S&R PERSPECTIVES

The Latest Fifth District Supervision and Regulation News & Events

Fall Issue 10

“While the bailout appeared to have temporarily mitigated the current and acute economic crisis in Greece, it is not a permanent solution and conditions are by no means stable.”

– Robert E. Carpenter

Emerging Issues

Changes to Discount Window Practices Regarding Disclosure of Lending Information

By Greg Robinson

In accordance with the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. No. 111-203), the Federal Reserve must disclose by December 1, 2010, specific information regarding certain loans or other financial assistance provided between December 1, 2007, and July 21, 2010. The provisions include disclosure of borrowings under the Term Auction Facility.

The information that the legislation requires the Federal Reserve's Board of Governors to release is the following:

- The identity of the entities provided financial assistance under the facility;
- The type of financial assistance provided;
- The value or amount of the assistance;
- The date on which the assistance was provided;

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In The News

Bureau of Consumer Financial Protection

With the recent passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”) a number of questions remain about the true effect this action will have on the financial institution regulatory environment. This article will be the first in a series providing a practical summary of the Act. This article focuses on the portion of the Act that created the Bureau of Consumer Financial Protection.

Note: This article is not intended to provide a holistic summary of the act nor is it intended to serve as supervisory guidance.

Establishment

Title X of the Act establishes the Bureau of Consumer Financial Protection (the “Bureau”) to regulate the offering and provision of consumer financial products or services under the Federal consumer financial laws. Consumer financial products or services include such financial products or services that are “for use by consumers primarily for personal, family, or household purposes,” and include the extension of credit, deposit-taking activities, funds transmission, check cashing, financial transaction data processing,

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Jennifer's Notes

Welcome to the fall 2010 edition of S&R Perspectives. Although the year is beginning to wind down, the pace doesn't seem to be following suit. With changes afoot on the regulatory front and continued stress in our banking environment, we, and you no doubt, are as busy as ever. During my first few months as senior vice president, I have enjoyed meeting with many of you. I have spent a lot of time discussing the Dodd-Frank Act and have heard your concerns about the potential impact the legislation will have on the banking environment and specifically the supervisory process. Additionally, I have heard your concerns about the stresses in the current supervisory process and we are working diligently to diffuse them. It is our strong desire to work closely with you and to provide you with strong support. It is important to me to hear your perspectives on both issues as we move through this process. Please do not hesitate to share your concerns or questions by emailing **BKSRCommunications.rich@rich.frb.org**. We want to hear from you!

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- The specific terms of any repayment expected, including the repayment time period, interest charges, collateral, and other material terms; and
- The specific rationale for the facility.

Additionally, effective for all discount window loans extended on or after July 21, 2010, the Federal Reserve is required to publicly disclose the following information, generally about two years after a discount window loan is extended to a depository institution:

- The name and identifying details of the depository institution;
- The amount borrowed by the depository institution;
- The interest rate paid by the depository institution; and
- Information identifying the types and amounts of collateral pledged in connection with any discount window loan.

The information disclosures may include the name and address of the borrowing institution, ABA number, etc. More specific guidance for information disclosures, the manner in which the information will be released and the extent of the collateral information provided will be determined and published later. If a depository institution has additional questions about the disclosure requirements, Credit Risk Management staff can be reached at 1-800-526-2036. Additionally, frequently asked questions regarding disclosure requirements and general discount window lending information can be found at **www.frbdiscountwindow.org**.

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In The News (continued from Page 1)

and the provision of certain financial advice. Offices defined to be housed within the Bureau include: Fair Lending and Equal Opportunity, Financial Education, Service Member Affairs, and Financial Protection for Older Americans. In addition, the Director will establish a Consumer Advisory Board to consult with the Bureau comprised of industry and consumer experts. At least six advisory board members will be appointed by Federal Reserve Bank presidents.

The Bureau will be an autonomous entity, or executive agency, within the Federal Reserve System and will be managed by a director, who will be selected for a five year term by the President and confirmed by the Senate. While a director has not yet been named, on September 18, 2010, the President appointed Elizabeth Warren as an assistant to the President and special adviser to Treasury Secretary Geithner in charge of setting up the Bureau. On this same day, July 21, 2011 was designated as the date for transfer of consumer financial protection functions to the Bureau.

Authority

The Bureau will have rulemaking authority under Federal consumer financial laws and the responsibility for supervising certain financial entities and taking appropriate enforcement actions to address violations of such laws. In particular, the Bureau will supervise any insured depository institution or credit union with total assets of more than $10 billion and its affiliates. Insured banks, savings associations, and credit unions with total assets of $10 billion or less will continue to be supervised for compliance with Federal consumer financial laws by the prudential regulator. The Bureau, however, may include its examiners on these examinations on a "sampling basis." In addition, supervision for compliance with the Community Reinvestment Act for all insured depository institutions and credit unions regardless of asset size will not transfer to the Bureau and will continue to be the responsibility of the prudential regulator.

The Bureau will also have responsibility for the supervision of certain nondepository covered entities that originate, broker, or service consumer mortgage loans or provide loan modification or foreclosure relief services in connection with such loans, offer consumer private education loans, or provide payday loans. In addition, the Bureau will supervise any entity that is a "larger participant of a market for other consumer financial products or services" or that engages in conduct that poses risks to consumers. The Bureau will consult with the Federal Trade Commission to define covered entities subject to this supervisory authority. Certain entities are specifically excluded from the Bureau's authority, including, but not limited to, merchants and retailers of nonfinancial goods or services; real estate brokerage activities; manufactured and modular home retailers; accountants and tax preparers; attorneys; the insurance industry; and auto dealers predominantly engaged in the sale, leasing or servicing of motor vehicles.

For the complete **Dodd-Frank Wall Street Reform and Consumer Protection Act** please visit **http://docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf** or for more information on regulatory reform visit **http://www.richmondfed.org/research/issues_in_financial_regulation/**.

Jennifer's Notes

For the latest information on regulatory reform please visit the Federal Reserve Bank of Richmond's website **http://www.richmondfed.org/research/issues_in_financial_regulation/** or the Board of Governors website **http://www.federalreserve.gov/newsevents/reform.htm**.

In this edition of the newsletter, we discuss a variety of financial industry topics, including the recent changes to the Discount Window lending disclosures resulting from the Dodd-Frank Act; this is certainly an important topic as it will likely impact many depository institutions directly. Also in this edition, we cover the details and importance of the Greek financial crisis we have watched unfold in the global markets. Troubled Debt Restructurings is a subject we have discussed in several past editions; as it continues to be a hot topic we carry-on with the frequently asked questions series. This edition also includes a brief summary of the portion of the regulatory reform legislation which created the Bureau of Consumer Financial Protection. As in the past, we have included important links to recently released guidance updates. I encourage you to review new guidance and contact your Federal Reserve Bank of Richmond relationship officer with any questions or concerns. For the latest information on new guidance, be sure to visit the Board of Governors' banking information website **http://www.federalreserve.gov/bankinforeg/default.htm**.

Finally, we want to continue to cover issues and topics that are meaningful to you. Please take a moment to complete a brief survey **http://www.richmondfed.org/banking/supervision_and_regulation/newsletter/index.cfm** and tell us what topics you would like to learn more about in future editions of S&R Perspectives. I would love to hear from you!

Jennifer

Examiner's Corner

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

Hotel Loans

Examiners in other Federal Reserve Districts have noted a number of instances where lenders failed to file UCC-1's on furniture, fixtures, and equipment for hotel loans. As a result, in foreclosure situations, these banks will have gained possession of empty shells. Nationally, larger lenders have been underwriting new and renewal hotel loans on the basis of debt service coverage as high as 1.7 times in order to compensate for the likelihood of higher interest rates over the next two years.

Non-rated Investments

Current economic conditions have compelled a number of banks to increase the frequency of credit quality reviews of investment securities, in particular state, county and municipal issues (SCMs), as some localities have been struggling with declines in tax revenues. In several instances, either issuers or insurers of SCMs have lost their credit ratings (i.e., nonrated debt).

Regulators expect institutions holding nonrated debt security exposures to demonstrate that they have made prudent pre-acquisition credit decisions as well as have effective risk based standards for the ongoing assessment of credit risk. Exposure to nonrated issuers should undergo credit analysis using normal credit standards (new investments should go through the bank's credit-approval process) with appropriate documentation to support the issuer's financial capacity. This analysis should receive the same rigor as credit analysis completed on commercial borrowers. Moreover, activity in nonrated issues outside the bank's target or geographic market should be more closely monitored.

In the current market environment, the fair value of many investment securities is below their cost basis, resulting in significant amounts of realized and unrealized losses in some securities portfolios. The increase in such losses has resulted in heightened attention by institutions, auditors and regulators on the impairment analyses performed by institutions in assessing whether a decline in fair value on securities should be deemed an other-than-temporary impairment (OTTI). Institutions are reminded to ensure compliance with appropriate accounting standards for OTTI such as FASB's Accounting Standards Codification (ASC) 320-10-35 Investments – Debt and Equity Securities – Subsequent Measurement.

Interest Rate Risk Management

Regulatory agencies issued new guidance for managing interest rate risk earlier this year. This is contained in Federal Reserve SR Letter 10-1, *Interagency Advisory on Interest Rate Risk* for state member banks. In general, the guidance calls for more rigorous stress testing of the balance sheet in light of the sharp changes in interest rates, which were experienced in recent years. Effective management of interest rate risk will receive increased focus during safety and soundness examinations.

Allowance for Loan and Lease Losses (ALLL)

Aside from determining a bank's ALLL based upon accounting standards such as Accounting Standards Codification (ASC) 310-10-35 Receivables - *Subsequent Measurement* (formerly FAS 114) and ASC 450-20 *Contingencies-Loss Contingencies* (formerly SFAS 5), bankers should also evaluate the ALLL for reasonableness. In that regard it would be appropriate to:

- Evaluate trends as compared to an institution's peer group and its own historical experience. For example, the relationship of the ALLL to adversely classified or graded loans, past due and nonaccrual levels, as well as historical gross and net charge-offs.
- Analyze changes in key ratios from prior periods, assess the directional consistency of the ALLL in relation to these changes and assess the appropriateness and reasonableness of the

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Emerging Issues

Troubled Debt Restructurings – FASB's Exposure Draft and Continuation of TDR Frequently Asked Questions

by David C. Schwartz C.P.A. & David W. Powers C.P.A[1]

This article is part of an ongoing series on Troubled Debt Restructurings, and is a continuation of the Fall 2009 and Summer 2010 articles "Troubled Debt Restructurings on the Rise" and "Troubled Debt Restructurings – Increased Examiner Focus, GAAP Updates, and Frequently Asked Questions," respectively. This article provides highlights of FASB's recently released exposure draft that addresses the inconsistencies in the practice of identification of Troubled Debt Restructurings (TDRs) by lenders, as well as provides a continuation of the frequently asked questions examiners typically encounter related to TDRs.

The Financial Accounting Standards Board (FASB) recently released for comment an Exposure Draft (ED) 'Receivables (Topic 310) Clarifications to Accounting for Troubled Debt Restructurings by Creditors' which is intended to address the current diversity in practice of creditors in the identification of TDRs by clarifying specific portions of FASB Accounting Standards Codification™ (ASC) 310-40 'Troubled Debt Restructurings by Creditors.' Current GAAP 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. . ." Some creditors, in their determination if a debtor has been experiencing financial difficulties, have been applying portions of GAAP contained in ASC 470-60-55-10 'Debt – Troubled Debt Restructurings by Debtors.' This portion of the ASC includes a test to determine whether a creditor has provided a concession from the *debtor's* perspective. The ED specifies that this test is only meant to be used by a debtor and is not intended to be used by the creditor when determining whether a concession has been granted. Additionally the ED also clarifies that (1) if a debtor does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the restructured debt, that the restructuring would be considered a TDR, (2) a restructuring that results in an insignificant delay in contractual cash flows may still be considered a TDR, (i.e., loans with temporary payment concessions may still be considered TDRs), (3) a borrower need not be in default in order to be considered experiencing financial difficulties, and (4) a restructuring that results in an increase (permanent or temporary) in a contractual interest rate does not automatically make it a rate that is above or at market.

The comment period on this Proposed Accounting Standards Update ends on December 13, 2010. The Accounting Standards Update (ASU), if issued, is expected to have an effective date for interim and annual periods ending after June 15, 2011. Additional information on this ED may be found on FASB's website www.fasb.org, in the "Exposure Documents Open for Comment" section under the "Projects" tab. We encourage you to read this ED and comment directly to the FASB, as these changes may have a direct impact on which restructurings you identify as TDRs. Readers should keep in mind that any conclusions reported by the FASB are tentative and subject to change, as changes to the ASC can only be promulgated by an Accounting Standards Update issued by the FASB.

TDR Frequently Asked Questions

As noted in the Summer 2010 article "Trouble Debt Restructurings – Increased Examiner Focus, GAAP Updates, and Frequently Asked Questions," the proper identification and accounting for TDRs is imperative as it will have a direct impact on the earnings and risk profile of a bank. The article **encouraged banks to consider reviewing their policies and procedures related to TDR identification to ensure proper GAAP and regulatory reporting requirements were being followed**. To aid readers in this work, the article included some frequently asked questions (FAQs) examiners have observed while in the field; the following is a continuation of these FAQs. (Please see the above-mentioned article for FAQs related to: Market and Effective Interest Rates and TDR Identification.)

Note: FAQs and related responses represent the authors' interpretation of GAAP and/or regulatory guidance and may not necessarily reflect the views of the Federal Reserve Bank of Richmond or the Federal Reserve System.

Forbearances & Trial Modifications

1. **Does informal forbearance of a loan constitute a TDR?**
   As per ASC 310-40-15-11 'Receivables - Troubled Debt Restructurings by Creditors – Scope and Scope Exceptions' a creditors' delay in taking legal action to collect overdue amounts of interest and principal would not be considered a TDR unless they involve an agreement between the debtor and creditor to restructure.

2. **What is a trial modification and are they considered TDRs?**
   At times, lenders implement a trial period before a loan restructuring is finalized. These trial periods assist the lender in determining whether the borrower has the capacity and the willingness to perform based on modified loan terms, before a formal restructuring takes place. Generally, a trial period before a modification is not considered a binding agreement between the creditor and debtor. Per ASC 310-40, Receivables - Troubled Debt Restructurings by Creditors, consummation and initial measurement of a trouble debt restructuring is at the time of the restructuring, which is indicated by the restructuring agreement or court order, which typically occurs after these trial periods. Therefore, the loans within trial modification periods are not considered TDRs; however once (if) the loan is formally restructured at the end of the trial period the bank would report the loan as a TDR by assuming the modification became a TDR on the date that the formal modification was consummated, and <u>not</u> the date the trial modification began.

3. **Are trial modifications included in regulatory reports?**
   As noted in FAQ number two, loans in a trial modification period are not considered TDRs, therefore, would not be listed as restructured loans in the Call Report. However, the past due status of a loan that is paying according to the restructured terms during a trial period should

remain consistent with the loan's original, pre-restructured terms and past due status at the time the trial period started. Once a trial period is complete and a loan is formally modified, it would be listed as a restructured loan in the bank's Call Report.

For example, assume a loan is 60 days past due on the first day of a three month trial period. The renegotiated terms require $600 monthly payments and the pre-modified loan required $1,000 monthly payments. The loan would not be listed as a restructured loan in the Call Report during the trial period. While the borrower would submit the three months of $600 payments according to the trial period terms, the past due status would be based on the pre-modified contractual terms, and would continue to worsen during the trial period as payment shortfalls would increase the aggregate of payments in arrears. At the end of the trial period, provided the loan is formally restructured and the trial period payments were paid as agreed, the loan will be listed as a restructured loan in the Call Report (because the loan is formally restructured) and would not be included in the past due schedules (because after restructuring, the past due status would be based upon the formally restructured terms).

Regulatory Classification and Accrual Status

4. **How should loans that have gone through a Troubled Debt Restructuring be classified?**

   TDR status should not impact the methodology used to classify loans. All loans, including modified loans, should be classified based upon the regulatory definitions provided in the examination manual and other supervisory guidance ("Pass," "Special Mention," "Substandard," "Doubtful," and "Loss"). This point is further stressed in SR 09-7 'Prudent Commercial Real Estate Loan workouts' which notes that "[l]oans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or the underlying collateral generally are not adversely classified. Similarly, loans to sound borrowers that are renewed or restructured in accordance with prudent underwriting standards should not be adversely classified or criticized unless well-defined weaknesses exist that jeopardize repayment. . ."

5. **What is the appropriate accrual status for a TDR?**

   A loan identified as a TDR is not automatically considered a nonaccrual loan but generally has characteristics that are consistent with loans that should be in nonaccrual status. For example, if a restructured loan has been partially charged-off and is not subject to an A/B loan split or debt forgiveness, the lender must consider whether the entire loan balance (i.e., including the charged-off portion) is reasonably assured of repayment in order to maintain the loan on an accrual basis. As outlined in the Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts, for restructured loans that are not already on nonaccrual status prior to the restructuring, an institution would need to consider whether the loan should be placed in nonaccrual status to ensure that income is not materially overstated. If a previously accruing loan is restructured so as to be reasonably assured of repayment and performance according to prudent modified terms, then the restructured loan does not need to be moved to nonaccrual status, provided the restructuring and any charge-off taken on the loan are supported by a current, well-documented credit assessment of the borrower's financial condition and prospects for repayment under the revised terms. Otherwise, the restructured loan must be placed in nonaccrual status.

   A loan that was on nonaccrual prior to the restructuring would remain on non-accrual until the conditions addressed in FAQ number six are reached.

6. **Can a loan be returned to accrual status immediately following a TDR?**

   Generally no, as a borrower must demonstrate the ability and willingness to pay under the restructured terms prior to returning the loan to accrual status. As per the Call Report instructions 'A loan or other debt instrument that has been formally restructured so as to be reasonably assured of repayment and of performance according to its modified terms need not be maintained in nonaccrual status, provided the restructuring and any charge-off taken on the asset are supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms. Otherwise, the restructured asset must remain in nonaccrual status.

   The evaluation must include consideration of the borrower's sustained historical repayment performance for a reasonable period prior to the date on which the loan or other debt instrument is returned to accrual status. A sustained period of repayment performance generally would be a minimum of six months and would involve payments of cash or cash equivalents. . .' This sustained period of repayment performance could include the time period prior to the restructuring taking place.

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NOTES:

1. With special thanks to Linda V. Ditchkus of the Federal Reserve Board and Archa M. Chadha of the Federal Reserve Bank of Chicago for contributing their loan accounting expertise and guidance.

Fifth District Indicators

Median Summary Statistics for Fifth District Commercial Banks (as of 8/30/2010)			
	Fifth District Commercial Banks		
	2010 Q2	2010 Q1	2009 Q2
Capital			
Total Equity Capital/Total Assets	9.55	9.54	9.70
Tier One Leverage Ratio	9.19	9.23	9.38
Total Risk Based Capital Ratio	13.77	13.62	13.30
Earnings			
Return on Average Assets	0.42	0.47	0.34
Net Interest Margin	3.77	3.74	3.52
Provision for Loan Losses/Average Assets	0.54	0.42	0.47
Balance Sheet Structure			
Total Loans/Total Deposits	85.65	85.30	91.37
Federal Home Loan Bank Advances/Total Liabilities	4.45	4.51	4.79
CDs Greater than $100,000/Total Deposits	21.52	21.74	21.00
Total Commercial Real Estate Loans/Total Equity	210.92	215.40	233.46
Total Construction and Land Development/Total Equity	82.14	86.17	97.90
Residential First Mortgages/Total Loans	21.99	21.56	22.15
Credit Quality			
Past Due Loans 30-89 Days/Total Loans	1.44	1.70	1.31
Past Due Loans 90+ Days/Total Loans	0.01	0.02	0.04
Nonaccrual Loans/Total Loans	2.14	2.07	1.50
Other Real Estate Owned/Total Loans	0.49	0.46	0.29
Loan Loss Reserve/Total Loans	1.62	1.54	1.38

** All Numbers Are Percentages. State member banks are commercial banks headquartered in the Fifth District that are state chartered and are members of the Federal Reserve System. Fifth District banks include all commercial banks headquartered in the Fifth District (nationally chartered, state chartered that are members of the Federal Reserve, and state chartered that are not members of the Federal Reserve).*

Aggregate Banking Statistics For 2010 Q2 (as of 9/2/2010)					
	Fifth District Commercial Banks				
	Number of Institutions	Total Assets	Total Loans	Total Liabilities	Total Equity
Virginia State Member Banks	66	$ 38,769,935	$ 28,801,382	$ 34,799,679	$ 3,949,765
Virginia Commercial Banks	106	$ 441,290,217	$ 245,699,212	$ 387,671,530	$ 53,586,397
West Virginia State Member Banks	11	$ 5,842,253	$ 4,134,681	$ 5,285,830	$ 516,685
West Virginia Commercial Banks	55	$ 18,604,760	$ 13,028,444	$ 16,745,835	$ 1,779,287
North Carolina State Member Banks	6	$ 28,518,845	$ 20,583,766	$ 24,199,930	$ 4,318,915
North Carolina Commercial Banks	73	$ 1,754,265,563	$ 899,974,641	$ 1,554,890,644	$ 195,892,906
South Carolina State Member Banks	1	$ 756,104	$ 526,967	$ 691,999	$ 64,105
South Carolina Commercial Banks	65	$ 44,010,355	$ 29,097,948	$ 40,299,200	$ 3,711,097
Maryland State Member Banks	14	$ 10,009,863	$ 7,043,656	$ 9,047,579	$ 962,284
Maryland Commercial Banks	49	$ 24,098,020	$ 17,147,409	$ 21,786,775	$ 2,311,243
DC State Member Banks	0	$ -	$ -	$ -	$ -
DC Commercial Banks	5	$ 1,536,640	$ 1,024,093	$ 1,369,528	$ 167,112
DC Commercial Banks	5	$ 1,490,849	$ 978,854	$ 1,332,294	$ 158,555
Total Fifth District State Member Banks	98	$ 83,897,000	$ 61,090,452	$ 74,025,017	$ 9,811,754
Total Fifth District Commercial Banks	353	$ 2,283,805,555	$ 1,205,971,747	$ 2,022,763,512	$ 257,448,042

** All Dollar Amounts are in thousands.*

It's a Small World After All: Why We Need to Care About a Debt Crisis in Greece

By Robert E. Carpenter

In late 2009, Greek government officials suggested that its macro economy was in peril. Fitch ratings followed one week later with a downgrade of its long-term debt. These events marked the beginning of a tumultuous period for Greece that reached a crescendo in May, 2010 with riots in Athens and an emergency bailout package pieced together by the European Central Bank (ECB), its central bank, and the International Monetary fund. While the bailout appeared to have temporarily mitigated the current and acute economic crisis in Greece, it is not a permanent solution and conditions are by no means stable. Furthermore, what is often called the "Greek debt crisis" has focused attention upon other European countries with fiscal imbalances. Correcting these imbalances without significant costs to financial market participants or to macroeconomic performance may be a difficult challenge.

The roots of the Greek debt crisis lie with the establishment of the European Monetary Union (EMU). When each country in Europe had its own currency, sovereign yields reflected the risks associated with the country and its currency, and disciplined government fiscal and monetary policy. If a country displayed what markets viewed as unsustainable fiscal imbalances, investors could assign a higher risk premium to its sovereign debt.

With monetary union and the ability of each member to issue debt denominated in a common currency, investors might assign a lower inflation risk premium to a sovereign nation running a large fiscal deficit (because they no longer independently manage monetary policy). Investors might also price in the probability of a bailout when assessing the default risk of a sovereign issue, anticipating the desire of the ECB to protect the Euro. In effect, a profligate state could issue sovereign debt at lower rates by borrowing a piece of the reputation of more fiscally responsible states; countries with poor inflation performance could issue sovereign debt and borrow the reputation for price stability embodied in the mandate of the ECB.

Greece took advantage of lower sovereign yields and ran large fiscal deficits from 2000 to 2005. Their pre-crisis budget deficits averaged over five percent of GDP. Government spending increased as a proportion of GDP when economic growth (and tax revenues) began to fall in 2006, leading to much larger deficits (the 2009 fiscal deficit was 13.6 percent of GDP). Much of the spending appears to have been directed towards government employee compensation. Now in crisis, Greece's strong public sector unions made needed fiscal adjustments challenging.

Other countries in Southern Europe also have relatively large fiscal deficits and relatively large public debt as a proportion of GDP. So, why did market participants focus on Greece? First, Greece has both high deficits and high public debt, and it is this combination which set Greece apart from the rest of the EU. Second, Greece also has a large trade deficit. Financing trade deficits requires borrowing from the rest of the world.

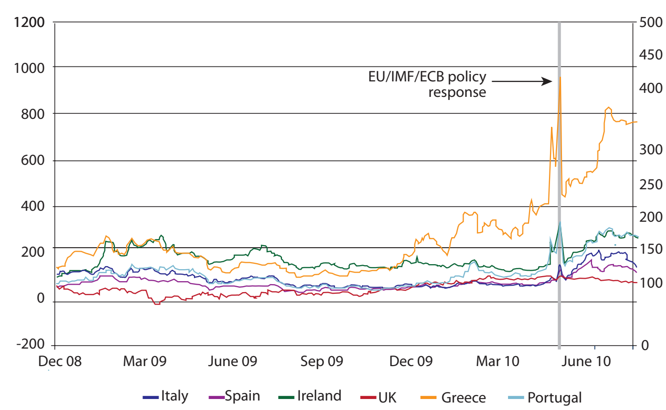
Borrowing from the rest of the world is often called "external debt." Greece, along with Portugal, Italy, and Spain, have relatively large net external debt positions. Servicing external debt requires sending interest payments abroad. To send these interest payments abroad and address both the private and public imbalances, residents must export more, and consume fewer goods and services.

But exporting more goods requires Greece and other periphery states to lower their real exchange rates, or to make their goods more "competitive." This requires either a reduction in the currency exchange rate (impossible for countries that share a common currency) or to reduce the price of a country's goods relative to other countries' goods. In practice, this typically requires lower wages, which reduces living standards. In addition, addressing their fiscal imbalances requires Greece to cut wages in the public sector or to increase taxes. While the Greek government narrowly passed a set of sharp austerity measures, strong protests make their ultimate success an open question.[1]

Evidence suggests that financial market participants remain concerned about financial difficulties in the periphery countries. European bond spreads relative to the ten year German bond dropped initially as a result of the policy responses by European authorities, but it is clear they remain highly elevated in the periphery and near crisis peaks. Five-year sovereign Credit Default Swaps (CDS) show very similar patterns.

Figure 1 ■ **European Bond Spreads**

Basis points, 10 year bond spread to German bonds



Source: Federal Reserve Bank of Atlanta, Bloomberg

On the other hand, the CDS spreads for large European banks (greater than $1 trillion dollars in total assets) have declined steadily since their crisis peak and now display levels and movements that are very highly correlated with large U.S. banks of similar size.

Click the link below to view the full article.
http://www.richmondfed.org/banking/supervision_and_regulation/newsletter/index.cfm

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Recent Guidance

CA 10-11
http://www.federalreserve.gov/boarddocs/caletters/2010/1011/caltr1011.htm
Reverse Mortgage Products: Guidance for Managing Compliance and Reputation Risks

CA 10-10
http://www.federalreserve.gov/boarddocs/caletters/2010/1010/caltr1010.htm
Revised Interagency Examination Procedures for Regulation Z

CA 10-09
http://www.federalreserve.gov/boarddocs/caletters/2010/1009/caltr1009.htm
Updated Examination Procedures for Regulation DD

CA 10-08
http://www.federalreserve.gov/boarddocs/srletters/2010/SR1013.htm
Interagency Supervisory Guidance for Institutions Affected by the Deepwater Horizon Oil Spill

CA 10-7
http://www.federalreserve.gov/boarddocs/caletters/2010/1007/caltr1007.htm
Revised Interagency Examination Procedures for Regulation E

SR 10-14
http://www.federalreserve.gov/boarddocs/srletters/2010/sr1014.htm
Implementation of Registration Requirements for Federal Mortgage Loan Originators

SR 10-13
http://www.federalreserve.gov/boarddocs/srletters/2010/sr1013.htm
Interagency Supervisory Guidance for Institutions Affected by the Deepwater Horizon Oil Spill

Examiner's Corner (continued from Page 3)

ALLL based on the collectability of the institution's loan portfolio in the current environment.

Ratio analysis, when used prudently, can be a supplemental check on the reasonableness of management's assumptions and analysis and may identify additional issues or factors that may not have been considered in the initial ALLL estimation process. These additional considerations may subsequently warrant further adjustments to estimated credit losses. It should be noted that ratio analysis is not a sufficient stand-alone basis for determining an appropriate level for the ALLL.

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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It's a Small World After All: Why We Need to Care About a Debt Crisis in Greece

Full Article

By Robert E. Carpenter

In late 2009, Greek government officials suggested that its macro economy was in peril. Fitch ratings followed one week later with a downgrade of its long-term debt. These events marked the beginning of a tumultuous period for Greece that reached a crescendo in May, 2010 with riots in Athens and an emergency bailout package pieced together by the European Central Bank (ECB), its central bank, and the International Monetary fund. While the bailout appeared to have temporarily mitigated the current and acute economic crisis in Greece, it is not a permanent solution and conditions are by no means stable. Furthermore, what is often called the "Greek debt crisis" has focused attention upon other European countries with fiscal imbalances. Correcting these imbalances without significant costs to financial market participants or to macroeconomic performance may be a difficult challenge.

The roots of the Greek debt crisis lie with the establishment of the European Monetary Union (EMU). When each country in Europe had its own currency, sovereign yields reflected the risks associated with the country and its currency, and disciplined government fiscal and monetary policy. If a country displayed what markets viewed as unsustainable fiscal imbalances, investors could assign a higher risk premium to its sovereign debt.

With monetary union and the ability of each member to issue debt denominated in a common currency, investors might assign a lower inflation risk premium to a sovereign nation running a large fiscal deficit (because they no longer independently manage monetary policy). Investors might also price in the probability of a bailout when assessing the default risk of a sovereign issue, anticipating the desire of the ECB to protect the Euro. In effect, a profligate state could issue sovereign debt at lower rates by borrowing a piece of the reputation of more fiscally responsible states; countries with poor inflation performance could issue sovereign debt and borrow the reputation for price stability embodied in the mandate of the ECB.

Greece took advantage of lower sovereign yields and ran large fiscal deficits from 2000 to 2005. Their pre-crisis budget deficits averaged over five percent of GDP. Government spending increased as a proportion of GDP when economic growth (and tax revenues) began to fall in 2006, leading to much larger deficits (the 2009 fiscal deficit was 13.6 percent of GDP). Much of the spending appears to have been directed towards government employee compensation. Now in crisis, Greece's strong public sector unions made needed fiscal adjustments challenging.

Other countries in Southern Europe also have relatively large fiscal deficits and relatively large public debt as a proportion of GDP. So, why did market participants focus on Greece? First, Greece has both high deficits and high public debt, and it is this combination which set Greece apart from the rest of the EU. Second, Greece also has a large trade deficit. Financing trade deficits requires borrowing from the rest of the world.

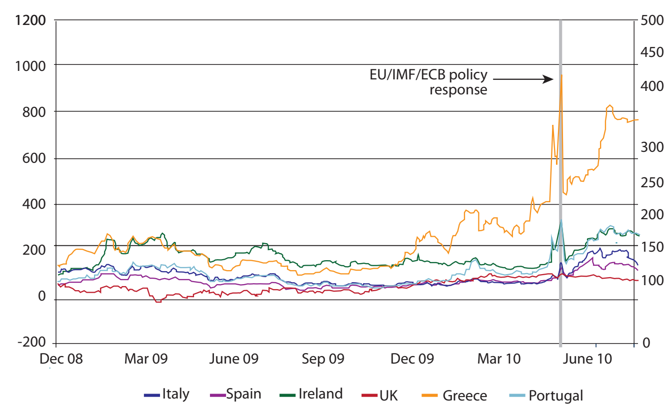
Borrowing from the rest of the world is often called "external debt." Greece, along with Portugal, Italy, and Spain, have relatively large net external debt positions. Servicing external debt requires sending interest payments abroad. To send these interest payments abroad and address both the private and public imbalances, residents must export more, and consume fewer goods and services.

But exporting more goods requires Greece and other periphery states to lower their real exchange rates, or to make their goods more "competitive." This requires either a reduction in the currency exchange rate (impossible for countries that share a common currency) or to reduce the price of a country's goods relative to other countries' goods. In practice, this typically requires lower wages, which reduces living standards. In addition, addressing fiscal imbalances requires Greece to cut wages in the public sector or to increase taxes. While the Greek government narrowly passed a set of sharp austerity measures, strong protests make their ultimate success an open question.[2]

Evidence suggests that financial market participants remain concerned about financial difficulties in the periphery countries. European bond spreads relative to the ten year German bond dropped initially as a result of the policy responses by European authorities, but it is clear they remain highly elevated in the periphery and near crisis peaks. Five-year sovereign Credit Default Swaps (CDS) show very similar patterns.

Figure 1 ■ **European Bond Spreads**

Basis points, 10 year bond spread to German bonds



Source: Federal Reserve Bank of Atlanta, Bloomberg

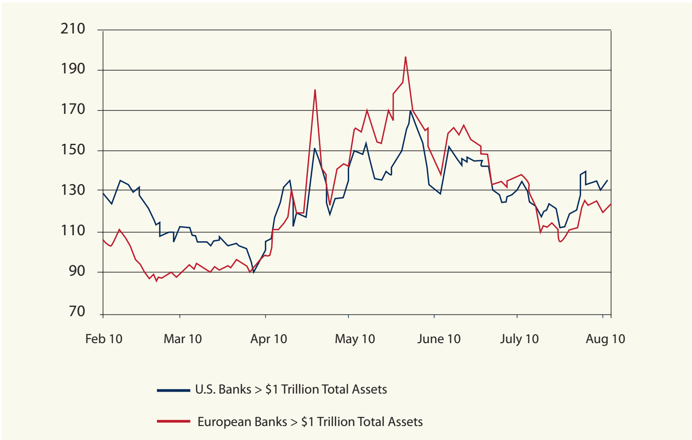
On the other hand, the CDS spreads for large European banks (greater than $1 trillion in total assets) have declined steadily since their crisis peak and now display levels and movements that are very highly correlated with large U.S. banks of similar size.

One interpretation of this data is that investors recognize that while the policy response has provided periphery countries with the ability to place sovereign debt, market participants also recognize that deep fiscal imbalances persist in these countries and the austerity measures passed by the various countries may not be sustainable. In short, the intervention has provided breathing room, but the possibility of sovereign default remains high. On the other hand, market participants may believe that the policy responses provide a liquidity backstop to the banks that purchase sovereign debt, reducing banks' risk. There may also be an implicit promise to support institutions holding sovereign debt, further reducing banks' risk. In essence, the declining CDS spreads for large European banks may reflect the promise of government support.

Figure 2 ■ **European vs. U.S. Banks**

Average CDS 5 year Senior Spreads (2/19/2010 - 8/20/10)

European Banks (13) CDS priced in € Euros, U.S. Banks (4) CDS princed in $ U.S.



Source: Bloomberg

At the beginning of the crisis, many U.S.-based observers asked why we should worry about Greece. U.S. banks' exposures to Greece are only $16.6 billion and to the periphery (less Ireland) total $128 billion. However, this ignores the interconnectedness of both U.S. and global capital markets. European banks' exposures to the periphery (less Ireland) are over $2 trillion dollars and U.S. banks have over $1.2 trillion in exposure to Europe.

With relatively large aggregate exposures to Europe, market participants and regulators should be highly interested in banks' exposures to the periphery as an important step towards measuring counterparty risk. The level of information disclosed by large European banks, however, has been disappointing. While many institutions have disclosed their exposures to Greece, less information is available for other countries in the periphery; regulators should be concerned about the potential for limited information to lead to interruptions in liquidity should there be an acute crisis in a periphery state. This lesson was recently learned in U.S. financial markets.

			Publicly Declared Exposure ($ millions) to:				
Institution	Country	Currency Reported	Portugal	Italy	Ireland	Greece	Spain
Credit Agricole	France	Euro €				3,430	
Societe General	France	Euro €				3,000	
BNP Paribas	France	Euro €				8,000	
Deutsche Bank	Germany	Euro €		3,200	200	500	
Deutsche Postbank AG	Germany	Euro €	50	4,700	350	1,300	1,200
Commerzbank	Germany	Euro €				3,100	
Lloyds Banking Group	UK	GBP £	0			0	
RBS	UK	GBP £	1,400			1,000	
Barclays	UK	GBP £	Small				Small
Standard Chartered	UK	GBP £				None	
HSBC	UK	Euro €				1,500	
Credit Suisse	Switzerland	CHF				Not Material	
UBS	Switzerland	CHF	Minimal			Minimal	None
Assicurazioni Generali Spa	Italy	Euro €	600			749	
Intesa Sanpaulo	Italy	Euro €				1,000	
UniCredit	Italy	Euro €	32	31,500	66	993	550
KBC	Belgium	Euro €	600			1,200	2,400

			Publicly Declared Exposure ($ millions) to:				
Institution	Country	Currency Reported	Portugal	Italy	Ireland	Greece	Spain
Ageas NV	Belgium	Euro €	2,250			3,152	1,780
Dexia	Belgium	Euro €				4,900	
ING Group	Netherlands	Euro €	1,900	7,900		3,000	3,000
Aegon	Netherlands	Euro €	58	143	138	92	1,780
Banco Bilbao Vizcaya Argentaria SA	Spain	Euro €	Little			Little	
Banco Santander	Spain	Euro €	3,300			200	24,000

Source: Institutions' public website

In an attempt to assuage market participants' concerns about the strength of European banks, the Committee of European Bank Supervisors (CEBS) recently concluded a stress test of 91 banks (50 percent of the total assets of the banking sector). The results have been widely reported and the reviews mixed.

Many observers concluded that the adverse scenarios employed in the stress test may not have been conservative enough. Observers were also critical of the fact that a passing grade was given to banks with a six percent Tier one capital ratio in the adverse scenario, as many preferred an eight percent threshold; viewing the choice of a lower threshold as a missed opportunity to encourage European banks to build capital. Observers also noted that sovereign debt in the banking book was not stressed. In the event of sovereign default, however, it is likely that cash flows will be interrupted or suspended, which could affect the value of securities even if they are held to maturity. Lastly, the stress test's estimated aggregate capital shortfalls of three billion dollars and the fact that only seven banks failed it suggest a weak test.

Correcting poor fiscal decisions now requires very sharp austerity measures in Europe's periphery. State pensions and wages in Greece, for example, are slated to fall 20 percent. The impact that these measures may have on a significant segment of the population may result in political turmoil and economic hardship in the periphery, a lesson the U.S. should pay close attention to given our own long-term fiscal imbalances. It remains an open question whether these austerity measures are sustainable or whether the increases in taxes and reduction in spending that are required to implement them will cause further contractions in GDP.

Supervisors and U.S. financial institutions have a number of options available to assess their exposures to a potential flareup of the Greek crisis. These options include testing direct exposures to selected periphery countries, stressing only sovereign debt in the trading book (as was done in the European stress tests) or to consider broad spillovers and contagion effects from a crisis in a periphery state. Until it becomes clear that the austerity measures implemented in periphery states are having their intended effects, and that public and private sector imbalances are being addressed, supervisors and U.S. institutions should work together to understand risks not only to periphery states, but also to the potential for wider impairment of European financial markets.

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ENDNOTES:

[1] Increasing government revenues through taxation may be especially challenging in Greece, where tax evasion appears somewhat common and a very large shadow economy exists. Some estimates suggest that nearly a quarter of economic activity in Greece takes place in the shadow economy, suggesting that a robust infrastructure already exists for market activities outside the tax system.