- Post-purchase analysis and monitoring independent of that obtained from the firm selling the product.
- Issuer limits and credit quality guidelines applicable to individual insurance carriers.
- Aggregate BOLI limits as a percentage of capital.
- Definition of the role of the credit risk management function in selecting and monitoring carriers.
- Mechanism to evaluate third party vendors or service providers.
- Analysis of state insurance fund coverage of insurance products purchased.
- Permissible investments and limits, including those for the underlying investments in a separate account, all of which must be limited to bank-eligible investments.
- Approval process for additional BOLI purchases.
- Tracking of relevant tax and insurable interest laws and regulations.
- Tracking of relevant accounting policy.
- Monitoring of credit risk and actions to be taken in the event of a decline in carrier credit quality.
- Risk aggregation processes to capture all credit exposures to an insurance carrier and ensure that credit risk concentrations are appropriately captured and monitored.
- Annual audit or compliance review to ensure adherence to laws and regulations.
- Accounting and risk-based capital treatment.

In addition, the financial institution should conduct analysis, independent of that obtained from the firm selling the product, to ascertain that the amount purchased is reasonably correlated to, and not excessive in light of, the bank's expected exposure under employee compensation and benefit programs, and that it is not used for speculative purposes or to generate funds for the bank's normal operating expenses.

Finally, board and senior management should receive at least annual reporting (or more frequently, if appropriate) of the key risks of the product. This reporting should address issues such as (i) the long-term nature of the credit exposure, (ii) its illiquid nature and the tax and surrender charge implications in the event of its liquidation, (iii) the amount and type of holdings (general account or separate account and underlying investments), (iv) other relevant risk analysis, (v) peer analysis of holdings as a percent of capital, (vi) compliance with state insurable interest laws and other relevant laws and regulations, and (vii) a recent credit assessment of the carrier(s).

Summary

BOLI can be an attractive product when used as part of a nonqualified deferred compensation and benefits program. It provides incentives to company executives, compensation to a company in the event of an executive's death, tax advantages not generally available in a non-qualified retirement and benefit plan, and an attractive after-tax yield to the bank. However, the purchase of BOLI or any other insurance product should match the objectives of bank management, director-approved risk guidelines, and the bank's risk profile. Bank management should remain cognizant of the fact that insurance is primarily the transfer of the financial effect of losses and should be considered as a part of the broader risk management process. It is imperative that management understands the risks and rewards of its investment decisions and appropriately identifies and quantifies all risks. Remember the adage, "If it looks too good to be true, it probably is."

If you have any questions on BOLI, please contact your primary banking regulator. If you are supervised by the Federal Reserve Bank of Philadelphia, please contact your institution's central point of contact or assigned manager at the Reseve Bank. Questions on this article can be addressed to Anne Maxwell (anne.l.maxwell@phil.frb.org) at (215) 574-6495. ■

"Credit Cultures at Community Banks" *continued from page 3*

that he or she has chosen to establish. It is also up to the CEO to insist on prudent discipline, guidelines, and accountability.

In recent years, the notion that a smart manager can manage anything has become very popular. Thus, many financial institution CEOs lack credit training and experience. This trend is exacerbated by the abandonment of formal credit training programs by many of the larger regional banks that have traditionally supplied the community banks with their CEOs and senior staff. Credit is a discipline and, like a profession, is not quickly acquired nor can it be brushed aside lightly. Boards of directors must be mindful of the uncertainty they introduce when their CEOs lack credit backgrounds.

Conclusion

A sound effective credit culture is the foundation of credit risk management in any bank. So what is the question for examiners to ask of the CEO or chief credit officer, or for the CEO or chief credit officer to ask him or herself? The question is: what is the credit culture of this institution? If the CEO or chief credit policy officer responds with a quizzical stare or summarily dismisses the question, credit risk management could be an area warranting additional concern and examiner scrutiny. A bank without a sound credit culture is like a ship in the dark during a raging storm—when the rocks appear, it is too late to change course, and certain disaster awaits.

If you have any questions about the concepts discussed in this article, please contact Thomas McManus (tom.mcmanus@phil.frb.org) at (215)574-3451. ■

Additional information on credit culture is presented in the following articles in *The RMA Journal*

Strischek, Dev. "Credit Culture : Part I." *The RMA Journal* v85 n3 (November 2002): 52-55.

Strischek, Dev. "Credit Culture : Part II Types of Credit Cultures." *The RMA Journal* v85 n4 (December 2002): 35-39.

Strischek, Dev. "Credit Culture: Part III Changing Direction & Implementing a New Credit Culture." *The RMA Journal* v85 n6 (March 2003): 38-43.

Whom To Call?

Financial institution management may need to contact an officer, manager, or staff in the Supervision, Regulation & Credit Department but not know whom to call. The following list should help management identify to whom to raise their questions. Financial institutions that have an appointed central point of contact should generally contact that individual directly.

Contact names appearing in **bold** are the primary contacts for their areas.

Community, Regional, and Global Supervision

John J. Deibel, VP 574-4141
Elisabeth V. Levins, AVP 574-3438
    Douglas A. Skinner, Manager 574-4310
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    John V. Mendell, Manager 574-4139
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Regulations Assistance Line 574-6568

Enforcement

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A. Reed Raymond, VP 574-6483
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