



Supervisory Letter



Interagency Supervisory Guidance for Institutions Affected By Hurricane Katrina

PURPOSE

The federal financial institutions regulatory agencies¹ and the state supervisory authorities in Alabama, Louisiana, and Mississippi are jointly issuing this examiner guidance to outline supervisory practices to be followed in assessing the financial condition of institutions directly affected by Hurricane Katrina. This guidance also applies to examinations of institutions that may be located outside the disaster area, but have loans or investments to individuals or entities located in the disaster area. The guidance recognizes that examiners retain flexibility in their supervisory response, given the unique and long-term nature of the problems faced by affected institutions.

Hurricane Katrina had a devastating effect on the U.S. Gulf Coast region that will continue to affect the business activities of the financial institutions serving this area for the foreseeable future. Some of these institutions may face significant loan quality issues caused by business failures, interruptions of borrowers' income streams, increases in borrowers' operating costs, the loss of jobs, and uninsured or underinsured collateral damage. Further, as a result of the significant loss in their tax and revenue base, state and local governments face major challenges in paying their obligations, which could adversely affect financial institutions with large investments in county/parish and municipal securities and loans.

OVERALL SUPERVISORY ASSESSMENT

It is critical that supervisory agencies are aware of the true condition of each affected financial institution. Therefore, examiners should continue to assign the component and the composite ratings in accordance with the definitions embodied

¹ This includes: the Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Office of Thrift Supervision, and National Credit Union Administration (collectively, the agencies).

in the Uniform Financial Institutions Rating System². When evaluating the CAMELS components at an affected financial institution, examiners need to consider the reasonableness of management's plans for responding to the hurricane's ramifications on its business strategy and future operations, given the economic conditions in its business markets. In particular, when assessing the management component, examiners should consider management's effectiveness in responding to the changes in the institution's business markets caused by this unprecedented disaster and whether the institution has addressed these issues in its long-term business strategy.

The examiner's assessment of Hurricane Katrina's effect on the CAMELS component ratings may result in a lower composite rating for some affected institutions. However, in considering the supervisory response for institutions accorded a lower composite rating, examiners should give appropriate recognition to the extent to which weaknesses are caused by external problems related to the hurricane and its aftermath.

Examiners should consult with their supervisors to determine what supervisory action, if any, should be taken. Formal or informal administrative action that would ordinarily be considered for lower-rated institutions may not be necessary, provided that prudent planning and policies are in place and management is pursuing realistic resolution of the problems facing the institution. In instances where a formal or informal supervisory response is warranted, supervisors should tailor the response to management's capabilities and efforts in resolving the institution's specific issues.

RISK ASSESSMENT

Examiners should expect affected institutions to have completed an initial risk assessment and have a process for refining their assessments as more complete information becomes available and recovery efforts proceed. In reviewing management's assessment, examiners should recognize that the issues faced by institutions are complex and may involve protracted resolutions. The institution's assessment should reflect management's best estimate of its asset quality, given the prevailing economic conditions in its business markets. Management should be able to explain the disaster's implications on the institution's earnings and capital, as well as its effect on liquidity and sensitivity to market risk.

As a part of the ongoing assessment process, examiners need to ensure that institutions are able to identify all loans and investments significantly affected by the disaster and any potential loss exposure. For secured loans, examiners should expect an institution to have a process for tracking information on the condition of collateral and the collectibility and timing of insurance. This

² Examiners of federally insured credit unions will use the guidance in NCUA Letter to Credit Unions 03-CU-04, CAMEL Rating System for assigning the CAMEL ratings.

analysis should be performed on an individual loan basis and supporting documentation should be included for significant credits. This process may necessitate a change in the institution's loan review criteria to reflect the need to monitor credits affected by the hurricane more frequently.

Institutions that experienced heavy damage to facilities or lost key personnel may still be working on their assessments. However, examiners should expect the institution to demonstrate its review methodology and reasonable progress given the circumstances. Examiners should review management's assessment to determine whether it is sufficient in scope and content. The examiner-in-charge should adjust the scope of the examination depending on the quality and thoroughness of the institution's internal risk assessment and consider the accuracy of this evaluation, as appropriate, in the CAMELS ratings.

CAMELS COMPONENTS

Examiners should evaluate the CAMELS components according to existing supervisory guidance. In addition, examiners should consider the following examination guidelines:

Capital Adequacy

When evaluating the capital component for an affected institution, examiners should consider any extraordinary expenses, unexpected deposit growth, contingent liabilities and risks, and loan losses that were incurred as a result of Hurricane Katrina. If significant declines in the affected institution's capital ratios have occurred or are projected, examiners should determine whether the institution's board of directors has developed a satisfactory capital restoration plan that provides for capital augmentation in a timely manner.

Asset Quality

Loan Reviews. Examiners should expect an institution's loan review practices to be sufficient to verify that it is adequately identifying and reporting the risk in its loan portfolio. Examiners also should identify any recourse arrangements with sold loans or other contractual agreements that may involve risk to the institution from deteriorating asset quality. Examiners should recognize that supporting file documentation may be limited due to unusual circumstances caused by the disaster. Initially, examiners should verify the accuracy of the internal assessment by transaction testing. Examiners should consider expanding the scope of the loan review if the transaction testing indicates that the internal risk assessment is insufficient.

New Loans. Examiners should review a sample of loans originated after Hurricane Katrina to determine whether the institution's underwriting standards are appropriate. There may be a number of legitimate reasons why management

may have eased underwriting standards after Hurricane Katrina to address the needs of its customer base. In addition, management may have changed its business strategy to focus on new lines of business or expanded into new markets. Examiners should note any significant changes in the financial institution's lending practices and ensure that these activities are consistent with the institution's loan policies, the board of director's strategic plan, and prudent underwriting standards.

Credit Modifications. Examiners should recognize that the economic conditions in disaster-affected areas may influence an institution's course of action as well as the timing of such action. Examiners generally should not criticize an institution that is attempting to constructively work with its borrowers in affected areas. Examiners should review an institution's policies and procedures for providing a borrower with a loan modification, extension, restructuring, or workout.

Credit modifications, extensions, and restructurings (including capitalization of interest) do not necessarily indicate imprudent lending practices. If a performing credit was appropriately modified as a result of Hurricane Katrina, then absent any unusual circumstances, examiners should not criticize these practices. Examiners should expect to see appropriate documentation to support the institution's agreement with the borrower, including the borrower's recovery plans, source of repayment, reliance on insurance proceeds, advancement of additional funds for rebuilding, value of additional collateral, and the condition of existing collateral. Regardless of the terms of the modification or workout agreement, examiners should expect the institution to appropriately recognize credit losses as soon as a loss can be reasonably estimated. Moreover, examiners should expect the institution to preserve the integrity of its internal loan grading methodology and maintain appropriate accrual status on affected credits.

Nonaccrual. Institutions may find it necessary to allow borrowers in affected areas to defer payment of principal, interest, or both for a reasonable period of time with the expectation that the borrower will resume payments in the future. Nevertheless, accrued interest should be written off (reversed) when it is deemed uncollectible. Examiners should ensure that financial institutions continue to follow applicable regulatory reporting requirements, as well as the institution's internal accounting policies, when reporting nonaccrual assets.

Insurance Claims. In many cases, repayment may be dependant on the collection of insurance claims on covered properties. However, management may be experiencing some difficulty in contacting the insurance carrier or may be uncertain regarding the timing and amount of any potential insurance claims.

Examiners should consider the type, amount and timing of any proposed settlement offers. If an insurance carrier indicates a valid claim on a mortgaged

property has been accepted, then the negotiated settlement amount normally would not be subject to adverse classification, barring any unusual issues. If the validity of an insurance claim is in doubt or a protracted resolution is likely, then examiners will need to exercise their judgment in classifying a loan based on its individual facts and circumstances.

Classification Standards. Examiners should rely upon existing credit classification standards for loans affected by Hurricane Katrina. The evaluation of each credit should be based upon the fundamental characteristics affecting the collectibility of a particular credit. Examiners should review management's assessment of the borrowers' repayment ability and financial condition as well as the institution's collateral protection to determine the appropriate credit classification.

Examiners should apply appropriate credit classification and charge-off standards in cases where the information available indicates a loan will not be repaid, or contact with the borrower has not been established. Examiners should also assess the reasonableness of management's plans for pursuing foreclosure of collateral on nonperforming assets, given the unknown environmental risks and other factors. In some cases, the deferral of foreclosure may be the most prudent course of action.

Allowance for Loan and Lease Losses (ALLL). Examiners should review the institution's methodology for calculating the ALLL. In determining an appropriate ALLL, management should consider all information available about the collectibility of the institution's loan portfolio. Consistent with generally accepted accounting principles (GAAP), the amounts included in the ALLL for estimated credit losses incurred as a result of Hurricane Katrina should represent probable losses that can be reasonably estimated. As institutions obtain additional information about loans to borrowers affected by the hurricane, management is expected to reflect revised estimates of loan losses in its regulatory reports.

For loans to borrowers in the affected area, there may be a period of time where institutions may find it difficult to accurately determine the collectibility of loans. Examiners should recognize that management may need more time than in normal economic conditions to evaluate the effect of the hurricane on the ability of the borrower to pay, assess the condition of underlying collateral, and determine potential insurance proceeds. Examiners should ensure that management has maintained the ALLL at an appropriate level based on its best estimate of probable losses within a range of loss estimates.

Obligations of Taxing Authorities. Examiners should review the institution's loan and investment portfolios to determine whether it has extended credit to taxing authorities via loans or through the purchase of county/parish or municipal obligations in areas that sustained damage during Hurricane Katrina. A significant number of communities located on the Gulf Coast are heavily

dependent on local sales, hotel, property, and income tax revenues. These sources of income have fallen sharply since the disaster, and the ultimate collection of such loans and investments may be adversely affected. Some loans and bonds also are tied to specific facilities, such as hospitals, that may not resume operations for an extended period.

The agencies and the state supervisory authorities will continue to treat municipal bonds issued by Hurricane Katrina-affected entities as investment quality debt securities, provided they were investment quality before Hurricane Katrina and have not been downgraded subsequently to below investment quality. For non-rated municipal bonds³, management should monitor the institution's risk exposures in order to assess whether those bonds continue to be the credit equivalent of an investment grade security. Many public obligors/issuers have insurance or have access to debt payment and other reserve funds that may avert a downgrade in their quality rating. Examiners generally should classify a bond according to existing guidance if its rating falls below investment grade.

Real Estate Values. The disaster-affected areas and neighboring evacuee locations have experienced significant fluctuations in real estate values. For both existing real estate loans and new loans, examiners should assess the institution's policies and practices with regard to estimating values on collateral in real estate markets that have experienced a significant, but possibly temporary, decrease or increase in real estate values as a result of the hurricane. When reviewing an institution's estimates of collateral values, examiners should ascertain whether the values are based on assumptions that are both prudent and realistic.

Appraisal Waivers. The agencies granted a three-year waiver from their appraisal regulations to institutions affected by Hurricanes Katrina (ending August 29, 2008) and Rita (ending September 24, 2008). These appraisal waivers cover real estate-related transactions in certain Alabama, Mississippi, and Texas counties and Louisiana parishes. To qualify for the waiver, a financial institution needs to document that:

- (1) the property involved was directly affected by these disasters or the transaction would facilitate recovery from the disaster;
- (2) there is a binding commitment to fund the transaction that is made within three years after the date these disasters were declared; and,
- (3) the value of the real property supports the institution's decision to enter into the transaction.

When an institution decides to rely on the appraisal waiver for a particular real estate-related transaction, the institution should provide sufficient documentation

³ A federal credit union may purchase and hold a municipal security, as defined in Section 107(7)(K) of the Federal Credit Union Act, only if a nationally-recognized statistical rating organization has rated it in one of the four highest rating categories.

in the loan file to support its credit decision and valuation of the collateral. Examiners should continue to review transactions exempted from the appraisal regulations.

Other Assets. Examiners should determine whether the institution has acquired other assets, such as temporary office facilities to replace destroyed or unusable branches as well as temporary lodging facilities for employees whose homes have become uninhabitable. Examiners should assess the short- and long-term effect, including the asset's disposal when no longer needed, that these assets may have on the institution's operations and earnings.

Management Capability

When rating management, existing supervisory policy stipulates that examiners should make a distinction between problems caused by the institution's management and those due to outside influences. Management of an institution with problems related to external factors would warrant a higher rating than management believed substantially responsible for an institution's problems, provided that prudent planning and policies are in place and that management is pursuing realistic resolution of the institution's problems.

Many of the financial institutions affected by Hurricane Katrina are being confronted with unprecedented issues. Examiners should evaluate management based on the scope and thoroughness of the institution's internal risk assessment and, if necessary, its strategic plan for business restoration. In assessing management, examiners should consider the institution's size, complexity, and risk profile. While management of an affected institution should be rated upon its ability to properly identify and manage these risks, examiners should give consideration to the extraordinary circumstances surrounding many of the decisions made immediately after the disaster as well as the actions subsequently taken to resume operations.

In light of this disaster, examiners should assess the adequacy of an institution's disaster recovery and business continuity plans and consider whether these plans need to be modified. This review should include an assessment of management's ability to:

- Deal with extensive damage to facilities and equipment;
- Operate with limited staffing;
- Re-establish internal telecommunications capabilities;
- Retrieve and restore data systems and electronic information;
- Handle and reproduce contaminated loan files, legal documents, and collateral documentation;
- Locate and contact third party service providers and key suppliers;
- Replace contaminated cash and coins;
- Handle contaminated safe deposit boxes and their contents; and,

- Locate and contact other key business partners.

Earnings

When evaluating the earnings component of an affected financial institution, examiners should consider the duration or longevity of any reductions to core earnings caused by the hurricane. Examiners should also assess the quantity and quality of prior earnings as well as the influence that Hurricane Katrina may have on the institution's future earnings potential. This assessment also should consider the adequacy and reasonableness of any revisions to the institution's budget and strategic plan.

Liquidity

Many financial institutions affected by Hurricane Katrina may experience sharp fluctuations in liquidity resulting from the receipt of FEMA payments, insurance proceeds, or other disaster-related funds, as well as outflows of municipal deposits, out-of-area funds, or other large deposits. In addition, collateral requirements for secured funding sources (such as a line of credit from a Federal Home Loan Bank) may be temporarily modified. Examiners should consider the nature and timing of disaster-related inflows and outflows when reviewing the adequacy of an institution's liquidity and be cognizant of how management is employing any influx of liquid resources.

Sensitivity to Market Risk

Many institutions affected by Hurricane Katrina may experience temporary shifts in their interest rate risk profiles from changes in cash flows associated with the short-term impact of the disaster. For example, the amount or timing of cash flows may be altered by deterioration in loan and bond portfolios or by the prepayment of mortgages via insurance proceeds.

Examiners should recognize that management may require a reasonable period of time to fully assess any changes to the institution's interest rate risk profile, and to distinguish between permanent structural changes versus short-term fluctuations during a transitional period. Examiners should ensure that the institution's asset and liability management models are being reviewed and updated for any unusual fluctuations in deposit balances, adjustments to loan payments, changes in interest rates, and other modifications to ensure the integrity, accuracy, and reasonableness of the models.