S&R PERSPECTIVES

The Latest Fifth District Supervision and Regulation News & Events

Spring Issue 10

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>
> – John Insley

Emerging Risks

Mobile Banking - Growing Opportunities, New Risks

By Richard Simpson

Consumer adoption of mobile banking, the delivery of financial products and services through portable devices capable of wireless Internet access, continues to grow. The Tower Group estimates that U.S. mobile banking usage will increase from 10 million active users in 2009 to over 53 million active users in 2013.

The increasing adoption of "smart phones" by U.S. consumers has created a fertile environment for the acceleration of mobile banking. Forrester Research defines a smart phone as a mobile phone or networked handheld device that uses a high-level mobile operating system. The proportion of adult U.S. mobile subscribers owning smart phones jumped to 17 percent last year, according to Forrester. At the end of 2009 there were 36 million smart phones in use in the United States, with the top three operating systems being RIM Blackberry, Apple iPhone and Windows Mobile.

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Emerging Issues

Regulation Z: Private Education Loans

By John Insley

On February 14, 2010, compliance became mandatory for provisions of Regulation Z that require new disclosures and introduce new consumer protections for borrowers that obtain "private education loans." Some lenders may think that because they do not have a formal student lending program, do not routinely arrange such loans, or do not promote loans to cover education expenses that the new rules will not apply to them – but this is likely not the case.

These new rules were prompted by passage of the Higher Education Opportunity Act of 2008, which amended the Truth in Lending Act. The amendments define a private education loan as a loan made expressly for postsecondary educational expenses[1], but excluding open-end credit, real estate-secured loans, and Federal loans under Title IV of the Higher Education Act of 1965. The HEOA also amended TILA to expressly cover private education loans even if the amount financed exceeds $25,000 – loans above this

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Mac's World at the Fed

In this edition of S&R Perspectives we focus attention on new developments in Regulation Z, FASB's financial instruments project and the recently released Interagency Statement on Meeting the Needs of Creditworthy Small Business Borrowers. Similarly to our emerging from an especially harsh winter in the Fifth District, it appears that our industry is beginning to slowly emerge from the financial freeze of the last two to three years. While institutions are still seeing an increasing number of problem assets, the rate of increase appears to be slowing. As this is shaping up to be a long, slow recovery, it is important for the industry to continue to focus on capital and liquidity retention and pay close attention to interest rate risk, as rates cannot stay at these low levels much longer. We are continuing to monitor the regulatory reform efforts and with the announcement of Senator Dodd's amended bill on March 15 we may see a vote by the full Senate in the next few months. On behalf of the Federal Reserve, I want to thank those of

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amount are otherwise excluded from Regulation Z coverage when not secured by real property or a principal dwelling.

What this means is that, unless otherwise exempt, a loan – such as an unsecured closed-end personal loan - for which any portion of the proceeds will be used for the stated purpose of postsecondary education expenses, is a "private education loan" and subject to the rules contained in sections 226.46 through .48 of Regulation Z. The types of postsecondary educational expenses that if financed would trigger compliance with these rules are quite broad and include tuition and fees, books, supplies, miscellaneous personal expenses, room and board, and an allowance for any loan fee, origination fee, or insurance premium charged to a student or parent for a loan incurred to cover the cost of the student's attendance.

Section 226.46 of Regulation Z sets forth the timing requirements of the disclosures required for private education loans while section 226.47 prescribes the content. Up to three separate sets of disclosures (model disclosure forms are contained in Appendix H of Regulation Z as H-18, H-19, and H-20) may be required for a single loan as follows:

- Application disclosures required by 226.47(a) that must accompany an application or solicitation for a private education loan;
- Approval disclosures required by section 226.47(b) before consummation on or with any notice of approval provided to the consumer;
- Final disclosures required by section 226.47(c) shall be provided after the consumer accepts the loan.

Where a loan may be used for multiple purposes, a creditor generally will not know before an application is received whether the consumer intends to use the loan for postsecondary educational expenses. For this reason, the creditor need not provide the disclosures required by section 226.47(a) on or with the application or solicitation for a loan that may be used for multiple purposes. However, if the consumer expressly indicates that the proceeds of the loan (not otherwise exempt) will be used to pay for postsecondary educational expenses, the creditor must comply with sections 226.47(b) and (c) as well as adhere to the limitations detailed in section 226.48.

Beyond the disclosure requirements, a consumer has certain rights associated with private education loans. In accordance with section 226.48(c)(1) the consumer has the right to accept the terms of a private education loan at any time within 30 calendar days following the date on which the consumer receives the approval disclosures. With limited exceptions, the creditor cannot change the rate and terms of the loan within this 30 day period. Similar to certain dwelling-secured transactions, the consumer also has the right to rescind a private education loan. The consumer may cancel a private education loan, without penalty, until midnight of the third business day following the date on which the consumer receives the disclosures required by section 226.47(c). No funds may be disbursed for a private education loan until the three-business day period has expired.

A number of other limitations on private education loans are contained in section 226.48 of Regulation Z that generally cover the marketing of such loans and certain relationships between lenders and educational institutions. Should a lender plan to market private education loans or enter into any type of arrangement with a covered educational institution the limitations in this section should be reviewed.

A lender may find that it has historically made, even if only occasionally, loans that now meet the definition of a private education loan; or, a lender may unexpectedly receive an application for such a loan in the future. Before extending any private education loans, a lender should ensure it has the capacity to comply with these new rules. If disclosure software is purchased from a vendor, the lender will likely want to inquire about the availability and cost of updates for supporting compliance with the new rules. Even if few such transactions are originated, the inability to generate correct disclosures when required would result in violations of Regulation Z.

John Insley, Jr., Principal Examiner, Federal Reserve Bank of Richmond.

Information in this article was accurate as of April 20, 2010 and is made available for educational and informational purposes only. The statements and views expressed in this article do not constitute legal advice. Any conclusions that readers draw from the information presented here are his or hers and are not to be attributed to the Federal Reserve Bank of Richmond. The views expressed herein do not necessarily reflect the views of the Federal Reserve Bank of Richmond or of the Federal Reserve System.

NOTES:

[1] Postsecondary educational expenses means any of the expenses that are listed as part of the cost of attendance, as defined under section 472 of the Higher Education Act of 1965 (20 U.S.C. 1087ll), of a student at a covered educational institution. A covered educational institution is an institution of higher education regardless of its accreditation status. "Institution of higher education" has the same meaning as in sections 101 and 102 of the Higher Education Act of 1965 (20 U.S.C. 1001-1002) and the implementing regulations published by the U.S. Department of Education. Such an institution may include, for example, a university or community college. It may also include an institution, whether accredited or unaccredited, offering instruction to prepare students for gainful employment in a recognized profession, such as flying, culinary arts, or dental assistance. A covered educational institution does not include elementary or secondary schools.

Smart phones have dramatically reshaped perceptions and expectations of mobile banking services. Significant improvements in the customer experience are attracting smart phone users to mobile banking. Appealing smart phone features may include:

- larger screens;
- touch-screen technology;
- better browsers;
- downloadable applications and;
- fast Internet access and response.

Financial institutions offering or planning to introduce mobile banking must address expanded risks along with benefits of smart phones. Increased use of more powerful browsers and mobile applications will lead to an increase in the number and sophistication of malicious or criminal attacks. These "cybercrime" attacks, primarily motivated by information theft to be used for financial gain, will target mobile banking users and financial institutions.

Sound information security risk management practices for securing mobile applications and authenticating users are essential to safeguard mobile financial transactions. The increased use of smart phones will make the following security practices more critical for financial institutions:

- Strong/multi-factor user authentication;
- Encrypted payment transaction transmissions;
- No unencrypted sensitive transaction data in the phone;
- Out-of-band (non-Internet) customer transaction verification methods;
- Use of one-time password authentication with rapid timeout;
- User awareness training for Internet and mobile device security practices.

The combination of smart phones and mobile banking applications provides compelling new products and services as well as opportunities for financial institutions to attract and retain customers. Appropriate management of information security risk is an essential step to fully achieving potential benefits from this powerful technology pairing while also protecting the institution and its customers.

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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.

Troubled Debt Restructures (TDR)

A troubled debt restructure (TDR) is a restructuring in which a bank, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. Bankers should determine if the borrower is experiencing financial difficulty, which could include; defaults on any debt, inability to service debt on reasonable terms, inability to obtain take-out financing as originally planned, inability to maintain tenants or rents, or inability to obtain funds from another bank at a rate granted to non-troubled borrowers, among others. Concessions may include forgiveness of interest or principal, decreasing the interest rate to a below market rate, deferment of principal payments (interest only), or extension of the repayment period. *If these considerations apply to the situation, then the loan should be reported as a Troubled Debt Restructure on either Schedule RC-C or RC-N per Call Report Instructions*.

Brokered Deposits

Banks whose capital levels have declined to less than well-capitalized status under Prompt Corrective Action (PCA) guidelines are prohibited from obtaining brokered deposits without prior permission or a waiver from the FDIC and must comply with interest rate restrictions under Section 337.6, as well. This has forced some institutions to immediately drop rates on non-maturity deposits and lower CD rates upon maturity. As a result of economic and industry conditions, waivers are extremely rare. Additionally, for banks that are under formal enforcement actions containing specific capital maintenance requirements, a return to "well capitalized" status may not be granted by the supervising agency until the enforcement action is terminated. This situation prohibits affected institutions from re-entering the brokered funds market while subject to enforcement. These conditions have adversely affected banks with business plans that rely heavily on wholesale funding to support predominantly commercial and commercial real estate loan portfolios. A number of these institutions have redirected their funding efforts to obtaining core deposits.

Interest Rate Floors

Some commercial banks successfully use interest rate floors in renewals of variable-rate commercial loans to maintain levels of interest income during periods of declining or low interest rates, thereby protecting their net interest margins. While this method has been successful for some institutions, every situation must be evaluated based on the individual factors which may impact certain loan portfolios and various institutions.

Appraisals

Obtaining useful real estate valuations remains a challenge due to the lack of recent sales comparables in some markets. Having an appraiser provide "market" and "liquidation" values for commercial real estate can be helpful when dealing with "work-out" versus "foreclosure" situations.

Remote Deposit Capture

A number of banks have implemented this deposit gathering tool without conducting appropriate due diligence, performing a risk assessment of the product, or establishing operating policies and procedures. Regulatory guidance is contained in SR Letter 09-02, *FFIEC Guidance Addressing Risk Management of Remote Deposit Capture Activities*.

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

Emerging Issues

FASB's Financial Instruments Project

by David C. Schwartz

Significant changes on how banks account for financial instruments will likely result from the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) joint project aimed at addressing the current complexity of financial instrument accounting. This article provides background and highlights of some of the key changes anticipated in FASB's exposure draft that is expected to be released in the second quarter of 2010. As of this writing, the FASB has yet to issue the exposure draft.

Readers are encouraged to keep abreast of these changes and comment on the exposure draft when issued, as these changes will have a direct impact on the financial reporting of all financial institutions and could significantly increase the number of financial instruments being measured at fair value and therefore, will impact how net income is measured and reported.

FASB & IASB Financial Instruments Project

As part of the "Accounting for Financial Instruments" joint project of the IASB and FASB, the FASB is expected to release an exposure draft in the form of a Proposed Accounting Standard Update (ASU) in the second quarter of 2010. The FASB notes on their Web site that it believes this project will significantly improve the decision usefulness of financial instrument reporting for users of financial statements, and will:[1]

1. Reconsider the recognition and measurement of financial instruments
2. Address issues related to impairment of financial instruments and hedge accounting
3. Increase convergence in accounting for financial instruments

The following information related to these three items drew on several sources available on the FASB's Web site; these sources have been included in the 'Resources' table at the end of this document and/or the related endnotes to this article. This summary, like the above referenced documents, is for informational purposes as any conclusions reported by the FASB are tentative and may be subject to change.

Recognition & Measurement of Financial Instruments

FASB's approach will significantly expand the use of fair value for financial instruments[i]; financial instruments would no longer be classified based upon the banks intent such as Held-to-Maturity, Available-for-Sale, Held-for-Sale or Held-for-Investment classifications under ASC 320 Investments Debt & Equity Securities and ASC 948 Financial Services Mortgage Banking (former FAS 115 & FAS 65 respectively), but instead would be classified into one of the three following categories:

1. Fair value through net income (FV-NI);
2. Fair value through other comprehensive income (FV-OCI);
3. Amortized cost (limited option).

FV-NI would be the default category with all instruments being measured at fair value with changes being reported in net income. Options would exist for certain changes in FV to be recognized in other comprehensive income (OCI), although not required. FV-NI would also include hybrid financial instruments containing embedded derivatives that do not meet the 'clearly-and closely related' criteria that would require separate accounting under ASC 815 Derivatives and Hedging.[2]

FV-OCI would be available only to debt instruments with principal amounts if the entity's business strategy is to hold the debt for collection or payment(s) of contractual cash flows rather than to sell or settle the financial instrument with a third party. Hybrid financial instruments containing embedded derivatives that do not require separate accounting under ASC 815 Derivatives and Hedging and meet the FV-OCI classification criteria may recognize certain changes in fair value in OCI.[2]

Amortized cost would be a limited option for certain types of a reporting entity's own debt. This debt would need to (1) meet the classification requirements in FV-OCI and (2) would have resulted in a measurement attribute mismatch had the bank applied FV-OCI classification.[2]

Initial recognition would be based upon the bank's business model as opposed to the banks' intent, reclassification among the categories would not be permitted after initial recognition. The financial statements would include one statement of comprehensive income with total comprehensive income and a subtotal for net income; earnings per share would be based on the net income only.[2]

Recognition & Measurement Items of Note

The proposed ASU is expected to contain certain exceptions to the above recognition and measurement criteria, including:

- A practicability exception from fair value measurement will be provided for certain types of investments that can only be redeemed with the issuer at a maximum of the amount contributed. FASB plans to include examples of these types of instruments in the proposed ASU.[1] Potential examples might include FRB Stock, FHLB Stock, and National Credit Union Share Insurance Fund (NCUSIF) Deposit.
- Banks would measure certain receivables and payables at carrying value provided the bank's business strategy is to hold the instrument for collection or payment. Instruments in this category must: (1) arise in the normal course of business, (2) be due in customary terms not exceeding approximately one year, (3) not be credit card receivables, and (4) be subject to the impairment model discussed below.[1]
- Core deposit liabilities[ii.] will be initially and subsequently measured at the present value of the average core deposit liability amount discounted at the rate differential between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity. FASB notes that this present value calculation would include expectations for future deposits, and would result in an intangible asset being reflected in the valuation.[3]
- FASB will address in the ASU how an institution's credit standing would directly impact the fair value measurement of its financial liabilities, and will require separate presentation of significant changes in fair value related to changes in the bank's own creditworthiness.[1]

How the changes in fair value related to the reporting entity's creditworthiness will be measured is yet to be determined.
- A four year deferral for nonpublic entities with less than $1 billion in consolidated assets will be provided. During this period reporting entities subject to the deferral would measure certain instruments at amortized cost with associated fair value disclosures in the notes of the financial statements.[1]

Impairment of Financial Instruments and Hedge Accounting

FASB's model for determining when an assets is impaired (i.e. carrying value exceeds its fair value and therefore needs to be written down) is also expected to change, potentially moving to earlier recognition than under the current FASB model. Banks would no longer consider a probability threshold regarding the occurrence of the loss events or the effect of specific conditions in determining whether a credit loss exists. Impairments would be recognized when one or more events indicate that all contractually promised cash flows would not be collected. Management would not be able to consider possible future scenarios in this analysis, but would include all available information relating to past events and existing conditions that are relevant to the collectability of the instrument. The FASB impairment model will require impairment analysis of instruments in the FV-OCI category each reporting period based upon the present value of management's current estimate of cash flows that are not expected to be collected. The FV-NI category would not require an allowance.[3,4]

The FASB, with one notable exception, decided that the proposed ASU will include the proposed changes to hedge accounting as outlined in their June 2008 exposure draft "Accounting for Hedging Activities." In contrast to the June 2008 exposure draft the proposed ASU will continue to allow for the hedging of risk components (bifurcation-by-risk), which the 2008 exposure draft proposed to eliminate.[5] Please see the resource section below for additional information on the June 2008 exposure draft.

Increased Convergence in Accounting for Financial Instruments

Although increased convergence of the IASB and FASB standards for financial instruments is one important goal of this joint project, it is unclear when actual convergence may be reached. While the FASB is expected to release a single comprehensive standard that will address (1) classification and measurement, (2) impairment of financial assets, and (3) hedge accounting, the IASB has pursued a three phased approach and is separately addressing each of these issues.

In a recent press release the SEC noted that it continues to encourage convergence of US GAAP and IFRS and has directed their staff to execute a work plan to help evaluate the impact of convergence on the U.S. securities markets, including the impact of various convergence projects currently underway between accounting standard setters. Dependent on the completion of the work plan and the related convergence projects, by 2011 the SEC will determine if, how, and when to incorporate IFRS into the U.S. financial reporting system. Expectations are for a first reporting date under the converged standards of no earlier than 2015.[6]

Commenting on FASB's Exposure Draft

The FASB has noted that in addition to input received on its tentative model they will also consider feedback the IASB receives on their exposure draft and IASB redeliberations. Through the comment process constituents will have the ability to have their views heard by FASB. As such we encourage you to submit your comments directly to the FASB during their exposure draft comment period.

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NOTES:

i. FASB definition of a 'Financial Instrument' as it relates to this project includes cash, evidence of an ownership interest in an entity, or a contract that both: (a) Imposes on one entity a contractual obligation either to deliver cash or another financial instrument to a second entity, or, to exchange other financial instruments on potentially unfavorable terms with the second entity; and (b) conveys to that second entity a contractual right either receive cash or another financial instrument from the first entity, or, to exchange other financial instruments on potentially favorable terms with the first entity. (For a complete definition please the document 'Accounting for Financial Instruments Summary of Decisions Reached to Date As of March 31, 2010' referenced below.)

ii. FASB tentatively plans to include the new term 'Core Deposit Liabilities' in the ASU, defined as deposits without a stated maturity that management believes are a stable source of funds.

ENDNOTES:

1. FASB's website 'Project Update Accounting for Financial Instruments (formerly Financial Instruments: Improvements to Recognition and Measurement and including the Accounting for Hedging Activities Project)—Joint Project of the IASB and FASB' (http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB/FASBContent_C/ProjectUpdatePage&cid=1175801889654)

2. FASB's 'Comparison of FASB and IASB Proposed Models for Financial Instruments – November 2009.

3. FASB's 'Accounting for Financial Instruments Summary of Decisions Reached to Date As of March 31, 2010.

4. FASB's 'October 21,2009 Board Meeting Minutes: Accounting for Financial Instruments.

5. FASB's 'March 10, 2010 Board Meeting Minutes: Accounting for Financial Instruments.

6. SEC website 'SEC Approves Statement on Global Accounting Standards FOR IMMEDIATE RELEASE 2010-27.

Mac's World at the Fed

(continued from page 1)
you who have written your Senators or Congressman to express your support for the Federal Reserve maintaining its role in bank supervision.

On a personal note, I have announced my retirement effective April 30, so this will be the last Mac's World column. It has been my pleasure to be a part of Fifth District Supervision and I feel humbled and honored to have led our endeavors over the last seven years, especially these last three incredibly "interesting" years. I feel that Fifth District Supervision will be in very capable hands as I pass the baton to my successor Jennifer Burns. Jennifer is extremely knowledgeable on all banking fronts and will do an excellent job maintaining the Fifth District's position as a supervisory leader. Over the next month we will be hosting a number of events to introduce Jennifer to Fifth District bankers, regulators and trade associations. Please take advantage of these and other opportunities to get to know her. Best wishes to each of you and I feel certain our paths will cross again.

Mac

Emerging Issues (continued from Page 4)

Resources

As the above contains only selected highlights, the following resources may be of interest to readers:

Document	Contains	Link
FASB's 'Accounting for Financial Instruments – Summary of Decisions Reached to Date As of March 31, 2010"	Tentative decisions by FASB including: Scope, Recognition, Measurement, Credit Impairment, and Presentation	http://www.fasb.org/cs/ContentServer?c=Docment_C&pagename=FASB/Document_C/DocumentPage&cid=1176156422130
FASB's 'Comparison of FASB and IASB Proposed Models for Financial Instruments – November 2009'	Side-by-side comparison of the FASB and IASB proposed models for financial instruments	http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176156445874
FASB's website 'Project Update - Accounting for Financial Instruments'	Project update summarizes the project activities and decisions of the IASB and the FASB	http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB/FASBContent_C/ProjectUpdatePage&cid=1175801889654
FASB's Exposure Draft 'Proposed Statement of Financial Accounting Standards Accounting for Hedging Activities an amendment of FASB Statement No. 133'	Proposed amendments to FASB Statement 133 'Accounting for Derivative Hedges and Hedging Activities' (SFAS 133 has been codified under FASB ASC 815 Derivatives & Hedging)	http://72.3.243.42/draft/ed_hedging_amendment_st133.pdf

Special Note:

Supervision, Regulation and Credit conducted a State Member Bank survey at the end of 2009. Management and staff would again like to thank everyone for their participation. The survey was active from November 1st to December 7th, 2009, and achieved strong participation and valuable responses from state member banks across the Fifth District. The survey questions were designed to better understand how our State Member Banks interact with the examination staff during the examination process. The information provided was analyzed and incorporated into SRC's annual business objectives as part of our ongoing commitment to continuously improve examination processes and the supervisory relationships with our institutions. The feedback and results from the survey are being incorporated into the planning process and are being taken into account when determining the agendas for the upcoming 2010 Banker's Forums.

Once again, we want to express our appreciation in taking the time to complete the survey. In addition to the Banker's Forums, you may hear more specifics regarding action plans over the next few months from your FRB primary contacts. The on-going feedback we receive from you gives us a unique insight into the way you view our services and guides us toward areas of improvement that have the potential to strengthen our relationship.

The on-going feedback we receive helps us to refine our process and guides us to improve and further strengthen our working relationships.

Recently Released Guidance

Interagency Statement on Meeting the Needs of Creditworthy Small Business Borrowers

By Jody Martin

On February 12, 2010, the Board of Governors of the Federal Reserve System, in conjunction with the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration, issued an interagency statement (SR 10-2) relating to lending to small businesses. The statement builds upon principles in existing supervisory guidance, including the November 2008 *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* and the October 2009 *Policy Statement on Prudent Commercial Real Estate Loan Workouts*.

The supervisory guidance recognizes the important role that small businesses play in our economy and acknowledges that some small businesses are experiencing difficulty in obtaining credit. The guidance notes that between June 30, 2008 and June 30, 2009, loans outstanding to small businesses and farms, as defined in the Consolidated Report of Condition (Call Report), declined by 1.8 percent, or approximately $14 billion. Several factors may be contributing to the decline in loan volume, including weakness in the economy, decreasing loan demand, higher levels of credit risk and delinquency, and efforts by lenders to strengthen their capital positions.

A strong advocate of prudent underwriting, the Federal Reserve System (FRS) nevertheless realizes that the current economic conditions may lead some institutions to become overly cautious in lending standards. The FRS further recognizes that excessive tightening can have harmful effects on our economic recovery, and is striving to communicate these concerns so that sound small businesses have access to needed credit. Through outreach and communication with industry, the FRS strives to ensure that financial institutions that engage in prudent small business lending after performing a comprehensive review of a borrower's financial condition will not be subject to criticism for loans made on that basis.

According to SR 10-2, underwriting of small business obligations should include:

- An understanding of the long-term viability of the business;
- A review and assessment of the borrower's business plan;
- A thorough analysis of the borrower's current and expected cash flows over a range of market conditions;
- The borrower's credit history and financial strength;
- An assessment of the strength of management;
- An analysis of the competition and local market conditions (as opposed to making decisions; based on national trends when local conditions may be more favorable);
- A review of secondary sources of repayment;
- A recognition of the lending institution's credit concentrations.

In addition to these borrower and market characteristics, the bank should also structure the loan in a manner that is suitable to the nature and need of the borrower's business. To emphasize the importance of a "know your customer approach" for small business lending, the guidance states that ". . . portfolio management models that rely primarily on general inputs, such as geographic location and industry, should not be used as a substitute for evaluation of an individual customer's repayment capacity."

The FRS remains committed to addressing the credit needs of small businesses, and by way of guidance such as SR 10-2, strives to clearly communicate supervisory expectations to the institutions that support this market.

Jody Martin is a Credit Risk Team Leader with the Federal Reserve Bank of Richmond.

Recent Guidance

SR 10-5
http://www.federalreserve.gov/boarddocs/srletters/2010/sr1005.htm
Interagency Guidance on Obtaining and Retaining Beneficial Ownership Information

SR 10-4
http://www.federalreserve.gov/boarddocs/srletters/2010/sr1004.htm
Clarification of the Risk Weight for Claims on or Guaranteed by the Federal Deposit Insurance Corporation (FDIC)

SR 10-3
http://www.federalreserve.gov/boarddocs/srletters/2010/sr1003.htm
FFIEC Retail Payment Systems Booklet

SR 10-2
http://www.federalreserve.gov/boarddocs/srletters/2010/sr1002.htm
Interagency Statement on Meeting the Needs of Creditworthy Small Business Borrowers

SR 10-1
http://www.federalreserve.gov/boarddocs/srletters/2010/sr1001.htm
Interagency Advisory on Interest Rate Risk

CA 10-2
http://www.federalreserve.gov/boarddocs/caletters/2010/1002/caltr1002.htm
Revised Interagency Questions and Answers on Community Reinvestment

CA 10-1
http://www.federalreserve.gov/boarddocs/caletters/2010/1001/caltr1001.htm
Revised Interagency Examination Procedures for Regulation Z

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Additional Reporting Updates

The Federal Reserve recently announced the availability of Electronic Applications, or "E-Apps," a new Internet-based system for financial institutions to submit regulatory filings. E-Apps allows firms and their representatives to file applications online, eliminating the time and expense of printing, copying, and mailing the documents. Registered users can access the system at any time to upload additional documents or create new filings. There are no fees for using E-Apps.

E-Apps has been designed to ensure the confidentiality of the data and the identity of individual filers. Institutions ready to start using E-Apps can find sign up forms at http://www.federalreserve.gov/bankinforeg/eappssignup.htm.

If you have any questions about E-Apps, please call Adam Drimer at 804-697-8980, or Wayne Cox at 804-697-8219.

Reporting Updates

Regulatory Reporting Affected by New Securitization Accounting in 2010

By Tim Pudner

The Financial Accounting Standards Board issued two new pronouncements in June 2009 that dramatically change the way that financial institutions must account for securitized assets. FAS 166, *Accounting for Transfers of Financial Assets*, and FAS 167, *Amendments to FASB Interpretation No. 46(R)* will require the re-recognition of many loans that previously received off-balance sheet treatment, as well as the consolidation of many trusts that legally hold securitized assets. These new rules are effective for 2010 and may have significant reporting and regulatory capital impacts for banking organizations that have previously securitized loans or other receivables. Note that these standards have now been codified in ASC 860, "Transfers and Servicing" (FAS 166) and ASC 810, "Consolidation" (FAS 167).

Loans that previously received sale treatment, due to their transfer to a Qualifying Special Purpose Entity (QSPE), will generally now be moved back onto the originating or selling banking organization's balance sheet. One major implication from the inclusion of these loans will be the effect on risk-based capital ratios caused by the associated increase in risk-weighted assets. However, on January 21, 2010, the federal banking regulatory agencies issued a final risk-based capital rule that includes an optional transition period allowing banking organizations to temporarily negate the impact of these newly consolidated assets on their risk-based capital ratios. This option allows banking organizations to exclude these assets when calculating risk-weighted assets for the first two quarters following their implementation of FAS 166 and 167. During the third and fourth quarter, 50 percent of the newly consolidated assets would be included in the calculation, followed by full inclusion beginning in the fifth quarter. Note that this optional phase-in will not affect Tier 1 leverage ratios.

Banking organizations implementing FAS 166 and 167 should be vigilant that the changes are properly reflected on their FR Y-9C and Call Reports. In addition to the loan (Schedule C) and capital sections (Schedule R), the securitization and servicing section (Schedule S), as well as the notes to the income statement and balance sheet will be affected. Institutions utilizing the optional phase-in period to exclude newly consolidated assets for Risk-Weighted Assets must also ensure they are in strict compliance with the requirements covered in the current Capital Adequacy Guidelines and March 31, 2010 version of the FR Y-9C and Call Report instructions. The updated instructions and supplemental information is available at the Board of Governors Web site at http://www.federalreserve.gov/reportforms/.

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Fifth District Indicators

Median Summary Statistics for Fifth District Commercial Banks (as of 3/2/2010)			
	Fifth District Commercial Banks		
	2009 Q4	2009 Q3	2008 Q4
Capital			
Total Equity Capital / Total Assets	9.61	9.84	9.68
Tier One leverage Ratio	9.20	9.34	9.28
Total Risk Based Capital Ratio	13.53	13.58	13.06
Earnings			
Return on Average Assets	0.23	0.28	0.44
Net Interest Margin	3.62	3.56	3.71
Provision for Loan Losses / Average Assets	0.74	0.60	0.44
Balance Sheet Structure			
Total Loans / Total Deposits	87.22	88.78	95.08
Federal Home Loan Bank Advances / Total Liabilities	4.58	4.68	6.81
CDs Greater than $100,000 / Total Deposits	21.82	21.63	19.76
Total Commercial Real Estate Loans / Total Equity	218.31	225.63	236.19
Total Construction and Land Development / Total Equity	91.03	95.27	109.32
Residential First Mortgages / Total Loans	21.96	21.94	21.34
Credit Quality			
Past Due Loans 30-89 Days / Total Loans	1.38	1.37	1.37
Past Due Loans 90+ Days / Total Loans	0.03	0.05	0.04
Nonaccrual Loans / Total Loans	1.91	1.58	1.01
Other Real Estate Owned / Total Loans	0.42	0.37	0.15
Loan Loss Reserve / Total Loans	1.50	1.43	1.30

** 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).*

Fifth District Indicators

Aggregate Banking Statistics For 2009 Q4 (as of 3/2/2010)					
	Fifth District Commercial Banks				
	Number of Institutions	Total Assets	Total Loans	Total Liabilities	Total Equity
Virginia State Member Banks	66	$ 37,232,656	$ 28,141,415	$ 33,300,876	$ 3,910,948
Virginia Commercial Banks	106	$ 392,781,911	$ 211,665,108	$ 341,942,051	$ 50,807,643
West Virginia State Member Banks	11	$ 5,825,862	$ 4,253,705	$ 5,279,646	$ 506,476
West Virginia Commercial Banks	55	$ 18,414,475	$ 13,158,080	$ 16,643,736	$ 1,691,100
North Carolina State Member Banks	6	$ 29,575,834	$ 21,463,926	$ 26,085,241	$ 3,490,593
North Carolina Commercial Banks	75	$ 2,219,498,972	$ 1,254,507,252	$ 1,955,694,271	$ 258,646,860
South Carolina State Member Banks	1	$ 748,471	$ 569,198	$ 686,345	$ 62,126
South Carolina Commercial Banks	67	$ 48,568,806	$ 34,320,018	$ 44,175,032	$ 4,393,716
Maryland State Member Banks	14	$ 9,535,006	$ 6,925,964	$ 8,604,777	$ 930,230
Maryland Commercial Banks	49	$ 23,569,550	$ 17,163,243	$ 21,293,651	$ 2,275,899
DC State Member Banks	0	$ -	$ -	$ -	$ -
DC Commercial Banks	5	$ 1,490,849	$ 978,854	$ 1,332,294	$ 158,555
Total Fifth District State Member Banks	98	$ 82,917,829	$ 61,354,208	$ 73,956,885	$ 8,900,373
Total Fifth District Commercial Banks	357	$ 2,704,324,563	$ 1,531,792,555	$ 2,381,081,035	$ 317,973,773
** All Dollar Amounts are in thousands.*					