S&R PERSPECTIVES

The Latest Fifth District Supervision and Regulation News & Events

Spring Issue 09

> "We are introducing a new feature, the Examiner's Corner. This section highlights the latest trends and emerging issues our examiners are noting during routine examinations."
>
> – Mac Alfriend

In The News

Tale of Jailed Agent Shows Value of Fighting Fraud

by Elaine Yancey

The story of how authorities caught a longtime former IRS agent illegally structuring bank deposits gave Fifth District bankers a real life, true crime example of how the Bank Secrecy Act can work.

An IRS investigator and a federal prosecutor talked about the case at a recent meeting of the BSA Coalition, a group of regulators and bankers who discuss how to develop and implement programs related to the law and other anti-money laundering efforts. The Richmond Fed plays an advisory role for the group.

Special Agent Judith Razzetti of the IRS and Laura Marshall, an assistant U.S. Attorney, told the story of Mohamed Soliman to BSA Coalition members at their December meeting in Richmond. As a 14-year veteran of the IRS, Soliman knew that the Bank Secrecy Act requires banks to report cash transactions in excess of $10,000. When he appeared in court in 2007, he admitted depositing $1.4 million in cash over the two previous years.

Razzetti said that Soliman and a business partner ran a convenience store in Isle of Wight County, Virginia.

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Emerging Issues

The Term Asset-Backed Loan Facility and Expansion under the Financial Stability Plan

by Laura Hall and Donna Thompson

To help stem the financial crisis, the U.S. Government has recently unveiled several more plans and programs to re-ignite the flow of credit. One recent initiative has specifically attempted to address the disruptions to the asset-backed securities (ABS) market since late 2008. Over the past few decades, the asset-backed securities market has become an important means for financial institutions to fund loans to consumers. Since August of last year, however, the ABS market has been virtually nonexistent for certain consumer products. At the same time, consumer credit conditions have tightened significantly. This article will discuss how the **Term Asset-Backed Securities Loan Facility (TALF)** attempts to conquer the stresses associated with this market and improve credit market conditions.

(continued on Page 2)

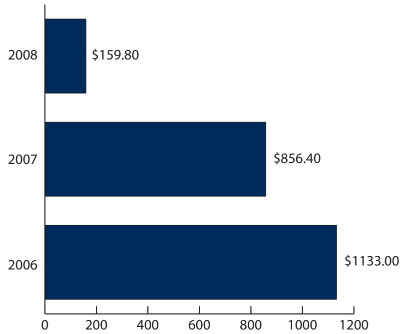
Mac's World at the Fed

In the Spring edition of S&R Perspectives, we are introducing a new feature, the Examiner's Corner. This section highlights the latest trends and emerging issues our examiners are noting during routine examinations. I hope that this will give you new insight into the examination process and begin a dialogue on how to manage emerging risks. Also in this edition is a continuation of an article from the Winter 2008 publication, summarizing the federal programs created in response to the financial crisis. In this time of constant change, we want to hear from you. Your perspectives and the lessons you have learned are important to us.

Please send any story ideas or questions about recent events to **BKSRCommunications.RICH@rich.frb.org**. I look forward to hearing from you.

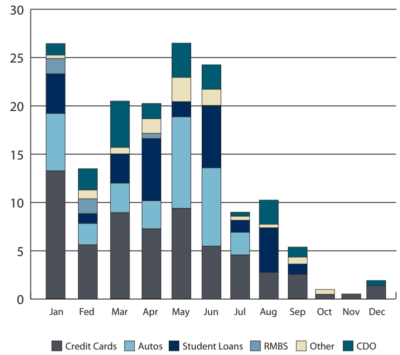
Mac

Figure 1 ■ **U.S. ABS public/144A issuance (US$bn)**



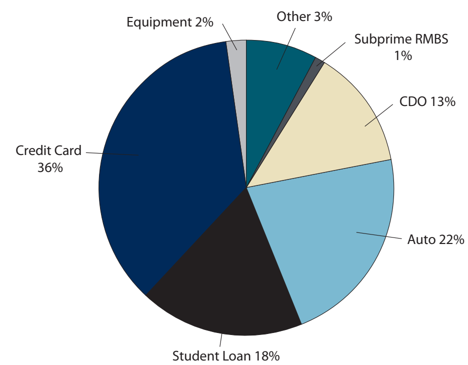
Source: Thomson Financial Securities Data

Figure 2 ■ **Monthly 2008 ABS issuance, by major asset class**



Source: Deutsche Bank, Thomson Financial

Figure 3 ■ **U.S. ABS sector breakdown (2008)**



Source: Thomson Financial Securities Data

The asset-backed securities market has historically played an important role in facilitating the availability of consumer credit. Consumer spending represents approximately 70 percent of gross domestic product and plays an integral role in the U.S economy's recovery. It is estimated that securities collateralized by consumer credit account for roughly 40 percent of all consumer lending - at the height of the credit boom, Wall Street issued more than $1 trillion a year of securities collateralized by these credits. When financial institutions are able to sell loans into a vibrant and liquid secondary market, funds can be recycled back to institutions to make additional loans.

The disruption in the asset-backed securities market since late 2008, however, has negatively impacted both the availability as well as the price of credit. A system-wide deleveraging in financial markets resulted in an evaporation of liquidity. Many market observers believe that as institutions faced difficulties selling loans into the secondary market due to a lack of investor demand, the supply of consumer credit tightened, putting upward pressure on interest rates. Alternatively, other market observers have suggested that a decline in macroeconomic factors have led to a reduction in demand for consumer loans. In either case, figures 1 and 2 show that asset-backed issuance has been essentially non-existent since the latter part of 2008, and securitized lending activity has declined by approximately $1 trillion (outside of GSEs) between 2006 and 2008. As a result, institutions that were traditionally reliant on the ABS markets have been forced to curtail loan originations and turn to more expensive sources of financing.

Recognizing the importance of making credit available to consumers, the Federal Reserve and Treasury authorized the creation of the TALF in November 2008, to facilitate the issuance and sale of consumer-related asset-backed securities. The TALF was designed to jump start new ABS issuance by providing financing to investors to support purchases of certain triple-A rated asset-backed securities. By stimulating these markets, the TALF will assist lenders in meeting the borrowing needs of consumers and small businesses, helping to stimulate the broader economy. Under the original TALF, the Federal Reserve Bank of New York committed to lend up to $200 billion on a secured, non-recourse basis to investors of newly issued, triple-A rated asset-backed securities collateralized by auto loans, credit card debt, student loans and also certain small business loans. To serve as credit protection, Treasury has committed to provide $20 billion from TARP funds to absorb losses.

While original terms of the TALF were released at the end of 2008, there have been several developments regarding this program. In particular, on February 10, Treasury Secretary Geithner announced an expansion of the TALF under one of the key components of the Financial Stability Plan (FSP), the Consumer and Business Lending Initiative. Under the FSP's Consumer and Business Lending Initiative, the Treasury proposed to increase its commitment to provide $100 billion in credit protection (increased from $20 billion) in connection with the TALF loans. In addition, the types of underlying eligible collateral may be expanded to include commercial mortgage-backed securities, and may encompass other types of triple-A rated newly issued ABS as well.

The TALF now has the potential to generate up to $1 trillion of lending for businesses and households. Eligible collateral used to secure the loans must be the highest investment-grade rating by two or more major nationally recognized statistical rating organizations and must be newly or recently originated exposures to U.S.-domiciled obligors. Investors may be enticed by the non-recourse feature on the TALF loans and the exclusion of a mark-to-market or re-margining requirement. The minimum size of each loan will be $10 million and will have a three-year term with interest payable monthly.

Issuers and investors in the private sector are expected to begin arranging and marketing new securitizations of recently generated loans. Subscriptions for funding in March were accepted on March 17, 2009, and funded on March 25. Going forward, monthly subscriptions will be scheduled on the first Tuesday of every month. The TALF will cease making loans on December 31, 2009, unless the facility is extended.

Some critics argue that the program's eligibility requirements and costs to investors may limit its relevance (e.g., some assets will not qualify because of TALF's triple-A rating requirements). According to Moody's, the key to the TALF's success might depend on whether investors and issuers find the loan pricing, advance rates, and maximum loan terms commercially attractive. In particular, certain bank-sponsored issuers may have cheaper funding sources, such as from deposits or other government sponsored programs. Lastly, if deteriorating economic conditions have decreased the demand for consumer loans, as some observers believe, the effect of the TALF may be more uncertain.

Questions on the TALF program should be directed to the New York Federal Reserve Bank's Public Affairs department at 212-720-6130 or via email to TALF@ny.frb.org. For additional information on this program, visit www.Financial Stability.gov.

Editor's Note:

Facts and figures noted in this article relative to market trends were publicly available, and all data is accurate as of March 5, 2009.

Donna Thompson is a supervisory examiner with the Federal Reserve Bank of Richmond. Laura Hall is a senior associate examiner with the Federal Reserve Bank of Richmond.

> "Financial institutions will test the resiliency of their portfolios and capital against both an expected and more severe economic landscape."
>
> – Donna Thompson and Laura Hall

The Financial Stability Plan's Capital Assistance Program

By Laura Hall and Donna Thompson

On February 10, U.S. Treasury Secretary Timothy Geithner announced a comprehensive set of measures under the Financial Stability Plan (FSP), created by the Treasury and the Federal Reserve, to restore confidence in the strength of U.S. financial institutions and ignite the flow of credit to households and businesses. While the FSP is composed of six core elements, this article focuses on one of the key components of this plan, the Capital Assistance Program (CAP).

The CAP was formulated to ensure that financial institutions are sufficiently capitalized to withstand the impact of an economic environment more adverse than currently anticipated, improve confidence in the banking system, and facilitate responsible lending. Under the CAP, institutions will undergo a consistent and forward-looking assessment, designed by regulators, to evaluate the capital needs of institutions under both a baseline scenario as well as under a more stressful economic environment over the next two years. Banks with total assets of more than $100 billion will be required to participate in this supervisory review process and comprehensive stress test. The 19 largest U.S. banking organizations meeting this criteria account for approximately 75 percent of all banking assets in the country. U.S. banking companies with less than $100 billion may also be eligible to receive capital through the CAP. Public companies requesting participation in the CAP have until May 25, 2009, to file an application with their appropriate federal banking agency. Furthermore, while the term sheet currently is available only to publicly traded companies, separate term sheets are expected to become available for non-publicly traded companies, subchapter S corporations, and mutual institutions.

Financial institutions will test the resiliency of their portfolios and capital against both an expected and more severe economic landscape. The adverse scenario analysis assumes an unemployment rate averaging 8.9 percent in 2009 and 10.3 percent in 2010. The unemployment rate reached 8.1 percent in February 2009. In addition, the stress test assumes a 3.3 percent contraction in gross domestic product in 2009, which would be the worst performance since 1946, and home price declines of 22 percent in 2009 and 7 percent in 2010. If the need for additional capital is warranted as a result of these assessments, the administration will require institutions to either raise private capital or accept a bigger investment from the U.S. government. The government's investment will come in the form of convertible preferred shares (convertible into common equity) and will be considered Tier 1 capital at the holding company. Institutions have the ability to convert the preferred shares into common equity at any time to protect against losses; however, the shares will automatically convert into common stock after seven years if not redeemed or converted before then. In addition, banks that have already sold preferred shares to the government as part of TARP's capital purchase program may be able to exchange their preferred shares for convertible securities.

The government's investment carries a dividend yield of 9 percent and is convertible into common equity at a 10 percent discount to the institution's average closing stock price for the 20-day period ending February 9, 2009. The investments made by the Treasury into qualifying financial institutions will be managed in a newly created Financial Stability Trust (FST) that was established as part of the FSP. While the CAP assessment process was initiated on February 25, 2009, a specific date of completion for this process is yet to be determined; however, it is expected to be no later than April 2009. All banks must submit a plan for intended use of the government's capital, and those plans will be available to the public once a bank receives funds. Institutions participating in the CAP are subject to the amended executive compensation requirements described in the Emergency Economic Stabilization Act of 2008, and recipients will also be subject to restrictions on paying common stock dividends, repurchasing shares, and pursuing cash acquisitions. Questions on the CAP program should be directed to Adam Drimer of the Federal Reserve Bank of Richmond at 804-697-8980 or adam.drimer@rich.frb.org.

For additional information on this program, visit www.FinancialStability.gov.

In The News (continued from Page 1)

Both were charged with structuring financial transactions to avoid tax-reporting requirements. Soliman, who said he used $400,000 for medical school for his children in Egypt, was sentenced to 6-1/2 years in prison. His partner is a fugitive.

In telling Soliman's tale, Razzetti and Marshall wanted to let bankers know the important role they play in helping to catch law-breakers. The case against Soliman started with the filing of a suspicious activity report. These reports, known as SARs, alert authorities to suspicious financial transactions and become the basis for criminal cases involving violations of the BSA.

Donna Kitchen, BSA officer of Gateway Bank and Trust, said banks look for suspicious activities in many ways, from the teller window to automated systems. It's often hard to know whether the information supplied through a SAR is helpful until law enforcement agencies start asking questions. Kitchen, who acts as sponsor of the BSA Coalition, said a review of the SARs generated by her bank was conducted during the examination process. The guidance offered by the examiners through this process can help banks with reporting and compliance issues related to the law.

Marshall leads the Richmond/Tidewater SAR Review Team, which seeks to assist compliance with the Bank Secrecy Act by educating the law enforcement community and judges about the law. Marshall also told bankers that SARs are important to law enforcement and are not ignored.

Each month, the team meets to review SARs and to decide which make sense to investigate. Criteria have been developed to help team members narrow their approach. Those criteria relate to the relevant geographic area and to BSA violations reported by banks and money services businesses. SARs that are not pursued by the team are referred to other agencies as appropriate. The SAR Review Team consists of representatives from federal, state and local law enforcement agencies, as well as regulators, including employees of the Fed's Banking Supervision and Regulation department.

At the December meeting, BSA Coalition members also learned about the investigative process used by the IRS to develop a structuring case and the specific criteria needed to bring charges. Marshall and Razzetti also provided the group with case statistics relating to seizure and criminal convictions. They concluded by suggesting that their experience with various cases and investigations had taught them that some convenience store owners try to evade taxes, that unlicensed check-cashing is pervasive – although not often prosecuted – and that SARs are an excellent source of intelligence for all law enforcement.

The Federal Reserve serves as an advisor to the BSA Coalition as part of the Bank's ongoing efforts to improve understanding and communication about BSA, anti-money laundering and fraud issues. The group recently launched a Web site, **www.bsacoalition.org** which contains information and links to other sites designed to facilitate AML compliance and to increase awareness about **common and emerging frauds**.

The BSA Coalition meets quarterly. The BSA Coalition Anti-Money Laundering Conference will be held June 17 at the Federal Reserve Bank of Richmond.

Elaine Yancey is a supervisory examiner in Banking Supervision and Regulation and is the Federal Reserve advisor to the BSA Coalition. She can be reached at Elaine.Yancey@rich.frb.org.

Emerging Risks

The Changing Threat Landscape: Professional Internet Crime Organizations

by Richard Simpson

As the reach of the Internet expands, criminal organizations have worked to infiltrate computer systems of financial institutions to steal confidential customer data and execute financial fraud. Financial institutions and service providers of all sizes are potential targets for Internet-originated attacks, which can result in the breach of databases, fraudulent credit and debit card transactions and wire transfers. Financial institutions also are exposed to heightened operational, reputational and legal risks – in addition to significant costs.

Internet criminals are driven by financial gain and use advanced technology to steal confidential data. These groups hire talented programmers to create malicious software, known as malware, which can enter a corporate network through several avenues, including e-mail, spam, outdated or incorrectly configured security software, contractors and vendors with infected devices and Internet-facing Web applications that were not designed with security in mind.

A sound information security program should include an evaluation of infiltration risk. Financial institutions that outsource their Internet services should ensure that service providers also evaluate Internet security risks. An evaluation should include the following:

- How informed is your organization about the threat of Internet-based crime?
- Is security software current?
- Does the organization have an actively managed Internet-facing intrusion-protection system?
- Is all e-mail from known hackers blocked?
- Does the institution filter outbound traffic for suspicious activity?
- How is security included in the development of Web-facing applications?
- Does the institution address Internet security with suppliers and technology vendors?
- Is security training for all employees, contractors and third-party resources required annually?

Financial institutions must understand the limitations of traditional information security practices and proactively seek to strengthen security methods to identify, control and respond to the threat created by Internet-based criminal activity.

Richard Simpson is a senior IT risk coordinator with the Federal Reserve Bank of Richmond. He can be reached at richard.simpson@rich.frb.org.

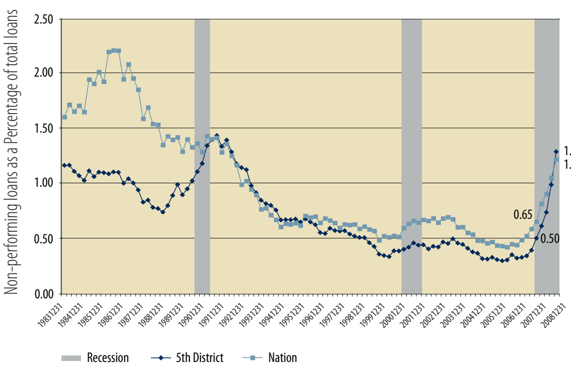
Emerging Trends

Reserving for Loan Losses: What do the aggregate numbers say?

by Eliana Balla

Banks throughout the United States and the Fifth District have been affected by the severe asset-quality deterioration related to housing-related loans and the weakening economy. The median commercial bank ratio of nonperforming loans to total loans, shown in Figure 1, grew 86 percent for the nation and 156 percent for the Fifth District in the course of 2008, reaching levels not seen since the end of the 1989-1992 credit crunch. Such a rapid increase in problem loans invites a closer look at loan loss reserves.

Figure 1 ▪ **Non-Performing Loans as a Percentage of Total Loans (Median Values)**

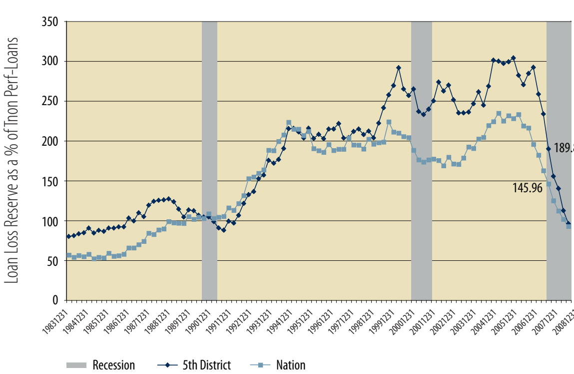


Source: Call Reports.
Note: Data Point Values represent Q4 2008 and Q4 2007.

The data from the three economic cycles presented here suggest that, in aggregate, adjustments to loan loss reserves have tended to lag credit problems and reserves in the U.S. banking system have increased slower than nonperforming loans during economic busts and fallen slower in booms. In the current downturn, median U.S. bank loan loss reserves, as a share of total loans, grew 6.6 percent in 2008, against a 12.3 percent growth in the Fifth District median. Both measures registered at 1.28 percent in December 2008. The loan loss reserves ability to cover nonperforming loans declined for 11 consecutive quarters across banks, crossing the 100 percent threshold in the fourth quarter of 2008. At 95.9 percent for the District and 92.6 percent for the nation, median bank coverage ratios were the lowest in 15 years (Figure 2).

As Figure 2 shows, coverage ratios peaked in 2005, with the Fifth District maintaining a significant spread relative to the nation during these recent boom years. A closer look at the data indicates that the spread is largely driven by lower levels of nonperforming loans in the District during this time as opposed to higher reserving. Also, splitting the sample of banks by the $10 billion marker in total assets indicates that the differences between the District and the nation seen in Figure 2 are largely driven by the smaller banking institutions. In the last 10 years, the spread between median coverage ratios in the District and the nation averaged 59.62 percentage points for institutions below $10 billion in assets and 10.39 percentage points for institutions above $10 billion in assets.

Figure 2 ▪ **Coverage Ratio (Loan Loss Reserve as a Percentage of Non-Performing Loans (Median Values))**

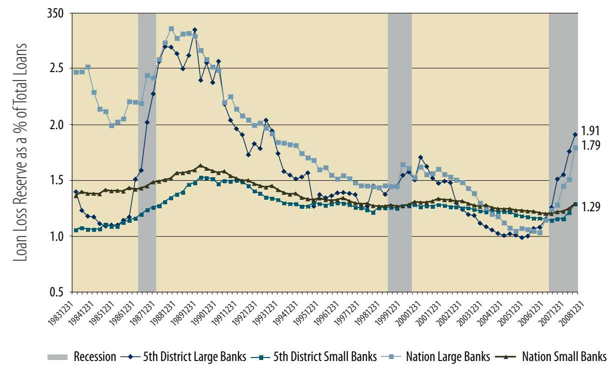


Source: Call Reports.
Note: Data Point Values represent Q4 2008 and Q4 2007.

Reserving at smaller institutions has been very stable in the last 10 years, trending at about 1.25 percent

of total loans, as shown in Figure 3. Median bank reserves for institutions above $10 billion in total assets rose rapidly during 2008, quickly surpassing the most recent highs out of the 2001 recession, after having dipped to levels bounding on 1 percent of total loans during 2005-06. At year-end 2008 median loan loss reserves at these larger commercial banks returned to levels not seen since 1996-1997. Median measures of loan loss reserves for both small and large institutions in the Fifth District track the nation closely, historically and in the current economic environment.

Figure 3 ▪ **Loan Loss Reserve as a Percentage of Total Loans (Median Values)**



Source: Call Reports.
Note: Large banks have total real assets greater than or equal to $10 Billion. Small banks have total real assets less than $10 billion. Real assets are expressed in year 2000 U.S. dollars. Data Point Values represent Q4 2008.

Coverage ratios (1) have fallen rapidly from the 2005 peaks to well below those of the last recession, (2) to now be in line with the 1989-92 credit crunch period,(3) demonstrating that at the end of 2008, loan loss reserves did not cover reported nonperforming loans. Economists forecast weak economic conditions through at least 2009, with the expectation of continued asset quality weaknesses, higher nonperforming loans levels and increased loan charge-offs. Bank earnings will likely continue to suffer from high loan loss provisions resulting from the need to build loan loss reserves.

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Examiner's Corner

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

Commercial Real Estate Loan Concentration

A number of institutions that have concentrations in commercial real estate loans exceeding 300 percent of tier one capital and reserves, and concentrations in acquisition, development and construction loans exceeding 100 percent of tier one capital and reserves have not implemented adequate risk management processes, as required by the Interagency Guidance on Concentrations in Commercial Real Estate contained in SR Letter 07-1. Banks whose lending in those areas exceeds these thresholds are strongly encouraged to revisit the guidance and strengthen risk management of these portfolios accordingly.

Delayed Development

Real estate development projects continue to be delayed across the Fifth District. In addition, borrowers and bankers face ongoing problems in instances where potential purchasers of developed and other real estate have walked away from contracts and deposits.

Cash Flow

Insufficient cash flow analysis of borrowers has been a problem in several banks. Lenders should capture all of a borrower's sources of cash, as well as the borrower's ongoing obligations to other financial institutions, in order to make an effective credit decision.

Growth and Liquidity

Limited deposit and external borrowing sources are beginning to constrain growth strategies of some Fifth District banks. In addition, deteriorating economic conditions are compelling many institutions to strengthen their liquidity contingency plans.

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.

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Federal Reserve Bank of Richmond

Board of Governors

Supervision and Regulation

Bankers Education

Outreach Calendar

BSA Coalition Anti-Money Laundering Conference

Date: June 17, 2009
Location: Federal Reserve Bank of Richmond
For more information visit: www.bsacoalition.org

Reporting Updates

Financial Reporting Rules of Business Combinations will Change in 2009

by Tim Pudner

The Financial Accounting Standards Board issued a new pronouncement in December 2007 that changes the way institutions must account for business combinations on their financial reports. Statement 141(R), which replaces the original FAS 141, must be applied to all mergers and acquisitions that occur on or after January 1, 2009. Under the revised pronouncement, business combinations are to be accounted for using the newly defined "acquisition method" of accounting. This method replaces the "purchase method" previously defined in the original FAS 141.

One of the significant changes of the revised FAS 141(R) that will affect bank reporting pertains to the issue of loans held for investment that are acquired through a business combination. Under the "acquisition method," the fair value of these loans will be transferred to the acquiring bank's balance sheet. Allowances for loan and lease losses (ALLL) cannot be carried over to the acquiring bank's balance sheet. The associated credit risk of acquired loans will instead be considered when determining the fair value of the loans. In other words, a "net" fair value (rather than a loan balance and a separate allowance balance) will be transferred to the loan account on the balance sheet.

Due to the pronouncement requirements, banks and bank holding companies must report new information on the Call and FR Y-9C reports. In order to meet the associated disclosure requirements, accounting systems must be able to segregate any loans acquired through business combinations. Information about how these changes will affect the March 31, 2009 FRY-9C and Call Reports is available at the Board of Governors Website http://www.federalreserve.gov/reportforms/review.cfm.

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