S&R PERSPECTIVES

The Latest Fifth District Supervision and Regulation News & Events

Fall Issue 09

> "The need for tight controls and encryption of sensitive data is becoming a critical means to preventing loss of customer data through portable devices."
>
> – Richard Simpson

Emerging Issues

Troubled Debt Restructurings on the Rise

By David Schwartz

Current economic conditions have contributed to an increase in some financial institutions restructuring and renegotiating loans. To properly convey an institution's credit risk profile in its financial statements and call reports, bankers must ensure that restructurings falling under Troubled Debt Restructuring (TDR) guidance are properly identified and accounted for in accordance with generally accepted accounting principles (GAAP). Given the recent rise in the number of commercial banks reporting TDRs over the last few quarters (see chart on page 3) and the importance of proper identification and accounting of these exposures, the following is a brief overview of existing guidance specific to TDR identification. The guidance serves as a useful reference when determining whether certain restructurings would fall under TDR guidance.

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In The News

Assessing the Effectiveness of the Paulson "Teaser Freezer" Plan: Evidence from the ABX Index

By Eliana Balla, Robert Carpenter and Breck Robinson

The first concerted policy effort to assist subprime borrowers was introduced on December 6, 2007, when then-Treasury Secretary Henry Paulson announced a voluntary plan to modify adjustable-rate mortgages. The plan represented the joint efforts of the American Securitization Forum, and the federal government. Recently, financial economists in Risk and Policy completed a research paper that utilizes movements in the ABX index to explore whether investors in subprime residential mortgage-backed securities (RMBS) viewed the Paulson Plan as a success.

Under the Paulson Plan:

1. Lenders and servicers are encouraged to inform borrowers of their options prior to falling into delinquency or default and encouraged to help borrowers avoid default by modifying or refinancing existing adjustable rate loans.

2. The centerpiece of the plan allows servicers to modify loans without having to contact individual borrowers or verify previously documented applicant or housing information. In addition, servicers are allowed to freeze the borrower's introductory interest rates for up to five years.

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Mac's World at the Fed

In the fall edition of S&R Perspectives, we are continuing to cover important financial market trends and emerging issues. In this edition, we discuss the rise of troubled debt restructuring and the complexity of this issue, which will remain a topic all financial institutions and their primary regulator should routinely discuss. While there is speculation in the media that the U.S. recession is ending, it is important for community banks to remain focused on measured growth, as economic recovery lags in its reach to this population. During our meetings and ongoing communication with institutions, we continue to stress the need for capital preservation and we seek to provide guidance on long term liquidity monitoring and maintenance.

As always, please send any questions, comments, or story ideas to **BKSRCommunications.RICH@rich.frb.org**.

Mac

Under the Paulson Plan:

Subprime borrowers are eligible for relief if they are unlikely to be able to refinance into an alternative mortgage product and likely to be able to retain ownership of their home following a modification. To qualify, the following eligibility criteria must be met:

1. Adjustable rate mortgages which includes 2/28 and 3/27 hybrid loans,
2. Loan must be originated between January 1, 2005 and July 31, 2007,
3. Loan must be included in a securitized pool,
4. Interest rate reset must occur between January 1, 2008 and July 31, 2010,
5. Borrower must be current or at worst 30-days delinquent and have no more than 1, 60-day delinquency over the past 12 months,
6. Borrower must occupy the property,
7. FICO score must be less than 660 and cannot have increased more than 10% from the original FICO,
8. No apparent fraud,
9. Borrower cannot be eligible for the FHA Secure loan program.

For additional details see "Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans Executive Summary," American Securitization Forum, December 6, 2007.

The study finds that some investors initially believed that the Paulson Plan would improve conditions in the subprime housing market, as evidenced by above average changes in the ABX when the policy was announced. The evidence suggests that the deterioration in the housing market was larger than originally anticipated, causing investors to revalue the relative riskiness of senior and subordinate tranches in the ABX.

The study also points to the interplay between policies designed to help homeowners and the investors who own the rights to the mortgage cash flows. Because the Paulson Plan is voluntary, investors must decide whether to do nothing or modify mortgages as outlined in the Plan, balancing the benefits from possible reductions in foreclosures with the potential loss in cash flows from modified loan terms. As the first loan modification plan, the Paulson Plan helped reveal the intricacies and limitations of mortgage loan modifications, which may have benefited subsequent plans.

NOTES:

1. The value of the ABX is constructed from the spreads on a standardized portfolio of credit default swaps (CDS) on 20 mortgage backed securities (MBS) backed by subprime home equity loans. The ABX has five different tranches that correspond to the tranches (defined by credit quality) of the underlying MBS in the index. The ABX is an equally weighted index with each MBS receiving a weighting of 5 percent.

For additional details on the ABX index see: **http://www.markit.com/en/products/data/indices/structured-finance-indices/abx/abx-prices.page**

2. ABX Index
The complete work referenced here can be found at **http://www.richmondfed.org/publications/research/working_papers/2009/pdf/wp09-7.pdf**

Eliana Balla is a financial economist and Robert E. Carpenter is a lead financial economist with the Federal Reserve Bank of Richmond. Breck Robinson is a visiting scholar from the University of Delaware.

Emerging Risks

Portable Device Security

by Richard Simpson

Portable devices such as laptop PCs, personal digital assistants, smart phones, mp3 players, and high capacity universal serial bus (USB) flash drives are growing in use. The volume of data stored on and transmitted through these devices represents a significant information security risk if not properly protected. These portable devices can be easily lost or stolen. There is also a risk of viruses, malware and illegal software being introduced to financial institutions when these devices are connected to a corporate network.

The need for tight controls and encryption of sensitive data is becoming a critical means to preventing loss of customer data through portable devices. In a recent breach, an employee of a major mortgage company was able to steal 2 million customer records by copying 20,000 records each day to a USB flash drive. USB drives can be purchased in sizes from 64 MB (megabyte) to 256 GB (gigabyte). In simple terms, a MB of storage can hold 500 pages of printed text; a GB of storage is 1,000 times more than a MB. The potential for information theft is enormous.
Smart phones and PDAs have many features of a computer, including large amounts of storage. RIM Blackberry devices feature 2 GB storage cards. The Apple iPhone is now offered with storage capacities of up to 16 GB. These and similar devices are equipped with standard features such as removable media card slots and multiple wireless and cellular interfaces.

Laptop or tablet computers are now a standard business tool for workers requiring mobility. Thousands of laptops are lost or stolen each year. In a June 2008 study, the Ponemon Institute found that U.S. air travelers lose more than 12,000 laptops each week. Furthermore, only 33 percent of those reaching airport 'lost and found' areas are claimed.

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The following questions may be useful in evaluating portable device security and controls.

- Has a risk assessment been performed to determine whether the institution has fully addressed portable device risks to corporate information assets?
- Have specific security policies for portable devices been developed, implemented and enforced?
- Does the institution have a domestic and international travel policy to safeguard portable devices and corporate data?
- How does the institution's information security staff monitor the risks associated with portable devices? How is management

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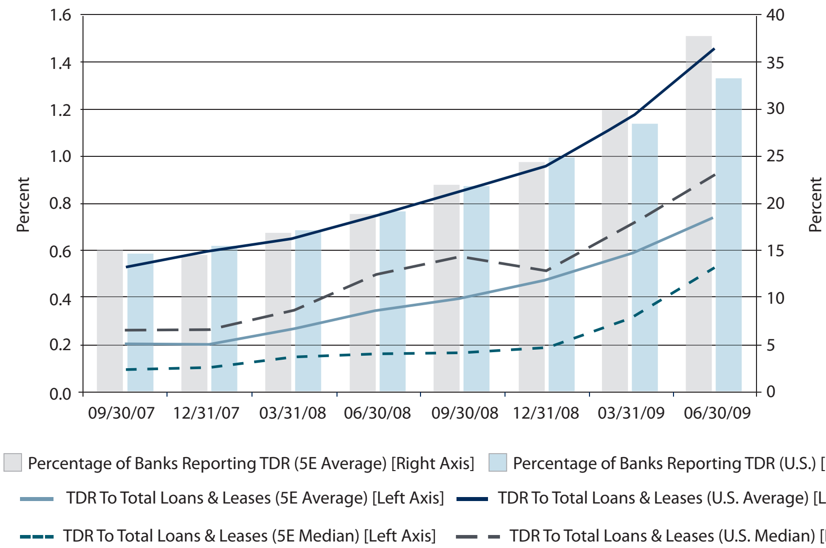
Figure 1 ■ **TDR Trends in the Fifth District & Nationally**



Source: Call reports filed by all commercial banks
Note: 5E represents the 5th District only; US represents all of the US, including the 5th District. Median & average figures includes only those banks reporting TDRs in the given quarter.

What is a Troubled Debt Restructuring?

Financial Accounting Standards Board's (FASB) Statement of Financial Account Standards (SFAS) No. 15 'Accounting by Debtors and Creditors for Troubled Debt Restructurings' establishes standards of financial accounting and reporting by debtors for troubled debt restructurings. The statement notes that ". . . restructuring of a debt constitutes a troubled debt restructuring. . . if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. . ." [1]

This definition presents two main questions: (1) is the debtor experiencing financial difficulties and (2) has a concession been granted that the creditor would not otherwise consider? Useful guidance in answering these questions can be found in FASB's EITF 02-4 "Determining Whether a Debtor's Modification or Exchange of Debt Instruments Is within the Scope of FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings." As granting a concession does not automatically render the restructuring a TDR, management's analysis should consider additional factors, as highlighted in the below referenced accounting literature.

Although TDRs may be seen as a potential sign of problems for a bank, as noted in the FRB's Commercial Bank Examination Manual, "[b]ankers may be involved in formally restructuring loans when borrowers experience financial difficulties... These actions, if consistent with prudent lending principles and supervisory practices can improve a bank's collection prospects."[2] SFAS 15 also conveys the message that TDRs, in and of themselves, are not negative events and could be seen as a prudent risk management practice. It states that "[w]hatever the form of concession granted by the creditor to the debtor in a troubled debt restructuring, the creditor's objective is to make the best of a difficult situation. That is, the creditor expects to obtain more cash or other value from the debtor, or to increase the probability of receipt, by granting the concession than by not granting it." [3]

Restructurings that Institutions Should Evaluate for Possible TDR Implications

As not all restructurings will be considered TDRs, it is important that an institution have in place the proper policies and procedures to ensure that restructurings are properly identified, monitored, and accounted for, **including impairment analysis** of the troubled, modified, and related exposures. Analysis of restructurings that occurs before and after the stated maturity, such as credit facility rollovers, should be included in these procedures.

Although it is good risk management practice to evaluate all restructurings for possible TDR implications, the following list (non-exhaustive) highlights those that <u>may</u> fall under TDR guidance: [4]

- Loan modification programs for existing borrowers (including mortgages) that include one or more of the following:
  - Extension of maturity date(s) at stated interest rates that are lower than the current market rate for new debt with similar risk
  - Reduction of principal or accrued interest
  - Reduction of stated interest rates for the remaining original life of the debt;
- Substitution or addition of debtors;
- Programs with financing terms available only to new customers who purchase properties or projects for sale by distressed borrowers of the bank, when said terms are more favorable than would otherwise be available to other customers of the bank of similar credit quality;
- Rollover or refinancing of existing borrowers to more favorable terms than would be otherwise available to non-troubled borrowers of similar credit quality;
- Transfer of assets to partially or fully satisfy the debt;
- Granting of equity interest to fully or partially satisfy the debt unless the equity interest is granted pursuant to existing terms for converting the debt into an equity interest.

Resources & Sources of Guidance

Although the list of guidance related to the proper identification of and accounting treatment for TDR is extensive, the following list highlights some guidance readers may find useful in identifying restructurings that should be accounted for under TDR guidance.

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ENDNOTES:

1. FASB's 'Accounting by Debtors and Creditors for Troubled Debt Restructurings' (SFAS No.15), Paragraph 2
2. Commercial Bank Examination Manual 2040.1, Page 15
3. SFAS No. 15, Paragraph 3
4. Partially from SFAS No.15, Paragraphs 5 & 42

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Resource	Provides	Link
Statement of Financial Accounting Standards No. 15 Accounting by Debtors and Creditors for Troubled Debt Restructurings	Establishes standards of financial accounting and reporting by the debtor and by the creditor for a troubled debt restructuring	http://www.fasb.org/pdf/aop_FAS15.pdf
EITF 02-4 "Determining Whether a Debtor's Modification or Exchange of Debt Instruments Is within the Scope of FASB Statement No. 15"	Guidance on determining whether a restructuring should be accounted for as a TDR	http://www.fasb.org/pdf/abs02-4.pdf
Instructions for Preparation of Consolidated Reports of Condition and Income (FFIEC 031 and 041)	Call Report Instructions, including among others, Schedule RC-C (Loans and Lease Financing Receivables) Memorandum Item 1 and Schedule RC-N (Past Due and Nonaccrual Loans, Leases, and Other Assets) Memorandum Item 1. Also see page A-83 for a detailed definition of TDR	http://www.ffiec.gov/PDF/FFIEC_forms/FFIEC031_FFIEC041_200906_i.pdf
Center For Audit Quality whitepaper "Application of Statement 114 to Modifications of Residential Mortgage Loans That Qualify as Troubled Debt Restructurings"	Among other items, includes a discussion on if the modification of the terms of a residential mortgage loan would be considered a troubled debt restructuring under SFAS 15	http://www.thecaq.org/newsroom/pdfs/FAS114_LoanModifications.pdf
Instructions for Forms 1099-A and 1099-C	Information regarding the requirements for filing form 1099-C when debt is canceled. Banks should consult their tax advisors.	http://www.irs.gov/pub/irs-pdf/i1099ac.pdf
FRB's Commercial Bank Examination Manual & Bank Holding Company Supervision Manual	Guidance on treatment of various restructurings	http://www.federalreserve.gov/boarddocs/supmanual/

Examiner's Corner

This section highlights trends noted by examiners conducting safety and soundness examinations of community banks within the Fifth Federal Reserve District.

Acquisition, Development and Construction (ADC) Lending

Several markets in the District appear to have oversupplies of vacant developed residential building lots, based on recent absorption. In an effort to generate cash flow for developers, some banks have been lending funds to developers for constructing houses intended to be rentals until the market for purchased housing improves. As part of the market analysis required by SR 07-01, banks considering this should assess the actual need for rental housing in their markets.

Several institutions have significantly slowed or cut back on ADC lending in response to the deterioration in the economy.

Bank Secrecy Act

The lending function should be included within an institution's suspicious activity monitoring program. Some institutions are reviewing loans for suspicious activity during workout or problem loan committee meetings. Particularly relevant in today's market, loans should be considered as potential vehicles for fraud and/or other forms of suspicious activity.

Liquidity Planning

Several institutions have noted that brokered deposits have been a cheaper and more reliable source of funds than core retail deposits due to fierce pricing competition in certain markets.

A number of banks are beginning to monitor their deposit accounts between $100,000 and $250,000.

Lack of adequate cash flow projections and liquidity contingency planning remains a problem with a number of banks. Additionally, unsatisfactory examination ratings can limit a bank's access to FHLB borrowings and brokered deposits. This should be considered in contingency planning.

Remote Deposit Capture

The use of remote deposit capture (RDC) has increased as banks attempt to grow commercial deposits. Institutions that intend to adopt this should appropriately assess all risks and conduct due diligence prior to implementation. Given the risk of fraud associated with this product, the importance of Customer Identification Program requirements and knowing one's customer increases. Guidance is contained in SR 09-2.

Workouts

With the deterioration in asset quality, a number of banks have been designating someone other than the originating loan officer to manage problem loans and workouts.

Interest Reserves

A number of banks have been using interest reserves to support acquisition, development, and construction (ADC) loans. Any extension or increase in a loan's interest reserve should be supported by a realistic assessment of the project's viability, time frame for completion, and guarantor support. When this support is lacking, the classification and accrual status should reflect the weakness. Interest reserves should not be used to delay the reporting and recognition of problems.

If you have questions about any of these or other topics please contact your Fifth District relationship manager, or email BKSRCommunications.RICH@rich.frb.org.

Emerging Risks

It contains the Federal Reserve's Name, but is it a Scam?

by Michael A. Breeding

Scam artists sometimes utilize the good names of individuals and financial institutions to legitimize their schemes. Federal Reserve Bank names are also commonly used for this purpose. At the Federal Reserve Bank of Richmond, we receive calls from individuals asking us to authenticate the validity of gold certificates, checks, consumer loan programs, bills of exchange, personal promissory notes, and/or private offset bonds, along with other similar inquiries. Federal Reserve Banks do not hold funds for or provide products and/or services to individuals or private companies, just to member financial institutions.

Gold Certificates

We have received calls regarding gold certificate scams. The most common variation of this fraud is when an individual attempts to pledge a railroad bond that is reportedly payable in gold as collateral for a loan. To give legitimacy to these bonds, scam artists indicate that they are part of a Federal Reserve System trading program, which is a complete fabrication. Even if the bonds were legitimate, bonds issued with gold clauses before 1977 are unenforceable in U.S. courts.

Checks

Just as financial institutions receive inquiries on the validity of checks drawn from customers' accounts, so does the Richmond Federal Reserve Bank. Fraudulent checks, drawn from a fabricated Federal Reserve Bank of Richmond customer account, are presented to be processed by the Federal Reserve System. These checks purport to be from various individuals around the United States who hold funds at the Federal Reserve Bank of Richmond. Many of these checks appear to be written to multiple credit card companies, and, in some instances, the checks are received by individuals for payment of goods and services. As mentioned previously, these checks are fraudulent because the Richmond Federal Reserve Bank does not maintain accounts or funds on deposit for individuals.

Consumer Lending Program

Consumers also call the Federal Reserve to validate a consumer lending program allegedly offered by the Federal Reserve System. Scam artists are targeting consumers by promoting a nonexistent Federal Reserve lending program that extends sizable secured loans to consumers. Under this fraudulent scheme, targeted individuals are told that that they can work through a broker to access this program. The Federal Reserve System offers no such program.

Bills of Exchange, Personal Promissory Notes, Private Offset Bonds

Just as scam artists invoke the name of the Federal Reserve to give an air of authenticity to fraudulent loan programs, they also do the same for fraudulent bills of exchange, personal promissory notes, and/or private offset bonds. Individuals and financial institution employees have called inquiring about the authenticity of these instruments that have been presented to them for payment and/or to secure debt. The Federal Reserve Bank is contacted because these instruments state that

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Emerging Risk

Portable Device Security (continued from Page 2)

Organizations must be aware of these risks and control corporate confidential or sensitive data that resides on portable devices. Did you know that Gramm-Leach-Bliley Act and Sarbanes-Oxley legislation make financial institutions accountable for ensuring that sensitive personal data and confidential corporate data are accurate, secure and safe from loss, alteration or disclosure?

Portable devices are tools that enhance mobility and help employees be more productive. Achieving these business results requires a carefully managed balance between security and usability. All financial institutions should continuously evaluate portable device security and controls to ensure that they have fully addressed the risks to information assets.

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updated on risk monitoring results and security incidents?

- Does the institution allow portable devices to connect to internal networks and if so, how is compliance with information security policies assured?
- Does information security policy prohibit confidential or highly sensitive information from being stored on portable devices without mitigating controls such as encryption?
- How is the institution protecting its portable devices from unauthorized access?

Examples of protective actions include:

- ✔ Prevent user changes to device 'read-only' security control parameters
- ✔ Disable riskier features such as Bluetooth wireless and instant messaging
- ✔ Mandate device passwords, with a minimum length, complexity and update frequency
- ✔ Require inactivity timeouts of no greater than 15 minutes
- ✔ Block application downloads not authorized by internal information security teams
- ✔ Mandate corporate policy requiring the exclusive use of encrypted USB flash storage devices

- Does the institution maintain and enforce usage of only authorized devices? Is an inventory and security audit of portable devices performed on a regular and random basis?
- Are clear policies and procedures in place to deal with lost or stolen devices? How is data protection and removal ensured for devices being retired from service?

Emerging Risks

It contains the Federal Reserve's Name, but is it a Scam?

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they should be settled through the Federal Reserve Bank of Richmond. Federal Reserve Banks do not process or collect upon bills of exchange, private bonds, or promissory notes.

These scams and many others use the Federal Reserve name to promote and/or give the appearance of authenticity. Scam artists are relying on the name to give them instant credibility. Federal Reserve Banks provide financial services to depository institutions, not to individuals or private companies. For further information on scams that use the Federal Reserve name, please visit the Federal Reserve Bank of Richmond Web site under the additional resources section (then select "Frauds and Scams") or contact Michael A. Breeding at 804-697-2727 or Elaine R. Yancey at 804-697-8313.

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Reporting Updates

Reporting Noncontrolling Interests on the FRY-9C Report

By Tim Pudner

Noncontrolling (or minority) interest is generally present when a parent company owns less than 100 percent of a subsidiary that it consolidates into its financial statements. In December 2007, the Financial Accounting Standards Board issued Pronouncement Number 160, *Noncontrolling Interests in Consolidated Financial Statements* (FAS 160) which became effective in 2009. The purpose of this statement is to make the presentation of noncontrolling interests more clear and uniform. As a result, several changes were made to the FR Y-9C report form.

Prior to FAS 160, noncontrolling interests could be presented in various ways on consolidated financial statements. These interests were often reported as either liabilities or in the mezzanine area of the balance sheet between liabilities and equity. This pronouncement now requires these balances to be reported as equity, but separate from parent's equity. The pronouncement also states that income attributed to the noncontrolling interests must now be clearly stated separately. It can no longer be treated as an expense or combined with any other deductions from net income. As a result, this portion of net income is now reported on the FR Y-9C in the separate line item HI 13, "Net Income attributable to Minority Interests." This amount is then subtracted from HI 12, "Net Income" to calculate the new item HI 14, "Net Income Attributable to Bank Holding Company." On the balance sheet, noncontrolling interests are now included as a sub-item of total equity in line item HC 27b, rather than in the mezzanine area between liabilities and equity.

The basic regulatory capital treatment of minority interests remains the same despite the report changes. However Schedule HC-R item 1 (the starting point for Tier 1 capital) has been relabeled "Total Bank Holding Company Equity Capital" rather than "Total Capital." Minority interests continue to be classified as Class A, B, or C for FR Y-9C purposes. The classification depends on whether the subsidiary that issued the equity is a depository institution, as well as the characteristics of the underlying equity. Class A minority interests are still included in Tier 1 capital without limit, while Class B and C are subject to certain limitations.

More details about the reporting of noncontrolling interests can be found in the complete FR Y-9C instructions and Supplemental Instructions which are both available at http://www.richmondfed.org/banking/reporting_forms/.

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Upcoming Events

2009 State Member Bank Survey

The Banking Supervision and Regulation department of the Federal Reserve Bank of Richmond will be asking for your input again. In November, you will receive an e-mail with a link to the 2009 State Member Bank survey. The survey is part of our ongoing effort to continuously strive to strengthen our relationships with our banks.

Quick Links

Click the links below to view more information

External BKSR Events

Board of Governors

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