S&R PERSPECTIVES

“While the nature, causes and severity of shortcomings in foreclosure practices vary from firm to firm, improvements are needed in internal practices, internal quality control processes, and regulatory oversight of these functions if confidence and stability in the housing markets are to be restored.”

– Jody Martin

The Latest Fifth District Supervision and Regulation News & Events

Winter Issue 2011

In The News

Dodd-Frank Act Reforms: Trust Preferred Securities No Longer Tier 1 Capital

By Eliana Balla, Kevin Cole and Breck Robinson

Trust Preferred Securities and Banks of All Sizes

Trust preferred securities (TPS), a financial innovation of the 1980s, are long-term hybrid securities with features of both equity and debt. The Federal Reserve System allowed TPS to be treated as Tier 1 capital for bank holding companies (BHCs) in 1996.[1] The definition of TPS in regulatory capital has been revised over the years with the most recent revisions occurring in 2005.[2]

Given high transaction costs at issuance, only the largest financial institutions issued TPS in the 1990s. With the rise of pooled TPS issuance, known as trust preferred collateralized debt obligations (TruPS CDOs), TPS went on to become a common capital raising instrument for community banks in the 2000s. Between year-end 1999 and 2008, outstanding TPS for BHCs increased from $31.0 billion to $148.8 billion. In the same period, the number of BHCs with outstanding TPS increased from 110 to 1400.[3]

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Emerging Issues

Understanding the Causes and Consequences of Residential Mortgage Foreclosure Problems

By Jody Martin

Beginning in late September 2010, almost all of the nation’s largest residential mortgage servicers acknowledged problems with their mortgage foreclosure practices. The two most common problems identified involved (1) signed attestations of facts by people without direct knowledge of the facts (otherwise known as “robo-signing”), and (2) improper notarization of legal documents (signatures on documents were notarized without the notary actually witnessing the signature).

Recognition of these issues resulted in many firms halting foreclosures until internal practices could be reviewed and any identified issues remediated. Many of these reviews were focused on the 23 states with *judicial* foreclosure laws. Generally speaking, judicial foreclosures occur before a judge, in contrast to non-judicial foreclosures, which are processed without court intervention. Within these two foreclosure categories, laws and practices vary from state to state. In response to the recognized issues,

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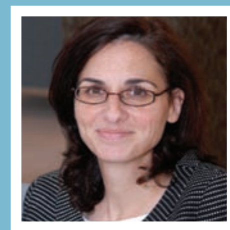
Jennifer’s Notes



Happy New Year and welcome to the winter 2011 edition of S&R Perspectives. I would like to begin this edition by expressing my sincere thanks to those in the Fifth District for their hard work and dedication in 2010. Last year continued to present new challenges to the banking environment, and the resolve and commitment of the banking community are what will help us to meet the challenges and successfully navigate 2011 and beyond. In this column, I share highlights from 2010 and some insights into risk perspectives for 2011.

During 2010, I attended a variety of banking events, and I’d like to share with you some of the questions I received. As I am sure you can imagine, there were questions about the Dodd-Frank regulatory reform legislation, specifically related to the creation of the Consumer Financial Protection Bureau (CFPB). I heard significant concern about how the new agency will interact with and affect community banks. The primary banking supervisor will remain the consumer

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the Federal Reserve, along with the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS) and the Federal Deposit Insurance Corporation (FDIC), conducted an in-depth review of practices at the largest mortgage servicing operations. These interagency examinations focused on foreclosure practices in general, but placed emphasis on breakdowns that led to inaccurate affidavits and other questionable legal documents being used in the foreclosure process. The on-site portions of the exams were completed in 2010, and it is anticipated that a summary overview of industry-wide practices will be released in early 2011.

To gain additional knowledge about foreclosure practices, the Federal Reserve also sent a self-assessment questionnaire to other Federal Reserve-regulated institutions that have mortgage servicing activity but were not part of the inter-agency examination effort.

While the results of the examinations have not been released, two factors have been identified as potential drivers of the breakdown in foreclosure practices: the significant increase in the number of foreclosures as a result of the real estate downturn and the myriad state laws governing the foreclosure process.

In 2006, the number of foreclosures initiated on residential properties was approximately 1 million. By 2009, that number had risen to 2.8 million, with expectations of approximately 2.5 million each in 2010 and 2011. This dramatic rise in the number of foreclosures undoubtedly strained the resources of mortgage servicers, not only for those directly processing foreclosures but also for those responsible for the quality control of the foreclosure process.

In addition to the number of foreclosures, the variety of legal requirements from state to state may have contributed to the breakdown in practices. There was a time when mortgage servicing portfolios were focused in certain localities or regions, allowing servicers to build expertise in the legal requirements specific to their portfolios. Now most servicers operate on a national scale, significantly adding to the complexity of foreclosure operations.

There have been several consequences of the problems identified in foreclosure practices and the efforts to remediate them:

- Firms have been delaying foreclosures to ensure compliance with legal requirements and to correct any deficiencies in practices. This has resulted in more time for borrowers to try to resolve financial difficulties, pursue mortgage modifications, and gain a better understanding of their rights and responsibilities in the foreclosure process. The delay has reduced the inventories of homes on the market, although this is viewed as temporary. There is concern that foreclosure delays will ultimately result in a glut of inventory coming to market all at once, and potentially causing a drop in housing prices in high-foreclosure areas.
- Purchasers may shy away from buying foreclosed properties because of concerns over their ability to obtain proper title. Again, this may have negative consequences on inventory and further weaken house prices.
- Legal costs associated with foreclosures will rise, changing the economics of both mortgage servicing and mortgage securitization.
- In addition to the reviews performed by the federal regulatory agencies, all 50 states, led by the attorneys general, are scrutinizing firms' compliance with foreclosure laws.

While the nature, causes and severity of shortcomings in foreclosure practices vary from firm to firm, improvements are needed in internal practices, internal quality control processes, and regulatory oversight of these functions if confidence and stability in the housing markets are to be restored. Additionally, many of the issues highlighted point to the need for structural changes in the foreclosure process; both those issues driven by requirements from investors and security holders, and those issues arising from the legal framework underpinning the foreclosure process. It is now up to the mortgage servicers and regulators and legislators at both the federal and state levels to effectively address these challenges.

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Acrual & Nonaccrual Frequently Asked Questions

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

Accrual & Nonaccrual Guidance – Accounting and Regulatory Guidance

As the ratio of nonaccrual to total loans continues to rise (see Fifth District Indicators on page 11), bankers may naturally be thinking about the appropriate time to move a loan from accrual to nonaccrual status and back again. The following is intended to reinforce bankers' understanding of when to place a loan on nonaccrual and what must occur prior to returning a loan to accrual status.

Accrual accounting is an area that crosses generally accepted accounting principles (GAAP) and regulatory accounting principles (RAP). GAAP provides general principles for accrual accounting but is not prescriptive; in contrast, RAP provides detailed requirements for placing a loan on accrual or nonaccrual status. Table 1 (on page 8) presents some common sources of guidance for both RAP and GAAP. One such source of RAP guidance is the Call Report instructions which highlight the following general rule for nonaccrual loans:

> *Banks shall not accrue interest, amortize deferred net loan fees or costs, or accrete discount on any asset (1) which is maintained on a cash basis because of deterioration in the financial condition of the borrower, (2) for which payment in full of principal or interest is not expected, or (3) upon which principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection.*

The following Frequently Asked Questions (FAQs) are provided to further explain this general rule, including when a loan can be returned to accrual status.

Frequently Asked Questions

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. The following information drew heavily on several sources available on the FRB, FASB and FFIEC web sites; these sources have been included in the 'Resources' table on page 8.

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protection supervisor for banks with less than $10 billion in assets. This means that the examination process will likely remain similar for these institutions. The most significant changes will be those related to new regulations that will become part of the examination process. The CFPB will have the ability to participate in examinations on a sampling basis. For banks with greater than $10 billion in assets, consumer protection examinations will be conducted by the CFPB; CRA and Flood Insurance examinations for banks of all sizes will continue to be conducted by the primary regulator. We pledge to keep you updated on new regulations and to keep the supervision process as streamlined as possible.

Another popular topic at banking industry forums was regulatory assessments of asset quality, in particular the adequacy of the loan loss reserve. In exams, we strive to provide an independent and fair assessment of the credit risk in a bank's loan portfolio and to ensure that reserve processes adequately capture that risk. Making these assessments has been challenging for us and for banks, given the slow pace of the economic recovery and continued degradation of commercial and residential real estate values in many areas. Our goal is to achieve a clear, mutual understanding of any issues that are presented during the examination process. We have taken some steps to improve communication with you and hope that we are achieving some success. I welcome your thoughts and ideas on this front.

Another question that is often asked is whether "Washington," including the Federal Reserve, values community banks. The answer to that question is unequivocally yes. The Federal Reserve recognizes the important role that community banks play in fueling the economies in their trade areas, areas that are often under-served by large financial institutions. Our interests are aligned with yours, and we hope to foster a vibrant community banking population. The Federal Reserve's interest is manifest in the recent creation of the Community Depository Institutions Advisory Council. This council will be charged with providing input on lending conditions, the economy and other issues to the Board of Governors. Membership will be drawn from similar councils at each Reserve Bank.

Given the amount of change that has occurred in the regulatory environment, I also received questions about what topics continue to concern regulators. While regulators strive for a holistic view and assessment of institutions, the following are those risk areas that will likely receive attention in 2011. As noted above, deterioration in asset quality continues to have a significant impact on our industry. Asset quality issues should continue to be proactively identified and managed effectively. Attention should be given to the quality and effectiveness of credit risk management governance practices, as well as the identification of eroding credits at the transaction level.

Capital planning is another important topic that should be a focus for the banking community. While our markets continue to be stressed, prudent capital management is essential. It is no longer enough to be well capitalized. Institutions are expected to hold capital levels commensurate with the risk they are taking. Current and future capital needs must be thoroughly understood and responded to on an ongoing basis. Liquidity, particularly contingency funding plans, remains an important topic. As conditions in a bank deteriorate, available funding sources change and are scarcer, making forward planning imperative. Interest rate risk remains an area of focus as the yield curve environment and stressed earnings make more complex, higher yielding investment vehicles attractive. Greater yield is directly correlated to greater risk; it is incumbent upon bank management to understand and effectively manage the risk characteristics of all investment transactions.

Finally, information technology issues should remain within your line of sight. Inappropriate security access levels remain a common examination finding. We recognize that maintaining textbook segregation of duties can be difficult, particularly for smaller community banks; nonetheless, in this environment, it is the best defense against insider fraud.

The importance of direct communication and information sharing with the banking and regulatory communities has been emphasized by the changeable banking environment. I realize that real-time information and open lines of communication are critically important, and so improving our communication with the banking community is a priority. It is my goal to work to share as much information with the community as quickly as possible. I am interested in your feedback on how we can improve our communications with you; if you have ideas or concerns you would like to share please email **BKSRCommunications.rich@rich.frb.org**. I want to hear from you!

Now, on to the rest of this edition of S&R Perspectives. In this edition we take a look at several unique topics. Issues related to the issuance of trust preferred securities are reviewed, as well as the foreclosure moratorium. This edition also includes a "frequently asked questions" guide to accrual and nonaccrual accounting issues. I hope that this edition of S&R Perspectives covers issues that are relevant to you and your institution. To ensure that we cover issues and topics that are meaningful to you, please take a few moments to complete a brief survey: **http://www.richmondfed.org/banking/supervision_and_regulation/newsletter/ index.cfm**.

Jennifer

Acrual & Nonaccrual Frequently Asked Questions (continued from Page 2)

Placing a Loan on Accrual Status

1. **Do all loans to the same borrower need to be maintained on the same accrual status?**

   Generally no. Accrual status for a loan should be determined based upon an assessment of the individual asset's collectability and borrower's payment ability and performance. When one loan to a borrower meets the status for nonaccrual, the remaining loans to the same borrower should be carefully evaluated to determine if they should also be placed on nonaccrual. However, the borrower's total exposure must be considered when making these accrual determinations, particularly when obligations rely on a single or common source of repayment.

2. **Are there other reasons besides Call Reporting purposes that I need to be concerned about properly identifying and accounting for nonaccrual loans?**

   Yes. There is the potential to overstate earnings as interest income will continue to be recognized on accruing loans until such time as they are properly placed on nonaccrual status. Additionally, failure to properly account for the loan as nonaccrual is a safety and soundness issue that may impact the proper calculation of the allowance for loan and lease losses (ALLL), potentially resulting in an inadequate, underfunded ALLL.

3. **Are there any exceptions to the general rule provided in the Call Report instructions?**

   Yes. The glossary entry for Nonaccrual Status in the Call Report instructions should be consulted for the exceptions to the general rule for:

   a. Purchased impaired loans or debt securities;
   b. Assets for which the criteria for amortization specified in AICPA Practice Bulletin No 6 are met with respect to a loan or other debt instrument (accounted for in accordance with that Practice Bulletin) that was acquired at a discount from an unaffiliated third party, including those that the seller had maintained on nonaccrual status;
   c. Consumer loans or loans secured by a 1-to-4 family residential property.

4. **3c above notes that consumer loans need not be placed in nonaccrual status in Call Reports, therefore is a bank precluded from putting such assets on nonaccrual?**

   Generally the answer is no. As noted in SR 03-1 'Account Management and Loss Allowance Methodology for Credit Card Lending,' although regulatory reporting instructions do not require consumer loans such as credit card loans to be placed on nonaccrual based on delinquency status, we expect all institutions to employ appropriate methods to ensure that income is accurately measured. Such methods may include providing loss allowances for uncollectible fees and finance charges or placing delinquent and impaired receivables on nonaccrual status.

Days Past Due

5. **When do you start counting for the third test in the general rule (i.e. . . .upon which principal or interest has been in default for a period of 90 days or more...")?**

   The Call Report instructions require that the date on which an asset reaches nonaccrual status is based on its contractual terms, even if this date falls between Call Report reporting periods.

6. **Does a bank need to wait until a borrower is 90 days past due prior to putting the loan on nonaccrual?**

   No. Loans may warrant being placed on nonaccrual status prior to being past due if the loan is either maintained on a cash basis because of deterioration in the financial condition of the borrower, or for which payment in full of principal or interest is not expected. These instructions are not to be used to avoid placing the asset on nonaccrual if any state statute, regulation or rule imposes a more stringent standard.

7. **Does GAAP require a loan to be charged off after a certain number of days past due?**

   GAAP does not contain any requirements that a loan should be charged off after a certain number of days past due (as required by RAP in certain situations).

Interest Income

8. **Is a bank required to reverse previously accrued but uncollected interest on a loan placed on nonaccrual status?**

   Generally yes. The reversal should be handled in accordance with GAAP, which includes a reversal of all previously accrued but uncollected interest.

9. **May a bank recognize interest income on a loan that is on nonaccrual status?**

   The cash basis of accounting is generally required under RAP for loans on nonaccrual status. Under the cash basis of accounting, some, all, or none of the cash interest payments when received may be treated as interest income provided that the remaining recorded investment in the loan (taking into account charge-offs) is determined to be fully collectable. This determination of collectability should be supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment, including considerations of the borrower's historical repayment performance and relevant factors. When a loan is on nonaccrual status and the collectability of the remaining book balance of a loan is uncertain, any payments received are to be applied to reduce principal until such doubt is eliminated.

10. **What are the GAAP requirements regarding placing a loan on nonaccrual and the subsequent recognition of interest income?**

    While regulatory guidance is clear on when a loan needs to be placed on nonaccrual status. GAAP does not explicitly address this practice. Instead GAAP does provide some broad principles regarding the recognition of interest income on an impaired loan. Some acceptable methods of recognizing interest income on an impaired loan under GAAP include the cost-recovery method, a cash-basis method, or some combination of the two. Under RAP, when doubt remains about the collectability of the remaining recorded amount of the loan, any payments received must be applied to reduce the principal balance of the loan. If full collectability is probable, the cash basis of accounting is generally required under RAP for loans on nonaccrual status. Under the cost recovery method, all payments received from the borrower are used to reduce the outstanding principal balance of the loan, until such time as all costs have been recovered (e.g., principal, fees, etc.). Under the cash basis of accounting, interest income may be recognized when interest payments are received.

A combination of the two methods would be the recognition of interest income for a portion (or none) of the cash interest payment received, while applying the remaining (or all of the) balance of the payment received as a reduction of principal. (See FAQ #9, for additional details). Bankers should follow RAP guidance for placing a loan on nonaccrual status, and the subsequent recognition of interest income.

11. Under the cash basis of accounting, if a portion of an interest payment is applied to reduce principal and then the loan is returned to accrual status, may a bank reverse this application and re-apply the payment to interest income?

No. Any recovery of principal under the cash basis of accounting should not be reversed when a loan is returned to accrual status.

Charge offs

12. How much of a charge off is required for a loan on nonaccrual status?

Placing an asset on nonaccrual status in and of itself does not require a write down of the asset, but any impairment must be provided for in the ALLL and any confirmed losses must be charged off. For example, at a minimum, any contractual principal payments that are not expected to be collected should be charged off.

Returning a Loan to Accrual Status

13. When can a loan be removed from nonaccrual status?

Generally, a loan may be removed from nonaccrual status when:

a. None of its principal and interest is due and unpaid, and the bank expects repayment of the remaining contractual principal and interest; <u>or</u>
b. When the loan otherwise becomes well secured and in the process of collection.

14. Are there expectations surrounding the bank's conclusion that "the bank expects repayment of the remaining contractual principal and interest"?

There is a general expectation bankers would have a well-supported and documented basis for their conclusion that they expect to receive the remaining contractual principal and interest. This support should include, at a minimum, a track record of payment history (at least six months, similar to a sustained period of payment performance outlined in FAQ #18) as well as a current well-documented credit evaluation of the borrower's financial condition and prospects for full repayment of contractual principal and interest. This documentation will likely be subject to examiner scrutiny.

15. What is meant by "well secured?"

Call report instructions define an asset "well secured" if it is secured by:

a. Collateral in the form of liens on or pledges of real or personal property, including securities, that have a realized value sufficient to discharge the debt (including accrued interest) in full; <u>or</u>
b. The guarantee of a financially responsible party.

16. What is meant by "in the process of collection?"

Call report instructions define an asset as "in the process of collection" if collection of the asset is proceeding in due course either:

a. Through legal action, including judgment enforcement procedures; <u>or</u>
b. In appropriate circumstances, through collection efforts not involving legal action which are reasonably expected to result in repayment of the debt or in its restoration to a current status in the near future.

17. Are there exceptions to the first requirement listed in FAQ #13?

Yes, there are a few exceptions to this rule, including:

a. Assets that fall under 3 a and b above;
b. The asset has been formally restructured and qualifies for accrual status;[2]
c. The borrower has resumed paying the full amount of the scheduled contractual interest and principal payments on a loan that is past due and on nonaccrual status, even though the loan has not been brought fully current and the following conditions are met:
   i. All principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within a reasonable period; <u>and</u>
   ii. There is a sustained period of repayment performance by the borrower in accordance with the contractual terms.

18. What is meant by a "sustained period of repayment performance by a borrower?"

Although the Call Report instructions describe a sustained period of repayment performance as generally being a minimum of six months, professional judgment must be used in making this determination. For instance a loan that requires monthly payments of interest and principal may likely fall into this six month window, a loan that contractually requires less frequent payments may require a longer period of payment performance. Consideration should also be given to the reasonableness of the payment terms in making this determination. For instance, a loan that has small monthly payments and a large balloon payment at maturity may require a longer period of payment history to meet these standards. Loans that are returned to accrual status, but are not current (see 17c above), should continue to be reported as past due until brought current (i.e., past due and accruing).

19. Do partial charge-offs associated with a nonaccrual loan (that has not been formally restructured) need to be fully recovered before a loan can be restored to accrual status?

Note: Before partially charging off the loan, regulators expect the bank to have considered a formal restructuring of the note, potentially into two separate notes, one for which payment is expected in full and a second that is usually charged off (often referred to as loan splitting or A/B Notes). As highlighted in SR 09-7 'Policy Statement on Prudent Commercial Real Estate Loan Workouts,' restructurings, such as loan splitting, may be part of a reasonable and prudent workout that if properly designed can be in the best interest of both the bank and the borrower; such benefits to the bank include the ability to return the performing portion of the loan to accrual status sooner than if the loan was partially charged off and not formally restructured. However, after considering such a workout, a bank may determine that it is in their best interest not to offer a formal restructuring and choose, instead to charge off a portion of the loan.

GAAP and RAP do not explicitly address this question; however as noted in the Commercial Bank Examination Manual Section 2040.1, Call Report instructions allow for the restoration of a loan to

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In The News (continued from Page 1)

Figure 1 shows aggregate single-issuer public placements of TPS offerings by banks and thrifts in billions of dollars over the past decade. After peaking in 2007, as the credit crisis worsened, the TPS market dried up for all but a few large institutions, such as Wells Fargo and BB&T.[4] The issuance of TruPS CDOs (not represented in Figure 1) was disrupted in February 2008 as a result of the financial crisis.[5]

Against this background, Sec. 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act , (Dodd-Frank) eliminated the use of TPS as a source of Tier 1 capital for those BHCs with an asset size over $500 million. In this article, we discuss the Dodd-Frank Act and its potential impact for the Fifth District in the context of concerns over the quality of capital in the banking sector.

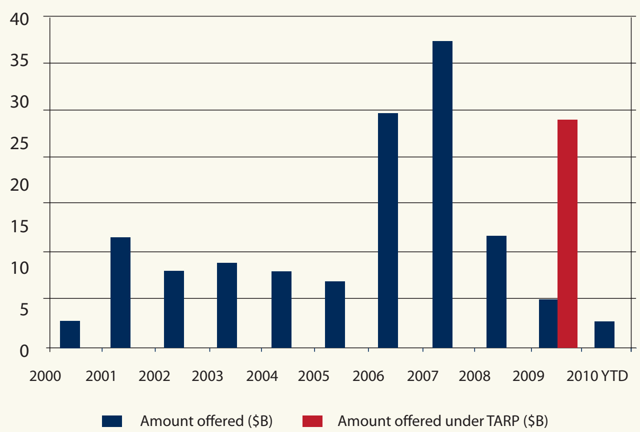
The Dodd-Frank Wall Street Reform and Consumer Protection Act

Dodd-Frank became law on July 21, 2010. Within Dodd-Frank, Sec. 171 restricts the use of TPS as a form of Tier 1 capital. The argument presented to eliminate TPS as a form of Tier 1 capital had been earlier argued by the FDIC Chairman Sheila Bair and subsequently brought before Congress by Senator Collins from Maine. Chairman Bair contends that TPS are debt, rather than equity instruments, because the dividend payments could not be deferred indefinitely. In her argument, TPS can only absorb losses on a gone concern basis, not going concern.[6]

Dodd-Frank aims to eliminate the differences in capital requirements between banks and BHCs.[7] Sec. 171 prevents most BHCs from using TPS as a source of Tier 1 capital. The legislation does allow for differences to persist for all but the largest BHCs.[8] Sec. 171(b) states that for BHCs with an asset size over $15 billion, TPS issued prior to May 10, 2010 can be applied towards Tier 1 capital requirements, but will be incrementally phased out over a three year period beginning in January 1, 2013.[9]

Further distinctions in capital treatment were made for smaller BHCs. For example, BHCs with assets between $500 million and $15 billion that issued TPS prior to May 10, 2010 could apply the current outstanding issue towards Tier 1 capital, but any subsequent TPS issue would not receive favorable regulatory treatment. The one true exception in Sec. 171(b) is BHCs that are designated under the Small Bank Holding Company Policy Statement as of May 19, 2010.[10] These institutions are allowed to apply current and future TPS issues toward Tier 1 capital. The overall impact on the banking industry from Sec. 171 of Dodd-Frank is significant for BHCs over $500 million in assets. Additionally, because of the removal of these larger participants from the TPS market, the smaller but still eligible BHCs may be affected as well. As stated previously, BHCs with an asset size over $15 billion will not be allowed to count TPS towards Tier 1 capital requirements after 2016. Using BHC data from Federal Reserve regulatory filings, our analysis shows that Dodd-Frank TPS restriction for these BHCs will have a negative impact on Tier 1 capital that averages 1.2 percent of total risk weighted assets (RWAs). The need for additional capital for some large BHCs may be further exacerbated by the timing of redemptions for TARP preferred stock. The potential increase in dividend rates to eight percent on TARP stock may encourage redemption around the same time that TPS lose their Tier 1 status, causing affected banks to experience even larger reductions in capital in the future.

Figure 1 ■ **Trust Preferred Securities Offerings by Banks and Thrifts ($B), 2000-2010**



Includes USD offerings only. Does not include pooled trust preferred offerings. Consists of offerings by companies classified by SNL as "bands" or "thrifts." Data as of May 2010.
Source: SNL Financial

For those BHCs between $500 million and $15 billion in assets, any negative impact from Dodd-Frank is pushed back until existing TPS issues mature or are redeemed. For this category, the potential impact on Tier 1 capital for Fifth District banks is on average 1.9 percent of total RWAs, against 2.1 percent nationwide.

The potential impact could have been much larger if BHCs under $500 million were required to remove TPS from Tier 1 capital. Small BHCs are more dependent on TPS as a percentage of total RWAs (2.2 percent within the Fifth District and 2.5 percent nationally) when compared to the larger asset groups. The ability to continue to use TPS as Tier 1 capital may be more important for small BHCs because they have fewer options to raise capital.

Calling TPS Back Home

As stated above, Sec. 171 does not require large BHCs to take immediate action to strengthen Tier 1 capital positions. However, most TPS covenants allow BHCs to redeem their TPS issues early and at par once a change in regulatory or tax treatment occurs. In the case of the Sec. 171 of Dodd-Frank, TPS will lose their favorable regulatory capital treatment for BHCs over $500 million in assets. The change in regulatory treatment of TPS represents a regulatory event that could facilitate early redemption. However, some market participants are currently debating what constitutes an "event" that would represent a change in regulatory treatment allowing for early redemption. Does the passage of Dodd-Frank constitute the regulatory event, is the event the first day that TPS are incrementally phased out as Tier 1 capital (January 1, 2013), or is it something else?

The uncertainty over an exact date of a regulatory event presented an opportunity for investors who wish to maintain their TPS holdings to suggest that BHC TPS early redemptions be delayed until the date that the phase out begins under Dodd-Frank. Investors contend that banks are "arbitrarily and capriciously" picking any date as the event date to initiate redemptions.[11] One reason why some BHCs may wish to redeem TPS prior to the phase out is the cost. Many TPS were issued during a period when market interest rates were elevated, causing coupon rates for these securities to be high relative to alternative sources of funding. As a result, investors are finding that even BHCs with an asset size below $15 billion are redeeming TPS at par based on the regulatory change clause, even though existing TPS issues outstanding would not experience a change in regulatory treatment.

Summary

Sec. 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act eventually eliminates the use of TPS as a source of Tier 1 capital for BHCs with an asset size over $500 million. Whether this requirement will have a material impact on Tier 1 capital ratios at large banks depends not only on the amount of TPS in Tier 1 capital, but also on the type of TPS and pending Federal Reserve rulemaking. The effect will be different depending on what portion of the ineligible TPS is callable or convertible to some form of qualifying preferred stock before or during the three-year phase-out period. The Federal Reserve has the authority to provide details regarding the timing of the elimination of TPS as Tier 1 capital over the three-year period. There may be a proposed rule by year-end 2011 to define the language "incrementally eliminated" in Sec. 171. The rule will have to be considered by bankers in their annual capital plan submissions to regulators to meet Tier 1 capital ratio standards and by examiners in the annual regulatory review of capital plans, including stress tests required by Dodd-Frank, and continuous evaluation of capital adequacy.

The primary criticism for using TPS as a source of Tier 1 capital was that it could not help the BHC absorb losses to maintain the institution as a going concern. The eventual loss of TPS as a source of Tier 1 capital, will cause a small number of BHCs in the Fifth District to obtain additional capital. While the number of BHCs that will directly need additional capital is small, the potential impact of Sec. 171 may be broader given that a number of BHCs may have to redeem TARP stock before the dividend payments on these securities increase. In combination, Dodd-Frank and TARP may lead to a larger number of BHCs to seeking capital.

Sec. 171 does not directly affect BHCs with assets under $500 million, but such BHCs may find it more difficult to issue TPS given their recent performance. In addition, the change in regulatory treatment associated with Sec. 171 for the largest BHCs may discourage institutional purchasers, given that small BHCs issue less than $5 billion of the $134 billion in TPS outstanding (aggregates as of first quarter 2010 regulatory data). As a result, Sec. 171 may have a larger impact than originally intended. Small BHCs tend to be more dependent on TPS as a source of Tier 1 capital, and any disruption in their ability to reissue TPS may force these institutions to seek traditionally higher cost sources of capital.

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NOTES:

1. For a history of TPS, see French, G.E, , A.N. Plante, E.W. Reither and R.D. Sheller, "Trust Preferred Securities and the Capital Strength of Banking Organizations," Federal Deposit Insurance Corporation, Supervisory Insights, Winter 2010.
2. See "Risk-Based Capital Standards: Trust Preferred Securities and the Definition of Capital," 70 Federal Register, 3/10/2005.
3. The TPS volume data and number of BHCs with TPS are from Eveson, Todd H. and Schram, John F., "Bank Holding Company Trust Preferred Securities: Recent Developments," *Carolina Banking Institute*, Vol. 11, 2007. Summary statistics in the remainder of the article come from FR Y-9C regulatory data as of Q2 2010, the time of the Collins Amendment. We analyzed the 642 FR Y-9C filers that reported Tier 1 qualifying TPS.
4. A small amount of Troubled Asset Relief Program (TARP) money was injected using private placement TPS. $27 billion of the $28 billion was injected into Citicorp, represented by the red bar in 2009. We chose to end the data coverage in Figure 1 in May 2010 because that is where Dodd-Frank draws the line for "grandfathering" treatment. As expected, there has been limited activity during the remainder of 2010. Since May 2010, Citigroup raised an additional $3 billion via TPS with the involvement of the U.S. Treasury.
5. The disruption of this market has given rise to serious fair market value issues for banks that hold TruPS CDOs. The valuation of TruPS CDOs is not a topic of this newsletter but continues to be a matter of concern for regulators.
6. French et al. note that there have been instances when TPS holders have limited the flexibility of the FDIC to recapitalize or sell troubled banks. Specifically, potential investors in troubled institutions may be less inclined to participate in a recapitalization or purchase of a troubled bank if TPS holders are not willing to take a haircut.
7. Sec. 171 of Dodd-Frank also moves U.S. capital standards for BHCs closer to international banking standards. One focus of Basel III is to strengthen capital standards by moving closer to a tangible common equity approach.
8. In the future, the Federal Reserve Board will establish restrictions consistent with Sec. 171 of Dodd-Frank on the use of TPS when applied to Tier 1 capital.
9. This restriction does not apply to debt or equity instruments issued under the Emergency Economic Stabilization Act.
10. For simplicity, in this analysis, we use the general but not all inclusive rule of total asset cutoff of $500 million to define this category.
11. Dakin Campbell, "Spectrum Asset Calls on Fed to Block Banks' TruPS Redemptions Until 2031," Bloomberg, September 8, 2010.

Table 1 ■ **Resources & Sources of Guidance**

Resource	Provides	Link
Instructions for Preparation of Consolidated Reports of Condition and Income (FFIEC 031 and 041)	Call Report instructions, including glossary entry for nonaccrual status among others.	http://www.ffiec.gov/PDF/FFIEC_forms/FFIEC031_FFIEC041_200906_i.pdf
FRB's Commercial Bank Examination Manual (CBEM) & Bank Holding Company Supervision Manual (BHCSM)	CBEM Section 2040.1 Loan Portfolio Management and BHCSM Section 2065.1 provides discussions on Nonaccrual Loans	http://www.federalreserve.gov/boarddocs/supmanual/
FASB's ASC 310-10-35 'Receivables – Subsequent Measurement'	Acceptable methods of interest recognition under GAAP	asc.fasb.org[3]
FASB's ASC 605-10-25 'Revenue Recognition - Recognition'	Acceptable methods of revenue recognition under GAAP	asc.fasb.org[3]

accrual status when (a) the loan has been brought fully current with respect to interest and principal, and (b) the bank expects the loan's full contractual balance (including any amounts charged off), plus interest, will be fully collectible under the terms of the loan. Therefore a partially charged-off loan need not be fully recovered before restored to accrual status provided that the loan has been brought fully current and the borrower's financial condition and repayment prospects have improved so that the full contractual principal (including any amounts charged off) and interest is expected to be repaid. This analysis, including the reasons for returning the loan to accrual status, should be well documented, including a current well-documented credit evaluation of the borrower's financial condition and prospects for full repayment of contractual principal (including any amounts charged off) and interest. This documentation will likely be subject to examiner scrutiny.

Policies and Procedures

20. Are there items that a bank policy on nonaccrual loans should include?

Yes. Banks should have a well defined policy for nonaccrual loans governing:

- When a loan should be placed on nonaccrual status;
- When a loan should be returned to accrual status;
- The treatment of interest income and the charge-off of accrued interest receivables;
- Treatment of previously accrued but uncollected interest;
- Treatment of multiple extensions of credit to a single borrower;
- Recognition of interest income on impaired loans, including how cash receipts are applied.

Resources & Sources of Guidance

Although the list of guidance related to the proper accrual status of a loan is extensive, the table above highlights some guidance that readers may find useful in making this determination.

David C. Schwartz is a an accounting and credit risk specialist and David W. Powers is an accounting policy specialist both with the Federal Reserve Bank of Richmond. They can be reached at david.schwartz@rich.frb.org and david.powers@rich.frb.org respectively.

NOTES:

1. With special thanks to Linda V. Ditchkus of the Federal Reserve Board for contributing her loan accounting expertise and guidance.

2. See the Fall 2010 issue of S&R Perspectives for information on returning a loan to nonaccrual status following a restructuring: (http://www.richmondfed.org/banking/supervision_and_regulation/newsletter/pdf/srperspectives_2010fall.pdf).

3. FASB offers free of charge access to the Basic View of the ASC at http://asc.fasb.org/home.

Examiner's Corner

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

By John Wiatt

In 2010, numerous Fifth District state member banks were approached by one or more consultants offering to arrange for the purchase of nonperforming real estate secured loans and other real estate owned (OREO) in return for the bank's commitment to acquire a book of performing residential real estate loans. Whether presented as a distressed asset exchange program, an asset swap, or a purchase and sale agreement, such transactions may represent a structural change in a financial institution's balance sheet, may present the bank with unforeseen risks, may result in little risk transference, and should be preceded by a rigorous due diligence review. The due diligence process for state member banks, particularly those operating under a regulatory enforcement action, should include the notification of the appropriate Reserve Bank representative of the bank's intention to engage in such transactions. An example of a proposal and its purported benefits are detailed below.

EXAMPLE: Consultant X will purchase all of the bank's nonperforming real estate secured loans and OREO at the bank's carrying value, and in return the bank will agree to purchase, at a multiple of five times the amount sold, a pool of performing HELOCs at 95 percent of par. In addition, a credit enhancement representing 3 percent of the incoming portfolio will be escrowed at the bank for two years to offset any losses associated with the purchased HELOC pool.

Appealing facets of the deal reportedly include:

- Replacing non-accruing assets with a significantly larger volume of accruing assets;
- Reducing classified assets as a percentage of Tier 1 capital;
- Reducing the Commercial Real Estate concentration;
- Releasing reserve amounts associated with individual impairment amounts under Financial Accounting Standards Board's ASC 310 Receivables (formerly FAS 114); and
- Eliminating the strain on management's time and attention.

The aforementioned transaction may appear to resolve many of a bank's credit concerns; however, it is recommended that institutions conduct a thorough review of the proposed transaction before making any decisions. Listed below is a truncated list of questions that an institution should include as part of its discovery process.

- Who are the consultants? How are they compensated?
- Who currently holds these performing loans and why are they eager to divest, at a discount, a book of performing loans?
- How does the consultant define "performing"? Is it possible that the first mortgage is delinquent while the HELOC is current?
- How is the HELOC performing (e.g., are advances automatically made against the line each month)? What is the utilization rate?
- Was an appraisal or an evaluation used to determine the loan-to-value (LTV) of the HELOC? What is the date of the valuation?
- What is the date of the most recent borrower credit score and debt-to-income calculation?
- Are the senior mortgages traditional or are they subprime, jumbo and/or ALT - A?
- Are there any geographic concentrations?
- How will this pool perform in different rate environments (e.g., a rising rate environment)?
- Does my bank have the ability to service these loans or will this responsibility be outsourced? At what cost?
- What is the volume of high-LTV loans? Does the aggregate amount of all loans in excess of supervisory loan-to-value limits exceed 100 percent of total capital?
- What are the credit risks associated with high-LTV residential real estate lending?
- What credit actions are authorized by the bank for the HELOC relationships (e.g., can lines be frozen)? For example, if the lines are frozen will such action constitute a Regulation Z – *Truth in Lending* violation?
- At what price are the non-performing loans being purchased?
- Over what time period will the performing loans be purchased – does the bank have any say in what loans are being purchased and when?
- Will the 'sale' of the nonperforming assets meet the requirements of a true sale under ASC 860 'Transfers and Servicing' (formerly FAS 166)? Is there a true conveyance of risk of the nonperforming loans (will the selling bank retain any of the credit risk associated with the nonperforming loans being sold)?
- Will the structures be considered variable interest entities (VIE) and will the proper analysis around consolidation accounting (ASC 810 'Consolidation', formerly FAS 167) need to be performed?

This is just a sample of questions for financial institutions to consider as part of their due diligence process. For more information on this process as it relates to these types of transactions, please contact your Reserve Bank representative. In addition, interagency guidance to promote sound risk management practices at financial institutions with home equity lending programs is detailed in SR-05-11 *Interagency Credit Risk Management Guidance for Home Equity Lending*. Also, SR-99-26 *Interagency Guidance on High Loan-to-Value Residential Real Estate Lending* provides discussion of the risks that high-LTV loans may pose to banks.

John Wiatt is a supervisory examiner in credit risk with the Federal Reserve Bank of Richmond. He can be reached at ***john.wiatt@rich.frb.org****.*

Other Assets Especially Mentioned

By Jacqueline Dreyer

A banker recently asked, "Is Special Mention still a valid risk rating?" While asset quality deterioration has resulted in the classification of many credits across the Fifth District, the category of Special Mention remains a valid loan risk rating, and is defined in the Commercial Bank Examination Manual as follows;

> A Special Mention extension of credit is defined as having potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may, at some future date, result in the deterioration of the repayment prospects for the credit or the institution's credit position. Extensions of credit that might be detailed in this category include those in which:

- The lending officer may be unable to properly supervise the credit because of an inadequate loan or credit agreement;
- Questions exist regarding the condition of and/or control over collateral;
- Economic or market conditions may unfavorably affect the obligor in the future;
- A declining trend in the obligor's operations or an imbalanced position in the balance sheet exists, but not to the point that repayment is jeopardized; and
- Other deviations from prudent lending practices are present.[1]

The difference between a Special Mention credit and a substandard credit primarily rests on the distinction between "potential weaknesses" and "well-defined weakness." While each credit presents a set of unique characteristics, examples of credits rated Special Mention during recent examinations exhibit one of the following:

- Decline in debt service coverage (DSC) since the credit was initially underwritten, although DSC was still 1.2X;
- Increase in loan-to-value (LTV) based on a recent appraisal; however, property type was income producing and still cash flowing;
- Improper loan structure utilized given the borrowing need, but the loan was performing (e.g., revolving line of credit vs. fixed term).

Each of the above examples, independent of the others, does not warrant a more severe classification given the specific details of the loan (not presented here). However, bankers are cautioned to note that the presence of multiple potential weaknesses in a single loan file, without compensating risk mitigants, should prompt the loan officer or management to place the credit on the internal watch list and possibly downgrade the credit to classified status. Similarly, the presence of a single well-defined weakness could be enough to warrant a downgrade of the credit without the presence of mitigating factors.

In addition to the information provided above, it is important to remember that the Special Mention category is a transient category. It is not a risk rating that a loan should stay in for a protracted period of time. Potential weaknesses that are present in Special Mention credits should be closely monitored and corrected if possible, changing the rating of the credit to pass once corrected. If left uncorrected, the weaknesses may become well defined over time, resulting in classification of the credit.

Lastly, an understanding of the migration of loan assets to and from the Special Mention category is an important element of credit risk management and one of several data points that management and the bank's board can use when reviewing the extent of risk in the loan portfolio.

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*Jacqueline Dreyer is a supervisory examiner with the Federal Reserve Bank of Richmond. She can be reached at **jaqueline.dreyer@rich.frb.org** .*

NOTES:

[1] Commercial Bank Examination Manual. Section 2060.1.
http://www.federalreserve.gov/boarddocs/supmanual/cbem/0005cbem.pdf.

Fifth District Indicators

Median Summary Statistics for Fifth District Commercial Banks (as of 11/30/2010)			
	Fifth District Commercial Banks		
	2010 Q3	2010 Q2	2009 Q3
Capital			
Total Equity Capital/Total Assets	9.69	9.55	9.84
Tier One Leverage Ratio	9.15	9.19	9.34
Total Risk Based Capital Ratio	14.06	13.77	13.58
Earnings			
Return on Average Assets	0.42	0.42	0.28
Net Interest Margin	3.81	3.77	3.56
Provision for Loan Losses/Average Assets	0.65	0.54	0.60
Balance Sheet Structure			
Total Loans/Total Deposits	84.70	85.65	88.78
Federal Home Loan Bank Advances/Total Liabilities	3.63	4.45	4.68
CDs Greater than $100,000/Total Deposits	21.65	21.52	21.63
Total Commercial Real Estate Loans/Total Equity	203.15	210.92	225.63
Total Construction and Land Development/Total Equity	77.24	82.14	95.27
Residential First Mortgages/Total Loans	22.53	21.99	21.94
Credit Quality			
Past Due Loans 30-89 Days/Total Loans	1.51	1.44	1.37
Past Due Loans 90+ Days/Total Loans	0.03	0.01	0.05
Nonaccrual Loans/Total Loans	2.36	2.14	1.58
Other Real Estate Owned/Total Loans	0.59	0.49	0.37
Loan Loss Reserve/Total Loans	1.65	1.62	1.43

** 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 Q3 (as of 11/30/2010)					
	Fifth District Commercial Banks				
	Number of Institutions	Total Assets	Total Loans	Total Liabilities	Total Equity
Virginia State Member Banks	66	$ 39,150,214	$ 28,687,500	$ 35,038,752	$ 4,090,285
Virginia Commercial Banks	106	$ 450,359,359	$ 249,139,863	$ 395,995,839	$ 54,330,194
West Virginia State Member Banks	11	$ 5,898,686	$ 4,060,775	$ 5,335,532	$ 523,414
West Virginia Commercial Banks	55	$ 18,789,757	$ 12,928,551	$ 16,904,265	$ 1,805,851
North Carolina State Member Banks	6	$ 29,242,808	$ 20,349,010	$ 24,960,057	$ 4,282,752
North Carolina Commercial Banks	73	$ 1,727,509,111	$ 885,639,711	$ 1,527,436,802	$ 196,684,194
South Carolina State Member Banks	1	$ 686,732	$ 510,815	$ 623,284	$ 63,448
South Carolina Commercial Banks	62	$ 31,347,472	$ 20,511,439	$ 28,443,902	$ 2,903,570
Maryland State Member Banks	14	$ 10,004,769	$ 7,080,942	$ 9,026,207	$ 978,564
Maryland Commercial Banks	48	$ 23,774,784	$ 16,959,135	$ 21,458,270	$ 2,316,515
DC State Member Banks	0	$ -	$ -	$ -	$ -
DC Commercial Banks	5	$ 1,590,332	$ 1,040,547	$ 1,416,011	$ 174,322
Total Fifth District State Member Banks	98	$ 84,983,209	$ 60,689,042	$ 74,983,832	$ 9,938,463
Total Fifth District Commercial Banks	349	$ 2,253,370,815	$ 1,186,219,246	$ 1,991,655,089	$ 258,214,646

** Dollar amounts are in thousands.*

For the latest Fifth District indicators please visit: **http://www.richmondfed.org/banking/markets_trends_and_statistics/**

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Recent Guidance

SR 11-3
http://www.federalreserve.gov/boarddocs/srletters/2011/sr1103.htm
De Novo Interstate Branching by State Member Banks

SR 11-2
http://www.federalreserve.gov/boarddocs/srletters/2011/sr1102.htm
Examinations of Insured Depository Institutions Prior to Membership or Mergers into State Member Banks

SR 11-1
http://www.federalreserve.gov/boarddocs/srletters/2010/sr1101.htm
Impact of High-Cost Credit Protection Transactions on the Assessment of Capital Adequacy

SR 10-17
http://www.federalreserve.gov/boarddocs/srletters/2010/sr1017.htm
Underwriting Standards for Small Business Loans Originated under the Small Business Lending Fund Program

SR 10-16
http://www.federalreserve.gov/boarddocs/srletters/2010/sr1016.htm
Interagency Appraisal and Evaluation Guidelines

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

CA 11-2/SR 11-2
http://www.federalreserve.gov/boarddocs/srletters/2011/sr1102.htm
Examinations of Insured Depository Institutions Prior to Membership or Mergers into State Member Banks

CA 11-1
http://www.federalreserve.gov/boarddocs/caletters/2011/1101/caltr1101.htm
Revised Interagency Examination Procedures for Regulation Z

CA 10-14
http://www.federalreserve.gov/boarddocs/caletters/2010/1014/caltr1014.htm
Interagency Examination Procedures for the Regulation on Risk-Based Pricing Notices

CA 10-13
http://www.federalreserve.gov/boarddocs/caletters/2010/1013/caltr1013.htm
FEMA Preferred Risk Policies (PRP) – Two Year Extension of Eligibility for Purchasing a Preferred Risk Policy

CA 10-12
http://www.federalreserve.gov/boarddocs/caletters/2010/1012/caltr1012.htm
Revised Interagency Examination Procedures for Regulation E

Special Notice: After 39 years of service with the Federal Reserve Bank of Richmond's Supervision, Regulation and Credit Department, Vice President Linwood Gill will retire in March 2011. Lin began his Fed career in 1971 as an assistant examiner in community bank supervision. Over the years, he has made significant contributions to the scope and framework of banking supervision, such as his participation in the System development of the initial bank holding company supervision program, and his work in resolving problem institutions during the financial crisis of the late 80s. Lin's most recent responsibilities include oversight of community and regional business line, the applications unit and examiner training. We would like to thank Lin for his many years of service and leadership; he will be missed in the Fifth District. Please join us in wishing Lin good luck and best wishes in this next chapter!

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Issues in Regulatory Reform