Board of Governors of the Federal Reserve System

Dealing with Weak Banks

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Jonathan Rono, Manager

Assetou (Aisha) Traore, Supervisory Financial Analyst

Introductory Remarks

- The U.S. banking landscape is unique compared to other jurisdictions - over 5,000 banks (community, regional, and large banks) spread across all 50 states and supervised by three different primary regulators, depending on charter type
- The Federal Reserve is committed to bank supervision policies and procedures that support prompt detection and mitigation of problems before they affect a viability of banks
- Early problem detection and prompt corrective action are critical components in managing troubled institutions
- This presentation aims to share processes and techniques used by the Federal Reserve in dealing with weak/problem banks in the U.S.

Agenda

- **Problem Banks in the U.S. – An Overview**
  - Defining Problem Banks
  - Trends since the Financial Crisis
  - Problem Banks Risk Profile

- **Problem Bank Identification and Monitoring**
  - Examiners Early Detection/Supervisory Action
    - Importance of Early Supervisory Intervention
      - Issues Escalation/Communication
  - Red Flags/Problem Identifiers
  - Early Warning Systems/Surveillance Tools

- **Rehabilitation of Problem Banks**
  - Corrective Action Overview
    - Enforcement Actions
  - Resolving Capital and Liquidity Problems

- **Resolution Management**
  - Failed Bank Closing Process
  - Resolution Methods

- **Open Discussion: Questions & Answers**

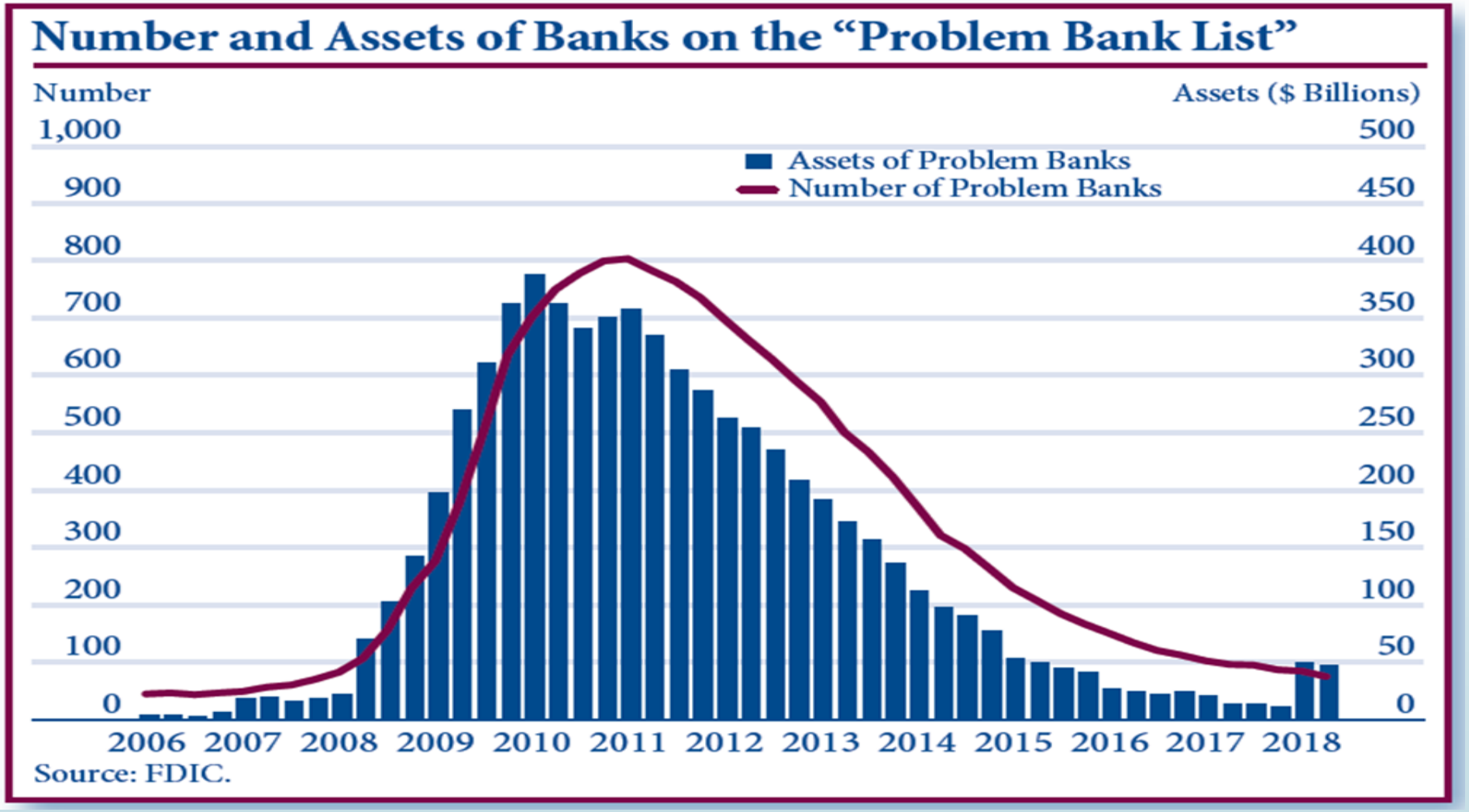
Problem Banks in The U.S. – An Overview

Defining Problem Banks

- The U.S. uses a Uniform Financial Institutions Rating System (CAMELS) whereby each bank is assigned a uniform composite rating, during an examination, based on the evaluation and rating of the following critical components of a bank's operations: ***Capital Adequacy***; ***Asset Quality***; ***Management***; ***Earnings***; ***Liquidity***; and ***Sensitivity to Market Risk***. The composite and component ratings are expressed through a numerical scale of **1 through 5** with1 being the highest rating and requiring the least degree of concern, and 5 being the lowest rating and therefore requiring the highest degree of supervisory concern

- In accordance with the Uniform Financial Rating System, a weak, problem bank is defined in the U.S. as an institution with a **4** or **5** composite rating

Trends Since the Crisis



Trends Since Crisis Cont'd/Problem Banks Risk Profile

- As of August 2018, the number of problem banks nationwide is at a record low of 71 ($54 billion in total assets) with only 5 being directly overseen by the Federal Reserve (State Member Banks). This is compared to approximately 800 problem banks at the peak of the crisis (2010) with about 120 being State Member Banks

- Problems are primarily asset quality (including stemming from CRE and/or Ag. Concentrations), liquidity (reliance on volatile/non-core funding), and/or capital driven with banks exhibiting elevated concentration (both assets and funding) levels with matching poor risk management practices ultimately leading to capital erosion via material losses

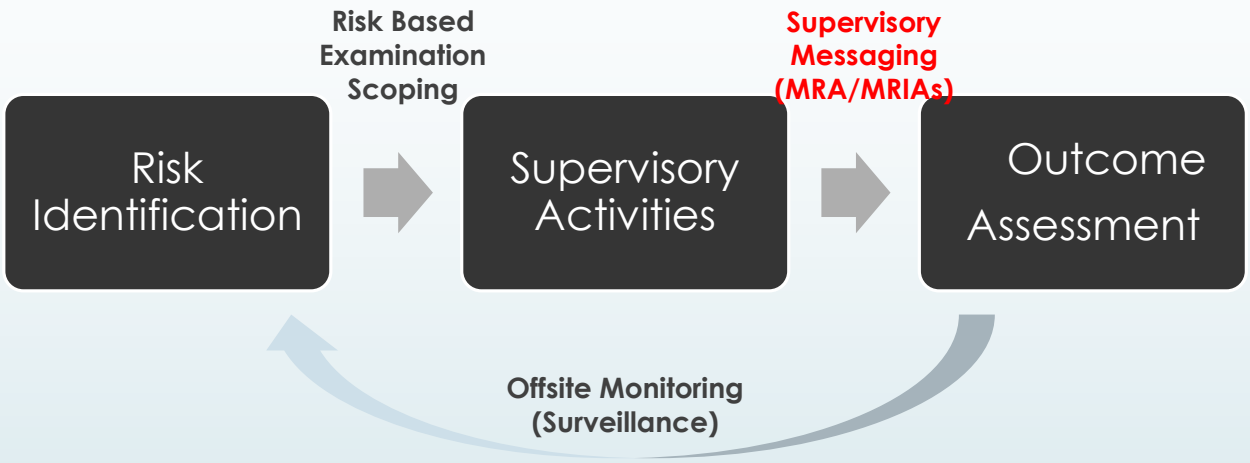
Problem Bank Identification and Monitoring

Importance of Early Problem Detection and Supervisory Action

- Problem bank identification is directly tied to the examination process and composite ratings. Examiners, therefore, play a pivotal role in the identification of weak, problem banks
- Early supervisory interventions prompt banks to address their weaknesses in a timely fashion. The purpose is either to put banks back on a sound footing or to mitigate the consequences of a potential failure
- One of the most challenging and important aspects of a bank examiner's job is knowing how to react to symptoms of problems that may not yet be apparent to bank management and directors. The point at which an examiner identifies potential problems and recognizes the possible effect on a bank's condition is critical
  - This is sometimes the last point in time when an examiner may make a difference, through effective communications and moral suasion, in whether the bank rights itself or becomes a problem bank requiring enforcement action
  - It is imperative for examiners to bring legitimate, significant concerns to the attention of bank management and directors, as early confrontation and action usually reduces the ultimate cost of correcting problems considerably

Supervisory Messaging

Key Components of Risk Aligned, Forward-Looking Supervision

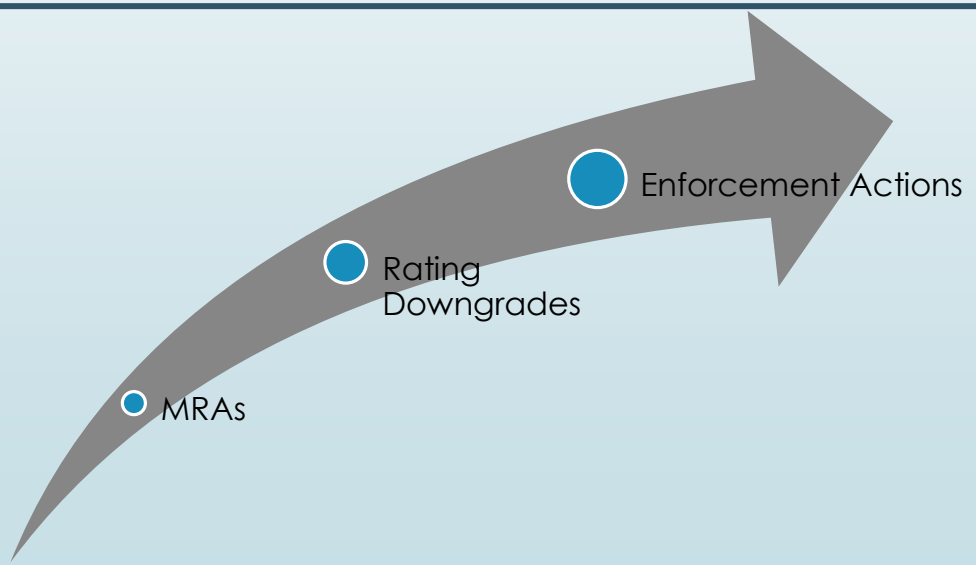


- The supervisory messaging is a key component of risk aligned, forward-looking supervision, the effectiveness of which can be seen in bank outcomes
- Federal Reserve examiners use **Matters Requiring Attention (MRAs)** and **Matters Requiring Immediate Attention (MRIAs)** to communicate weaknesses requiring bank management/board attention and corrective action

What is MRA and MRIA*?

- Matters Requiring Attention (MRAs) are issues that are **important** and that the Federal Reserve expects a supervised firm to **address over a reasonable period of time**
- Matters Requiring Immediate Attention (MRIAs) are issues of **significant importance and urgency** that the Federal Reserve requires a supervised firm to **address immediately**
- The issuance of MRAs and MRIAs is a critical first step in the problem identification and issues escalation path. Examiners may use more progressively stringent actions to compel banks to correct deficiencies
- Through clear and achievable objectives, coordinated supervisory actions, clear messages to banks and credible escalation processes, supervisors can effectively influence bank behavior

Stringency Progression of Supervisory Actions



* Collectively known as "MRAs"

Red Flags/Problem Identifiers

Red flags and identifiers of problem banks take many forms and require supervisors to consider a number of diverse factors before determining the most appropriate supervisory response. The following subsections outline a few critical identifiers/indicators that may point to potential problems

- Asset Quality Deterioration
  - Significant loan growth with or without increases in delinquencies, losses, or ALLL provisions
  - Increasing concentrations
  - Increasing levels of past due and nonperforming loans as a percent of loans, either in aggregate or within loan types
  - Significant changes in the Allowance for Loan and Lease Losses (ALLL)
  - Deterioration in local economic conditions

- Strained Liquidity
  - Low levels of on-hand liquidity
  - Funding mismatches (i.e., funding long-term assets with short-term liabilities).
  - Higher costs of funds relative to the market
  - Significant increases in borrowings, warehouse lines, and Federal Home Loan Bank lines

Red Flags/Other Problem Identifiers Cont'd

- Management/Risk Management Deficiencies
  - Inexperienced senior management team and passive board
  - Incentives and growth pressures
  - Poor strategic planning
  - Internal control weaknesses
  - An internal audit program that lacks independence
  - Poor concentrations management
  - Insider transaction irregularities/insider abuse and fraud
  - Management that does not anticipate emerging technology needs
  - Acquisition due diligence processes that do not consider the risks associated with new products and compatibility with corporate goals

Early Warning Systems/Surveillance Tools

Data driven, forward-looking Surveillance models play an important part in the supervision/monitoring of problem banks

- Banks provide quarterly financial reports to their regulators
- Watch List Program: Identify banks with emerging financial issues and accelerate their examination schedules
- Inform examination scoping: Provide examiners with a starting point for risk tailoring examination scope and work programs to risk
- Identify industry trends: When aggregated to the industry level, surveillance models help identify industry trends

Two distinct types of Surveillance models are used in different stages of the supervision process

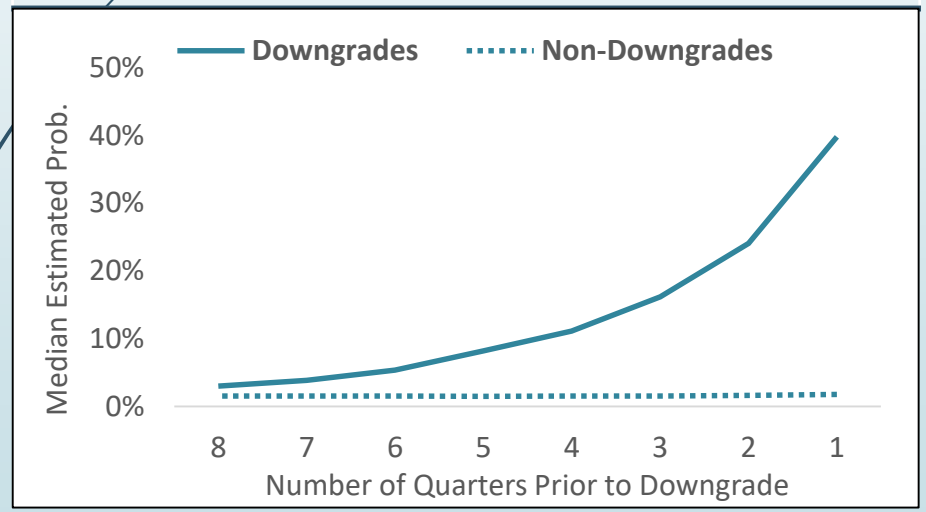
- SR-SABR *(*Supervision & Regulation Statistical Assessment of Bank Risk*)* models identify deterioration in a bank's overall financial health that may require attention between exams
- BETR *(*Bank Exams Tailored to Risk*)* models identify risk levels for each kind of risk, or risk stripe, in order to inform the scope and intensity of the work programs used during an exam

SR-SABR	BETR
• Used mainly for monitoring financial health between scheduled exams • Can lead to an acceleration of a bank's exam schedule • Launched in 2006, drives the Watch List Program	• Used mainly for exam scoping and planning exam work programs • Can lead to streamlined exams for Low-risk cases and intensive exams when risk is High • First stage launched in 2014, with metrics for all risk stripes expected this year

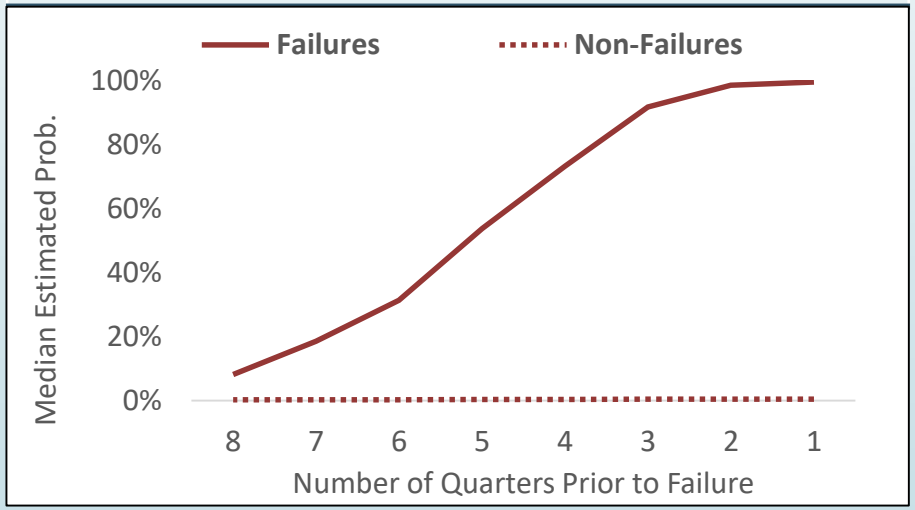
SR-SABR identifies banks whose financial health is deteriorating

- SR-SABR models track a bank's overall financial health using several metrics, including:
  - An Adverse Change Grade based on the probability of a downgrade in a bank's CAMELS rating
  - A Viability Grade based on a bank's probability of failure
- SR-SABR has been shown to anticipate CAMELS rating downgrades and bank failures

Estimated Probability of Downgrade Prior to Actual Downgrade



Estimated Probability of Failure Prior to Actual Failure



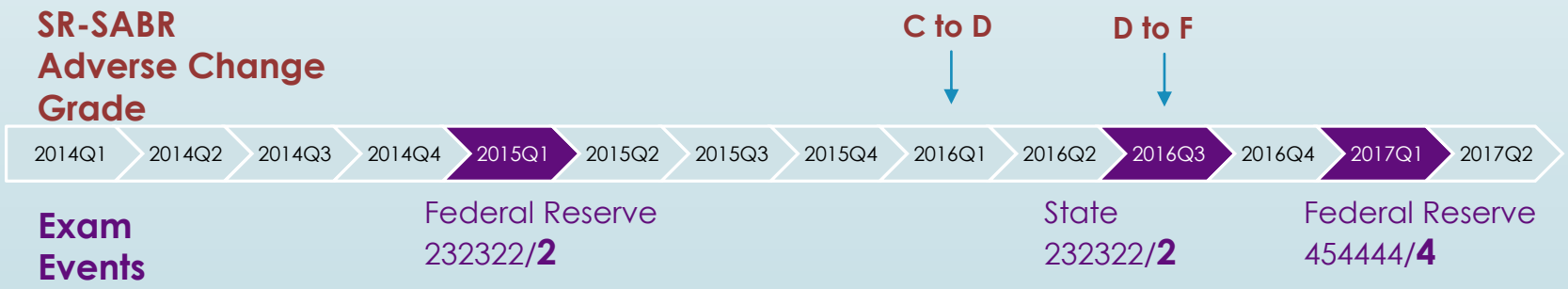
Note: Both charts show median probability scores prior to actual events. Downgrade events include all commercial exams where the CAMELS rating was downgraded from '1' or '2' to '3' or worse during the 2005-17 period. Failure events include all bank failures during the same period. For comparison, non-event peer groups are constructed from banks of similar size and geography.

Watch List Example

Inclusion on the Watch List can lead to an accelerated examination schedule

- Each quarter, Reserve Bank examiners assess whether the CAMELS rating last assigned to each Watch List bank remains appropriate
- Example: A non-problem bank had been examined on an 18-month cycle. However, the bank's Adverse Change Grade slipped to D in 2016Q1, and to F in 2016Q3
- In response, the bank was examined in 2017Q1 by the Federal Reserve, only two quarters after its previous exam, and its CAMELS rating was downgraded to a 4

Example: Anonymous Bank



Surveillance models play important roles in risk identification and risk-tailored bank supervision

- SR-SABR provides timely information on banks' financial health and can trigger heightened supervisory attention and the acceleration of examination schedules
- BETR provides a foundation for the risk tailoring of examination work programs
- Both suites of models are useful in identifying industry trends

As such, these models are essential tools for a forward-looking supervision program

- Timely identification of financial deterioration facilitates early intervention and the containment of losses
- Granular views of risk levels offered by BETR can aid examiners in promoting adequate risk management practices

Rehabilitation of Problem Banks

The rehabilitation process is based on the development of a specific and viable plan for corrective action for each troubled institution and subsequent monitoring to ensure adherence to the plan

At the conclusion of this stage of problem bank resolution, a bank normally returns to a safe and sound condition or advances to treatment as a resolution candidate

Correction Action Overview

Determining the Need for Corrective Action

The Fed's supervisory process attempts to identify problems early enough to enable remedial action that will prevent serious deterioration in a bank's condition. Accordingly, when problems are detected, examiners must determine their severity promptly as well as the timing and form of any needed corrective action. Some factors/questions considered during this process include:

- ***What types of problems has the bank had in the past?*** If current problems are similar to past ones, the bank may not have corrected the root cause of the problem. Corrective action may be warranted
- ***Has the severity of problems progressed?*** If the severity of problems is increasing, more vigorous corrective action is warranted
- ***Is the ownership and management team the same as in the past?*** If the management team has not changed, examiners should consider the type of response given to previously identified problems. If a change has occurred, examiners must look at responsiveness to recent corrective action, if applicable
- ***Does the management team have a history of identifying problems within the bank or do outside parties usually surface them?*** Management's ability to identify problems will influence the type of corrective action needed. If third parties routinely surface problems, management may need more guidance in the corrective action process.
- ***Does the management team have the ability to fix the current problem?*** If management lacks the necessary skills, they may need to bring in new management who have demonstrated an ability to rectify the problems
- ***Has the bank been placed under an enforcement action before? If so, how long ago and for what?*** The date and nature of a prior action may trigger the need for a new enforcement action to effect correction of current supervisory problems

Types Corrective Action

- Supervisory and enforcement actions fall within two broad categories: **informal** and **formal**. The latter is generally more severe, public, and enforceable by law. The severity of action chosen should be based primarily on the bank's current condition with consideration given to the cooperation, responsiveness, and capability of the board and management

- The selection of specific corrective measures should be tailored to the institution and designed to correct identified deficiencies, improve its overall condition, and return the bank to a safe and sound condition as quickly as possible

Informal Actions

- Informal actions are not legally enforceable and are commonly used in “well-” or “adequately-” capitalized banks, banks with composite ratings of 1- or 2-, and 3-rated banks with capable management
- If an informal action does not result in the desired outcome, the regulator either has to persuade the bank through moral suasion or take a more severe formal action but cannot enforce compliance in federal court or assess civil money penalties for noncompliance

Type of Corrective Action	**Description of Action**
Informal Actions:	
Supervisory Letter	Least severe form of enforcement action used to correct minor problems
Board Resolution	Bank-generated document capturing commitments made by directors on behalf of the institution to address one or more concerns identified by the Regulator.
Memorandum of Understanding	Bilateral document similar to formal enforcement actions in form and content. Non-binding legal document.

Formal Actions

- Formal actions are appropriate when a bank has significant problems, especially when there is a threat of harm to the institution. Such actions are also used when corrective action by the board is not forthcoming, or when informal actions are insufficient
- Formal actions are authorized by statute and are enforceable. Unlike informal actions, formal enforcement actions are public

Type of Corrective Action	Description of Action
Formal Actions:	
Written Agreement	Bilateral document signed by the board of directors and the Regulator with provisions set out in an article-by-article form to prescribe necessary corrective action. Violation of a formal agreement can provide the legal basis for more serious proceedings (e.g., cease and desist).
Cease and Desist Order	Official order generally issued by consent requiring immediate halt of an activity by an institution or individual.
Capital Directive	An order designed for establishing and enforcing capital levels and for taking capital-related action.
PCA Measures	Mandatory and discretionary measures based on a bank's PCA category (e.g., restrictions)
Civil Money Penalties	Authorized monetary penalties for violations of law, formal written agreements, final orders, conditions imposed in writing, and certain unsafe and unsound banking practices and breach of fiduciary duty. Amounts determined by statute, based on the number of and severity of violations or practices.

Actions Against Individuals

Regulators have authority to take actions against individuals from the management team and/or the board contributing to or exacerbating the unsafe and unsound condition at an institution. Actions include:

- Orders requiring individuals to cease and desist certain activities
  - Reprimand Letter
- Removal and replacement of management team and/or board of directors
- Prohibiting individuals from participating in the business of banking going forward
  - Can be related to specific unsafe and unsound actions at covered institutions
- Civil Money Penalties
- Section 19 letters to individuals convicted of a criminal offense involving dishonesty, breach of trust, or money laundering and therefore cannot become an institution affiliated party without prior consent of the FDIC

Follow-up Actions

- Once an enforcement action is signed, the onus is on the management team to successfully implement the corrective action plan
  - Requires a significant change in the behavior of directors, officers, and employees throughout the institution, and such changes are not always easy
- Examiners can facilitate the process of change by following up closely on how well the bank is implementing its corrective action plan and providing constructive advice on where the bank is falling short of expectations
  - On-site follow-up for problem banks typically occurs 3 - 6 months following last examination event
  - Communication with bank both orally and in writing on a regular basis regarding compliance efforts is important
- A bank will be considered in compliance with an enforcement article/provision only if it has adopted, implemented, and adhered to all of the corrective actions set forth in the article, and examiners have verified through the examination process that the bank has done so
- An action generally should not be terminated until the bank has complied with all articles in the document

Resolving Capital Problems

Maintaining Capital

- Capital can dissipate rapidly especially in the face of significant credit losses, underscoring the importance of timely resolution of capital-related supervisory concerns

- Various laws and regulations mandate minimum capital levels for banks and detail actions for both the bank and supervisors if capital falls below those established minimums. Statutory requirements are minimums, and the Federal Reserve has the authority to require more capital in banks with significant risk

- Managing the capital needed to meet statutory requirements is crucial. Problem banks typically take steps to improve capital ratios by:
  - Reducing total on-balance sheet assets
  - Restructuring the balance sheet and replacing assets that require higher risk weights with lower risk-weighted assets

Retaining Capital

- A bank with insufficient capital should take steps to prevent further depletion
- Paying dividends or repaying certain capital issuances could further deplete the capital base to an inadequate level and may constitute an unsafe and unsound banking practice, even though failure to make such payments could have adverse market ramifications by signaling problems at the bank or parent holding company
- When considering dividends and debt retirement, a problem bank's board of directors should use caution not to materially exacerbate any deficiency in the bank's capital
- To ensure that this does not happen, the Federal Reserve has statutory and regulatory authority to restrict capital outflows (dividends, repayment of instruments) in certain circumstances and requiring prior regulatory approval

Raising Capital/Capital Planning

- Although not always possible in seriously troubled cases, the most direct way for a problem bank to improve its capital ratios and reduce risk is by raising additional capital. This can be attempted privately through the bank's holding company, directors, or other shareholders, or publicly by accessing the capital markets

- The most common form of new capital for banks results from the down streaming of proceeds from a securities issuance at the parent holding company level (source of strength). However, a company experiencing significant financial difficulties will have trouble obtaining capital at reasonable rates because investors naturally are reluctant to invest in risky or poorly performing companies

- A bank experiencing problems should recognize the need to raise additional capital before it falls to the undercapitalized level, as defined in PCA, or its capital ratios fall below the regulatory minimums. In the event a bank does not independently undertake capital raising efforts, the Federal Reserve may legally require the bank to develop and implement a plan to increase capital

Prompt Corrective Action (PCA)

For banks facing emerging and excessive risks to capital, the requirements of PCA are essential to the problem bank rehabilitation process. PCA includes provisions for discretionary and mandatory supervisory actions and requires regulators to place increasingly stringent restrictions on banks as regulatory capital levels decline. The following are the Prompt Corrective Action capital categories/thresholds:

A bank must meet each of these thresholds to be considered…	Total Risk-based Capital Ratio	Tier 1 Risk-based Capital Ratio	CET1 Risk-based Capital Ratio	Tier 1 Leverage Ratio	Critically Under-capitalized Tangible Equity Ratio
Well Capitalized	10%	8%	6.5%	5%	---
Adequately Capitalized	8%	6%	4.5%	4%	---
Undercapitalized	<8%	<6%	<4.5%	<4%	
Significantly Undercapitalized	<6%	<4%	<3%	<3%	---
Critically Undercapitalized if under…	---	---	---	---	2%

PCA Restrictions

Restrictions for All Banks

- Prohibited from making any capital distribution or management fee payment to any person who controls the bank, if the distribution or fee payment would result in bank being undercapitalized

Restrictions for Adequately Capitalized Banks

- Must apply for and receive a waiver from the FDIC before able to accept, renew or rollover brokered deposits. Until such waiver is received, the bank may not use a broker, and the bank is limited to paying rates of deposits to no more than 75 basis points over the average rate of local financial institutions

Restrictions for Undercapitalized Banks

- Submission of a Capital Restoration Plan (CRP). The CRP is one of the most important documents in the rehabilitation of problem banks and must be filed by the bank within 45 days of notification of undercapitalized status
- CRP not acceptable unless each company controlling the bank submits a written guarantee of the plan. The guarantee ensures that the holding company will provide a financial commitment
- Absent an approved CRP, restrictions on asset growth and on certain expansion of activities, including acquisitions, new branches and new lines of businesses

Restrictions for Significantly Undercapitalized Banks

- Restrictions applicable to undercapitalized banks, including the requirement to submit an acceptable CRP
- Requiring recapitalization
- Restrictions on transactions with affiliates
- Restrictions on interest rates and the use of brokered deposits

Restrictions for Critically Undercapitalized Banks

- All restrictions applicable to undercapitalized and significantly undercapitalized banks
- When tangible equity ratio falls below 2 percent, bank must be placed in receivership or conservatorship within 90 days of notification of being critically undercapitalized

Resolving Liquidity Problems

- To remain viable, a bank must have liquidity — the ability to obtain cash for operations and to satisfy its obligations when needed at a reasonable cost
- Managing liquidity during a crisis, particularly when difficulties arise and financial deterioration is known to the public, can mean the difference between an orderly return to stability and an acute crisis, including insolvency
- Managing the release of information to the public is therefore as important as managing financial positions and cash flows. Customer reaction, which can be difficult to predict, significantly influences needs for on-hand liquidity and access to contingency sources

Causes of Liquidity Impairment

Liquidity problems usually stem from:

- Poor liquidity monitoring and risk management practices not commensurate with liquidity risk profile
- Shift in bank funding activities/structure making management of liquidity risk more challenging for banks and more dependent on marketplace perceptions
  - Increased reliance on more volatile, expensive market/institutional funding sources at the expense of core deposits
  - Market funding sources not available in times of most need given institutional fund providers and other market-based sources being significantly more price and credit sensitive than retail customers (less willing to provide funds to banks facing real or perceived financial difficulties)
    - Reduced borrowing capacity/increased collateral requirements & collateral haircuts
- Strong positive correlation between real or perceived asset quality problems and liquidity problems
    - Uninsured deposits and uncollateralized funding sources are particularly credit sensitive

Statutory Considerations

Various provisions of PCA, and its implementing regulations, also directly affect bank liquidity. In certain cases, these provisions eliminate eligible funding sources for banks. Statutory liquidity restrictions are triggered by declines in regulatory capital

Brokered Deposits Restrictions

- Adequately capitalized banks must apply for and receive a waiver from the FDIC before they can "accept, renew or roll over any brokered deposit." Moreover, the effective yield on these brokered deposits cannot be more than 75 basis points greater than the yield on a comparable deposit offered in the normal market area
- Significantly undercapitalized and critically undercapitalized banks may not accept, renew, or roll over any brokered deposit. Further, such institutions may not solicit deposits with an "effective yield more than 75 basis points above the prevailing market rate”

Federal Reserve Discount Window Restrictions

- Undercapitalized banks may not have discount window advances outstanding for more than 60 days in any 120-day period
- Critically undercapitalized banks may have discount window advances only during the five-day period that begins on the day they become critically undercapitalized

Liquidity Risk Management

Banks and examiners typically can use two distinct discretionary tools in the management of liquidity — a **funds flow analysis** and a **contingency funding plan (CFP)**. Although both tools should be included in any effective liquidity risk management system during normal times, they are critically important during a crisis

The funds flow analysis - depicts a bank's historical sources and uses of funding and provides a general sense of funding activity and trends

The contingency funding plan - is a forward-looking document that projects sources and uses of funding under alternative scenarios, when adverse circumstances exist for both the bank as well as the capital markets

The funds flow analysis and contingency funding plan should be tailored to the specific institution

Monitoring Requirements

- Regulatory monitoring is an effective process in assessing potential liquidity insolvency. The level and frequency of monitoring depends on the severity of a bank's liquidity position
- For banks experiencing serious liquidity problems, examiners typically monitor liquidity position onsite and provide regular (sometimes daily) reports on the position
- If the liquidity risk encountered by the institution becomes more pronounced (point of liquidity crisis), examiners will consider correspondingly more dramatic supervisory responses

Resolution Management

Resolution Management

If continued viability becomes doubtful or the bank's condition or behavior otherwise warrants consideration of receivership, the federal banking agencies will begin the process of resolution management

- This does not always mean that the bank is certain to fail — any reasonable opportunity for the bank to correct its problems and avoid closure is duly considered — but regulators must consider and prepare to implement bank failure contingency scenarios
- Timely and effective involvement of resolution authorities is important. Coordination between supervisory and resolution authorities is also key

In the resolution of problem banks, the goal is to resolve an institution in a manner that avoids or minimizes losses to the deposit insurance funds. Common grounds for receivership and early resolution include:

- Bank's assets being less than its obligation to its creditors (capital insolvency)
- The bank being likely to be unable to pay its obligations or meet its depositors' demands in the normal course of business (liquidity insolvency)
- The bank is critically undercapitalized

Bank Closing Process

The following steps are followed in the closing process:

- Capital Call Meeting for Critically Undercapitalized Banks
  - The capital call meeting signals the beginning of the closing process for a critically undercapitalized bank
- Bid Process
  - FDIC begins marketing of failing bank and invites all approved bidders to an information meeting to encourage competition. Meeting usually occurs 1 – 2 weeks after capital call
  - Confidential on-site due diligence by prospective bidders ensures
- Setting a Closure Date/FDIC Appointed as Receiver
  - Closure normally occurs 90 days after being critically undercapitalized
  - Banks are typically closed at the end of the normal business day on Friday. If under new ownership, the bank normally reopens the following Monday to ensure continuity of operations and access to customer deposits
- Accounts Balancing Immediately after Closing

Resolution Methods

The FDIC has three basic resolution methods for failing institutions:

- Deposit Payoff
  - Occurs when the FDIC is appointed as receiver and there is no purchaser for the bank's insured deposits, or the FDIC determines that a deposit payoff is the least costly resolution method
  - The FDIC, as insurer, pays all of the failed institution's depositors the full amount of their insured deposits up to the $250,000 insurance limit
  - Uninsured depositors and other general creditors of the failed institution receive receivership certificates entitling them to a portion of the receiver's collections on the failed institution's assets
- Purchase and Assumption (P&A) Transaction
  - A closed bank transaction in which a healthy institution (generally referred to as either the acquirer or the "assuming" bank) purchases some or all of the assets of a failed bank and assumes some or all of the liabilities, including all insured deposits
  - As a part of the P&A transaction, the acquirer usually pays a premium to the FDIC for the assumed deposits, which decreases the FDIC's total resolution cost
- Open Bank Assistance (OBA)Transaction
  - The FDIC, as insurer, provides financial assistance to an operating insured bank determined to be in danger of failing. The FDIC can make loans to, purchase the assets of, or place deposits in a troubled institution. When possible, an assisted institution is expected to repay its assistance loan
  - OBA is no longer a commonly used resolution method

Open Discussion

Contacts Information

Jonathan Rono is the manager for the Community Bank Supervision (CBS) Section of the Supervision and Regulation Division of the Board of Governors of the Federal Reserve System.
Email: jonathan.k.rono@frb.gov
Phone: (202) 721-4568

Assetou (Aisha) Traore is a Supervisory Financial Analyst in the CBS Section of the Supervision and Regulation Division of the Board of Governors of the Federal Reserve System. Part of her supervisory oversight responsibility includes the monitoring of weak, problem institutions.
Email: assetou.traore@frb.gov
Phone: (202) 974-7066