S&R PERSPECTIVES

The Latest Fifth District Supervision and Regulation News & Events

Summer Issue 09

“The guidance may lead to companies using their judgment to a greater extent in determining the fair value of their assets.”

– Diane Rose

In The News

FASB Clarifies Fair Value Accounting Guidance

By Diane T. Rose

The Financial Accounting Standards Board, or FASB, issued guidance on April 9, 2009, to clarify fair value measurement and to change the accounting treatment for other-than-temporary impairments for debt securities. Proponents of the change contend that during the current financial crisis, fair value accounting, also known as mark-to-market accounting, has pushed valuations lower and caused financial firms to recognize significant other-than-temporary security losses.

In response, FASB issued FASB Staff Position(FSP) FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* and FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*.

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Emerging Issues

Revisiting Limitations on Interbank Liabilities

By A. J. Duke and Debbie Cook

On May 1, 2009, the $4.1 billion Silverton Bank was closed by the OCC and placed into receivership. The correspondent or “bankers’ bank” served approximately 1,400 banks or banking organizations. While Silverton’s highly leveraged structure and commercial real estate loans made it an anomaly among bankers’ banks, it offers a clear signal to bank management that now may be the time to ensure the processes are in place to continually assess risk and exposure to correspondents as well as maintain compliance with *Regulation F*.

Limitations on Interbank Liabilities, or Regulation F was established to “limit the risks that the failure of a depository institution would pose to insured depository institutions.” Minimum due diligence outlined in the regulation requires that bank management establish written policies and procedures to prevent “excessive exposure” to any individual correspondent bank and take into account credit and liquidity risks. Internal limits on exposure and a method for monitoring exposure and compliance with these limits are also

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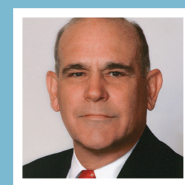
Mac’s World at the Fed



Welcome to the summer 2009 edition of S&R Perspectives. I am excited to share that the Federal Reserve Bank of Richmond hosted the first annual BSA Coalition Anti-Money Laundering Conference, topics were focused on the importance of the development and implementation of effective BSA and AML programs; presentations are available on our public website. In this edition, is an update on regulatory revisions that may directly impact capital levels for some institutions.

On June 9, 2009 we released a special report on risk based capital requirements associated with investing in certain types of structured securities. To read more about this topic, please visit **http://www.richmondfed.org/banking/supervision_and_regulation/**.

As always, please continue to share your perspectives on emerging issues and best practices in the banking industry. Please send any questions, comments, or story ideas to **BKSRCommunications.RICH@rich.frb.org**.

Mac

required. Finally, the Board of Directors is tasked with reviewing the program at least annually.

Credit exposure to an individual correspondent on an interday basis should not exceed 25% of the total capital, unless management can prove that the correspondent is at least adequately capitalized (as defined within Regulation F). When calculating credit exposure of the bank and its subsidiaries, management should ensure that there is a robust system in place to monitor aggregate exposure to a correspondent. Exposure should be aggregated across correspondent accounts (less applicable FDIC insurance), Federal funds sales, loan participations, off balance sheet items, and any other obligations. Bankers are required to review the condition of their correspondents on a quarterly basis. The information needed to prove a bank is at least adequately capitalized is widely available publicly in regulatory reports, other financial filings, or from rating agencies. The expectation is that a review of these financials be done and documented in the Regulation F file.

Although Regulation F sets no limit on transactions with banks that are at least adequately capitalized, more stringent internal limits of a correspondent's financial condition may prevent losses. Banking consultants are advocating more prudent reviews that go beyond assessing whether an upstream correspondent's capital position meets minimum standards. Additional criteria include earnings trends, balance sheet structure (assets and funding sources), and the volume of charge-offs, past dues, and nonaccrual loans. Some experts further suggest that management's analysis also include a review of the services provided (and associated costs) by each upstream correspondent to evaluate both the risks and benefits of the relationship.

Finally, bankers must create procedures for reducing exposure when a correspondent bank is no longer at least adequately capitalized. Regulation F states that aggregate exposure must be less than 25% of total capital within 120 days of the Call Report (or other information) becoming available. A system that provides for reducing exposure or terminating relationships with correspondent banks if their financial condition deteriorates could prevent financial losses or service disruptions.

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Emerging Risks

Cloud Computing – New Services / New Risks

by Richard Simpson

"Cloud computing" is a term describing a rapidly growing set of technology products and application capabilities delivered as a service, using the Internet. It refers both to the applications delivered as services and the hardware and systems software in the third-party data centers that provide those services. The data center hardware, software and connecting networks make up what is called the "cloud."

Product offerings are described in terms such as on-demand services, utility computing, cloud services or 'software as a service.' IBM, Google, Microsoft and Amazon all are actively marketing services ranging from the simple email services or hosting Web sites to the complex, such as replacing all in-house IT processing at some companies. Many small providers are also offering cloud computing services.

Financial institutions may find cloud computing attractive for several reasons:

- It offers computing resources and capacity on demand and eliminates the need to plan for and purchase internal computing resources.
- The customer incurs no capital costs, just operational costs that are on a pay-per-use basis, generally without long term contractual obligations.
- Cloud computing suppliers offer customers the ability to acquire business applications quickly without significant internal development and IT infrastructure investment costs.

The potential advantages of cloud computing services must be weighed against the following risks the institution may face:

- Security of information, security of networks and loss of control over critical or sensitive data;
- Regulatory requirements concerning data privacy/confidentiality and information protection;
- Potential service availability and application performance issues, integration challenges with existing internal systems;
- Business continuity/disaster recovery planning complexity because of data location;
- Risk of being locked into an unsatisfactory supplier relationship because of proprietary programming languages, information stored with the supplier, or lack of access to software source code;
- Potential customer impacts if cloud computing services become unstable or result in direct licensing or usage fees for customers;
- Potential reputation and litigation issues if the cloud computing provider goes out of business, experiences significant performance issues or has security breaches;

Institutions considering the use of cloud computing services should weigh the benefits with the potential risks outlined above. Cloud computing standards and security practices are evolving concepts that will take years to mature. In the near term, a careful evaluation of the institution's needs and a cautious approach to deploying cloud computing is a prudent strategy.

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In The News (continued from Page 1)

FSP FAS 157-4 reaffirms that the objective of fair value measurement is to reflect the price for an asset in an orderly transaction, as opposed to a distressed or forced transaction. It emphasizes the need to use judgment in ascertaining if a formerly active market has become inactive and in determining fair values when markets have become inactive. In such an environment, the guidance may lead to companies using their judgement to a greater extent in determining the fair value of their assets, which could result in higher valuations. Institutions will be required to disclose changes in valuation techniques and quantify its effects in their financial statements.

FSP FAS 115-2 and FAS 124-2 distinguishes the credit and noncredit components of impaired debt securities that are not expected to be sold in an attempt to bring greater transparency and to respond to concerns that current market conditions have caused institutions to realize higher investment impairments than the actual economic loss based on cash flow analysis. The measure of impairment remains fair value despite the bifurcation between credit losses, which hit earnings, and noncredit losses, which will be included in other comprehensive income in equity capital. There is also a one-time "true up" adjustment to adjust for previously taken other-than-temporary impairments from non-credit losses. This adjustment could result in an increase in Tier 1 capital.

Both are effective for interim and annual periods ending after June 15, 2009, but entities may become early adopters of both FSPs for the interim and annual periods ending after March 15, 2009.

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Are You Ready?

For the new NACHA rules regarding international ACH transactions?

These rules were written to assist OFAC compliance and will require the use of a new code and format on all ACH payments entering or exiting the United States.
They were created to improve transparency of international ACH transactions.
The effective date is September 18, 2009.
Learn about how to comply below.
http://www.nacha.org/IAT_Industry_Information/
http://www.frbservices.org/help/fedach_iat.html/

Summary: "Estimating the lognormal-gamma model of operational risk using the MCMC method"

By Bakhodir A. Ergashev

The complete work referenced in this article is available at: http://www.journalofoperationalrisk.com; the working paper is available at: http://ssrn.com/abstract=1316428.

The new international framework for measuring and managing the risks of banking institutions, also known as Basel II, aims to improve the consistency of capital regulations internationally, make regulatory capital more risk-sensitive, and promote enhanced risk-management practices among large, internationally active banking organizations. According to Basel II, banks are required to measure their operational risk in addition to credit and market risks. To address this requirement, banks are now developing their advanced systems of modeling and measuring operational risk. Because measuring operational risk is a relatively new discipline, being able to model it effectively is fraught with many challenges. Recently, the author drafted a research paper that puts forth an option for addressing some of those challenges. The research paper was published in the Spring 2009 issue of the "The Journal of Operational Risk." The option proposed is the lognormal-gamma model, which is one of a few available operational risk models with some very attractive features. Currently, this model is being used by some banks to quantify their operational risk capital under Basel II requirements. However, since this particular model's estimation technique or fitting is vendor-developed and -supported, its software is essentially a "black box" for regulators as well as other banks that choose to use it. To address this situation, the paper offers an alternative and novel approach to fitting this model, which essentially opens the black box and makes the fitting transparent and available for all interested parties.

Also, the paper addresses another important challenge that both regulators and Basel II mandatory banks currently face. Specifically, Mignola and Ugoccioni (2006) among others find that operational risk models substantially overestimate regulatory capital and create uncertainty around capital estimates. Based on this finding, experts representing the global banking industry are trying to persuade regulators that it is necessary to significantly reduce the currently accepted percentile level for regulatory capital to improve the accuracy of capital estimates. The capital implications of this act would be enormous – as the amount of regulatory capital related to operational risk could materially drop. This is likely not an option from the regulatory standpoint, because the likelihood of losses wiping out capital increases substantially.

The novelty of the paper's approach is that it improves capital estimates without any reduction in the currently accepted percentile level for regulatory capital. The incorporation of expert opinions about the frequency and severity of losses into the model through the well-known Markov Chain Monte Carlo method has resulted in this improvement. Expert opinions are extremely important when historically observed data are insufficient to fit models well.

REFERENCE:

Mignola, G., and Ugoccioni, R. (2006). Sources of uncertainty in modeling operational losses. The Journal of Operational Risk 1(2), 33-50.

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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.

Appraisals

The use of stale appraisals to underwrite new or renewed loans when additional money is extended is becoming an issue. Generally, a new appraisal is required for these transactions when there has been a material change in market conditions. SR Letter 94-55 provides regulatory guidance.

Allowance for Loan and Lease Losses

Reportedly, some CPA firms are advising banks to shorten the historical loss period to one year or to assign a higher weight to the most recent period for analyzing ALLL adequacy, in light of the sharp deterioration in the economy.

Capital

Some bank holding companies have decided to borrow funds to provide capital to their subsidiary banks as an alternative to accepting assistance from the U.S. Treasury under the Troubled Asset Relief Program. Institutions considering this path should analyze its affect on the parent company's leverage and double leverage ratios. The Federal Reserve's Bank Holding Company Inspection Manual contains some guidance.

Generally, regulatory concern increases as a company's double leverage ratio approaches 120%.
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.

Reporting Updates

By Tim Pudner

Several new items and clarifications were added to the 2009 FR Y-9C reports and instructions related to the Regulatory Capital section (HC-R). A few of the more significant issues are highlighted below.

In light of continued stress in financial markets and the efforts of bank holding companies to increase their overall capital levels, on March 17, 2009, the Board of Governors of the Federal Reserve System announced the postponement of the new limits on the inclusion of restricted core capital elements (e.g. trust preferred securities) in Tier 1 capital of bank holding companies. The rule changes, which were previously scheduled to go into effect on March 31, 2009, have been postponed until March 31, 2011. However, HC-R will reflect the new limits on restricted core capital elements in separate line items within Tier 1 capital. For example, any excess trust preferred securities that would have been subject to the additional limits will be reported in Schedule HC-R, item 10, "Other additions to Tier 1 capital.", rather than item 6b, "Qualifying restricted core capital elements". See the section titled "Reporting of Qualifying Restricted Core Capital Elements in Tier 1 Capital" beginning on page HC-R 3 of the FR Y-9C Instructions for a more detailed description and example calculations.

Also, in an effort to boost capital levels at financial institutions, the U.S. Treasury announced the Capital Purchase Program, or CPP, under the Troubled Asset Relief Program in October 2008. Bank holding companies participating in the program sell cumulative senior perpetual preferred stock and warrants for common stock to the Treasury. For regulatory capital purposes, the entire amount of both the preferred stock and common stock warrants are generally treated as unrestricted core capital and included in Tier 1 capital.
New line items were added to Schedule HC-M to capture the preferred stock and common stock warrants associated with the CPP. For details about reporting these new capital components, see the Supplemental Instructions posted to the "Reporting Forms for Financial Institutions" available at www.richmondfed.org.

Report instructions were also updated to clarify the capital treatment of certain subordinated asset backed securities. The ratings based approach is commonly used by banks and bank holding companies to determine the proper capital charge for these holdings that are externally rated. However, this approach of risk weighting is not available for securities that have been downgraded more than one level below investment grade. The capital charge is instead based on their face value and the pro-rated portion of any senior level securities that they support. The exact charge will be dependent on the amounts of the various tranches of the securitization outstanding and determining if the "low-level exposure rule" is applicable. Due to the confusion related to risk-weighting these securities, the March 2009 Call Report instructions were updated to provide detailed examples and tables to assist in the calculation. See "Treatment of Purchased Subordinated Securities That Are Direct Credit Substitutes Not Eligible for the Ratings-Based Approach" beginning on page RC-R 17. Corresponding information has been added to the June 30, 2009 FR Y-9C instructions.

A complete list of the report changes and supplemental instructions for these items is available at http://www.richmondfed.org/banking/reporting_forms/.

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