GUIDELINES FOR A NEW FINANCIAL INSTITUTION

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DEPARTMENT OF BANKING AND FINANCE

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MEMORANDUM

TO: All State Chartered Financial Institutions

FROM: David G. Sorrell
Acting Commissioner

DATE: December 16, 2002

SUBJECT: Policy Statement On Guidelines For Policy Development

On August 10, 1984, the Department originally issued a policy statement for the guidance of all newly chartered financial institutions. To recognize changes in the financial industry and operating requirements of financial institutions the policy statement has been revised. The Department continues to feel that these guidelines could be useful to established financial institutions in policy development and maintenance.

If you have any questions, please contact the Department.

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Enclosure

GUIDELINES FOR A NEW FINANCIAL INSTITUTION POLICY DEVELOPMENT

Members of the Board of Directors have the responsibility for formulating a set of rules for their organization. The formulation of written policies offers a financial institution's directors and officers the opportunity to consider and develop basic objectives and to determine the desired institutional direction.

Policy formulation is a fundamental activity for all newly chartered financial institutions prior to opening for business. This commentary is designed to help management articulate sound flexible written policies to govern areas critical to a new financial institution's success. The suggested areas of coverage for each policy discussed represent minimum recommended coverage for the policy. In all cases, the newly chartered institution will want to expand coverage in the policy to tailor the policy to the unique needs of the institution. Also, the policies included in this commentary are not and should not be considered as the only policies that an institution needs to operate effectively. This statement is a starting point for policy formulation.

It is the Board of Directors' responsibility to review and revise, as necessary, written policies adopted at least annually.

ASSET/LIABILITY (FUNDS) MANAGEMENT POLICY
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Funds management involves estimating and satisfying liquidity needs in the most cost-effective way possible and without unduly sacrificing income potential. Management should avoid funding concentrations, as concentrations in funding sources increase liquidity risk. Funding diversification allows management to maintain access to different funding lines and allows more flexibility in selecting the appropriate funding source. Also, in times of financial distress, an institution will benefit from a diversified funding base rather than the situation where funding is concentrated in one source. Along with the cost of funds and diversification issues, management should consider maturity and repricing balance sheet mismatches, anticipated funding needs, and economic and market forecasts in its liquidity planning.

In the current financial environment, management has to manage the entire balance sheet, both assets and liabilities. Effective analysis and management of liquidity requires management to measure the liquidity position of the bank on an ongoing basis and to examine how funding requirements are likely to evolve under various scenarios, including adverse conditions. The formality and sophistication of funds management depends on the size and sophistication of the bank, as well as the nature and complexity of its activities. The objectives and guidelines of asset/liability management in today's financial environment should encompass the following:

1. Establishing risk tolerances and individual and aggregate limits on borrowed funds by type and source

2. Managing Net Interest Margins

3. Managing Profitability

3. Controlling Interest Rate Risk Exposure

4. Ensuring Liquidity

5. Performing Balance Sheet Planning (asset mix, liability mix)

6. Performing Tax Planning

7. Planning Bank Funding

8. Addressing funding concentration in or excessive reliance on any single source or type of funding.

9. Mitigating Interest Rate Risk

These nine objectives must be considered a part of any functioning asset/liability management policy with appropriate but flexible benchmarks utilized for each area. Benchmarks or quantitative goals should fit the individual institution's short and long-term planning objectives and desired goals. The policy should establish ratio thresholds which are attainable and mirror the Board's risk tolerance. Each institution will be unique based upon its operating environment and stated goals.

To properly conduct asset/liability management, a financial institution should establish an Asset/Liability Management Committee to:

(1) Monitor business conditions, financial markets and regulatory changes on a continuing basis;

(2) Manage mix of rate sensitive sources and uses of funds over interest rate cycles; and

(3) Evolve key loan, deposit, and investment and funds management strategies consistent with profit planning and longer-range goals and objectives.

The composition of this committee should include the Chairman and/or President, Senior Investment Officer, Senior Financial Officer, Senior Corporate Banking Officer, and the Senior Retail Banking Officer. It is realized that all financial institutions may not have these positions categorized this way, but all financial institutions should have people responsible for these areas.

This Committee should be involved in everything the financial institution intends to do and should meet on a regular basis. Staff support will be important, and the management information systems utilized to gather information for the committee must be thorough and timely. The amount of information considered, therefore, will make the use of manual preparation of information extremely burdensome and often untimely. The asset/liability management software package should be flexible and tailored appropriately to meet the institution's needs whether adopted through use of a microcomputer, minicomputer, or internal or external mainframe computer. The important point is that information is available in the format needed and at the time needed to make sound business decisions.

Financial institutions should have an adequate system of internal controls that ensures the independent and periodic review of the interest rate risk management process and models. In addition, the review should encompass compliance with policies, procedures and interest rate strategies. Monitoring compliance should include adherence to limits for managing and monitoring interest rate risk. This process should also include monitoring internal and external factors and events that could have a bearing on the institution's liquidity.

The following comments represent, for illustrative purposes, certain strategies which an asset/liability management policy can employ to accomplish stated goals. <u>These strategies are not intended to represent the Department's views or endorsement of these areas.</u> That decision rests with the institution's individual circumstances and management policies.

1. Convert business loan pricing from the "prime" rate to a rate more closely parallel to the institution's cost of funds;

2. Introduce variable/renegotiable rate mortgages and installment loan products tied to money market yields or internal cost of funds index – pricing strategies could reduce the marketability and liquidity of assets;

3. Develop secondary mortgage market capabilities through mortgage originations and mortgage swap programs to reconfigure the existing portfolio;

4. Reassess the role of the investment portfolio in light of funding strategies balance sheet mix;

5. Increase portfolio's responsiveness to changing levels of interest rates by emphasizing shorter maturities and money market instruments to better match funding liabilities.

The institution should have an adequate system of internal controls that ensures the independent and periodic review of the interest rate risk management process and models. In addition, the review should encompass compliance with policies, procedures and interest rate strategies. Monitoring compliance should include adherence and limits for managing and monitoring interest rate risk. The process should also include monitoring internal and external factors and events that could have a bearing on the institution's liquidity.

A financial institution is never too large or too small to have a functioning asset/liability management policy to implement its balance sheet goals. In an ever-changing industry, management must consider the objectives to be covered by an asset/liability management policy and provide the institution direction through a flexible, tailored, written policy. Since asset/liability management affects all bank activities, the remaining policy areas discussed herein interrelate with asset/liability management policy objectives.

LIQUIDITY POLICY

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Liquidity represents the ability to efficiently and economically accommodate decreases in deposits and other liabilities as well as fund increases in assets. A financial institution has liquidity potential when it has the ability to obtain sufficient funds in a timely manner at a reasonable cost. Liquidity is essential in all financial institutions to compensate for expected and unexpected balance sheet fluctuations and provide funds for growth. Liquidity risk is the risk of not being able to obtain funds at a reasonable price within a reasonable time period to meet obligations as they become due. Because liquidity is critical to the ongoing viability of any bank, liquidity management is among the most important activities that a bank conducts.

Liquidity has its cost which is a function of market conditions and the risk profile of the bank in both interest rate and credit risk, reflected in the balance sheet. If liquidity needs are met through holdings of high-quality, short-term assets, generally the cost is the income sacrificed by not holding longer term and/or lower quality assets. If liquidity needs are not met through liquid asset holdings, a financial institution may be forced to acquire additional liabilities under adverse market conditions at excessively higher rates. At different times, similar liquidity positions may be adequate or inadequate depending on anticipated need for funds. To provide funds to satisfy liquidity needs, one or a combination of the following must occur:

1. Conversion of liquid assets;

2. Increase in short-term borrowing and/or issuance of additional short-term deposit-like liabilities;

3. Decrease in holdings of long-term assets;

4. Increase in long-term liabilities; and

5. Increase in capital funds.

Developing assumptions with regard to the future by intelligent forecasting, as opposed to speculation, is essential to liquidity planning. Management must consider the effect future events are likely to have on funding requirements as well as the probability of such events occurring. If management does not consider future events and postulate the financial institution's funding strategy accordingly, the financial institution may be run by the dictates of the economy rather than by management. All financial institutions are affected by changes in the economic climate, but sound financial management can minimize negative changes and maximize positive ones. Management must also have contingency plans in case projections fail to materialize. Liquidity management includes evaluating various funding sources and the costs associated with the sources identified.

The board of directors should understand the nature and level of the institution’s liquidity risk, establish the institution’s tolerance for liquidity risk, and approve significant policies related to liquidity management. The board, or a committee of the board members, should also ensure that senior management takes the necessary steps to monitor and control liquidity risk.

Determination of the adequacy of a financial institution's liquidity position depends upon:

1. An analysis of the current liquidity position;

2. Historical funding requirements;

3. Anticipated future funding needs; and

4. Options for reducing funding needs or attracting additional funds.

A good liquidity policy should generally provide for forward planning which takes into account the unique characteristics of the bank, management goals regarding asset and liability mix, desired earnings, and margins necessary to achieve desired earnings. Forward planning should also take into account anticipated funding needs and the means available to meet those needs. The policy should establish responsibility for liquidity and funds management decisions and provide a mechanism for necessary coordination between the different departments of the bank. Strategies should be based on sound, well-deliberated projections. The board of directors should be satisfied that the assumptions used in the projections are valid and the strategies employed are consistent with projections.

Based upon the foregoing elements of liquidity, the development of a Liquidity Policy should include the establishment of guidelines for the following topics:

1. Periodic review of the bank’s deposit structure, including the volume and trend of total deposits and the volume and trend of the various types of deposits offered, the maturity distribution of time deposits, rates being paid on each type of deposit, rates being paid by trade area competition, caps on large time deposits, public funds, out-of-area deposits, and any other information needed.

2. Conveys the board's risk tolerance and establishes target liquidity ratios such as a loan-to-deposit ratio, a loan-to-asset ratio, long-term assets funded by less stable funding sources, individual and aggregate limits on borrowed funds by type and source, or a minimum limit on the amount of short-term investments.

   A. Internal liquidity guidelines and limits should be established in the written liquidity policy of the financial institution. Limits may be established for target core liquidity and secondary liquidity sources. Additionally contingency plans should be established in the event that liquidity declines below established minimum levels. Target levels should allow the bank to operate without the need for borrowed funds to meet liquidity needs on an ongoing basis. Management information systems adequate to measure, monitor, control and report liquidity risk should be in place, and reports should be regularly provided to the board of directors and senior management. The financial institution should set its target ratio to fit its operating environment and business plan.

   B. A target loan to deposit ratio or loan to asset ratio to allow for funds to be invested in more liquid assets, to provide for reserve funds for meeting additional loan demand or asset growth, and to maximize profits while maintaining adequate liquidity. Target ratios should allow a bank to operate without the need for borrowed funds on an ongoing basis. The financial institution needs to tailor its targets to the institution's operating environment.

   C. Recognition of seasonal loan demand and deposit patterns. Recognition of cyclical fluctuations in cash demands, as well as deposit fluctuations, will enable the financial institution to anticipate and plan for increased cash demands.

3. An adequate system of internal controls that ensures the independent and periodic review of the liquidity management process, and compliance with policies and procedures and liquidity strategies. Monitoring compliance should include adherence and limits for managing and monitoring liquidity to ensure adequate liquidity is maintained at all times. This process should also include monitoring internal and external factors and events that could have a bearing on the institution's liquidity.

4. When assessing the bank's liquidity position, management may use analytical tools such as the Uniform Bank Performance Report (UBPR) ratios in concert with the institution's internal liquidity ratios on a level and trend basis. Some UBPR ratios that may be used are:

   a) Net Short-Term Non Core Funding Dependence.
   b) Net Non-Core Funding Dependence.
   c) Net Loans and Leases to Deposits.
   d) Net Loans and Leases to Total Assets.
   e) Short-Term Assets to Short-Term Liabilities.
   f) Pledged Securities to Total Securities.
   g) Brokered Deposits to Deposits.
   h) Core Deposits to Total Liabilities.

The UBPR along with instructions and definitions is available on the Federal Deposit Insurance Corporation web site.

5. A contingency plan that address alternative sources of funds if initial projections of funding sources and uses are incorrect or if a liquidity crisis arises.

6. Establishment of bank lines and periodically test their use. These include unsecured/secured lines of credit with correspondent financial institutions. Diversification reduces dependence on any one supplier. The financial institution should not exceed its capacity to borrow in any one area or market. A limit should be set for each category of borrowing and the run-off at any time should be restricted.

7. Long-range Investment Strategy with Regard for Liquidity Needs: Liquidity is sought while at the same time minimizing the cost of those funds. If the financial institution experiences cyclical loan demand or deposit fluctuations, educated predictions can be made for funding requirements and investments can be purchased with those needs in mind.

8. Consideration of Interest Rate Risk Exposure: The degree of interest rate risk exposure will affect liquidity due to the cash flow changes that result from interest on rate-sensitive asset and liabilities is sought. It must be planned so that earnings will not be affected from changes in interest rates.

9. In conjunction with the bank's investment policy, a determination must be made regarding of types of investments permitted, the desired mix among those investments, the maturity distribution and the amount of funds that will be available, and reviews of pledging requirements. A maturity ladder in the investment portfolio which is consistent with the liability structure of the financial institution should coincide with both the sources and uses of funds. Liquidity has consisted of balancing maturing liabilities with maturing assets by monitoring runoff. Now, liquidity involves developing future sources of funds which may or may not be required but which can be made available at any time at reasonable cost.

10. Periodic Review and Evaluation of the Liquidity Policy by the Board of Directors, Funds Management/Liquidity Committee and/or the Investment Committee: Adequate review of compliance and success of the above items is necessary so that immediate remedial action can be taken to correct imbalances and avoid illiquid conditions. Where noted changes in the financial institution's environment affect management's predictions concerning anticipated liquidity needs, periodic review of the Policy and the financial institution's planned liquidity position can be fine-tuned to meet the liquidity needs due to the uncontrolled changes in the marketplace.

11. Approval procedures for exceptions to policies, limits, and authorization should be defined.

Once anticipated and potential needs have been determined, management must decide how those needs will be met through asset/liability management. Every financial institution should carefully consider all options to establish optimum liquidity management conditions.

LOAN POLICY

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A primary purpose of a written loan policy is to provide a framework of standards and points of reference within which individual lending personnel can operate with confidence, relative uniformity and flexibility. Loans comprise a major portion of the asset structure of most banks and it is the asset category which ordinarily presents the greatest credit risk and, therefore, potential loss exposure to banks. A written loan policy can greatly assist management in the maintenance of proper credit standards, in the avoidance of unnecessary risks and in the proper evaluation of new business opportunities. The lending policy should be tailored to fit the financial institution's specific needs, staff and objectives. The financial institution's objectives for the lending function should include safeguarding of assets, earnings performance, liquidity and asset/liability management.

Establishment of a lending policy is particularly important in newly organized financial institutions where management and staff are often unacquainted with each other or unfamiliar with the operations of the financial institution. The actual drafting of the policy may be delegated to the chief executive officer and the lending staff, but the Board should have a role in the process, either by reviewing and approving the policy once formulated or by direct participation at critical points in the drafting process. While it is not suggested that the written loan policy should actually be written by the Board, it should be approved by them, and not in a cursory or perfunctory manner, but rather after careful explanation, consideration and discussion.

A constructive starting point in establishing a written loan policy is the careful evaluation and coverage, at a minimum, of the following points:

1. A description of the general fields of lending in which the financial institution shall engage, the type of loans and collateral considered desirable and the types of loans and collateral considered undesirable.

2. An identification of the geographical trade area from which financial institution loans should be generated, and circumstances under which loans outside the trade area may be granted.

3. The financial institution's legal lending limits and other legal constraints should be set forth to avoid inadvertent violations of financial institution regulations.

4. The responsibility of the Board of Directors in reviewing and approving loans and periodically reviewing major lines of credit.

5. The lending authorities of a loan or executive committee, if any, and each loan officer. These authorities should be approved at least annually, for each individual by written resolution of the Board of Directors and kept current at all times

6. The guidelines under which unsecured loans will be granted.

7. The guidelines for rates of interest and terms of repayment for (i) unsecured loans and (ii) secured loans.

8. Limitations on the amount of secured loans that will be made in relation to the market value of the collateral or security pledged, and an identification of the types of supporting documentation required by the financial institution for each type of secured loan.

9. The maintenance and review of complete and current credit files on each borrower.

10. Appropriate and adequate collection procedures, including but not limited to, the action to be taken against borrowers who fail to make timely payments.

11. Guidelines establishing limitations on the maximum dollar volume of loans in relation to types of funding sources such as assets or deposits of financial institution based on seasonal demands and loan mix or an established level of loans by type; i.e., commercial, consumer, term, etc. Also, the bank's plans for monitoring and taking appropriate corrective action, if deemed necessary, on any concentration that may exist.

12. Specific guidelines governing loans to officers and directors of the financial institution, including a prohibition against recurring overdrafts or cash items held against deposit account of the officers, directors or other insiders of the financial institution (see prohibition of Federal Reserve Regulation O).

13. Appropriate limitations on the extension of credit through overdrafts.

14. A prohibition against (a) the addition of uncollected interest on the unpaid balance of any loan on which such interest is due, (b) the acceptance of a separate note for uncollected interest due on any loan unless supported by additional tangible collateral which adequately and completely secures the loan, (c) the continuation of accrual of interest on any loan delinquent in principal or interest payments 90 days or more, or (d) any other device that essentially avoids recognition of overdue loans and/or artificially inflates the income of the financial institution.

15. The guidelines under which uncollectible and seriously past-due loans will be charged off.

16. Establishment of an allowance for loan and lease losses by the Board of Directors which will be maintained against the reasonable risk inherent in the lending operation based on a quarterly review of the loan portfolio and the financial institution's loan volume.

17. Exact definition of a borrower's total liability to the financial institution is a necessity in reviewing and controlling loans to customers.

18. Plans as to how exceptions will be identified and treated.

19. Limitations on the maximum dollar volume of loans in relation to total assets.

20. Guidelines for obtaining and reviewing real estate appraisals as well as for ordering appraisals, when needed.

21. Guidelines addressing the bank's loan review and grading system ("Watch list).

Loan Review Systems

Management should maintain written policies and procedures governing major areas of its loan review system. These should be reviewed and approved at least annually by the board of directors. The term loan review system refers to the responsibilities assigned to various areas such as credit underwriting, loan administration, problem loan workout, or other areas. The complexity and scope of a loan review system will vary based upon an institution's size, type of operations, and management practices. Although, smaller institutions may not be expected to maintain separate loan review departments, it is essential that all institutions maintain an effective loan review system.

Regardless of its complexity, an effective loan review system is generally designed to address the following objectives:

- To promptly identify loans with well-defined credit weaknesses so that timely action can be taken to minimize credit loss;

- To provide essential information for determining the adequacy of the Allowance for loan and lease losses (ALLL);

- To identify relevant trends affecting the collectibility of the loan portfolio and isolate potential problem areas;

- To evaluate the activities of lending personnel;

- To assess the adequacy of, and adherence to, loan policies and procedures, and to monitor compliance with relevant laws and regulations;

- To provide the board of directors and senior management with an objective assessment of the overall portfolio quality; and

- To provide management with information related to credit quality that can be used for financial and regulatory reporting purposes.

Credit Grading Systems

Accurate and timely credit grading is a primary component of an effective loan review system. Credit grading involves an assessment of credit quality, the identification of problem loans, and the assignment of risk ratings. An effective system provides information for use in establishing valuation allowances for specific credits and for the determination of an overall ALLL level.

Credit grading systems often place primary reliance on loan officers for identifying emerging credit problems. Given the importance and subjective nature of credit grading, a loan officer's judgment regarding the assignment of a particular credit grade should generally be subject to review. Reviews may be performed by peers, superiors, or loan committee(s), or by other internal or external credit review specialists. Credit grading reviews performed by individuals independent of the lending function are preferred because they often provide a more conservative assessment of credit quality. A loan review system should, at a minimum, include the following:

1. A formal credit grading system that can be reconciled with the framework used by regulatory authorities;

2. An identification of loans or loan pools that warrant special attention;

3. A mechanism for reporting identified loans, and any corrective action taken, to senior management and the board of directors; and

4. Documentation of an institution's credit loss experience for various components of the loan and lease portfolio.

Loan Review Policy

Management should maintain a written loan review policy that is reviewed and approved at least annually by the board of directors. Policy guidelines should include a written description of the overall credit grading process, and establish responsibilities for the various loan review functions. The policy should generally address the following items:

1. Qualifications of loan review personnel should be based on level of education, experience, and extent of formal training. In addition, they should be knowledgeable of pertinent laws and regulations that affect lending activities, sound lending practices and their own institution's specific lending guidelines.

2. Management should ensure that, when feasible, all significant loans are reviewed by individuals that are Independent of the loan approval process personnel.

3. Frequency of reviews: The loan review function should provide feedback on the effectiveness of the lending process in identifying emerging problems. Reviews of significant credits should be performed annually, upon renewal, or more frequently when factors indicate a potential for deteriorating credit quality.

4. Scope and depth of reviews: Reviews should cover all loans that are considered significant and the analysis should include important factors such as credit quality, sufficiency of credit and collateral documentation, proper lien perfection, compliance with internal policies and procedures, applicable laws and regulations and the accuracy and timeliness of credit grades assigned.

5. Review of findings and follow-up: Loan review findings should be reviewed with appropriate loan officers, department managers, and members of senior management. Any existing or planned corrective action should be elicited for all noted deficiencies. All

deficiencies that remain unresolved should be reported to senior management and the board of directors.

6. Workpapers for loans reviewed should consist of documentation supporting assigned ratings.

7. A report should be prepared and submitted to the board that summarizes the results of the review at least quarterly. Findings should address adherence to internal policies and procedures, and applicable laws and regulations, so that deficiencies can e remedied in a timely manner.

Environmental Risk and Lender Liability Program

A growing area of potential risk associated with lending is the potential for liability under various environmental laws and claims of lender liability by borrowers, and possibly their other creditors and shareholders. The potential adverse effect of environmental contamination on the value of real estate collateral and the potential for liability have become important factors in the evaluation of real estate transactions and making loans secured by real estate. The Environmental Protection Agency (EPA) has responsibility for enforcement authority of environmental laws. The EPA may be contacted for information or exemptions available to financial institutions regarding liability and clean up of contaminated property. Legislation and the authority of the EPA are still evolving regarding liability of financial institutions as lenders holding a security interest in contaminated property. In order to minimize the financial institution's exposure when holding a security interest in real or personal property that may be in violation of federal or state environmental laws, and when making loans to borrowers who engage in a potentially environmentally sensitive businesses, the following should apply to all real estate loans in which the financial institution has a security interest or owns outright through foreclosure, with the exception of single family residences:

1. Procedures: When taking a loan application from the borrower, the loan officer should make a determination as to whether or not the borrower is involved in any way with the use of hazardous substances. The bank should develop and maintain a list of such businesses which may engage in a potentially environmentally sensitive activity. The bank should establish guidelines for actions to be taken when a borrower is suspected to engage in a business that uses hazardous substances.

2. Risk Assessment: If it is determined that the borrower may be involved in a suspect industry or business, the officer should follow establish procedures such as a Preliminary Environmental Risk Review. After completing the assessment, a determination must be made as to whether or not an environmental risk audit by an outside firm should be ordered and performed prior to making the loan to the suspect business.

3. Documentation: When closing a loan which is secured by real property of a suspect business, the customer should execute an indemnity and hold harmless covenant. This document should be attached to the Security Deed.

4. Managing the loan: Under existing federal and state laws, the financial institution may have an exemption from environmental liability as the holder of a security interest in the real property collateral as long as the financial institution's actions involved with the customer do not constitute "participating in the management" of the business. The

financial institution should not exercise any decision making control over the borrowers' environmental compliance obligations. Also, the financial institution should not take any responsibility for all or substantially all of the operational aspects of the borrower's enterprise.

Financial Institutions should address procedures in the written loan policy to manage the risk of lender liability through file documentation and loan administration practices. Claims of lender liability usually involve problem workout and collection loans. The financial institution's handling of the loan should be documented with the following:

1. Memoranda to file on the various terms of the credit and any agreements reached with potential borrowers. Management must be consistent in its handling of the borrower. Files should be cleansed free of extraneous materials and care should be exercised in file maintenance.

2. Conduct of loan officer should be professional and oral agreements of any kind should be avoided, or if one is made, it should be confirmed in writing with the borrower, with a copy to the file.

3. Participation by the loan officer in management of the borrowers' business or interferences in its day-to-day affairs should be avoided.

4. Management activities should be carried out in good faith and fair dealings and in accordance with the terms of the loan agreement.

After adoption of a written loan policy, the administration of the policy is the responsibility of the Board of Directors. Procedures should be implemented to determine compliance with the loan policy. A tool used in this regard is the establishment of loan review and grading systems. The systems may be implemented by the auditor, loan review officer, or a loan review committee who should report directly to the Board. The nature, scope and structure of loan review and grading systems will vary with the size and complexity of each financial institution; however, every financial institution should have a loan review system which, at a minimum, provides for:

1. An identification or grouping of loans that warrant the special attention of management;

2. For each loan identified, a statement or indication of the reason(s) why the particular loan merits special attention; and

3. A mechanism for reporting periodically to the board on the status of each loan identified and the action(s) taken by management.

It is most important that the loan policy be adaptable to changing economic conditions, money market considerations, the financial institution's financial position and competitive conditions. Once adopted, the policy should be reviewed periodically by the Board for any changes needed.

Georgia Fair Lending Act (GAFLA)

The policy should include guidelines for determining compliance with all provisions of the GAFLA. The institution should adopt guidelines to prohibit abusive home loan practices; to

provide for definitions; and to provide for prohibited practices and limitations relating to covered home loans and high-cost home loans. The institution should also provide guidelines for determining interest and fees charged, loan terms, prepayment and late payment fees, any notice or disclosure required, and remedies for addressing inadvertent violations.

The institution's information system should identify loans that must comply with the GAFLA. All loans that are covered by the GAFLA should be evaluated for compliance through the loan review and/or internal audit function. All violations should be reported to the board of directors.

Subprime Lending Program

There is not a universal definition of a subprime loan in the industry, but subprime lending is generally characterized by the lending program or strategy that targets borrowers who pose a significantly higher risk of default than traditional retail banking customers. Institutions often refer to subprime lending by other names such as the nonprime, nonconforming, high coupon, or alternative lending market.

The term "subprime" refers to the credit characteristics of the borrower at the loan's origination, rather than the type of credit or collateral considerations. Subprime borrower typically have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria.

Financial institutions should have comprehensive written policies and procedures, specific to each subprime lending product, that set limits on the amount of risk that will be assumed and address how the institution will control portfolio quality and avoid excessive exposure. Policies and procedures should be in place before initiating the activity. Additionally minimum regulatory capital requirements will not apply to an institution's portfolios that exhibit substantially lower risk profiles that exist in subprime loan programs. Acceptable origination channels, dealers, brokers, correspondents, and marketing firms, for subprime loans should be included in written policies. Subprime lenders should retain additional capital support consistent with the volume and nature of the additional risks assumed. These institutions are expected to establish procedures for quantifying the amount of capital needed to offset the additional risk in subprime lending activities, and for fully documenting the methodology and analysis supporting the amount specified.

Subprime lending should only be conducted within a comprehensive lending program that employs strong risk management practices to identify, measure, monitor, and control the elevated risks that are inherent in this activity. If risks associated with subprime lending activities are not properly controlled, subprime lending may be considered an unsafe and unsound banking practice.

The board's decision to engage in subprime lending programs should be based on the institution's overall business strategy and risk tolerances, and with a full knowledge of all business risk issues. When establishing subprime lending programs, management should proceed slowly and cautiously. The following items are essential components of a risk management program for subprime lending:

Planning and Strategy. Prior to engaging in subprime lending, the board and management should ensure that all involved parties have properly addressed critical business risk and issues including:

1. Costs associated with attracting and retaining qualified personnel, and investments in the technology necessary to manage a more complex portfolio.

2. Developed a clear solicitation and origination strategy that allows for after-the-fact assessment of underwriting performances.

3. Establishment of appropriate feedback and control systems.

4. Development of a risk assessment process that extends beyond credit risk and appropriately incorporates operating, compliance, market, liquidity, and reputation and legal risks.

5. Implementation of periodic Strategic Plan performance analysis to detect adverse trends or circumstances and take appropriate action in a timely manner.

Management and Staff- Prior to engaging in subprime lending, the board should ensure that management and staff possess sufficient expertise to appropriately manage the risks in subprime lending and that staffing levels are adequate for the planned volume of activity. Generally, it is not sufficient to have the same staff responsible for both subprime and prime loans. Staffing issues include:

1. Subprime lending requires specialized knowledge and skills that many financial institutions do not possess.

2. Marketing, account origination, and collections strategies and techniques often differ from those employed for prime credit.

3. Servicing and collecting subprime loans can be very labor intensive and requires a greater volume of staff with smaller caseloads.

4. Compensation programs should not depend primarily on volume or growth targets; any targets used should be weighted towards factors such as portfolio quality and risk-adjusted profitability.

Profitability and Pricing- A key consideration for lenders in the subprime market is the ability to earn risk-adjusted yields that appropriately compensate the institution for the increased risk and costs assumed. The institution must have a comprehensive framework for pricing decisions and profitability analysis that considers the following for each product:

1. Origination, administrative/servicing, expected charge-offs, funding, and capital.

2. Fees - including the extent they are recurring and a viable source of revenue.

3. Profitability projections should be incorporated into the operating budget and business plan.

4. Method of tracking actual performance against projections regularly and a process for addressing variances.

Loan Review and Monitoring- The board should adopt and implement a comprehensive analysis and information system that identify measure, monitor and control the risks associated with subprime lending.

1. The analysis must promote understanding of the portfolio and early identification of adverse quality/performance trends.

2. Systems employed must posses the level of detail necessary to properly evaluate subprime activity.

3. Analysis should take into consideration the effects of portfolio growth and seasoning, which can mask true performance by distorting delinquency and loss ratios.

4. Liquidity and funding sources for subprime lending should be reviewed and assessed periodically.

5. Management should monitor customer behavior and credit quality and take proactive measures to avert potential problems.

Concentrations in Real Estate Acquisition, Development and Construction Lending

Generally a concentration is a significantly large volume of economically-related or collateral-related assets that an institution has advanced or committed to a person, entity, affiliated group, or industry. These assets may in the aggregate present a substantial risk to the safety and soundness of the institution. Adequate diversification of risk allows the institution to avoid the excessive risks imposed by credit concentrations. Concentrations generally are not inherently bad, but do add a dimension of risk which the Board of Directors should consider when formulating plans and policies. When reasonable diversification realistically cannot or is not maintained, the resultant concentration call for capital levels higher than the regulatory minimums.

In formulating policies, management should, at a minimum, address goals for portfolio mix and limits within the real estate acquisition, development and construction (ADC) loan categories. Management should consider the need to tract and monitor the economic and financial condition of specific geographic locations, industries and groups of borrowers in which the bank has invested heavily.

The degree of risk in real estate loans depends primarily on the loan amount in relation to collateral value, the interest rate, and most importantly, the borrower's ability to repay in an orderly fashion. Banks can jeopardize their capital structure by a concentration in ADC loans. Apart from localized, adverse economic conditions which could not have been foreseen, could result in a temporary or permanent "wash out" of realty values, principal errors made in granting real estate loans include inadequate regard to normal or even depressed realty values during periods when it is in great demand plus inflating the price structure, the maximum debt loan and paying capacity of borrowers, and failure to reasonably restrict real estate loans on properties for which there is limited demand.

When concentrations exist, the board should adopt policies that address the following factors:

- The maximum amount that may be loaned on a given property, in a given category, i.e. subdivision;

- The need for appraisals (professional judgments of the present and/or future value of the real property);
- Limits on residential single-family construction lending;
- Limit on number of speculative and pre-sold construction home loans granted to each builder and in each development;
- Minimum requirement for initial equity investment;
- Establish guidelines for support of draw requests by inspections;
- Monitoring of concentrations of credit periodically;
- Information system that provide reports by loan types or repayment source for industry concentrations which include dollar volume/amount and percentages for funded and unfounded totals measured against Tier 1 Capital; and
- Establish limitation for specific ADC concentration.

INVESTMENT POLICY

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Management of a financial institution's investment portfolio requires the adoption of a defined investment policy. The uncertainty and volatility of the bond and other investment markets of the past underscore the need for sound investment portfolio administration to achieve the desired goals of high profitability, optimum liquidity, and acceptable quality. It is the responsibility of the Board of Directors and senior management to develop the investment policy. To insure that the directorate does not delegate policy decisions, a financial institution's investment policy must provide details and encompass minimums and maximums rather than a philosophical description of objectives. The policy should be in written form, reviewed periodically by the Board and revised as needed in view of changing circumstances and the needs of the individual financial institution. By establishing clarity of direction, a written investment policy should provide the basic foundation upon which effective portfolio strategy can be developed.

Each financial institution, regardless of size or its unique characteristics, should consider at a minimum the following major factors in formulating a written investment policy:

1. A Statement of the Objectives of the Investment Portfolio: Such objectives should include the following:

   (a) To provide an investment medium for funds which are not needed to meet loan demand, or deposit withdrawal;

   (b) To optimize income generated from the investment account consistent with the stated objectives for liquidity and quality standards;

   (c) To meet regulatory standards;

   (d) To provide collateral which the financial institution is required to pledge against public monies;

   (e) To provide an investment medium for funds which may be needed for liquidity purposes;

(f) To provide an investment medium which will balance market and credit risk of other assets and the financial institution's liability structure; and

(g) Other objectives (as deemed appropriate for the specific financial institution).

2. Assignment of Responsibilities: Responsibilities of the Board of Directors, investment officer(s), and Investment Committee should be detailed.

3. Listing of Acceptable Investments: Acceptable investments may include U.S. Treasury securities, Federal Agency securities, municipal obligations, certificates of deposits of other financial institutions, bank acceptances, collateralized mortgage obligations (CMOs), etc. All investments should conform to applicable Sections of the Code of Georgia and the Rules of the Department of Banking and Finance.

4. Investment Portfolio's Composition and Investment Limitations: The policy should define responsibility for establishing minimum and maximum amounts to be invested in the various acceptable investments. Proper diversification in the investment portfolio will avoid unfavorable concentrations in obligations of a single issuer or in the types of investments whose quality depends largely upon the same set of circumstances. Appropriate geographic distribution in municipal investments should be established. Factors to be considered in establishing investment limits should include regulatory requirements and constraints, liquidity needs, tax position and collateral and pledging requirements.

5. Acceptable Maturity Ranges: A soundly planned maturity schedule will take into consideration the financial institution's invested position, prevailing and anticipated loan demands, and the stability of mixed funding sources.

6. Acceptable Quality Ratings of Investments: Investments whose rating is reflective of speculative elements or substandard quality should not be purchased. Nonrated purchases should be restricted and purchased only after proper credit documentation has been analyzed to determine their investment quality.

7. Acceptable Lot Sizes: Minimum and maximum lot sizes should be established for purchases.

8. Acceptability of Trading Securities: Trading is a day-to-day operation of buying and selling securities that requires easy access to the securities market. Trading requires experience and an expertise not available to most financial institutions. Gains and/or losses should be considered in light of the financial institution's earnings, tax, and capital positions.
9. Pledging Practices and Requirements: Investments should be adequate to secure deposits which by statute are required to be secured.

10. Accounting and Recordkeeping: Guidance on the accounting and reporting for securities should be based on generally accepted accounting principles (GAAP).

11. Credit Risk: Management should be restricted to investment grade instruments. The board may permit management to acquire nonrated instruments; however, these instruments should be consistent with investment grade standards or the credit equivalent of investment quality. Guidelines on credit analysis and due diligence suitability analysis should be performed to determine if instruments are suitable for purchase relative to the bank's tolerance for credit risk, asset liability position, sensitivity to market risk, and its liquidity exposure.

Securities activities by financial institutions may be affected by internal factors such as a slackening of loan demand and a drop in net interest margins which may prompt some financial institutions to look more closely at the investment portfolio as a source for improving profitability. Certainly this should always be a consideration; however, there are certain boundaries that regulators feel should always be observed. Several financial institutions in other parts of the country have failed due to speculative securities activities. Some of these activities are encouraged by securities dealers whose primary motivation is commission income and not the safety and soundness of the financial institution system. The following points should always be observed to help alleviate problems:

1. Written investment policies which discourage speculative trading activity should be adopted by the Board of Directors and followed by appropriate financial institution management.

2. The financial institution should adhere to specific limits on individual security issues contained in its investment policy.

3. The investment securities officer of the financial institution should know the securities dealers with whom the financial institution regularly does business. References should be checked out on any new securities dealer.

4. Comparison pricing should always be done when purchasing securities. Investment officers should get at least two quotations for securities purchases.

5. The investment officer should ascertain that the securities to be purchased are, in fact, legal investments for the state financial institution. A determination of eligibility or ineligibility of securities is published in the Georgia Department of Banking and Finance Bulletin in the month when the determination is made.

6. The investment officer should review a stress test before purchasing a Collateralized Mortgage Obligation, or similar investment, in order to ensure that the investment is not a "high-risk" security. Stress tests should be reviewed periodically in an assessment of the suitability and investment eligibility of the security for the financial institution's needs. Stress tests are required on at least an annual basis, but during times of rapid interest rate movements, should probably be performed on a quarterly basis.

7. Management needs to be aware of the accounting treatment for the particular types of investments purchased. The designation of a security as either "Held To Maturity," "Available for Sale," or "Trading" under FASB 115 may have a significant impact on the financial institution's earnings and/or capital.

AUDIT POLICY

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Much has been written concerning the need for each financial institution to have an adequate audit program. However, in this day of advanced electronic funds transfer and high technology, this basic aspect of sound financial institution management has never been more important. It is particularly important for the new financial institution to start out with a sound, comprehensive and technically advanced program of audit protection.

One of the primary tools to be used by the Board of a new financial institution to insure the implementation of an adequate audit program is the development of a written policy on audit considerations. Such a policy would allow the Board to target and direct the audit program of the institution, thereby having a direct influence to insure that the audit program is tailored to the needs of the institution. The policy would afford the Board the opportunity to consider the specific needs of the institution while giving proper consideration to the bookkeeping system being employed, the qualifications of the audit staff, the audit reporting system, and the satisfaction of legal requirements when establishing the audit program.

The management of each new financial institution must decide the most effective audit technique which best fits their overall management plan. Every financial institution shall have an audit of its books and records performed at least annually by independent public accountants in accordance with generally accepted auditing standards. The Board should contract and appoint the independent firm to perform the annual audit. The policy should address the independence of the internal and external audit functions. An internal auditor shall be appointed by the Board of Directors and charged with implementation of the financial institution's internal audit program. Some management teams may choose to use a qualified in-house internal auditor, while others may choose to employ the services of an independent CPA firm to perform the duties of the internal auditor. Whichever method is utilized, legal restrictions contained in the Official Code of Georgia should be reviewed in detail to insure complete technical compliance with the provisions contained therein. Statutory audit requirements and Department regulations require each state-chartered financial institution's audit to contain comments on the following three areas, without exception: (1) scope of the audit; (2) evaluation of the system of internal routine and controls; and (3) such other tests and reviews of the banks books and records as deemed appropriate by the independent auditor, including confirmation of the bank’s loan accounts and deposit accounts. A properly established statistical sampling procedure may be used in performing confirmations.

When establishing a formal audit program, there are three basic goals which the program should attain:

1. The audit program should provide assurance that the records are being posted (by whatever means employed) in an accurate, timely, safe and sound manner;

2. The audit program should have provisions which help monitor the operating procedures being practiced; and

3. The audit program should monitor to insure that there is proper adherence to all management policies and established procedures as well as all applicable laws and regulations.

Since the responsibility for the quality of an audit program ultimately rests with the Board of Directors, the Board must periodically review and make determinations concerning the qualifications of the auditor, the scope of the audit being performed, the frequency of the various audit functions, and the techniques to be utilized.

One major aspect which must be addressed in the formation of a new financial institution is the type of bookkeeping system which will be established. Different types of bookkeeping systems will require slightly different approaches when determining the most effective audit techniques to be used. Many financial institutions which are being formed use either an independent servicer, or purchase or lease an in-house computer. Particularly where an in-house computer is used, the financial institution's program of internal testing and auditing is most important.

It is very important that the financial institution audit be reported directly to the Board or a committee thereof. This point should be stated in the audit policy to provide the audit Policy independence needed to be effective and also to make sure the Board is fully informed.

CONFLICTS OF INTEREST POLICY

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The primary purpose of a written conflicts of interest policy is to manage potential risk and liability from the conduct of the affairs of the financial institution. This risk is usually manifested in the conduct of directors, officers and employees in discharging their duties and responsibilities in the management of the affairs of the financial institution. The Board of Directors should adopt a policy to avoid even the appearance of a conflict of interest by its directors, officers, and employees when performing their fiduciary duties of care and loyalty to the financial institution. The Conflict of Interest Policy shall address the following situations or circumstances which should be avoided and/or reported by directors, officers, employees, and/or principal stockholders to the Board of Directors immediately:

1. Personal interest, direct or indirect, in any assets, real or personal, owned by the financial institution either purchased from or sold to the financial institution without the prior approval of the Board of Directors.

2. Report ownership interest held in the form of "business trusts" or other entities without disclosure of the identity or personal guarantees of the principals.

3. Loans or other transactions in which the officer, director, or principal stockholder (or immediate family member of each) of the financial institution receives or holds a beneficial interest.

4. Loans or other transactions in which the officer, director, or principal stockholder (or immediate family member of each) of another depository institution receives or holds a beneficial interest.

5. Loans or other transactions at any depository institution in which an officer, director, or principal stockholder (or immediate family member of each) holds a beneficial interest, either direct or indirect.

6. Loans or other transactions at any depository institution in which an officer, director, or principal stockholder (or immediate family member of each) has no direct interest but which involve parties with whom an insider has other partnership or business associations.

7. Loans extended personally by officers, directors, or principal stockholders (or immediate family member of each) to parties who are also borrowers from the financial institution or loans extended personally by any borrowing customers to an officer, director or principal stockholder of the financial institution.

8. Written procedures for notification to the Board of Directors or any committee when asked to review a loan approval request or other transaction in which an officer, director or principal stockholder may be involved.

9. Prohibition for directors and officers to make or participate in voting on a loan or other transaction where there is a financial interest in the transaction.

10. At least annually directors, officers, and principal shareholders shall disclose their business interest and individuals and customers that they also do business with.

11. Directors, officers, principal stockholders and their related interest shall conduct all transactions with the financial institution in compliance with State law and Federal law, including Regulation O of the Federal Reserve Board.

12. Directors, officers, employees, principal stockholders and their related interest will not engage in activities in competition with the financial institution.

13. Establish procedures and practices designed to prevent conflicts of interest and self-dealing by directors, officers and employees, with respect to using confidential or other inside information in making investment decisions; using voting power as a shareholder; and authority of their position when exercising their duties in the conduct of affairs of the financial institution.

The above practices and procedures should be adopted to limit any exposure, to avoid losses and to prevent violations of civil and criminal laws from conducting the affairs of the financial institution.

INTERBANK LIABILITY POLICY

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The Board of Directors should adopt written policies and procedures to prevent excessive exposure to any individual correspondent bank in relation to the condition of the correspondent, and to monitor the financial condition of those entities. Federal Reserve Regulation F is made applicable to state nonmember banks by Section 18(j) of the FDIC Act. Policy consideration should include:

- Standards for selection correspondent banks;
- Periodic review of the financial condition of correspondent banks;
- Reliance on another party, such as a bank rating agency or the bank's holding company, to assess the financial condition of correspondence banks, provided the bank's Board of

Directors has reviewed and approved the general assessment used by that party;

- Establish internal limits on exposure to the correspondent Bank
- Transactions shall be structured with the correspondent bank to monitor exposure to the correspondent;
- Establish appropriate procedures to address compliance with internal limits
- Establish procedures for periodic review and approval of policies by the board of directors.

ELECTRONIC BANKING POLICY

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Electronic commerce is a broad term applied to activities involving the exchange of goods or services for value over a computer network or automated system. Financial institutions are becoming more aggressive in adopting electronic banking capabilities that include sophisticated marketing systems, remote banking capabilities, and stored value program. The extent of a financial institution's risk management program should be commensurate with the complexity and sophistication of the activities in which it engages. Electronic financial services pose inherent risks. Management must understand those risks and adopt a comprehensive risk management program to mitigate them. The institution should develop an electronic banking policy which addresses, at a minimum, the following points.

- Security measures: The financial institution needs to have the appropriate firewalls, virus protection, intrusion detection, encryption, and penetration testing. The institution should also be aware of and install new updates and patches in a timely manner. Additionally, management should incorporate dual control procedures wherever possible.

- Monitoring requirements: Each institution should establish monitoring requirements for all phases of its E-Commerce activities. Monitoring procedures allow the institution to determine what works and what does not. Additionally, electronic banking activities should be included in the scope of the institution's audit, both internal and external.

- Incident response procedures: The institution's incident response plan should establish guidelines for dealing with various types of incidents within reasonable timeframes, thus minimizing the risk of loss.

- Vendor oversight: Management should obtain and review vendor financial statements to determine vendor viability.

- Contingency planning/Disaster Recovery: The institution's contingency plan should address how to minimize the disruption of services and financial loss to the institution.

- Employee Internet Usage Guidelines/Employee Access Restrictions

- Customer E-Mail Procedures and Controls

- Account Access Procedures and Controls: Access may be controlled through the use of password and User ID standards, or by other methods described in the policy.

Electronic capabilities can be segregated into three categories by degree of functionality:

- systems that simply provide information as defined by the publisher or allow for transmission of non-sensitive electronic mail (Information-only);
- systems that allow users to share sensitive information and communicate electronic information transfer systems; and
- systems that facilitate electronic funds transfer and other financial transactions (electronic payment systems).

Many systems will involve a combination of these capabilities.

Unique risks are posed by electronic delivery channels. Reliance on third party vendors for technology and uncertainties in the legal and regulatory environment also introduce unique risks to electronic delivery and payment systems. Management should minimize transaction, compliance, reputation, and liquidity risks relating to its electronic banking activities. A primary focus of risk management is to minimize the negative effects of operating in an electronic environment. The policy should incorporate an ongoing process of identifying, measuring, monitoring, and managing potential risk exposure.

CONCLUSION

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Creating written policies allows the Board of Directors and senior management an opportunity to reconsider the basic objectives of the financial institution as well as emphasizing to financial institution personnel the priority that the Board and senior management give to policy areas. Therefore, the formulation of sound written policies is important. However, implementation, adherence, and regular review of the written policies are critical to the success of the financial institution's safety and soundness.

The adoption of written policies does not guarantee the financial institution's success. Financial institutions operating in a financial services environment must have sound overall strategic planning supported by flexible written policies and capable management to succeed in a highly competitive environment. Hopefully, these guidelines for policy development will give the new financial institution as well as existing financial institutions the needed support to develop a healthy and successful operation.